TRAVELS ALONG THE EFFICIENT FRONTIER . . . TOWARD A NEW DUTY OF LOYALTY

by Gregory T. Holtz[*]

I. INTRODUCTION

When Eugene Gant left his home and family in search of a better life in Thomas Wolfe's novel *Look Homeward Angel,* he began to discover and understand the past does not always offer a bridge to the future.[1] He realized the need and the imperative to turn one's eyes to the "distant soaring ranges."[2]

The same imperative has manifested itself within the trust and fiduciary landscape.[3] It is no longer prudent or appropriate to rely on past practices and traditions.[4] Instead, it is imperative that the fiduciary and his or her counsel turn their eyes upon a distant, soaring range brought about by changes in long standing theories and practices fundamentally altering approaches to trust investment and administration.[5] Failure or refusal to accept changing landscape

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* Adjunct Professor of Wills, Trusts and Estates at Ave Maria School of Law.

1. *See generally* THOMAS WOLFE, LOOK HOMEWARD ANGEL (Random House, 1929) (a coming of age novel about a young man who leaves his home town in North Carolina and heads to Harvard University in Boston, Massachusetts).

2. *See id.*

3. *See infra* Part IV.B–C.

4. *See infra* Part IV.B–C.

5. *See infra* Part IV.B–C.

creates liability, and in some cases ethical dilemmas and liabilities that did not exist even a quarter century ago.[6]

This paper will explore the impetus for such change and its implication for trustees and their counsel. It will take a fresh look at the historical backdrop that gave rise to prudent investing and the impact it has had on trust investment and administration.

However, there is another goal and purpose to this discussion. As one reflects on the sweeping change in the approach and purpose to fiduciary administration and investment, one cannot help but understand and believe that the interrelationship between the parties to the establishment of the trust—grantor, trustee, and beneficiary—has changed. Can it be argued that prudent investing and its imperatives redefined the nature of fiduciary duty in this area? Consider the following observation a court made when defining fiduciary duty:

> [a] very broad term embracing both technical fiduciary relations which exist whenever one man trusts in or relies upon another. One founded on trust or confidence reposed by one person in the integrity and fidelity of another. A "fiduciary relation arises" whenever confidence is reposed on one side, and domination and influence result on the other; the relation can be legal, social, domestic, or merely personal. Such relationship exists when there is . . . reposing of faith, confidence and trust, and the placing of reliance by one upon the judgment and advice of the other.[7]

The imperative of prudent investing has in fact created a new sense of responsibility, and never has "reliance . . . upon the judgment and advice of [another]" been more crucial and more necessary in ensuring the terms and expectations of a fiduciary relationship are met.[8] These realities create new expectations and expand the breadth and scope of the duties each party of the trust has to the other.[9]

The duty most impacted and influenced by these changes is the duty of loyalty.[10] That duty, more than any other, has been "modernized," resulting in the creation of a new standard of conduct parties must observe within a fiduciary relationship.[11] The implications of the "new" duty of loyalty and how the parties of today's fiduciary relationships can and should respond to this new landscape comprise central components of this discussion.

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6. *See infra* Part IV.A–C.
7. Kurth v. Van Horn, 380 N.W.2d 693, 695 (Iowa. 1986).
8. *Id.*
9. *See infra* Part IV.A–C.
10. *See infra* Part IV.A–C.
11. *See infra* Part IV.A–C.

II. HISTORICAL PERSPECTIVE

A brief historical discussion is necessary to gain a sense of perspective. Every journey in this area must begin with *Harvard College v. Amory*.[12] *Harvard College* attempted to offer guidance in the area of fiduciary administration.[13] Not only did it establish the prudent man rule, but it also suggested a standard for judging "reasonableness" in investing.[14]

The *Harvard College* opinion constituted a constructive attempt at establishing an investment strategy and policy. The opinion suggests that a trustee is "to observe how men of prudence, discretion, and intelligence manage their own affairs . . . in regard to the permanent disposition of their funds."[15] Trustees are also invited to analyze "probable income as well as probable safety of the capital to be invested."[16] The opinion implies that reasonable investing will vary from instance to instance.[17]

However, the *Harvard College* approach was not universally accepted and, in fact, ran contrary to a view that insisted on analyzing each asset in isolation to determine prudence in the investment management process.[18] This line of reasoning, unfortunately, encouraged a bifurcated approach to portfolio analysis and fiduciary conduct.[19] As a result, some assets were thought to be inherently inappropriate for use by trustees giving rise to a long string of cases that restricted a trustee's investment options.[20]

Courts developed a litmus test approach to asset selection, culminating in the development of so-called "legal lists."[21] Legal lists did little more than create an artificial framework in which Trustees could find a safe harbor, escape scrutiny and liability so long as trust corpus was invested in assets contained on the statutory lists of a given jurisdiction.[22] This framework gave scant thought to the needs and objectives of beneficiaries.[23]

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12. Harvard College v. Amory, 26 Mass. (9 Pick) 446 (1830).
13. *See id.*
14. *See id.*
15. Harvard College, 26 Mass. (9 Pick.) at 469.
16. *Id.*
17. *See* W. Brantley Phillips Jr., *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 339–42 (1997).
18. *See* Harvard College, 26 Mass (9 Pick.) at 461.
19. *See* Phillips, *supra* note 17, at 340.
20. *See* Christopher P. Cline & Marcia L. Jory, *The Uniform Prudent Investor Act: Trust Drafting and Administration*, 26 EST. PLAN. 451, 455–58 (1999).
21. *See* Phillips, *supra* note 17, at 341.
22. *See* Stewart E. Sterk, *Rethinking Trust Law Reform: How Prudent is Modern Prudent Investor Doctrine?,* 95 CORNELL L. REV. 851, 891 (2010).
23. *See, e.g.*, *In re* Flavin, 18 N.E.2d 514, 517 (Ohio. Ct. App. 1938) ("It seems. . .elementary that if a guardian makes an illegal investment of his ward's funds . . . he is liable for the loss that may be occasioned thereby, regardless of the question of due care.").

Dissatisfaction with this limitation led to the creation of the "prudent person rule,"[24] which rule allowed "non legal list" investments if said investment did not exceed 40% of the corpus.[25]

Given this backdrop, it is not difficult to understand why the beneficiaries and the general public became frustrated with fiduciary investment. The term "conservative" acquired an almost pejorative connotation, suggesting that the approach to fiduciary investment had very little to do with the needs of beneficiaries and market conditions, but everything to do with creating an arbitrary shield protecting trustees from attack and scrutiny.[26]

Such criticism was and is well founded as it focused attention not on the art of crafting an investment portfolio, but instead on insuring that a portfolio observed arbitrary statutory constructs.[27] More attention and intellectual capital was expended in meeting the "magic" percentages than the needs of beneficiaries. Beneficiary goals and objectives often became subservient to meeting statutory requirements, an exercise that achieved results directly opposed to those intended by statute.[28]

Two cases offer an example of how counterproductive this process was. In the first, *Fidelity Union Trust Co. v. Price*, the trust company sought declaratory judgment, individually and in its fiduciary capacity, as to the constitutionality of the Prudent Man Investment Statute and its application to four trusts created prior to the passage of the Act.[29]

The case is very much a product of its time, focusing exclusively on an analysis of the powers clauses of four trusts, as it attempts to glean the trustor's intention regarding investment protocols in light of legal lists and the Prudent Man Investment Statute.[30] The court observed, "Unless the trust instrument provides otherwise, it is presumed that the Trustor intended that his trustee should have the power to make such investment as the Legislature in its wisdom might from time to time permit."[31]

The above quote is interesting in its implication—it is the intention and the action of the legislature, not the beneficiaries, that controls the investment function.[32]

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24. Phillips, *supra* note 17, at 339.

25. *See* Sterk, *supra* note 22.

26. Sjur Midness, *Minnesota's Prudent Investor Rule: Aligning Law with Practice*, 23 WM. MITCHELL L. REV. 713, 729 (1997) ("Whereas traditional investment practices principally benefited the Trustee, by creating a safe harbor from liability, the new rule forces trustees to serve the specific interests of settlors and beneficiaries.").

27. *See id.*

28. *See* Phillips, *supra* note 17, at 343–44. For example, the rule "imposes no duty on the trustee to protect the trust principal from inflation. Considering that, historically, inflation has outpaced the returns available from interest bearing assets, this oversight jeopardizes virtually every portfolio." *Id.*

29. Fidelity Union Trust Co. v. Price, 93 A.2d 321, 322 (1952).

30. *Id.*

31. *See id.* at 325.

32. *Id.*

This approach became ingrained over the years as a means of defining appropriate fiduciary conduct and can be seen through a consideration of *In re Gershcow's Will*.[33] The Minnesota Supreme Court decided *Gershcow* almost fifty years after *Fidelity Union* and twenty years after the introduction of modern portfolio theory.[34]

In *Gershcow*, an action was brought against an individual trustee alleging breach of fiduciary duty and mismanagement of a trust investment portfolio.[35] Several savings accounts, one Series H United States savings bond, and some minimal shares of stock funded the trust.[36] For over six years, the trustee maintained possession of those assets and despite a specific request from a remainderman, made no changes in the trust portfolio.[37]

The trustee based her rationale for keeping the investment portfolio intact upon her belief that her sister had a "preference for savings account investments and did not believe in speculative investments."[38] While evidence from several sources suggested changes in the portfolio could have resulted in higher yields to the potential benefit of the trust beneficiaries, the court was seemingly impervious to that argument.[39] The decision suggested that savings deposits and time deposits, especially when insured by the Federal Deposit Insurance Corporation (FDIC), were proper trust investments: "It is discretionary with the Trustee as to the proper investment of funds, and that the Trustee should not be surcharged for failure to earn a higher rate of return."[40]

Gershcow confirmed the notion that a trustee's duty rests in assuring assets are appropriate for retention, not whether, when taken as a whole they meet the needs and objectives of current and future beneficiaries.

III. A RESPONSE . . . PRUDENT INVESTING

A number of influences, both market and academic, caused a rethinking and reversal of the prudent man standard articulated in cases such as *Fidelity Union* and *Gershcow*. Beginning with Markowitz's advancement of modern portfolio theory and continuing on with the Restatement Third of the Law of Trusts and the enactment of the Uniform Prudent Investor Act, the prudent man rule was replaced with the prudent investor rule.[41]

33. *In re* Gerschow's Will, 261 N.W.2d 335, 339 (Minn. 1977).
34. *Id.*
35. *Id.* at 337.
36. *Id.*
37. *Id.* at 337–38.
38. *Id.* at 339.
39. *Id.* at 338.
40. *Id.*
41. *See* Alyson J.K. Bailes, *Formal Recognition of Modern Portfolio Theory—Investing for Total Return Trusts*, 10 PROB. L.J. OF OHIO 49, 49–55 (Sept./Oct. 2000) (summarizing trends leading to the recognition of modern portfolio theory).

Repeal of the prudent man rule requires trustees to approach their responsibilities with a new viewpoint and new set of standards.[42] These standards create an administrative "trickle down," requiring a rethinking of the traditional interrelationship between principal and income within a trust portfolio.[43]

This occurred because the prudent investor rule mandates that assets be evaluated within a context of risk and return, as well as "total return" and "cash flow."[44] Managing a portfolio in this way constitutes a significant departure from past practice, creating a new expectation on the part of current and future trust beneficiaries.[45]

Prudent investing also has an effect on other areas of trust administration, most especially the discretionary distribution process.[46] Traditionally, trustees operated within a fairly prescribed playing field as they evaluated discretionary distributions and the effect they might have on the trust portfolio.[47] Generally, discretionary distributions had a fairly predictable feel.[48] So long as assets within the trust portfolio met appropriate statutory standards, trustees could render a decision with somewhat secondary attention to the effect a distribution might have on a portfolio.[49]

However, the prudent investor rule, with its focus on concepts such as cash flow and total return, requires a whole new level of attention and analysis.[50] Relative certainty is replaced by the need to integrate fiduciary administration with the requirements of new statutory protocols, requiring a rethinking of what "impartiality" should mean on a portfolio-by-portfolio basis.[51] For example, traditionally income generated by trust assets would accrue to income

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42. *See id.*

43. *Id.*

44. *See* FLA. STAT. ANN. § 518.11(1)(e) (West 1997).

45. A consideration of the interrelationship of the statutory framework proves helpful and instructive. For example, Florida Statute section 518.11(1)(e) reads in pertinent part:

> The fiduciary has a duty to pursue an investment strategy that considers both the reasonable production of income and safety of capital, consistent with the fiduciary's duty of impartiality and the purposes of the trust, estate, or guardianship. Whether investments are underproductive or over productive of income shall be judged by the portfolio as a whole and not as to any particular asset.

Id. When read in conjunction with the oversight responsibility set forth in Florida Statute section 518.112(1), this requirement alters and expands a trustee's traditional responsibility to its beneficiary. FLA. STAT. ANN. § 518.112(1) (West 1997).

46. Mark Day, et al., *Living Trust and Estate Planning*, 6 TEXAS LAWYER ROUNDTABLE SERIES, no. 16, Oct. 18, 2010, at 1, 6, *available at* http://www.androvett.com/clientuploads/PDF_Roundtable/trusts-and-estates-texas-lawyer-roundtable-oct1018.pdf.

47. *CFTA Continuing Education Seminar: Use and Abuse of Discretionary Distribution Powers* (2001) *available at* http://www.estateplan-hc.org/abendroth%20article%202.pdf.

48. *See* Rev. Rul. 77-60, 1977-1 C.B. 282.

49. *See* C. Boone Schwartzel, *Is the Prudent Investor Rule Good for Texas?*, 54 BAYLOR L. REV. 701, 780 (2002).

50. *See id.*

51. *See generally* Ronald R. Volkmer, *The Latest Look in Nebraska Trust Law*, 31 CREIGHTON L. REV. 221 (1997).

beneficiaries, while the remaining beneficiaries would benefit from any appreciated capital. The Uniform Principal and Income Act modified that traditional practice by introducing the power to adjust or transfer sums of principal for the benefit of an income beneficiary if adjustment was necessary to discharge the fiduciary duty of impartiality.[52] The reason for enactment was stated as such:

> . . . [T]o permit adjustments between principal and income in order to take advantage of investments which may yield a substantial appreciation of principal while yielding relatively little income in the conventional sense, or, conversely, an investment which yields a relatively high conventional income might yield a disproportionately low possibility of appreciation principal. The trustee may take those factors into account. He may make the adjustment between principal and income so that each class, the income beneficiary and the remainder beneficiary, . . . are fairly treated.[53]

Once it is determined that the power to adjust should appropriately be effected, an additional level of analysis is required, focusing on a number of variables including the nature of the trust; settlor intent; circumstances of the beneficiaries; and needs for liquidity, income, and capital preservation. Of absolute significance is the fact that variables requiring consideration in deciding whether to adjust are identical to those enumerated in developing an investment policy as a prudent investor.[54] This interrelationship impacts traditional administrative practices.

For example, consider a jurisdiction that has adopted a Uniform Principal and Income Act statute with a "safe harbor" provision.[55] Trustees in those jurisdictions have to grapple with a number of issues. Initially, the trustee must decide if the beneficiary's request falls within the trust's discretionary standard. A trustee may consider the beneficiary's other sources of income, frequency of requests, and sometimes family dynamics to craft a decision.[56]

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52. *See, e.g.,* TEX. PROP. CODE. ANN. § 116.004–.005 (West 2005).

53. *In re* Orpheus Trust, 179 P.3d 562, 566–67 (Nev. 2008).

54. Florida Statute section 738.104(1) allows adjustment "between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor . . . ." FLA. STAT. ANN. § 738.104(1) (West 2005). Florida Statute section 738.104(2) offers nine factors for a trustee to consider as it deliberates whether to exercise the power to adjust. FLA. STAT. ANN. § 738.104(2) (West 2010). The guidelines in section 738.104(2) track those set forth in section 518.11. *See supra* note 45.

55. Ohio Revised Code section 5812.03(G)(3) reads in pertinent part:

> For purposes of this section . . . from time to time a trustee may make a safe-harbor adjustment to increase net trust accounting income up to and including an amount equal to four per cent of the trust's fair market value determined as of the first business day of the current year. If a trustee determines to make this safe-harbor adjustment, the propriety of this adjustment shall be conclusively presumed.

OHIO REV. CODE. § 5812.03(G)(3) (West 2009).

56. *See* TEX. PROP. CODE ANN. § 116.005.

However, trustees must also consider the interrelationship of the beneficiary's request and the effect it might have on the entire trust portfolio.[57] Prior to the safe harbor provisions provided by the Uniform Principal and Income Act, a beneficiary requiring additional income might have those needs met by an increase in a fixed income component of the portfolio.[58] Trustees must now review portfolios within their entirety, viewing them as a comprehensive and ongoing investment vehicle created to meet the needs of current and future beneficiaries.[59] Strict considerations of trust accounting income are replaced by "cash flow," a concept that contemplates distribution of both income and principal.[60]

There are consequences to this new safe harbor approach. For example, assume a $100,000 trust with provisions for mandatory distribution of income and a discretionary standard allowing for distribution on a "health, support, and maintenance basis." Assume also that the trust generates a 2% yield, and that a beneficiary makes an appropriate request for a $400 distribution. Under traditional analysis, the remaining $200 would represent a mandatory income distribution and $200 would be the result of an exercise of fiduciary discretion. However, in a jurisdiction with a 4% safe harbor, the same beneficiary would be entitled to a distribution of the entire 4% as part of a statutory directive, in effect creating a mandatory distribution of income and discretionary principal.

This safe harbor procedure requires that a trustee not only evaluate a beneficiary's request, but he or she must also consider that request in view of a portfolio's asset allocation strategy. In addition, because these distributions are principal and income neutral, great attention must be paid to asset allocation and the impact current market conditions might have on such distributions.[61] Cash flow and total return are crucial as the focus shifts from "protecting" the trustee to meeting the needs of its beneficiaries.[62] Trustees can no longer hide behind artificially created percentages and lists; trustees must understand the need to correlate between risk and return, and make conscious and continuing assessments based upon a trust's own unique circumstances and beneficiaries.[63]

57. *See* David Schaengold, *New Uniform Principal and Income Act Being Promulgated*, TR. & EST. 38, 42–43 (Dec. 1999).

58. *See id.* at 42.

59. *See id.* at 40.

60. *See id.* at 42–43.

61. *See* Schwartzel, *supra* note 49, at 720.

62. *See id.* at 750–51.

63. Consider the following example:

> A and her cousin, B, were childhood friends. After graduating from high school, A moved across the county from B. The two rarely kept contact over the 60-year period between A's graduation and death. In fact, A became almost a hermit, working out of her small apartment, rarely going out, saving most of what she earned, and depositing her money in the bank in a savings account and in certificates of deposit. When A died, she left a $500,000 estate and the following holographic will: "I leave my property to the Bank, in trust, to pay the income to B during her lifetime and the rest to Charity." B has sufficient financial resources and does not need the trust distributions for her support. Because A was such a loner, no one has any idea concerning A's purposes in establishing the trust.

These concepts alter the interrelationship between trustees, beneficiaries, and their counsel because trustees are required to adopt a new type of investment strategy. Because meeting the needs of a beneficiary class is of paramount importance, no investment is categorically improper. Today's portfolios often look substantially different than their traditional counterparts because market conditions might dictate the use of a variety of alternative investments along with the traditional use of stocks and bonds.[64]

Prudent investing within this context creates a new knowledge and expectation level.[65] An investing benchmark that simply looks to what other men of prudence might do with their own assets may not be good enough.[66] It is the attention given to the specific portfolio over which the trustee has discretion that matters.[67] A trustee must have the ability and insight to add asset classes consistent and in consonance with the investment objectives of a trust portfolio, with needs and objectives controlled and guided by beneficiaries.[68]

Fiduciary responsibilities within this context are also different.[69] This is true because failure or inability to prudently invest can cause a quantifiable impact on market value, purchasing power, or total return thus, creating potential liability.[70] That is a far cry from the world view of *Gerschow* and the cases that came before.[71] Investing within this context argues for and requires a new proficiency for trustees—proficiency that requires either an understanding of risk, return, and correlation, or how to bring that proficiency into the trust's administration and management.[72] Prudent investing changes a trustee's "job qualification."[73] Prospective grantors and their counsel need to understand how and why that is the case because failure to do so carries with it implications and potential liability.[74]

Id. at 762. How does the trustee invest? The prudent man rule would have directed the trustee "to invest in the manner preferred by the current beneficiary," while the prudent investor rule would direct the Trustee to invest "to preserve the purchasing power of the trust estate for the remaindermen." *Id.* at 762. The dynamic as to how the Trustee accomplishes that under the prudent investor rule depends on the trust purposes and the beneficiary's distribution requirements." *Id*. In short, the prudent investor rule offers no "boilerplate" for today's trustee. *Id.*

64. *See* Jay MacDonald, *Alternative Investments in a Volatile Stock Market*, BANKRATE.COM (Sept. 20, 2002), www.bankrate.com/brm/news/investing/20020920a.asp.

65. *See* Midness, *supra* note 26, at 728–38.

66. *See id.*

67. *See id.* at 739–41.

68. *See id.*

69. *See id.*

70. *See id.*

71. *See id.* at 731–32. *See also In re* Will of Gerschow, 261 N.W.2d 335, 339 (Minn. 1977).

72. *See* Midness, *supra* note 26, at 724–38.

73. *See* Jessica Gilbert, *The Evolving Responsibility of the Trust Fiduciary and How Hedge Funds Play a Role*, COOK PINE CAPITAL, LLC, at 4 (Aug. 2008), www.cookpinecapital.com/pdf/Trusts%20and%20Hedge%20Funds.pdf.

74. *See id.*

IV. THE "NEW" DUTY OF LOYALTY

A. Overview and Challenge

Prudent investing continually focuses a fiduciary's actions and decisions on ensuring that a portfolio responds to the specific needs of its beneficiaries.[75] Therefore, measuring a trustee's success in this area is challenging as objective and subjective standards blend to create an overall assessment of effectiveness. While Trustees should understand objective concepts, such as total return and the importance of cash flow, they must do so within the context of purely subjective standards, such as beneficiary need and perspective.[76] Loyalty to the trust and its beneficiaries offers the Trustee the insight to fulfill that obligation.[77]

Loyalty has always been a stalwart benchmark in determining the success of a trustee's stewardship.[78] However, the prudent investing standard imposes a requirement that loyalty be viewed in a different way. Trustees have long had a duty of loyalty to beneficiaries, and have been held liable for losses sustained as a result of their misfeasance or malfeasance—actions that tend to show "disloyalty."[79] Traditional loyalty analysis forbids a trustee from placing itself in a position of profiting from the trusteeship.[80] Conflicts of interest must also be avoided.[81] Analysis in this specific area is fairly predictable in nature. Situations that run afoul of the duty of loyalty almost always generate that uneasy or uncomfortable feeling, an indication that what is being contemplated is wrong and detrimental to the needs and interests of the beneficiaries.

However, there is another more intriguing aspect to the duty of loyalty. Black's Law Dictionary, in considering the definition of a duty, observes that "it is used, in a wider sense, to designate that class of moral obligations which lie outside the jural sphere; such, namely, as rest upon an imperative ethical basis, but have not been recognized by the law as within its proper province for purposes of enforcement or redress."[82] A duty in this case comprises an obligation that ought to be done to affect a positive and just result.[83] It is almost, as some courts have suggested, an extension of public policy.[84]

Viewed in this manner, loyalty requires a mindset that extends, reaches, and remains imperative throughout the fiduciary relationship; from its inception

75. *See* Benjamin G. Carter, *Relief for Beneficiaries Suing for Breach of Fiduciary Duty: Payment of Accounting Costs Before Trial*, 76 WASH. U. L. QUARTERLY 1411, 1414–15 (1998).

76. *See id.*

77. *See id.*

78. *See id.* at 1415.

79. PAUL G. HASKELL, PREFACE TO THE LAW OF TRUSTS 98 (Harry W. Jones ed., The Foundation Press, Inc. 1975).

80. *Id.*

81. *Id.* at 99.

82. BLACK'S LAW DICTIONARY 595 (Rev. 4th. Ed. 1968).

83. *See* Gonzalez v. S. Cal. Gas Co., No. D054677, 2010 WL 4380077, at *2–3 (Cal. Ct. App. Nov. 5, 2010).

84. *See id.* at 3–4.

to the conclusion of its administration, loyalty is a process that in today's environment creates a new type of link between the grantor, trustee, and beneficiary. The court in *Uzyel v. Kadisha* within this context noted:

> A trustee also is strictly prohibited from administering the trust with the motive or purpose of serving interests other than those of the beneficiaries. A trustee also is strictly prohibited from engaging in transactions in which the trustee's personal interests may conflict with those of the beneficiaries without the express authorization of either the trust instrument, the court, or the beneficiaries. *It is no defense that the trustee acted in good faith, that the terms of the transaction were fair, or that the trust suffered no loss or the trustee received no profit*. (emphasis added) (internal citations omitted).[85]

Therefore, the duty of loyalty must focus on the "moral obligation" because the parties to the trust arrangement must understand and accept that their roles and responsibilities are interconnected throughout the administration of the trust.[86] As trustees strive to fulfill their obligations, good faith, fairness, or lack of loss are not by themselves defenses to a breach of the duty of loyalty.[87] The focus falls squarely on the trustee's actions in upholding the duty of loyalty through "prevention" of a trustee's self-dealing.[88]

As a result, a trustee's "skill set" must vary on a situational basis, which may require additional and specific expertise.[89] If every trustee's imperative is to act in the best interests of trust beneficiaries and the needs of those beneficiaries vary, then the grantor must pay attention to a trustee's ability and inclination to meet those needs and act as a prudent investor.[90]

Traditional legal analysis and commentary defines unsuitable behavior for a trustee and sets forth, for example, what might constitute grounds for removal.[91] Yet, fulfilling fiduciary responsibility in today's environment calls for sensitivity to the nuances of trust investment and administration within a statutory framework that mandates multilevel analysis in crafting and maintaining a trust portfolio.[92] The court in *Zastrow v. Journal Communications, Inc.* amplified this principle when it observed that "at its core, a fiduciary's duty of loyalty involves a state of mind, so that a claimed breach of that duty goes beyond simple negligence."[93]

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85. Uzyel v. Kadisha, 116 Cal. Rptr. 3d 244, 275 (Cal. Ct. App. 2010).

86. *See generally* BLACK'S LAW DICTIONARY (8th Ed. 2004) (discussing a moral obligation when defining duty of loyalty). *See also Uzyel*, 116 Cal. Rptr. at 275–76.

87. *See Uzyel*, 116 Cal. Rptr. at 276.

88. *See* French v. Wachovia Bank, No. 06-C-8 69, 2011 WL 2649985, at *9 (E.D. Wis. July 6, 2011) (citing Bank of Cal. v. Hoffman, 38 N.W.2d 506, 509 (Wis. 1949)).

89. *See French*, 2011 WL 2649985, at *13.

90. *See id.*

91. *See* RESTATEMENT (THIRD) OF TRUSTS § 37 cmt. 3(e) (Tentative Draft No. 2, 1999) (setting forth "illustrative" grounds justifying a court to remove a trustee, among them "unfitness . . . want of skill, or the inability to understand fiduciary standards and duties").

92. *See id.*

93. Zastrow v. Journal Communications, 718 N.W.2d 51, 60 (Wis. 2006).

As stated, today's version of a trustee's duty of loyalty must encompass more than avoiding profiting and conflict of interests.[94] It requires a state of mind that understands that all actions within the administration and investment of a trust portfolio have implications.[95] The very best and most proactive trustees understand that reality and always act in the best interests of the beneficiaries in a new and unique way.[96] Accordingly, it is this writer's view that trustee selection has never been more important or significant than it is today. Taking the time to ensure that a trustee has the qualities and qualifications necessary to serve the interests of the beneficiary within the specific, unique situation that the trustee is asked to serve is crucial, requiring the thoughtful attention of the grantor and her counsel.

B. Loyalty Revisited . . .From the Trustee's Perspective

The *Zastrow* court refers to a "state of mind" as it defines the duty of loyalty.[97] That term seems particularly appropriate when considered in light of the trustee's duty to act as a prudent investor. Static or defensive trust administration may result in the delivery of inferior performance and perhaps economic loss. If the law in this area offers any take away, it is the clear expectation that a fiduciary's actions meet and conform to the specific nature and challenge of the trust. Trustees who ignore the implications of their beneficiaries' needs and goals, particularly in the management of the trust portfolio, stand to violate their duty of loyalty and call into question the wisdom of placing them in a fiduciary role.[98]

An area of administration offering an instructive example of what this state of mind might look like going forward is the requirement that a trustee monitor portfolio performance. In *O'Neill v. O'Neill* a beneficiary sued a trustee for alleged breach of fiduciary duty regarding the safeguarding and monitoring of the performance and activity of an investment advisor.[99] The case is interesting because it analyzes the actions and protocol of an individual trustee within a family setting.[100]

In *O'Neill*, the appellant, Patrick, was a principal beneficiary of an irrevocable trust established by his grandfather, the settlor.[101] The trust

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94. *See* BLACK'S LAW DICTIONARY, *supra* note 82.

95. *See id*.

96. *See* John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 652 (1996) (observing that "the new Restatement not only empowers the trustee to delegate investment and management powers, it provides that the trustee 'may sometimes have a duty . . . to delegate [investment] functions in such manner as a prudent investor would delegate under the circumstances'").

97. *Zastrow*, 718 N.W.2d at 60.

98. Cline & Jory, *supra* note 20, at 457. In analyzing trustee investment performance in the *Cooper* and *Wilde* cases, note that "[i]n each case the court probably was inclined to find trustee liability as a result of the careless performance of the trustees." *Id.*

99. O'Neill v. O'Neill, 865 N.E.2d 917, 919 (Ohio Ct. App. 2006).

100. *See id.* at 917 n.24.

101. *Id.* at 918.

designated two co-trustees, one of whom was the appellant's paternal uncle.[102] At issue was the decision to delegate investment management responsibilities to an outside portfolio manager who invested heavily and almost exclusively in high technology stocks.[103]

The portfolio suffered drastic losses during the market collapse in 2000.[104] Unfortunately, this coincided with the appellant's 40th birthday, the time when he was to receive the balance of his trust corpus.[105] As a result, the appellant alleged a tripartite breach of fiduciary duty, namely failing to observe appropriate standards of care in delegating investment management of the trust, establishing the scope of delegated authority, and acting unilaterally without the participation of the other co-trustee.[106]

The court considered the scope of the trustee's delegation of his investment management function.[107] At issue was the extent and nature of the delegation.[108] While the investment manager claimed the delegation was participative in nature, "keep[ing] the [a]ppellant apprised of all investments," the appellant argued that the delegation was "monistic," providing the investment manager total discretion over the portfolio.[109] This difference in view required the court to consider "how much reviewing and monitoring is required by a trustee to satisfy the mandates of R.C. 1339.59(A)(3)[.]"[111]

The court noted that "scarce" secondary authority on this particular issue exists, observing that:

> The circumstances under which the trustee's actions are to be judged must be considered "under the rule that when one knows and what one in the exercise of ordinary care and prudence ought to know are regarded as equivalent in the law." If it becomes clear or should have become clear that the investment is no longer proper for a trust, it is the duty of the trustee to dispose of it within a reasonable time.[112]

Using that rationale, the court affirmed the grant of summary judgment to the defendant trustee holding that "nothing suggests that the trustee 'fell asleep at the wheel.'"[113]

This may be true, but the opinion also includes the following description of the defendant trustee's deposition:

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102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.*
106. *Id*. at 919.
107. *Id.* at 920 n.21.
108. *Id.*
109. *Id.* at 920.
111. *Id.* at 921.
112. *Id.*
113. *Id.* at 922.

> Asked how often he spoke with Lesinski during the time frame in question, the trustee responded, "Very seldom." The trustee also testified that although he did not scrutinize the account statements, he reviewed them. In addition the trustee said, "And I want to explain that when I put somebody in charge of something you don't second guess them. So whatever he-if he was in charge, that's, you either get rid of him or leave it go.[114]

It is without question that the facts that gave rise to the case occurred during extraordinary times. Markets, particularly in the technology area, produced almost breathtaking returns.[115] People questioned time-honored investment principles, and investments in concentrated positions made significant amounts of money.[116] When the bubble burst, the court correctly noted that "[m]any people lost money in the stock market, particularly . . . at the dawn of the . . . millennium."[117] However, it is not difficult to surmise that a different, and perhaps more proactive approach to monitoring the nature, philosophy, and purpose of the investment delegation would have resulted in much different sum being available to the beneficiary on his 40th birthday.

Cases like *O'Neill* encourage a rethinking of the thought process that must and should occur in a grantor's selection of a trustee.[118] Traditionally, the grantor chose a trustee based upon family history and a variety of a predispositions and preferences.[119] The choice was often benign, especially when the grantor could evaluate the actions of the trustee with certainty through analysis and evaluation of benchmarks such as a legal list.[120]

This traditional approach changed with the advent of modern portfolio theory, prudent investing, and the resulting codification of those principles in trust codes prevalent in many jurisdictions. The needs and expectations of beneficiaries have become primary and paramount, and trustees often can only achieve results on behalf of those beneficiaries through knowledge and proactivity.[121] The failure to understand, even on an elementary level, concepts such as asset allocation, cash flow, and negative correlation can have far reaching impact on portfolio performance for current and future beneficiaries.

In addition, trustees must have the ability and acumen necessary to monitor investment performance, and if the trustees lack the ability or confidence to discharge those responsibilities, then they must delegate their investment

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114. *Id.*
115. *See id.*
116. *See id.*
117. *Id.*
118. *See id.*
119. *Cf.* Marty McKeever, *Choosing a Trustee For Your Planned Gift Program*, PLANNED GIVING DESIGN CENTER, http://www.pdgc.com/pgdc/choosing-trustee-your-planned-gift-program (last updated May 18, 2011).
120. *Id.*
121. North Carolina Bar Ass'n, et al., *Trusts*, PLANNING YOUR ESTATE, http://www.ncbar.org/download/planningYourEstate/trusts.html (July 2000).

responsibilities to a third party.[122] The key is "conduct" and whether a trustee has the ability, experience, and knowledge necessary to meet the standards of such conduct.[123] Consider the following hypothetical:

> Attorney is reviewing and updating estate plan with long standing clients, H & W. Attorney appropriately recommends development of trust instruments. A discussion ensues regarding the designation of a trustee. H insists that he would like to appoint his brother, Y, because "Y will know how to take care of things if I am gone." Attorney notices W rolling her eyes. The next day W calls Attorney and says in part, "you know Y is a nice guy but he scares me—he buys things that I do not understand. Can we not we do something?"

This type of scenario probably played out on a fairly regular basis and was not the cause for much concern in the day of the prudent man and legal lists. All Y had to do was pick the right assets to ensure his success as a trustee.

However, after considering the *O'Neill* case several questions inevitably come to mind. First, given the dictates and objectives of prudent investing, does H have a duty of loyalty to W and his children to appoint a trustee with the ability, competency, and inclination to administer and manage the portfolio as a prudent investor?[124] Second, does counsel have a responsibility to so advise H?[125]

Although the answer to the first question must be "yes," its implementation from a practical perspective poses a number of challenges. The first challenge is knowledge. It is fair to say the grantors of the world are often not schooled in the nuances of prudent investing. There is often a comfort zone in appointing a family member or friend as a trustee. In addition, the grantor's definition of a "good job" in this area likely also influences the choice. But consider again the

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122. *See* Cline & Jory, *supra* note 20, at 454–55 (noting that the official Comment explains the "tension" inherent in a permissive delegation rule). If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate. *See id.* at 453. However, if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries. *See id.* The requirement that the trustees use care, skill, and caution in selecting agents, in formulating the terms and in monitoring compliance "is designed to strike the appropriate balance between the advantages and the hazards of delegation." *Id.*

123. *See In re* Estate of Cooper, 913 P.2d 393, 398 (Wis. Ct. App. 1996).

124. One would think the answer to those questions is a resounding "yes." The Florida Trust Code requires "a trustee shall administer a trust solely in the interests of the beneficiaries." FLA. STAT. ANN. § 736.0802 (West 2010). *See also* Mark Gillett, *Wills and Estates: Investing Trust Assets: Prudence Redefined*, 29 OKLA. CITY U. L. REV. 505, 544 (2004). Gillett states:

> The duty of loyalty encompasses more than potential conflicts of interests. The trustee must always act in the best interests of the trust's beneficiaries. The comments state that a trustee who engages in "social investing" violates its duty of loyalty if the investment results are thereby compromised. *In this case, the trustee must establish that its investment decisions did not harm the beneficiaries*.

Id. at 544 (emphasis added.). Query—given the demonstrable evidence that understanding and implementing concepts of asset allocation and negative correlation impact performance and risk management, can H simply appoint Y because he "thinks" he will know what to do? If H insists on appointing Y, then doesn't counsel have a responsibility to suggest some measure of guidance or protocol?

125. *See* Uzyel v. Kadisha, 116 Cal. Rptr. 3d 244, 276 (Cal. Ct. App. 2010).

court in *French* viewing the duty of loyalty as one of "prevention." Whether the grantor realizes it or not, his or her choice of trustee is focused on preventing unnecessary risk or loss to a portfolio due to a trustee's inaction or misunderstanding of the meaning and requirements of prudent investing. To ensure that this does not happen, the grantor owes his beneficiaries a duty of "loyalty" to exercise appropriate, thoughtful care in the selection of a trustee.[126]

The answer to the second question is "probably." If one assumes counsel has traditionally represented the entire family, may counsel continue joint representation at this point? Maybe not. From an ethical perspective, it is clear that once such an "objective indication" arises that the interests of the parties have diverged a conflict exists.[127] In addition, this type of situation fosters tension between a lawyer's duty to maintain client confidences and the duty to disclose within the context of spousal estate planning.[128] The issue of trustee selection creates a situation where joint representation is probably not possible.

It is surmised that increasing trustee selection will give rise to this type of conflict. The conflict is not necessarily one of personality, but of expectation. Simply stated, the potential impact trustee selection may have on a beneficiary's comfort and expectation level creates an objective indication that a conflict exists.

In this case, Y as Trustee, without assistance and counsel, is most likely to deliver performance that differs over time from that created by the Trustee who understands the nuances and imperatives of prudent investing. The cause of action that the beneficiaries might have results from what the *Zastrow* court referred to as an obligation that places a restraint on the fiduciary's discretion.[129] The safe haven of asset-by-asset oversight is replaced by the need for the fiduciary to embrace continuing, affirmative actions on behalf of the

126. It seems clear that a grantor and counsel representing the grantor need to consider the qualifications of a trustee within the framework of loyalty to the beneficiaries—considering their best interests in making a selection. Recall that conduct—not necessarily performance—is a key measure in evaluating the trustee under the prudent investor rule. *See In re* Estate of Cooper, 913 P.2d 393, 398 (Wash. Ct. App. 1996). Of additional interest is the fact that some courts have sua sponte removed fiduciaries for investment conduct that runs contrary to the provisions of the prudent investor act. *In re* Trust Estate of CNZ Trust, No. 06CA008940, 2007 WL 1390650, at *4 (Ohio. Ct. App. May 14, 2007).

127. Professional Ethics of the Florida Bar, Opinion no. 95-4, addressed this issue and read in pertinent part:

> We conclude that, under the facts presented, Lawyer's duty of confidentiality must take precedence. Consequently if Husband fails to disclose (or give Lawyer permission to disclose) the subject information to Wife, Lawyer is not ethically required to disclose the information to Wife and does not have discretion to reveal the information. To the contrary, Lawyer's ethical obligation of confidentiality to Husband prohibits Lawyer from disclosing the information to Wife.

Professional Ethics of the Florida Bar, Opinion 95-4, May 30, 1997, *available at* http://www.floridabar.org/TFB/TFBETOpin.nsf/SMTGT/ETHICS,%20OPINION%2095-4.

128. *Id.* at 3.

129. *See* Zastrow v. Journal Communications, Inc., 718 N.W.2d 51, 59 (Wis. 2006) ("A consistent fact of a fiduciary duty is the constraint on the fiduciary's discretion to act in his own self-interest because by accepting the obligation of a fiduciary he consciously sets another's interest before his own.").

beneficiaries. This requires an attentiveness and sensitivity to beneficiary need and an understanding of how those needs can and should be met.

Suppose, for example, at some point during the trust's administrative lifecycle, issues concerning the need or advisability to exercise the statutory power to adjust arise.[130] As previously suggested, Trustees, in considering whether to exercise the power to adjust, must consider no less than nine factors "relevant to the trust and its beneficiaries" in making their determination.[131] In addition to the needs of beneficiaries, factors such a liquidity, preservation and appreciation of capital, assets held in trust, actual and anticipated effect of economic conditions, and tax consequences must be considered.[132] These matters must be revaluated on a continual basis.

It is fair to question first, whether Y can or will be sensitive to the difficult and complex issues exercising the power to adjust and fiduciary discretion entail, especially in view of unique and often unanticipated circumstances, and second, whether Y will provide current and future beneficiaries with an administrative and investment product that prudent investing offers them a right to expect.

This reality places counsel in a difficult and challenging situation. Issues with respect to trustee selection have often been resolved by the traditional inclination to do what the client wants. In this area, however, doing what a client wants can run afoul of the duty of loyalty owed to trust beneficiaries. It is incumbent for counsel to understand, react, and respond to this imperative.

C. Loyalty Revisited . . . From Counsel's Perspective

Prudent investing creates a whole series of new and unanticipated interrelationships. Grantors, trustees, and beneficiaries are dependent on each other to ensure that the goals of each fiduciary relationship are met. None of the parties can insulate themselves from each other and the performance of their duties and responsibilities. It is incumbent upon counsel to understand the nature of these interrelationships and offer appropriate representation.

Weighing the interests of multiple parties is nothing new in the estate planning process.[133] However, traditional estate planning issues have typically arisen during the representation of multiple individual parties, such as spouses, children, and grandchildren. Individuals serving as counsel during these situations often help families and individuals and, as a collective, develop an asset distribution plan that is acceptable on a number of different levels. The

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130. Uniform Principal and Income Act (1997), § 104 (Trustee's Power to Adjust).

131. *Id.* at § 104(b).

132. *Id.*

133. *See* THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL FOUNDATION, COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT 91 (4th ed. 2006), *available at* www.actec.org/Documents/misc/ACTEC_Commentaries_4th_02_14_06.pdf (last visited Oct. 22, 2011).

family members may share confidences so long as the interests of the various individuals are not divergent.[134]

It is also not unusual for this type of estate planning process to give rise to situations where a client or clients will not take a lawyer's advice. These decisions can lead to bad planning results or expensive tax consequences. The lawyer can protect himself or herself in this situation by disclosure and obtaining the client's informed consent. The American College of Trust and Estate Counsel (ACTEC) commentaries offer the following observation with respect to "facilitating informed consent": "In the course of the estate planning process the lawyer should assist the client in making informed judgments regarding the method by which the client's objectives will be fulfilled. The lawyer may properly exercise reasonable judgment in deciding upon the alternatives to describe to the client."[135]

The commentaries continue by providing that "if an adequately informed client directs the lawyer to take action contrary to the lawyer's advice and the action is neither illegal or unethical, the lawyer should generally follow the client's direction."[136]

Does the same procedure apply to the trustee selection process? Informed consent generally applies where a client accepts the consequences for decisions or actions that will affect him or her personally—the consequences, for example, of not taking counsel's advice with respect to a tax planning issue. The dynamic changes during the trustee selection process. One cannot know or predict the effect and economic impact of poor, misinformed, or negligent trusteeship, and the decision itself will often not directly affect the grantor but the beneficiaries.

Presume then that the client fails to take counsel's advice and names a trustee without the qualifications necessary to assume resulting fiduciary responsibilities. To what extent can that exercise of poor judgment contribute to a cause of action? The answer is dependent on the nature of poor judgment. Take for example, the ramifications of the poorly equipped or incompetent personal representative during the administration of a decedent's estate. The

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134. *See id. See also* Fiedler v. Adams, 466 N.W.2d 39, 41 (Minn. App. Ct. 1991) (reversing grant of summary judgment in a malpractice action against a lawyer on appeal when the lawyer failed to inform the clients of multiple conflicts of interest, "arising from his duty as trustee [of employee benefit plan], his duty as [the Plaintiffs'] attorney, his personal interests in the real estate partnership and his interests as shareholder, director and attorney for [Trustee Bank] and when [the lawyer] did not advise [the Plaintiffs] of alternative methods to deal with their financial difficulties, nor did he advise them to seek independent counsel").

135. THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL FOUNDATION, *supra* note 132, at 33–34.

136. *Id.* at 34. The Commentaries seem also to assign counsel a degree of responsibility with respect to fiduciary selection, noting:

> The lawyer advising a client regarding the selection and appointment of a fiduciary should make full disclosure to the client of any benefits that the lawyer may receive as a result of the appointment. In particular, the lawyer should inform the client of any policies of practices known to the lawyer that the fiduciary under consideration may follow with respect to the employment of the scrivener of an estate planning document as counsel for the fiduciary. The lawyer may also point out that a fiduciary has the right to choose any counsel it wishes.

Id. at 95.

representative's attorney can quantify effects of his neglect with some degree of certainty. Inventories can be amended, tax returns can be corrected and in the extreme case, bonds can be surcharged. Therefore, the attorney can often quantify and mitigate these losses.

That is not always possible in cases of faulty or inept trust administration and investment. In these cases, the attorney cannot always quantify the impact of a trustee's poor performance because analysis of the effect of holding concentrations, or failure to properly allocate among asset classes, depends on a variety of variables including market conditions and a beneficiary's need for funds. For example, would a beneficiary be more likely to have requested the trust exercise discretion given positive portfolio performance than she would have been from a portfolio experiencing negative returns? There is no clear answer to this question as it blends psychology, fortune, and market conditions into one giant question mark.

In addition, the needs of current and future beneficiaries may be very different, giving rise to a conflict of interest. On the one hand, while conflict is almost inherent in the planning process as one struggles with mortality, family history, and predispositions developed over a lifetime, through persistence and patience, counsel will often be able to develop solutions that meet multigenerational needs and requirements. The decision to implement specific planning strategies can result in conversations having a prescribed beginning, end, and resolution.

Generally, an estate planning attorney cannot hold the same type of conversation when evaluating different investment styles and philosophies. Spouses may have differing ideas as to how they want to invest family assets. Additionally, the presence of closely held stock or a family business may further complicate the discussion. Things become even more complicated when the decision is made to vest a family member with the fiduciary duties of a trustee. That individual often cannot continue to observe past investment philosophies and inclinations, but they must look to the needs and requirements of the trust beneficiaries. The ability to incorporate and understand that necessary change in perspective requires a special sensitivity and understanding. As such, it can be unwise to allow the process of Trustee selection free reign within the family unit. Counsel must "constrain" the family decision maker when it comes to Trustee selection. Loyalty to the other family members demands no less.

Consider the following fact pattern:

> Assume H dies survived by his second wife W, and two children from his former marriage, A and B. H's will provides for the estate to pass to W as Trustee. The Trust provides that W is to receive all income (with discretionary provisions). At W's death, the remainder passes in equal shares to A and B. W has no resources outside of the trust. During their lifetime, H and W were "conservative" investors, committing most of their assets to

> certificates of deposit and government bonds. W comes to counsel's office for guidance.[137]

Unwittingly, H has placed W in a very difficult position.[138] H may feel an inherent obligation to vest in the survivor both the opportunity and responsibility of caring for their children and grandchildren. However, H may not realize the implications of naming a trustee ill-equipped to fulfill the obligations of today's trustee.[139]

If W, as Trustee, continues an investment philosophy she is used to, namely fixed income, thereby neglecting or refusing to add an equity growth component, then do the remaindermen A and B (or perhaps the children of A and B) have a cause of action against her? Relying on the past in this situation may be dangerous. Although the prudent man rule might not attach liability, it is likely the prudent investor rule will impose liability since prudent investing requires trustees to have a clear understanding of the trust portfolio and invest accordingly.[140] W's comfort level with investing is not relevant. If she fails to act and remaindermen suffer economic loss, a cause of action certainly could arise.[141]

The question thus needs to be raised whether H breached a duty of loyalty to his beneficiaries by placing his spouse in the unenviable position of assuming trusteeship—a position that she was probably not qualified or prepared to accept.[142] Presuming counsel has traditionally represented the entire family unit and is familiar with H and W's investment style, counsel absolutely must take his or her representation to the next level and understand that the traditional view of doing what the client wants does not serve the best interests of the client or the surviving family unit.[143] An ACTEC commentary agrees: "A lawyer may not represent clients whose interests actually conflict to such a degree that the lawyer cannot adequately represent their individual interests.[144]

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137. *See* Schwartzel, *supra* note 49, at 740–41.

138. See Alfred M. Falk, *Pity the Poor Trustee: Dealing With the Hazards of Trusteeship for Nonprofessional Trustees*, PROB. & PROP., at 6 (Nov./Dec. 2000).

139. *See id.*

140. Schwartzel, *supra* note 49, at 741. In *Law v. Law*, an appeal arose out of the administration of a testamentary trust. 753 A.2d 443, 444 (Del. 2000). In *Law*, the remaindermen claimed that the trustee failed to invest in the trust as a "prudent investor." *Id.* at 445. The trustee invested in tax-free government bonds and the remaindermen argued that the trustee had an obligation to invest to obtain growth. *Id.* During the administration of the trust, Delaware law changed from the prudent man to the prudent investor rule. *Id.* at 448. While the appeals court overturned the trial court ruling, surcharging the trustees for violating their duty of impartiality by favoring the income beneficiary over the remaindermen, the Supreme Court of Delaware noted that "in today's economic environment, much can be said for an approach that broadens the ability of a trustee to balance considerations of safety with a desire to increase principal." *Id.* at 449. Would the *Law* court have decided differently if the prudent investor rule had existed throughout the trust administration?

141. *See* Schwartzel, *supra* note 49, at 740–41.

142. *See id.*

143. *See id*.

144. *See* THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL FOUNDATION, *supra* note 132, at 93.

Prudent investing can spawn conflict; accordingly, counsel must respond with sensitivity. For example, W cannot safely invest in fixed income because that is "what she is used to." Without W acquiescing to the development of an investment policy friendly to both classes of beneficiaries, it is also difficult to imagine counsel remaining the "family" attorney.[145]

What about disclosure? Consider the following:

> (a) A lawyer shall not represent a client if. . .there is a substantial risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person, or by a personal interest of the lawyer unless:
>
> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation of each affected client;
>
> (2) each affected client gives informed consent, confirmed in writing, or clearly stated on the record at a hearing.[146]

Generally, lawyers may represent clients with related but not necessarily identical interests.[147] However, it is difficult to imagine a lawyer representing multiple classes of beneficiaries in this situation.[148]

Prudent investing requires counsel to carefully rethink the dynamics of family representation. Relying on one's traditional "feel" for resolving issues of this nature may be dangerous because prudent investing adopts a standard different from that which was acceptable as a "prudent man." As such, W should be counseled to abandon her proclivity to income producing securities and to consider the inherent interest of the remaindermen, in this case her stepchildren.[149] No mandatory inference can be made from the investment policy H and W may have developed and followed during H's life in establishing an investment policy going forward.

Additionally, counsel probably has a responsibility to advise W that if she continues an investment philosophy emphasizing fixed income—neglecting to add an equity component—the remaindermen, her step children, may have a cause of action against her.[150] If she refuses to act and insists on carrying on as

145. Would this kind of situation constitute a situation where counsel could adequately represent individual interests, especially in view of the impact of asset allocations? *See* FLA. ST. BAR R. 4-1.7.

146. *See* FLA. ST. BAR R. 4-1.7(b)–(c).

147. *See id.*

148. *See generally* THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL FOUNDATION, *supra* note 132 (discussing rule 1.6).

149. *See id.*

150. *See* Schwartzel, *supra* note 49, at 743 ("Consequently, while one of the stated goals of the Restatement (Third) was to give trustees 'reasonably clear guidance to safe harbors that are practical, adaptable, readily identifiable, and expectedly rewarding'; the Restatement (Third), in fact, may have effectively eliminated the safe harbors which previously existed under the prudent man rule and set trustees adrift in a sea of uncertainty to deal with such matters 'rather abstractly' and at the risk of surcharge."). Given

she and her husband did in the past, counsel must make a difficult choice, including potentially, withdrawal.

Analysis of this problem emphasizes the need to be cautious and careful with trustee selection in era of prudent investing.[151] Since asset allocation can or should result in profound differences in rates of return and performance,[152] can W exercise the right to make an asset allocation decision for her stepchildren, particularly when the decision has a demonstrable negative economic impact?[153] The answer is probably not, and parties to the planning process should be cognizant of these issues and challenges during their deliberations.

V. Some Final Observations

A. Generally

The journey we have been on offers conclusions and quandaries. First, it is clear that the requirements of prudent investing have altered the approach, thought process, and responsibility trustees and their counsel must undertake as they construct and develop a trust relationship.[154] The reason for this is quite simple: contemporary fiduciary administration is result and process focused—its goal is meeting the needs of trust beneficiaries—both present and future.[155] Asset allocation, asset selection, development of investment policy, and if necessary, discretionary distribution strategy, must be part of a unified process serving all beneficiary classes within the terms and conditions of the trust instrument.[156]

Loyalty, understood in today's terms, fosters and nurtures that process.[157] All parties to the trust relationship must have confidence in the other's ability to perform and discharge their duties and obligations.[158] And while all parties participate and contribute to the trust administrative process, it is the trustees who, through their insight, knowledge, and diligence steers the process to success and completion.[159] We saw how a misguided or perhaps negligent trustee selection hampers that process.[160]

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this uncertainty, does estate planning counsel face greater challenges in terms of potential conflict and the need to disclose the effect and impact of asset allocation choices?

151. *See generally id.* at 719 (explaining that a prudent investor must use a continuous strategy of caution and planning).

152. *See id.* at 725–26.

153. It is difficult to see how W could do so within the context of "prudence." *See* STEWART E. STERK ET AL., TRUSTS AND ESTATES 220–24 (Foundation Press, 4th ed. 2006).

154. *See supra* Part III.

155. *See supra* Part IV.

156. *See supra* Part IV.C.

157. *See supra* Part IV.C.

158. *See supra* Part IV.

159. *See supra* Part IV.B–C.

160. *See supra* Part IV.B–C.

Simply stated, prudent investing requires that a trustee adopt and embrace a certain standard of conduct.[161] Beneficiaries have a right to expect that standard of conduct throughout the trust's lifecycle.[162] Selection of a potential trustee, who understands that standard of conduct and is able to deliver the same, is perhaps one of the most crucial actions during the development and establishment of a trust relationship. It is the grantor, in consultation with counsel, who is charged with the responsibility of making that selection.

This responsibility vests a standard of conduct in the grantor. If he cares about a trust's "end result" and the impact it will have on its beneficiaries, he must realize that not everyone has the ability, temperament, and inclination to be a trustee; a trustee's responsibilities and duties require affirmative and thoughtful action.[163] Prospective grantors must be willing to think in the alternative with respect to trustee selection and understand the implications of an inappropriate trustee selection. If that selection, made in disregard to its implications, results in damages due to inappropriate trust investment, performance, or administration, it is the opinion of the author that such a selection should carry consequences with it.

The crucial issue is determining what consequence, if any, should attach to inappropriate or ill-advised trustee selection. Trustees have long been (and should be) held liable when they fail to discharge their fiduciary duties.[164] However, the requirements of prudent investing focuses attention on how and why ill equipped trustees are placed in a position of fiduciary responsibility in the first place.[165]

In reflecting on this issue, one cannot help but recognize that case law has found a cause of action against an employer who negligently hires or retains incompetent employees.[166] In those cases, courts allow an injured party to recover because an employer's wrongful conduct facilitated the tortuous conduct of the employee.[167] Applying this theory to a trust relationship is more difficult not only because of the whole nature of the gratuitous transfer, but also due to the fact that, as this article has suggested, inappropriate trustee selection carries with it consequences that often manifest themselves well into the future. However, it must be remembered that in other areas of the law, courts have not hesitated to impose responsibility in situations where someone ought to know better or when consequences attach to ill-thought decisions.[168] Exercising care and deliberation in trustee selection has thus never been more critical, reflecting

161. *See supra* Part IV.B.
162. *See supra* Part IV.B.
163. *See supra* Part IV.
164. *See, e.g.*, Marsman v. Nasca, 573 N.E.2d 1025, 1026 (Mass. App. Ct. 1991).
165. *See supra* Part III.
166. *See* Kiesau v. Bautz, 686 N.W.2d 164, 172 (Iowa 2004).
167. IMT Ins. Co. v. Crestmoor Golf Club, 702 N.W.2d 492, 496 (Iowa 2005).
168. Software Design & Appl. v. Hoefer & Armnett, Inc., 56 Cal. Rptr. 2d 756, 763 (Cal. Ct. App. 1st Dist. 1996) (suggesting that courts attach responsibility for "sufficiently suspicious" activity when it puts up red flags to fraudulent activity).

an approach and state of mind today's "new" duty of loyalty requires and perhaps demands.[169]

It thus falls to counsel to ensure such care and deliberation take place during the trustee selection process.[170] While resolution of this issue may well be on the checklist of many estate planners, a few suggestions and recommendations may prove helpful.

B. Recommendations

For an attentive estate planner, the process for selecting a trustee is similar to the will preparation process, especially if a contest in anticipated.[171] For example, the attorney must conduct a focused and comprehensive conversation with a client contemplating the establishment of a trust. Furthermore, counsel must ensure the client understands the nature of the trust relationship, the specific needs of beneficiaries, and any unusual characteristics relating to the assets that the trust might hold. The attorney should also consider both the short and long term implications of closely held or unique assets.[172]

As these matters are discussed, counsel must ensure the client understands the fiduciary's responsibilities, including the ongoing administration and retention of such assets. Then and only then can a thoughtful discussion ensue regarding potential trustee selection. In cases where a client steadfastly insists on the appointment of a potentially unqualified trustee, counsel must discuss the likely necessity of delegating a portion of the trustee's responsibility and ensure that the powers clause contains language allowing for such delegation.[173]

Once these general discussions occur and the client understands the challenge inherent in trustee selection, counsel should employ the following specific strategies in developing and creating the final trust product.

1. The Trust Should Accommodate and Embrace Prudent Investing

The trust instrument that the grantor ultimately executes must provide the flexibility to react to changes in both current and future market conditions.[174] Counsel can and must play a key role in this regard. The prospective grantor should avoid letting biases regarding, for example, investment philosophy, control and limit ongoing and future investments of trust assets. The best way to ensure this situation does not occur is to require a trustee to act as a prudent

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169. *See generally supra* Part IV.

170. *See generally supra* Part IV.

171. *See* Schaengold, *supra* note 57 (suggesting that a lawyer should assist the client in carefully making legal decisions).

172. *See* Schaengold, *supra* note 58 and accompanying text (suggesting that counsel has a duty to help a client make informed decisions).

173. *Supra* Schaengold, *supra* note 59 and accompanying text (suggesting counsel must follow the clients wishes).

174. *See* Schwartzel, *supra* note 49, at 720–21.

investor.[175] A great deal of discussion and planning should take place with the client so that the trust clearly articulates a vision and offers a framework that the trustee can understand and follow:

> Strangely, at least if one views the matter from a perspective other than that of a trusts and estates professional, our traditional trust forms typically do not prescribe how much is to be distributed to the current beneficiary or the remainder beneficiary. . .And our trust documents typically do not prescribe how the trust is to be invested. In fact, a number of pages in the typical trust are spent making as clear as possible that the trustee should be able to do whatever the trustee thinks is the best thing. Now all of this might be confused with flexibility, if not for the fact that most trust documents do not describe the goal of the trust.
>
> Consequently, in theory at least, the trustee is left adrift at sea, and the economic value that flows to the current beneficiary and the remaindermen is likely to be dependent upon which investment direction is chosen**.**[176]

A carefully crafted powers clause should facilitate investment for total return and the appointment of advisors.[177] Counsel should consider incorporating provisions that describe investment philosophy and guidelines.[178]

2. The Trust Should Establish and Embrace Specific Performance and Administrative Protocols

Prior to choosing a trustee, clients should understand the need to incorporate ongoing procedures and safeguards. Clients must understand that it is a trustee's responsibility to develop and utilize, in concert with the beneficiaries, an investment policy as part of the trust administrative process.[179] Mechanisms that evaluate performance should be clear, understandable and followed.[180]

Counsel must provide clients with an understanding that trustees in today's prudent investing environment must adopt a structured course of conduct as they perform their duties.[181] In many ways, the process is more important than the outcome, requiring adoption of an asset allocation methodology, diversification

175. *See id.* at 715–19.

176. *See id.* at 755 (quoting Robert B. Wolfe, Estate *Planning with Total Return Trusts: Meeting Human Needs and Investment Goals Through Modern Trusts Design*, 36 REAL PROP. PROB. & TR. J. 169, 199 (2001)).

177. *See* Schwartzel, *supra* note 49, at 756.

178. *See id.*

179. *See id.* at 755–56.

180. *See id.* at 761–62 (suggesting that when a grantor's intent is not explicit, trustee's may face criticism for their decisions).

181. *See id.* at 781 (asserting that the test for a trustee is prudence of conduct, therefore the grantor might want a structured plan instead of flexibility).

strategy, and portfolio review process.[182] Grantors who balk at the use and integration of such safeguards invite scrutiny and liability.[183]

VI. CONCLUSION

Contemporary trust administration has witnessed striking changes in approach and responsibility. A "new" duty of loyalty transcends the fiduciary relationship, requiring implementation of an ongoing process to insure that the needs of beneficiaries are met.[184] This paper began with the suggestion that all parties to the fiduciary relationship need to embrace the challenges and opportunities a new duty of loyalty offers.[185] Embracing and understanding those responsibilities offers one an opportunity to make a significant difference—now and for generations to come.

182. *See id.* at 787–88.
183. *See id.* (suggesting that the prudent investing rule allows trustees flexibility that causes beneficiaries to complain).
184. *See supra* Part IV.
185. *See supra* Part IV.