

FIDUCIARY PRACTICE

REPORT

Message From The Firm

My law firm has recently begun publishing a series of newsletters concerning fiduciary litigation and fiduciary responsibility at all levels. These newsletters cover both state and federal governance of fiduciaries. They cover fiduciaries for trusts, probate estates, retirement plans, and positions of high trust.

This is our second fiduciary newsletter. The first dealt with fiduciary litigation; this newsletter focuses on tips for fiduciary compliance and for the avoidance of disputes. (For a copy of the first newsletter, go to www.reish.com/publications/pdf/trustestlitmov07.pdf.)

We have begun writing these newsletters because we believe that fiduciary relationships will be coming under greater scrutiny. There are a number of reasons for that. For example, the "greatest generation"—the World War II generation—is transferring its wealth to the baby boomer generation. Much of that transfer will occur in a fiduciary arrangement, such as trusts (which are regulated by state fiduciary laws). The baby boomer generation is advancing in age, with the first boomers reaching the early social security retirement age. That generation will depend heavily on participant-directed retirement funds that are managed by federally regulated fiduciaries and individual retirement accounts (where investments and relationships are regulated by both state and federal law).

Unfortunately, where there is money, there is trouble. And, trouble spells litigation.

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The Universal Fiduciary



By Fred Reish (FredReish@Reish.com)

The common denominator for almost all fiduciary governance is the concept of a "prudent" fiduciary. Further, the conduct required of a prudent fiduciary is, universally, that of a prudent process.

Procedural prudence may seem, at first blush, like an amorphous concept . . . attractive sounding, but difficult to apply. Or, procedural prudence may sound like a grand idea in the realm of academics, but of little application in the real world.

However, neither of those conclusions is correct. Instead, prudent process is, at a fundamental level, both specific and implementable. But it does require a commitment to engaging in a process to make decisions.

As a matter of context, when I use the term "fiduciary," I am referring to fiduciaries of all ilks, regardless of whether regulated by state or federal law. That includes trustees of individual trusts, committee members for retirement plans, executors of probate estates and, generally, any person who makes decisions for the benefit of third parties.

What, then, must fiduciaries do in making decisions?

There are at least four steps to engaging in a prudent process. Those are:

1. The duty to make necessary decisions. The failure to make a necessary decision is a fiduciary breach . . . the only question is whether there are damages. In some cases, the issue is obvious. For example, trust funds must be invested in a manner consistent with the objectives of the trust. In other

cases, though, the need to make a decision may be less obvious.

2. The duty to follow the terms of the governing documents. That is true regardless of whether the governing document is a trust agreement, a will, a retirement plan, or another instrument. The fiduciary is obligated, with a few exceptions, to be faithful to the settlor's intent, as expressed through the governing document. Fiduciaries must read and understand those materials and, if needed, hire attorneys or others to explain the provisions.
3. The duty to investigate. A prudent process requires that the fiduciary investigate any issues about which the fiduciary will make a decision. A fiduciary needs to gather the information that is material to making an informed and reasoned decision. The fiduciary then needs to review and understand that information. As a final step, a fiduciary needs to reach a decision that is informed by the investigation and that is reasoned—in a sense that it has a rational connection to the information evaluated.
4. The duty to hire experts, when needed. Fiduciaries are not required to be experts on all of the issues that come up in the administration and management of a fund. However, where a fiduciary lacks the expertise, the fiduciary must hire experts to assist in the investigation and/or decision making. Those experts could include investment advisers, appraisers, accountants, attorneys and others. As a part of that process, the fiduciaries need to prudently select the advisers, especially in terms of qualifications,

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Exculpation Clauses in Trusts are not Foolproof



By David Schwartz (DavidSchwartz@Reish.com)

We were recently involved in a case in which our client, the beneficiary of an irrevocable trust, had certain complaints with the way the trustee was administering the trust. The trustee had provided the beneficiary with an accounting which, consistent with the trust document, required on its face that any objections to the actions of the trustee be made within 90 days of the date of the accounting. If the beneficiary did not object to the accounting within 90 days, the accounting provided that the beneficiary would be time-barred from lodging any complaint in the future.

When the beneficiary approached us with her complaints regarding the trustee long after the 90-day period had expired, she assumed that she was out of luck and any pursuit of a claim against the trustee was time-barred. In fact, that was not the case.

It is a common misconception that a trust provision exculpating the trustee for breaches of trust, or a trust provision limiting the amount of time during which a beneficiary may bring an action against the trustee for breaches of trust, is automatically effective to protect the trustee. However, there are limits on the impact that an exculpation clause will have.

In general, a beneficiary has three years from the date of receipt of an accounting, or from the date of receipt of any other written report adequately describing a claim against a trustee, to bring a proceeding against a trustee for breaches of trust. An account or report adequately discloses the existence of a claim if it provides sufficient information so that the beneficiary knows of the claim or reasonably should have inquired into the existence of a claim. If an account

or written report is not provided, or otherwise does not adequately disclose the existence of a claim against the trustee, then the three year statute of limitations does not begin to run until the beneficiary discovered, or reasonably should have discovered, the subject of the claim. This means that the statute of limitations on bringing an action against a trustee may, in many cases, never run, because the trustee does not provide the beneficiary with the information necessary to start the running of the statute of limitations.

A provision in the trust document that releases the trustee from liability if the beneficiary fails to object to an item in an account or written report within a specific time period is effective only if certain conditions are satisfied. Those provisions are found in Section 16461 of the California Probate Code, and the clause that provides such time limit must be consistent with the form provided in California Probate Code Section 16461(c).

If the trustee does not comply with these provisions, either the statute of limitations will not begin, or the three year statute of limitations above will apply. Thus, it is important that, in providing accountings or notices to the beneficiaries, the accountings or notices be sufficiently detailed to adequately disclose all relevant information concerning the activities of the trust. If there is a provision imposed by the trust instrument that limits the amount of time that the beneficiary may bring a claim, it is also important that the trustee follow the requirements imposed by Probate Code Section 16461. Because the notice in our client's case did not conform to the requirements of the Probate Code, our client was not time-barred in objecting to certain items provided in the trustee's accounting. ❖

Universal Fiduciary

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fees and potential conflicts of interests. Where the relationship is ongoing, a fiduciary needs to periodically monitor the performance of the expert. Finally, the fiduciary cannot rubber stamp the expert's advice, but instead must analyze it, obtain clarification if needed, and reach an informed and reasoned decision.

Each of these steps is implementable. Fiduciaries must consider the important issues in the administration of their duties; they must review and understand the terms of the governing document; they must make informed decisions; and they must hire advisers when needed. All of those activities are performed by attentive fiduciaries on a regular basis.

However, where a person does not view the fiduciary duties as a separate job from his or her other activities, he is treading on thin legal ice. For example, if a person believes that they are acting as a fiduciary as a favor, or as an agent of the settlor (rather than an independent actor), the potential for problems is great.

In addition to engaging in a prudent process to make decisions, fiduciaries must communicate appropriately with their beneficiaries (or participants, as they are called in the benefits community). While most breaches may occur in the implementation of the governing documents or in the investment of fund assets, a sad reality is that a significant amount of fiduciary litigation has its genesis in the failure to adequately and/or accurately communicate with the beneficiaries.

Education is the first step in helping fiduciaries understand the importance and consequences of their position. Advisers to fiduciaries need to inform them, at the very least, of the need for a prudent process and of the basic steps for implementing that process.

Equipped with that information, some may decide not to serve. In those cases, that decision is probably better for both the nominated fiduciary and for the beneficiaries. On the other hand, others who are willing to be attentive will do a better job . . . for themselves, for the fund, and for the beneficiaries. ❖

Keeping the Beneficiaries Informed Can Avoid Costly Litigation



By Trudi Sabel Schindler (TrudiSchindler@Reish.com)

We are often consulted by a trustee after a petition has been filed with the court compelling the trustee to provide a formal accounting to the beneficiaries of the trust. The wheels of litigation have already been set in motion—leaving the trustee in a defensive position and requiring that the trustee file a response with the court. That involves the expenses associated with compiling a formal accounting and being a respondent in a court proceeding as well as the time and trauma of court proceedings. In the context of a family trust with a family member serving as trustee, the experience of being drawn into court by another family member can be especially trying, divisive and harmful to the family relationship.

Often the court proceedings could have been avoided if the trustee would have been proactive in communicating in keeping the beneficiaries informed of the status of the trust's assets and the activities of the trustee in administering the trust. When a trustee voluntarily provides information, beneficiaries gain confidence in the trustee and mistrust (and litigation) is usually avoided.

By law, the trustee has an affirmative duty to keep the beneficiaries reasonably informed of the trust and its administration. Upon request by the beneficiary, the trustee must report information about the trust's activities relative to the beneficiary's interest in the trust within sixty days of receiving the request. This duty applies to family members serving as trustees as well as institutional trustees.

A report of the trust's activities can be as simple as a report of the trust's assets, liabilities, receipts and disbursements, the acts of the trustee and any other

pertinent information relevant to that particular beneficiary's interest in the trust. This information voluntarily provided on a regular basis is generally enough to set the beneficiary's mind at ease that the trust is being managed properly and that trustee is safeguarding the trust assets and investing them in way with the beneficiary's interests in mind.

If this information is not provided voluntarily and the beneficiary makes a reasonable request for the information that is ignored by the trustee, then the trustee can be the subject of a petition which could require the trustee to file a formal accounting with the court. The accounting must be supported by schedules, financial institution statements and backup receipts for disbursements made by the trustee. In other words, the process can become much more elaborate and costly when a beneficiary must resort to the court for basic information about the trust.

Another advantage to voluntarily providing reports to the beneficiaries on a regular basis is that the information that is disclosed to the beneficiary in the report establishes a time limit for which the beneficiary may object to the trustee's actions in administering the trust—this rule applies for information that is fully disclosed in the trustee's report.

To protect the trustee from challenges by beneficiaries, the trustee is wise to keep accurate and detailed records of all income and disbursements of the trust and any actions taken by the trustee. If the trustee is a family member, as opposed to a professional fiduciary, and there is any doubt that the trustee has the ability to maintain accurate records or provide regular, accurate and adequate reports to the beneficiaries, the trustee should seek the advice of an attorney specializing in trust administration. Good records are the

best means of protection if a beneficiary questions actions taken by the trustee. If the trustee cannot provide adequate records to support his or her actions, the trustee's acts may be presumed to be imprudent. Additionally, the trustee may be ordered to reimburse the trust for disbursements made if there is no record to validate the disbursement.

If a trustee has any doubt as to their ability to keep adequate records, the records should be kept by the trust's attorney or accountant. Even the most organized trustee should periodically review the trust's books and records with the aid of an attorney to correct any errors as soon as possible.

Trusts are generally established by individuals who wish to keep their estate plans private and administered without the court's involvement. If you are serving as trustee, provide information to the beneficiaries on a regular basis and if you receive a request for information from one of the trust's beneficiaries, a timely and complete response within sixty days should satisfy the beneficiary and will likely avoid the matter being brought before the court. ❖

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Further, there seems to be even more trouble where the money is managed by third parties for the benefit of others. As a result, we see a rapidly expanding industry of fiduciary management which, in turn, means there is a need for education to help the fiduciaries and there is a need for litigation to protect the beneficiaries.

Going forward, we believe that both fiduciary education and litigation will be an important part of our law firm's practice, as well as the practice of many other firms.

These newsletters will put the emphasis on education, which will hopefully reduce the need for litigation.

-Fred Reish

Prudent Selection and Monitoring of Providers



By Stephanie Bennett (StephanieBennett@Reish.com)

The fiduciary duties of trustees of individual trusts are dictated by state law. By now, many states have wholly adopted the Restatement Third of Trust's revised standard of prudent investment, known as the "Prudent Investor Rule" or adopted legislation based on its concepts (as California did in 1995).

Under UPIA, a trustee may enlist the help of others by delegating investment and management functions, but the trustee must exercise reasonable care, skill and caution in selecting that individual or company and establish the scope of duties for that individual or company that is consistent with the terms of the trust. The trustee's duties do not end with delegation; under UPIA the trustee has an ongoing duty of "periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation." Similarly, under the Employee Retirement Income Security Act of 1974 (ERISA) fiduciaries of retirement plans may delegate duties and, just as under UPIA, fiduciaries retain the duty to monitor the performance of all service providers.

ERISA's fiduciary obligations regarding selection and ongoing monitoring of providers are similar, but more developed than, the obligations imposed on trustees under UPIA. As a result, trustees of individual trusts can benefit from court cases interpreting ERISA and guidance from the Department of Labor (the "DOL"

is the body authorized to interpret and enforce the provisions of ERISA).

The DOL guidance on selecting a provider focuses on process. That is, in selecting a provider, the trustee should engage in a process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service. Once selected, DOL guidance instructs that the fiduciary who has appointed other fiduciaries has a duty to review the performance of the provider: "At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards and satisfies the needs of the plan." In a later interpretive bulletin, the DOL provided insight into how fiduciaries should address the task of monitoring, "[i]t is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring." In a leading ERISA case, a court outlined the due diligence process required to be followed in connection with the selection of service providers, "At the very least, trustees have a duty to (i) determine the needs of a fund's participants, (ii) review the services provided and fees charged by a number of different providers and (iii) select the provider whose service level, quality and fees best matches the fund's needs and financial situation."

In light of a trustee's duty to prudently select and monitor providers, how should a trustee satisfy that duty?

First, a trustee should establish the scope and terms of the delegation, to effectively communicate that with the provider, and monitor the performance of the service provider. To do that, a trustee should establish procedures to be followed and performance standards or criteria for measuring that performance, which will assist in the trustee's ongoing oversight. For example, for trusts other than very large trusts that have investment managers, the trustee will more than likely enlist the services of an investment adviser to assist in selecting investments. In those situations, the trustee is well-advised to contractually require that the investment adviser create a "portfolio" of well-diversified investments (like mutual funds) consistent with generally accepted investment theories, such as the modern portfolio theory. To do otherwise invites risk.

Finally, any standards or criteria for measuring performance and any documents regarding ongoing monitoring (such as a checklist or some other document memorializing performance) should be reduced to writing. That is, the trustee should maintain documentary proof of ongoing oversight and monitoring of the provider's activities and progress toward any established goals. ❖

Congratulations to Trudi Sabel Schindler

Trudi currently serves as the Legal Update Co-Chair of the Trust and Estate Executive Committee of the Beverly Hills Bar Association.

Using a Prudent Process to Manage Trust Assets



By Debra Davis (DebraDavis@Reish.com)

Trustees of personal trusts are responsible for overseeing the trusts' investments. In fulfilling their responsibilities, trustees are held to the standard of a prudent investor.

The Uniform Prudent Investor Act (UPIA) explains that, in order to satisfy this standard, a trustee must "considering the purposes, terms, distribution requirements, and other circumstances of the trust..." Furthermore, the UPIA requires the trustee to "exercise reasonable care, skill, and caution."

Similar provisions are contained in the Employee Retirement Income Security Act of 1974 (ERISA), which applies to the investment of trust assets for retirement plans. The preamble to UPIA indicates that the authors considered the principles under ERISA to be applicable to other types of trusts as well.

Courts have interpreted the language in ERISA that requires trustees to act as prudent persons to mean that trustees must engage in a prudent process. That is, they must conduct an investigation to obtain relevant information and then use that information to make a reasoned decision. In evaluating whether a fiduciary has satisfied ERISA's requirements, courts have looked at whether the fiduciary engaged in a prudent process when making decisions. One court explained, "In short, there are two related but distinct duties imposed upon a [fiduciary]: to investigate and evaluate investments, and to invest prudently." Similarly, another court explained the process of evaluating whether a fiduciary satisfied their duties by evaluating "whether the

fiduciary employed the appropriate methods to diligently investigate the transaction and...whether the decision ultimately made was reasonable based on the information resulting from the investigation."

Fiduciaries are evaluated objectively on the process used, rather than whether they reached the right decision. As the 5th Circuit Court of Appeals explained, "In determining compliance with ERISA's prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions."

Thus, trustees should use a prudent process when selecting and monitoring the trust's investments. The UPIA states that "[a] trustee shall invest and manage trust assets as a prudent investor would..." "Managing" as used in UPIA reflects a continuing responsibility for oversight of the suitability of investments already made, as well as the decisions regarding new investments. That is, trustees have an ongoing responsibility to evaluate the trust's investments to determine whether they continue to be appropriate for the trust.

Trustees should determine the factors that they will focus on when selecting the trust's investments. Many trustees consult with investment professionals in order to get help with this process. Frequently, an investment policy statement (IPS) will be used to guide the trustees. The IPS describes the process, including the factors that they

may consider when making these types of decisions.

UPIA does not establish specific criteria for the frequency of monitoring the trust's investments. In the context of delegating investment and management functions, the UPIA provides that the trustee must "exercise reasonable care, skill, and caution in...periodically reviewing the agent's actions in order to monitor the agent's performance..."

Trustees should periodically review the trust's investments and compare them to other investments available to the plan. The trustees should analyze whether their investments continue to be appropriate for the trust and, if not, remove and/or replace them.

While there is no explicit requirement, trustees should document their selection and monitoring process in writing. In the event trustees are required to establish that they selected and monitor the trust's investments as a prudent investor, documentation of their activities will be critical to prove that they acted appropriately. ❖

CEFEX Advisory Council

In January, Fred Reish was appointed to the Advisory Council for CEFEX, the Centre for Fiduciary Excellence.

CEFEX is an international organization that provides an independent certification process for fiduciaries. The certification is granted, if a fiduciary organization is qualified, after a detailed fiduciary assessment. The certification provides assurance to investors, including the fiduciaries of retirement plans, that a fiduciary has demonstrated adherence to a standard set of fiduciary practices.

The role of the Advisory Council is to provide recommendations to CEFEX regarding its certification standards and procedures.

Around the Firm

Speeches: Debra Davis and Stephanie Bennett co-presented “Recent Developments for 401(k) Plans” to the California Society of CPAs San Fernando Valley Discussion Group on December 18th. Fred Reish presented the following webcasts “Auto Enrollment and QDIAs—New Rules, New Opportunities” on December 5th; “The Direction of 401(k) Plans: Changes that are Shaping the Future” on November 13th; “Helping Plan Sponsors Manage Their Risk” on November 12th.

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