A Trust Primer for Trustees and Investment Advisers

As the popularity of trusts has increased over recent years, the number of individuals asked to serve as a trustee for loved ones or friends has multiplied. Deciding how best to cope with these new situations can be confusing for those individuals and financial professionals entrusted with this duty. This article is intended to provide basic guidance for trustees and their investment advisers when titling and investing trust assets.

What is a trust?

Fundamentally, a trust is not an entity like a corporation, partnership, or limited liability company. It is a right or relationship, enforceable by courts, among the creator of the trust ("the trustmaker"), the owner of trust property ("the trustee"), and the persons or entities ("the beneficiary" or "beneficiaries") for whose benefit the trustee is required to exercise such property ownership. In short, it is someone (the trustee) owning property subject to a set of enforceable rules as to how that property is to be held and administered for the benefit of the beneficiaries. A trust is the means by which the ownership of property can be separated from enjoyment of the benefits of such ownership.

Titling Trust Assets

Under Maryland law, trust property is not appropriately titled unless legal title is actually transferred to, and vested in, the trustee. An account to be held by a trustee must be titled to the trustee, not the trust *per se*. (A legal right, as opposed to a person or entity, cannot own property.) Such an account should not therefore be titled to "the XYZ Trust." Instead, the account should be titled in the name of the trustee of the trust in question with an indication that he or she owns it as a fiduciary.

Ideally, the trustee's title should reflect not only the trustee's name, but also the document or set of rules pursuant to which the trustee must act. In addition, since the owner of the property may change over time under the terms of the trust, title to trust property should also indicate that that ownership rests not only in the current trustee-owner, but also in his or her successor trustees as designated in the terms of the trust. To accomplish all these goals for titling legal ownership of trust property, the title to such property is best written as follows:

> "ABC, Trustee, and his [her, their, or its] successors in trust, under the XYZ Trust dated [trust date]"

For Maryland real estate intended to be held in trust, the Legislature has recognized that trust real estate is often not properly titled in our land records. To correct this situation, by statute, "A grant of

property by deed to a grantee designated in the deed as a trust has the same effect as if the grantor had granted the property to the trustee or trustees appointed and acting for the trust on the effective date of the deed." Similarly, "If executed by the trustee or trustees appointed and acting for the trust on the effective date of the deed, a grant of property by deed from a grantor designated in the deed as a trust has the same effect as if the grantee had received the property from the trustee or trustees appointed and acting for the trust on the effective date of the deed." Unfortunately, this savings language does not apply to trustee ownership of anything other than land. Financial accounts must therefore be appropriately titled to reflect that the owner of the account is the trustee, not the trust.

Fiduciary Duty: the "Glue" that Makes Trusts Work

As we noted in a prior article, trusts work because our legal system deems the separation of property ownership from enjoyment so valuable that trusts have guaranteed enforceability in our courts. The lynchpin of such strategies is making sure that those entrusted with trust property ownership and decision-making authority can be held accountable to those intended to benefit from such entrustment.

In this regard, trustees owe three primary duties to their beneficiaries:

1. To carry out the terms of the trust and the intentions of its trustmaker(s);
2. To act loyally and impartially for the benefit of the beneficiaries and to put the beneficiaries' interests before those of the trustee(s); and
3. To exercise prudence, diligence, and reasonable care to carry out the trustmaker's intent and to benefit the beneficiaries.

Impacts of Trust Fiduciary Duties on Trust Investments

The Terms of the Trust and Applicable Law

A trustee's most fundamental duty is to carry out the intentions of the trustmaker as included in the terms of the trust. As a backdrop to these terms, states often have statutes providing general rules to govern trust property ownership to provide an operating context for trustmakers. These statutes are sometimes mandatory in applicability. However, they are often default rules that can be overwritten by a trustmaker in the express terms of the trust. For example, the need for beneficiaries to have information with which to enforce their rights is so basic that the rights of adult beneficiaries' to receive trust information from their trustee is generally mandatory, regardless of the terms of the trust. On the other hand, notwithstanding statutes governing trust investments, the terms of trusts often permissibly restrict, otherwise alter, or guide the trustee's common-law or statutory responsibilities in investment matters. These terms may even expressly leave such investment matters solely to the discretion of the person chosen to be trustee.

If an investment adviser aids a trustee in breaching the terms of a trust, the investment adviser may have liability to the beneficiaries for such activity. As a result, it is important that the investment

adviser know what the trustee can and cannot do. For this reason, investment advisers often require that a trustee account holder certify his or her investment authority and/or provide copies of that authority as stated in the terms of the trust. The best source for that information is a copy of the written trust itself. However, trusts are, by their nature, private instruments intended to be made known only to trustees and the beneficiaries for whose benefit they are written. It may be inappropriate for an investment adviser to request information about how any particular beneficiary will receive distributions when that does not affect investment authority or performance.

In addition, trust advisers do not generally like to store multiple lengthy trust documents. As a result, most states (including Maryland) allow trustees to use a written trust certification stating their identity and authorities in lieu of providing complete trust documents to persons not beneficially interested in the trust itself. Such trust certification statutes include comfort to the financial advisers reasonably relying on such certifications by absolving them from liability for such reasonable reliance. Using trust certifications is a reasonable compromise between legitimate needs on the part of the adviser to protect himself or herself from liability and the desires of trust participants to preserve their privacy.

How the Trustee Duty of Loyalty Affects Trust Investment Activity

Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries. Other than in discrete circumstances (such as the right to receive permissible trustee commissions), the trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict of interest between the trustee's fiduciary duties and personal interests. A trustee's duty to act loyally and impartially and to put beneficiaries' interests before those of the trustee means that a trustee cannot personally profit from his or her trust investment activities. Unless the terms of the trust provide otherwise, if a trustee derives such personal profit from actions as trustee, he or she may have to account for and surrender those profits to the trust account.

Because of this strict duty to avoid self-dealing and the potential liability associated with it, financial advisers are not generally allowed by their sponsoring company to serve as a trustee. In addition, they need to be aware of situations where their clients might be involved in such self-dealing to avoid being targeted for complicity.

The Prudent Investment Standard

In the investment of trust assets, the trustee has a duty to exercise prudence, diligence and reasonable care in carrying out the trustmaker's intent for the benefit of beneficiaries. This duty of reasonable care requires a trustee to invest and manage the funds of the trust as would a prudent investor in light of the specific purposes, terms, distribution requirements, and other circumstances of the trust. The trustee may not invest trust assets with the same impunity with which he or she might invest his or her personal funds. In general, the standard requires the exercise of reasonable care, skill, and caution. Modern law theoretically applies this standard in the context of the entire trust portfolio and as a part of overall investment strategy which incorporates risk and reward objectives reasonably suited to the trust. However, those niceties may be of little value when reasonable care is reviewed retrospectively after losses have already occurred.

Most states (including Maryland) now have statutes adopting prudent-investor principles to govern investments by trustees unless the terms of a trust provide otherwise. These statutes include guidelines and standards by which fiduciary investment decisions are to be judged. In particular, they make it clear that individual investment decisions are not to be judged in isolation and that no particular investment decision is, taken alone, prudent or imprudent. Instead, trustees may exercise reasonable business judgment regarding the anticipated effect on the portfolio of fiduciary assets as a whole under facts and circumstances prevailing at the time of the decision or action. Unfortunately, Maryland's prudent-investor standards statute does not apply to all trustees. Unless the trustee is a trust company, a trustee must make a written statement to the Commissioner of Financial Regulation electing to have the statute apply to all fiduciary assets controlled by the trustee before it will be applicable.

The Importance of Diversification

In general, one of the most important means by which a trustee can satisfy his or her duty to manage trust assets prudently is to diversify the trust assets he or she holds. Diversification is a technique that reduces risk by allocating investments across various financial instruments, industries, and other categories. It aims to maximize returns by investing in different areas that would each react differently to the same event. Most investment professionals agree that, although diversification does not guarantee against loss, diversifying trust assets is one of the most important components for reaching long-range financial goals while minimizing risk. In making and implementing investment decisions, a trustee therefore has a duty to diversify the investments of the trust unless such diversification is contrary to the terms of the trust or the trustee reasonably believes that investing otherwise is in the best interests of the beneficiaries or furthers the purposes of the trust. Absent specific authority in the terms of the trust, the trustee is likely to be faced with a heavy burden to show the reasonableness of his investment activities when he or she invests in concentrated positions and fails to diversify trust assets. In any event, the financial adviser's role in counseling the trustee in these regards is a very important component in proof by the trustee that he or she has acted reasonably and with due prudence, diligence, and care.

In particular, a trustee has a duty to review the contents of the trust with such care within a reasonable time after the creation of a trust or his or her succession to the trusteeship. Trust assets that were appropriate under prior circumstances may no longer be appropriate for the purposes of the trust. For example, a trust invested to provide income to an elderly beneficiary may no longer be appropriately invested after that beneficiary dies. To comply with his duty of care, the trustee needs to review the trust assets within such a reasonable time and to make and implement decisions concerning the retention and disposition of the original investments.

Compliance with the trustee's duty of prudence, diligence, and reasonable care is often difficult for any trustee, especially if that trustee was chosen because of his or her family relationship and knowledge of beneficiary needs rather than financial acumen. His or her investment experience is often limited to personal investment rather than to the requirements of doing so in a fiduciary role. The financial adviser, therefore, becomes an important participant in the process of making sure that the trustee acts in accordance with all of his or her fiduciary duties to the beneficiaries. As such, it is

important that the adviser know and understand the duties and framework in which the trustee must operate.

If we can assist you either as a trustee or trust adviser in these regards or with regard to specific trust circumstances, please contact us.

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