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A Practitioner's Perspective on Emerging Legal Trends | 2021 Issue 4

Trustees and Investing: Best Practices to Avoid Liability

Introduction

Many attorneys, regardless of practice area, find themselves in the position of being asked to serve as a trustee for a trust. Maybe the attorney is an estate planning lawyer and being a trustee is a regular part of their job, or maybe the attorney is the only lawyer in the family and is trusted with their aging parent's trust, or a support trust for a disabled relative. Regardless of the reason, attorneys routinely accept the responsibility of serving as a trustee and then find themselves as the custodian of a significant sum of money. Naturally to avoid running the trust dry, the attorney-trustee now must become an investor. So how should an attorney go about making trust investments without incurring liability? The answer comes by first examining the legal duties a trustee has with respect to investing.

Generally, the goal is not asset accumulation, but asset preservation so that the trust lasts for the beneficiaries. A good strategy is one that is neither too conservative nor aggressive.

The responsibility of being a trustee carries with it multiple duties. They may be either explicit in the trust itself, or implied by law. Even though every jurisdiction is slightly different, the following lists the most common trustee duties, which the trust instrument can modify or eliminate:[1]

1. Duty of Prudence
2. Duty of Loyalty
3. Duty to Account
4. Duty of Impartiality
5. Duty with Respect to Delegation
6. Duty with Respect to Co-Trustees
7. Duty to Inform Beneficiaries
8. Duty to Segregate and Identify Trust Property
9. Duty to Administer Trust According to its Terms

Investment decisions can be a factor in determining if a trustee breached any duty, thus creating multiple avenues of potential liability.

1 Restatement (Third) of Trusts §§ 76-84 (2007).

Duty of Prudence

A trustee has a duty to manage trust assets comparable to a prudent investor. The trustee must consider the purposes, terms, distribution schemes, and other circumstances of the trust.[2] Most states, including California, New York, Illinois, and Florida, have codified this duty by adopting in full or part the Uniform Prudent Investor Act ("UPIA").[3] The UPIA specifies that liability for an imprudent decision is determined by evaluating the whole trust portfolio and investment strategy. Furthermore, trustees have a duty to diversify the trust investments (unless it is imprudent to do so) and upon becoming a trustee there is a duty to review the investment portfolio after acceptance.[4] The UPIA also lists several circumstances for a trustee to consider in making prudent decisions, and every trustee should consult their local UPIA for specific factors.[5]

Now, assume the trustee has no investment experience. Jurisdictions allow trustees to delegate so long as the delegation is prudent, and the agent is chosen prudently.[6] But, if any trustee has significant investment experience and special skills, then that trustee is required to use his special skills and will have a higher duty of care.[7] There is no requirement in the duty of prudence that the investment always grow the trust. The standard is one of conduct, not of result, so losing trust funds on the stock market does not automatically lead to a finding of imprudence – the conduct leading to the loss is what determines liability.[8]

Duty of Loyalty

A trustee has a duty of loyalty to the trust beneficiaries which demands that a trustee administer the trust solely in the beneficiaries' interest.[9] Generally, this duty requires trustees to refrain from administering trust assets in any manner which benefits the trustee.[10] This duty is not breached when the trustee invests in a particular stock individually and simultaneously the trust is invested in the same stock by the trustee. Instead, the duty prohibits a trustee, acting individually, from engaging in substantial competition with the trust.[11] However, once self-dealing is found there is a presumption of a breach of duty, regardless of good-faith intentions, with few exceptions.[12] One pertinent exception that exists statutorily in most states allows a trustee to invest trust funds into the securities of an investment company or investment trust where the trustee is an employee, provided the trustee abides by the local statutory safeguards.[13]

Duty to Account

Most jurisdictions require the trustee to provide the trust beneficiaries with an accounting of the trust assets. Essentially, a trustee has a duty to keep the beneficiaries apprised of the value of the trust. Some states require an annual accounting,[14] while others do not.[15] In addition, trustees are generally required to provide an accounting upon trust termination, upon a change in trustee, and upon the request of a beneficiary.[16] The accounting should show the beneficiaries the receipts and disbursements of the trust account during the accounting period.[17]

Other Duties Concerning Investment

A trustee must deal impartially with all beneficiaries while protecting their interests.[18] However, a trustee can exercise discretion that may favor one beneficiary over another if it is not unreasonable or arbitrary. For example, when a trust provided for an income beneficiary and a principal beneficiary, the trustee (who was also the income beneficiary) did not breach the impartiality duty by pursuing an investment strategy that maximized the income without growing the principal.[19] In addition, a trustee normally should not delegate their duties, unless it is prudent to do so, and even then, a trustee must exercise prudence when selecting an agent.[20] So, an attorney-trustee can delegate the trust investing to a professional.

When there are multiple trustees, each trustee has a duty to prevent the others from breaching any duty.[21] Therefore, if a co-trustee is making an imprudent investment, the other co-trustees must attempt to stop him and cannot turn a blind eye or claim ignorance regarding the investment.[22] Finally, trustees generally have a duty not to mingle trust funds with their own. However, there are some circumstances where it is permissible to co-mingle funds, especially where consolidation and co-mingling can decrease administrative costs. However, in these situations, the trustee must be careful to earmark trust funds and keep them separate from personal funds.[23]

2 Cal. Prob. Code § 16047 (Deering 2021).
3 *See* Cal. Prob. Code §§ 16047-54, N.Y. Est. Powers & Trusts Law §11-2.3, 760 ILCS 3/901, Fla. Stat. Ann. § 518.11.
4 *See* Cal. Prob. Code §§ 16047-54, N.Y. Est. Powers & Trusts Law §11-2.3, 760 ILCS 3/903-4, Fla. Stat. Ann. § 518.11.
5 *See* Cal. Prob. Code §§ 16047.
6 *See* N.Y. Est. Powers & Trusts Law §11-2.3.
7 *See* N.Y. Est. Powers & Trusts Law §11-2.3, Fla. Stat. Ann. § 518.11.
8 *See* Fla. Stat. Ann. § 518.11.
9 *See* Cal. Prob. Code §§ 16002, 760 ILCS 3/802, Fla. Stat. Ann. § 736.0802.
10 *See* Cal. Prob. Code §§ 16002, 760 ILCS 3/802, Fla. Stat. Ann. § 736.0802.
11 *Rubin v. Laser*, 301 Ill. App. 3d 60, 65-66 (1st Dist. 1998).
12 *Van de Kamp v. Bank of America*, 204 Cal. App. 3d 819, 835 (2d Dist. 1988).
13 Restatement (Third) of Trusts §78 (2007).
14 760 ILCS 3/813.1-813.2; Cal Prob. Code § 16062.
15 Fla Stat. Ann. § 736.0813.
16 *See* 760 ILCS 3/813.1-813.2, Cal Prob. Code § 16062, Fla Stat. Ann. § 736.0813.
17 Cal Prob. Code § 16063
18 *Northern Trust Co. v. Heuer*, 202 Ill. App. 3d 1066, 1070 (1990).
19 *See generally Carter v. Carter*, 2012 IL App (1st) 110855 (2012).
20 760 ILCS 3/807; Fla Stat. Ann. § 736.0807.
21 *See In re Rothko*, 43 N.Y.2d 305, 320 (1977).
22 *See In re Rothko*, 43 N.Y.2d 305, 320 (1977).
23 *In re Goldstick*, 581 N.Y.S.2d 165, 172 (App. Div. 1st Dept. 1992).

Best Practices for Avoiding Liability

As shown by the various legal duties, being a trustee with investment responsibilities can expose the trustee to significant liability. A breach of duty could lead to

1. Removing the trustee from office;
2. Placing a lien on the trustee's personal assets;
3. Ordering the trustee to restore the value of the trust property by paying monetary damages;
4. Assessing legal fees and costs against the trustee; and
5. Other remedies exist.[24]

Accordingly, a trustee with investment responsibilities should adhere to using best practices in order to best limit their potential liability.

Diana Law, of the law firm Law Hesselbaum, is the Kane County Public Guardian and Administrator in Illinois and has served as a trustee with investment duties on multiple trusts. When taking over as a trustee, the first thing Ms. Law does is secure the accounts. If she is not the original trustee, this includes reaching out to any existing financial advisors and institutions and sending them the appropriate documentation alerting them of the change in trustee. For a new trust, the trustee should determine the assets in the trust and organize them in a clear and coherent manner. Additionally, from the onset, a trustee should learn as much as they can about the trust beneficiaries. This includes determining the purpose of the trust, what the beneficiaries' needs are, the beneficiaries' financial situation, and their tax filings. When a trustee takes over the management and operation of a trust, the trustee shall promptly do an inventory of the assets and prepare an opening balance sheet / accounting.[25]

If Ms. Law is a successor trustee of a trust with assets already invested, Ms. Law determines if there is a strong or longstanding relationship with the financial advisor or institution. In these cases, it is often best to respect the pre-existing relationship. However, if there is no prior relationship with a financial advisor or the previous trustee was a "do it yourself" investor, it is best to outsource the asset investing to a trusted advisor or institution. Nevertheless, it is still the duty of the trustee to ensure prudent investment. To do so, the trustee should not authorize any risky investments.

Generally, the goal is not asset accumulation, but asset preservation so that the trust lasts for the beneficiaries. A good strategy is one that is neither too conservative nor aggressive. Ms. Law notes that some trusts encourage aggressive investment by eliminating the prudent investor rule in the trust document, but in those cases, she advises following the rule to the extent consistent with the trust language. Even if the trustee is a sophisticated investor, Ms. Law likes a "checks and balances" system. Engaging a third-party professional investor provides a "second set of eyes" that can help limit liability since the trustee is being prudent in seeking professional advice. Again, professional services are not a complete shield from liability, but it can help.

Since one co-trustee is liable for the actions of all co-trustees, Ms. Law has prudently decided to not become a co-trustee. However, in the situation where a co-trustee is breaching duties, the non-breaching trustees must take action, which includes hiring an attorney and engaging necessary professionals. Further, the non-breaching, prudent, co-trustee can take steps to remove the problem co-trustee.

Insurance Coverage

Lawyers serving as trustees should review their lawyers' professional liability ("LPL") policy to determine if the policy will cover any claims arising from the lawyer/trustee providing investment advice or services to the trust. The CNA LPL policy offers such coverage, but not all LPL policies offer coverage for this activity, subject to all other terms and conditions of the policy. Therefore, it may be necessary for lawyers to obtain a trustee insurance policy if the LPL policy will not cover them for providing investment advice or services to a trust. In addition, lawyers serving as trustees should determine whether the liability limits of their coverage are at least equal to the value of the trust in which they are serving as trustee. If the limits of the primary policy do not align with the value of the trust, lawyers should consider obtaining excess insurance to protect themselves in the event of a claim for damages in an amount that equals the value of the trust.

24 760 ILCS 3/1001; 760 ILCS 3/1002.
25 The information presented in this article was obtained through an interview with Diana Law, Esq. and is published herein with the permission of Diana Law, Esq.

Conclusion

As a part of practice, attorneys may find themselves as trustees with investment responsibilities. When this happens, the attorney-trustee, generally, must invest the assets, but doing so opens them up to potential liability. When investing, a trustee runs the risk of breaching the duties of prudence, loyalty, and accounting, among others, if they are not careful. Trustees should limit liability by securing and organizing the assets, which often requires an accounting. Even if the trustee is a sophisticated investor, it is best to hire a professional investor to serve as a check on the trustee. The trustee can still direct the professional and is still required to ensure prudent investment. Trustees should also always avoid self-dealing and should keep the beneficiaries apprised of the trust value through regular accountings. In addition, it is best to avoid being a co-trustee as all co-trustees are responsible for one another, and the actions of one create liability for all. Finally, the laws governing trusts vary by state, so the best way to limit liability is to consult the local Trust and Trustee Act.

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