

Estate Planning Council of Greater Miami
Fiduciary Liability in Troubling Times
Panel Discussion
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ESTATE PLANNING COUNCIL – CASE STUDY A

Decedent died on July 1, 2001, survived by her husband, Mr. Beneficiary, thirty-eight years her junior. Decedent's Last Will and Testament, dated April 1, 2000, bequeathed almost her entire estate (but for \$10,000), to Mr. Beneficiary. Mrs. CFP, decedent's friend and long time financial advisor, was the nominated personal representative and Letters of administration were issued to Mrs. CFP on August 1, 2001.

Decedent's estate was comprised of forty \$1,000 bonds, a house valued at \$100,000 and an investment portfolio with a date of death value of \$600,000. The house and most of the portfolio were distributed in kind to Mr. Beneficiary. The stock was transferred to Mr. Beneficiary on October 1, 2002. Mrs. CFP's final estate accounting shows a loss of \$200,000, representing the difference between the portfolio's value at the date of death and its value on the date Mrs. CFP transferred it to Mr. Beneficiary.

Mrs. CFP made a plan shortly after Letters were issued: to distribute the investment portfolio in kind to Mr. Beneficiary. Decedent's Will did not restrict the personal representative's investment decisions, but the stocks which were in Decedent's estate were stocks she had owned, as invested, for years.

Mr. Beneficiary, being considerably younger than his wife, was the measuring life for the investment horizon, and the stocks were kept as invested given Mr. Beneficiary's age and Mrs. CFP's plan to distribute them in kind. The portfolio had met the income needs of Mr. Beneficiary and the decedent for years prior to decedent's death. The portfolio itself was a varied mixture of stocks, but seventy-five percent of the corpus's value was comprised of stock from only six companies. Though communications were infrequent and eventually antagonistic, Mr. Beneficiary was aware of Mrs. CFP's initial plan and had no apparent objection to it until after the market began a decline. Nor did Mr. Beneficiary take it upon himself to solicit any additional communications with Mrs. CFP or make any requests for liquidation.

On January 2, 2004, Mrs. CFP filed a petition for judicial settlement of her final accounting. Objections were filed by Mr. Beneficiary on March 1, 2004, seeking to surcharge Mrs. CFP for the loss suffered by the estate.

Does the prudent investor rule apply to personal representatives?

Did the personal representative's conduct comply with the prudent investor rule?

Was the personal representative required to liquidate the investment portfolio to cash?

Would you have done anything differently than this personal representative to avoid the litigation filed by the beneficiary?

Should the personal representative be surcharged for the loss in value of the portfolio?

What if we had a corporate personal representative instead of Mrs. CFP?
Does your opinion change?

REFERENCES TO CONSIDER:

- (1) *In re Duffy*, 25 Misc.3d 901, 885 N.Y.S.2d 401 (2009)
- (2) *Nat'l Soc'y for Prevention of Blindness, Inc. v. Parson*, 374 So. 2d 531 (Fla. 4th DCA 1979) (“A personal representative who is under a duty to promptly liquidate securities in an estate, but neglects to do so and their value drops substantially, may be liable for breach of fiduciary duty.”)
- (3) *Barnett v. Barnett*, 424 So. 2d 896 (Fla. 1st DCA 1983) (trustee not liable for decline in market value of stock)
- (4) Section 518.10, Fla. Stat. (2009)

For the purpose of ss. 518.11-518.14, a “fiduciary” is defined as an executor, administrator, trustee, guardian (except any guardian holding funds received from or currently in receipt of funds from the United States Department of Veterans Affairs, to the extent of those funds alone), or other person, whether individual or corporate, who by reason of a written agreement, will, court order, or other instrument has the responsibility for the acquisition, investment, reinvestment, exchange, retention, sale, or management of money or property of another.

- (5) Section 733.612, Fla. Stat. (2009)

733. 612. Transactions authorized for the personal representative; exceptions

Except as otherwise provided by the will or court order, and subject to the priorities stated in s. 733.805, without court order, a personal representative, acting reasonably for the benefit of the interested persons, may properly:

- (1) Retain assets owned by the decedent, pending distribution or liquidation, including those in which the personal representative is personally interested or that are otherwise improper for fiduciary investments.

- (6) Section 518.11, Fla. Stat. (2009)

518. 11. Investments by fiduciaries; prudent investor rule

(1) A fiduciary has a duty to invest and manage investment assets as follows:

(a) The fiduciary has a duty to invest and manage investment assets as a prudent investor would considering the purposes, terms, distribution requirements, and other circumstances of the trust. This standard requires the exercise of reasonable care and caution and is to be applied to investments not in isolation, but in the context of the investment portfolio as a whole and as a part of an overall investment strategy that should incorporate risk and return objectives reasonably suitable to the trust, guardianship, or probate estate. If the fiduciary has special skills, or is named fiduciary on the basis of representations of special skills or expertise, the fiduciary is under a duty to use those skills.

(b) No specific investment or course of action is, taken alone, prudent or imprudent. The fiduciary may invest in every kind of property and type of investment, subject to this section. The fiduciary's investment decisions and actions are to be judged in terms of the fiduciary's reasonable business judgment regarding the anticipated effect on the investment portfolio as a whole under the facts and circumstances prevailing at the time of the decision or action. The prudent investor rule is a test of conduct and not of resulting performance.

(c) The fiduciary has a duty to diversify the investments unless, under the circumstances, the fiduciary believes reasonably it is in the interests of the beneficiaries and furthers the purposes of the trust, guardianship, or estate not to diversify.

(d) The fiduciary has a duty, within a reasonable time after acceptance of the trust, estate, or guardianship, to review the investment portfolio and to make and implement decisions concerning the retention and disposition of original preexisting investments in order to conform to the provisions of this section. The fiduciary's decision to retain or dispose of an asset may be influenced properly by the asset's special relationship or value to the purposes of the trust, estate, or guardianship, or to some or all of the beneficiaries, consistent with the trustee's duty of impartiality, or to the ward.

(e) 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 overproductive of income shall be judged by the portfolio as a whole and not as to any particular asset.

(f) The circumstances that the fiduciary may consider in making investment decisions include, without limitation, the general economic conditions, the possible effect of inflation, the expected tax consequences of investment decisions or strategies, the role each investment or course of action plays within the overall portfolio, the expected total return, including both income yield and appreciation of capital, and the duty to incur only reasonable and appropriate costs. The fiduciary may, but need not, consider related trusts, estates, and guardianships, and the income available from other sources to, and the assets of, beneficiaries when making investment decisions.

(2) The provisions of this section may be expanded, restricted, eliminated, or otherwise altered by express provisions of the governing instrument, whether the instrument was executed before or after the effective date of this section. An express provision need not refer specifically to this statute. The fiduciary is not liable to any person for the fiduciary's reasonable reliance on those express provisions.

(3) Nothing in this section abrogates or restricts the power of an appropriate court in proper cases:

(a) To direct or permit the trustee to deviate from the terms of the governing instrument; or

(b) To direct or permit the fiduciary to take, or to restrain the fiduciary from taking, any action regarding the making or retention of investments.

(4) The following terms or comparable language in the investment powers and related provisions of a governing instrument shall be construed as authorizing any investment or strategy permitted under this section: “investments permissible by law for investment of trust funds,” “legal investments,” “authorized investments,” “using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to

speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital,” “prudent trustee rule,” “prudent person rule,” and “prudent investor rule.”

(5) This section applies to all existing and future fiduciary relationships subject to this section, but only as to acts or omissions occurring after October 1, 1993.

ESTATE PLANNING COUNCIL - CASE STUDY B

Uncle Joe, the Decedent died on May, 1, 1986, was not married and had no issue. Decedent's Last Will and Testament, dated September 1, 1985, bequeathed his entire estate to his niece, Bobbi Joe, under Trust. The Trust named Bobbi Joe as Co-Trustee with the Corporate Trustee. Bobbi Joe as current beneficiary is entitled to income only during her lifetime. The trust specifically states, "My Trustees shall make no distribution of Principal under this Trust during the lifetime of Bobbi Joe." Bobbi Joe is unmarried and in her mid 50's and has no issue. If she dies without issue then, her cousins Billy Joe and Betty Joe are the remaindermen.

Uncle Joe's Trust Under Will was funded in 1986 with approximately \$1,000,000 in stocks and US Treasury Notes. The asset allocation was and has remained over the years approximately 80% Stocks, 15% Fixed Income and 5% Cash Equivalents. Bobbi Joe is not concerned about generating more income from the Trust.

Bobbi Joe interprets the following language in the Trust to mean that she should not sell her Uncle Joe's stocks that he had at his death. "Trustees shall invest and reinvest the assets of this Trust in the same or similar type securities as now constitutes the corpus of this Trust." Also under the Trustee Powers section of the Trust, the following is stated "to retain, invest or reinvest in securities or other property of a kind or in a proportion which ordinarily might not be considered suitable for a trust investment."

As a result, over the last 24 years the Corporate Trustee has not been able to diversify the portfolio due to Bobbi Joe not agreeing to make any changes to the Trust Portfolio in the capacity of Co-Trustee. The Corporate Trustee has taken their fee every year for the last 24 years in any event. Despite the portfolio only containing 15 dividend producing stocks, primarily in the energy and telecommunications sectors, the Trust, net of income distributions and fees has grown to \$2,000,000 or 4.2% per year on average. In addition, you have unrealized long term Capital Gains of \$1,000,000 in this Trust.

After acting as Corporate Trustee for the last 24 years the Corporate Trustee now after surviving the worst economic meltdown in 70 years wants to resign stating that the Co-Trustee, Bobbi Joe, is preventing the Trust from

being diversified in accordance with the Prudent Investor Rule. The Trust requires a Co-Trustee.

Would you accept your appointment as Co-Trustee of this Trust?

If you accept your appointment and Bobbi Joe the Co-Trustee does not agree to any plans to diversify the portfolio, would you feel comfortable with the language contained in the Trust? i.e. "to retain, invest or reinvest in securities or other property of a kind or in a proportion which ordinarily might not be considered suitable for a trust investment." Does this language absolve you from following the Prudent Investor Rule?

What about the capital gains issue discussed previously. Does that impact how you manage according to the prudent investor rule? Given the increase in the Capital Gains rates should you accelerate the recognition of capital gains in 2010?

Is documentation of the portfolio recommendations made by you as Co-Trustee and Bobbi Joe's refusal to act in her capacity as Co-Trustee, sufficient to protect you as Co-Trustee should the portfolio implode?

The asset allocation is 80% Stocks, 15% Fixed Income and 5% Cash Equivalents. It is industry practice that unless there is language to the contrary, a split interest trust should have a balanced allocation so as not to benefit one beneficiary over another, i.e. income beneficiary vs. remainderman. Despite the income beneficiary wanting an allocation that does not benefit her, do you feel that the overweighting in equities is still appropriate? What additional risk does it place on you as Trustee?

Given the current interest rate environment, is it the Trustees obligation to invest in more dividend producing stocks?

If this beneficiary wanted more income, is it the Trustees obligation to bring up the idea of The Trustees Power to Adjust under the Uniform Principal and Income act or is it the responsibility of the income beneficiary to request more income?

What could the current Corporate Trustee do other than resign to limit their

potential liability if anything regarding these circumstances? Even if they resign now after 24 years do they have any exposure as a result of how they acted in the past?

REFERENCES TO CONSIDER:

518. 11. Investments by fiduciaries; prudent investor rule (See Case A for Complete Version of the Statute)

1. (b) No specific investment or course of action is, taken alone, prudent or imprudent. The fiduciary may invest in every kind of property and type of investment, subject to this section. The fiduciary's investment decisions and actions are to be judged in terms of the fiduciary's reasonable business judgment regarding the anticipated effect on the investment portfolio as a whole under the facts and circumstances prevailing at the time of the decision or action. The prudent investor rule is a test of conduct and not of resulting performance.
1. (e) 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.
1. (f) The circumstances that the fiduciary may consider in making investment decisions include, without limitation, the general economic conditions, the possible effect of inflation, the expected tax consequences of investment decisions or strategies, the role each investment or course of action plays within the overall portfolio, the expected total return, including both income yield and appreciation of capital, and the duty to incur only reasonable and appropriate costs. The fiduciary may, but need not, consider related trusts, estates, and guardianships, and the income available from other sources to, and the assets of, beneficiaries when making investment decisions.
2. The provisions of this section may be expanded, restricted, eliminated, or otherwise altered by express provisions of the governing instrument, whether the instrument was executed before or after the

effective date of this section. An express provision need not refer specifically to this statute. The fiduciary is not liable to any person for the fiduciary's reasonable reliance on those express provisions.

738.104 Trustee's power to adjust.

(1) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or shall be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in s. 738.103(1), that the trustee is unable to comply with s. 738.103(2).

(2) In deciding whether and to what extent to exercise the power conferred by subsection (1), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

(a) The nature, purpose, and expected duration of the trust.

(b) The intent of the grantor.

(c) The identity and circumstances of the beneficiaries.

(d) The needs for liquidity, regularity of income, and preservation and appreciation of capital.

(e) The assets held in the trust; the extent to which the assets consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the grantor.

(f) The net amount allocated to income under the other sections of this chapter and the increases or decreases in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available.

(g) Whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.

(h) The actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.

(i) The anticipated tax consequences of an adjustment.

(3) A trustee may not make an adjustment:

(a) That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(b) That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

(c) From any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

(d) If possessing or exercising the power to adjust causes an individual to be treated as the owner of all or part of the trust for income tax purposes and the individual would not be treated as the owner if the trustee did not possess the power to adjust;

(e) If possessing or exercising the power to adjust causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to adjust;

(f) If the trustee is a beneficiary of the trust; or

(g) If the trustee is not a beneficiary of the trust but the adjustment would benefit the trustee directly or indirectly, except that in the case of a trustee

whose compensation for acting as trustee is based upon the value of trust assets, an adjustment that affects the value of trust assets shall not be deemed to benefit the trustee.

(4) If paragraph (3)(d), paragraph (3)(e), paragraph (3)(f), or paragraph (3)(g) applies to a trustee and there is more than one trustee, a co trustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee is not permitted by the terms of the trust.

(5)(a) A trustee may release the entire power to adjust conferred by subsection (1) if the trustee desires to convert an income trust to a total return unitrust pursuant to s. 738.1041.

(b) A trustee may release the entire power to adjust conferred by subsection (1) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (3)(a)-(e) or paragraph (3)(g) or if the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (3).

(c) A release under this subsection may be permanent or for a specified period, including a period measured by the life of an individual. Notwithstanding anything contrary to this subsection, a release of the power to adjust pursuant to paragraph (a) shall remain effective only for as long as the trust is administered as a unitrust pursuant to s. 738.1041.

(6) Terms of a trust that limit a trustee's power to adjust between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power to adjust conferred by subsection (1).

(7) Nothing in this chapter is intended to create or imply a duty to make an adjustment and no inference of impropriety shall be made as a result of a trustee not exercising the power to adjust conferred by subsection (1).

(8) With respect to a trust in existence on January 1, 2003:

(a) A trustee shall not have the power to adjust under this section until the statement required in subsection (9) is provided and either no objection is made or any objection which is made has been terminated.

1. An objection is made if, within 60 days after the date of the statement required in subsection (9), a super majority of the eligible beneficiaries deliver to the trustee a written objection to the application of this section to such trust. An objection shall be deemed to be delivered to the trustee on the date the objection is mailed to the mailing address listed in the notice provided in subsection (9).

2. An objection is terminated upon the earlier of the receipt of consent from a super majority of eligible beneficiaries of the class that made the objection, or the resolution of the objection pursuant to paragraph (c).

(b) An objection or consent under this section may be executed by a legal representative or natural guardian of a beneficiary without the filing of any proceeding or approval of any court.

(c) If an objection is delivered to the trustee, then the trustee may petition the circuit court for an order quashing the objection and vesting in such trustee the power to adjust under this section. The burden will be on the objecting beneficiaries to prove that the power to adjust would be inequitable, illegal, or otherwise in contravention of the grantor's intent. The court may award costs and attorney's fees relating to the trustee's petition in the same manner as in chancery actions. When costs and attorney's fees are to be paid out of the trust, the court may, in its discretion, direct from which part of the trust they shall be paid.

(d) If no timely objection is made or if the trustee is vested with the power to adjust by court order, the trustee may thereafter exercise the power to adjust without providing notice of its intent to do so unless, in vesting the trustee with the power to adjust, the co

738.1041 Total return unitrust.--

(1) For purposes of this section, the term:

(a) "Disinterested person" means a person who is not a "related or subordinate party" as defined in s. 672(c) of the United States Internal Revenue Code, 26 U.S.C. ss. 1 et seq., or any successor provision thereof, with respect to the person then acting as trustee of the trust and excludes the grantor and any interested trustee.

(b) "Fair market value" means the fair market value of assets held by the trust as otherwise determined under this chapter, reduced by all known noncontingent liabilities.

(c) "Income trust" means a trust, created by either an inter vivos or a testamentary instrument, which directs or permits the trustee to distribute the net income of the trust to one or more persons, either in fixed proportions or in amounts or proportions determined by the trustee and regardless of whether the trust directs or permits the trustee to distribute the principal of the trust to one or more such persons.

(d) "Interested distributee" means a person to whom distributions of income or principal can currently be made who has the power to remove the existing trustee and designate as successor a person who may be a "related or subordinate party," as defined in the Internal Revenue Code, 26 U.S.C. s. 672(c), with respect to such distributee.

(e) "Interested trustee" means an individual trustee to whom the net income or principal of the trust can currently be distributed or would be distributed if the trust were then to terminate and be distributed, any trustee whom an interested distributee has the power to remove and replace with a related or subordinate party as defined in paragraph (d), or an individual trustee whose legal obligation to support a beneficiary may be satisfied by distributions of income and principal of the trust.

(f) "Unitrust amount" means the amount determined by multiplying the fair market value of the assets as defined in paragraph (b) by the percentage calculated under paragraph (2)(b).

(2) A trustee may, without court approval, convert an income trust to a total return unitrust, reconvert a total return unitrust to an income trust, or change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust if:

(a) The trustee adopts a written statement regarding trust distributions that provides:

1. In the case of a trust being administered as an income trust, that future distributions from the trust will be unitrust amounts rather than net income, and indicates the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined.

2. In the case of a trust being administered as a total return unitrust, that:

a. Future distributions from the trust will be net income rather than unitrust amounts; or

b. The percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust will be changed, and indicates the manner in which the new unitrust amount will be calculated and the method in which the new fair market value of the trust will be determined;

(b) The trustee determines the terms of the unitrust under one of the following methods:

1. A disinterested trustee determines, or if there is no trustee other than an interested trustee, the interested trustee appoints a disinterested person who, in its sole discretion but acting in a fiduciary capacity, determines for the interested trustee:

a. The percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent;

b. The method to be used in determining the fair market value of the trust;
and

- c. Which assets, if any, are to be excluded in determining the unitrust amount; or
2. The interested trustee or disinterested trustee administers the trust such that:
 - a. The percentage used to calculate the unitrust amount is 50 percent of the applicable federal rate as defined in the Internal Revenue Code, 26 U.S.C. s. 7520, in effect for the month the conversion under this section becomes effective and for each January thereafter; however, if the percentage calculated exceeds 5 percent, the unitrust percentage shall be 5 percent and if the percentage calculated is less than 3 percent, the unitrust percentage shall be 3 percent; and
 - b. The fair market value of the trust shall be determined at least annually on an asset-by-asset basis, reasonably and in good faith, in accordance with the provisions of s. 738.202(5), except the following property shall not be included in determining the value of the trust:
 - (I) Any residential property or any tangible personal property that, as of the first business day of the current valuation year, one or more current beneficiaries of the trust have or have had the right to occupy, or have or have had the right to possess or control (other than in his or her capacity as trustee of the trust), and instead the right of occupancy or the right to possession and control shall be deemed to be the unitrust amount with respect to such property; however, the unitrust amount shall be adjusted to take into account partial distributions from or receipt into the trust of such property during the valuation year.
 - (II) Any asset specifically given to a beneficiary and the return on investment on such property, which return on investment shall be distributable to such beneficiary.
 - (III) Any asset while held in a testator's estate;
- (c) The trustee sends written notice of its intention to take such action, along with copies of such written statement and this section, and, if applicable, the determinations of either the trustee or the disinterested person to:
 1. The grantor of the trust, if living.

2. All living persons who are currently receiving or eligible to receive distributions of income of the trust.

3. All living persons who would receive distributions of principal of the trust if the trust were to terminate at the time of the giving of such notice (without regard to the exercise of any power of appointment) or, if the trust does not provide for its termination, all living persons who would receive or be eligible to receive distributions of income or principal of the trust if the persons identified in subparagraph 2. were deceased.

4. All persons acting as advisers or protectors of the trust.

Notice under this paragraph shall be served informally, in the manner provided in the Florida Rules of Civil Procedure relating to service of pleadings subsequent to the initial pleading. Notice may be served on a legal representative or natural guardian of a person without the filing of any proceeding or approval of any court;

(d) At least one person receiving notice under each of subparagraphs (c)2. and 3. is legally competent; and

(e) No person receiving such notice objects, by written instrument delivered to the trustee, to the proposed action of the trustee or the determinations of the disinterested person within 60 days after service of such notice. An objection under this section may be executed by a legal representative or natural guardian of a person without the filing of any proceeding or approval of any court.

(3) If a trustee desires to convert an income trust to a total return unitrust, reconvert a total return unitrust to an income trust, or change the percentage used to calculate the unitrust amount or the method used to determine a fair market value of the trust but does not have the ability to or elects not to do it under subsection (2), the trustee may petition the circuit court for such order as the trustee deems appropriate. In that event, the court, in its own discretion or on the petition of such trustee or any person having an income or remainder interest in the trust, may appoint a disinterested person who, acting in a fiduciary capacity, shall present such information to the court as shall be necessary for the court to make a determination hereunder.

(4) All determinations made pursuant to sub-subparagraph (2)(b)2.b. shall be conclusive if reasonable and made in good faith. Such determination shall

be conclusively presumed to have been made reasonably and in good faith unless proven otherwise in a proceeding commenced by or on behalf of a person interested in the trust within the time provided in s. 736.1008. The burden will be on the objecting interested party to prove that the determinations were not made reasonably and in good faith.

(5) Following the conversion of an income trust to a total return unitrust, the trustee:

(a) Shall treat the unitrust amount as if it were net income of the trust for purposes of determining the amount available, from time to time, for distribution from the trust.

(b) May allocate to trust income for each taxable year of the trust, or portion thereof:

1. Net short-term capital gain described in the Internal Revenue Code, 26 U.S.C. s. 1222(5), for such year, or portion thereof, but only to the extent that the amount so allocated together with all other amounts allocated to trust income, as determined under the provisions of this chapter without regard to this section and s. 738.104, for such year, or portion thereof, does not exceed the unitrust amount for such year, or portion thereof.

2. Net long-term capital gain described in the Internal Revenue Code, 26 U.S.C. s. 1222(7), for such year, or portion thereof, but only to the extent that the amount so allocated together with all other amounts, including amounts described in subparagraph 1., allocated to trust income for such year, or portion thereof, does not exceed the unitrust amount for such year, or portion thereof.

(6) In administering a total return unitrust, the trustee may, in its sole discretion but subject to the provisions of the governing instrument, determine:

(a) The effective date of the conversion.

(b) The timing of distributions, including provisions for prorating a distribution for a short year in which a beneficiary's right to payments commences or ceases.

- (c) Whether distributions are to be made in cash or in kind or partly in cash and partly in kind.
 - (d) If the trust is reconverted to an income trust, the effective date of such reconversion.
 - (e) Such other administrative issues as may be necessary or appropriate to carry out the purposes of this section.
- (7) Conversion to a total return unitrust under the provisions of this section shall not affect any other provision of the governing instrument, if any, regarding distributions of principal.
- (8) Any trustee or disinterested person who in good faith takes or fails to take any action under this section shall not be liable to any person affected by such action or inaction, regardless of whether such person received written notice as provided in this section and regardless of whether such person was under a legal disability at the time of the delivery of such notice. Such person's exclusive remedy shall be to obtain, under subsection (9), an order of the court directing the trustee to convert an income trust to a total return unitrust, to reconvert from a total return unitrust to an income trust, or to change the percentage used to calculate the unitrust amount. If a court determines that the trustee or disinterested person has not acted in good faith in taking or failing to take any action under this section, the provisions of s. 738.105(3) apply.
- (9) If a majority in interest of either the income or remainder beneficiaries of an income trust has delivered to the trustee a written objection to the amount of the income distributions of the trust, and, if the trustee has failed to resolve the objection to the satisfaction of the objecting beneficiaries within 6 months from the receipt of such written objection, then the objecting beneficiaries may petition the court in accordance with subsection (3).
- (10) This section shall be construed as pertaining to the administration of a trust and is applicable to any trust that is administered either in this state or under Florida law unless:
- (a) The governing instrument reflects an intention that the current beneficiary or beneficiaries are to receive an amount other than a reasonable current return from the trust;

- (b) The trust is a trust described in the Internal Revenue Code, 26 U.S.C. s. 170(f)(2)(B), s. 642(c)(5), s. 664(d), s. 2702(a)(3), or s. 2702(b);
 - (c) One or more persons to whom the trustee could distribute income have a power of withdrawal over the trust:
 - 1. That is not subject to an ascertainable standard under the Internal Revenue Code, 26 U.S.C. s. 2041 or s. 2514, and exceeds in any calendar year the amount set forth in the Internal Revenue Code, 26 U.S.C. s. 2041(b)(2) or s. 2514(e); or
 - 2. A power of withdrawal over the trust that can be exercised to discharge a duty of support he or she possesses;
 - (d) The governing instrument expressly prohibits use of this section by specific reference to the section. A provision in the governing instrument that, "The provisions of section 738.1041, Florida Statutes, as amended, or any corresponding provision of future law, shall not be used in the administration of this trust," or similar words reflecting such intent shall be sufficient to preclude the use of this section; or
 - (e) The trust is a trust with respect to which a trustee currently possesses the power to adjust under s. 738.104.
- (11) The grantor of a trust may create an express total return unitrust which will become effective as provided in the trust document without requiring a conversion under this section. An express total return unitrust created by the grantor of the trust shall be treated as a unitrust under this section only if the terms of the trust document contain all of the following provisions:
- (a) That distributions from the trust will be unitrust amounts and the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined.
 - (b) The percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent.
 - (c) The method to be used in determining the fair market value of the trust.
 - (d) Which assets, if any, are to be excluded in determining the unitrust amount.

ESTATE PLANNING COUNCIL CASE STUDY C: DISTRIBUTABLE “INCOME” IN A LOW YIELD ENVIRONMENT

BACKGROUND

Jack Spratt, a widower, found comfort and a bit a joy in his declining years with Mary, his second wife. His now middle-aged children thought her purely a gold-digger, but tolerated her because she seemed to make Jack happy. Jack provided a trust under his will to provide a life income to Mary, and on her demise the remainder vested with Jack's grandchildren. Jack's eldest son, Joseph and a local trust company are co-trustees of this trust.

Mary “has needs”, due partly to her own health issues. Jack's kids are not terribly sympathetic and are eager to provide the largest nest-egg prudently available for their respective children.

But Mary is no slouch. She hires Hugh Louis Dewey, Esq., who suggests that the corporate trustee adopt an asset mix biased toward fixed income securities and stocks that pay high dividend yields in order to respect the “unstated intent” of Jack Spratt that Mary be well supported. In the current environment (with 10 year Treasury notes yielding barely 4% and the S&P 500 dividend yield about 2.5%), income as traditionally defined is a scarce commodity.

Joe, on the other hand, is concerned that if the Trust Portfolio is managed primarily for current income rather than total return, his children and their cousins will be stiffed out of the inheritance that he believes they deserve.

Bob Banks is the trust officer. What are his alternatives?

1. How does he set asset allocation in a fashion that does not disadvantage either the income beneficiary or the remainder beneficiaries?
2. Over the long-term (although not over the most recent decade), equities have provided significantly higher total return (dividend income plus capital appreciation) than fixed-income securities (bonds). However, these returns are notoriously unpredictable. What is the role of equities and other alternatives in the portfolio?

3. What are Bob's options for possibly taking advantage of asset classes with high return potential, but low income (as traditionally defined)?
4. Can Bob manage this account for "total return" and convert to a unitrust framework? What preconditions, if any, must the facts satisfy?

DISCUSSION

ASSET ALLOCATION: Many institutions have internal policies relating to asset allocation for split interest trusts. In general the allocation to growth-oriented asset classes needs to be sufficiently high to provide a benefit to the remainder beneficiaries. The asset allocation suggested by Mary's counsel was about 40% equities, with those slanted toward current income rather than total return. The asset allocation suggested by the individual co-trustee was 60% in equities and other growth assets, with the equities chosen for appreciation rather than for current income.

A total return portfolio with a specified distribution policy (a unitrust) may provide a better outcome for the remainder beneficiaries.

Bob needs to ascertain a few preconditions:

1. Does the trust instrument permit the Power to Adjust trust assets? This would permit distributions to the current beneficiary from principal.
2. Does governing law permit a unitrust construction? Florida Statute 738.104 (4) permits the trustees to operate the trust as a unitrust with each year's distributions based on a predetermined percentage of the value of corpus as of the start of the year.
3. To use unitrust construction, however, the trustees must release the Power to Adjust. See F.S. 738.104 (5)

A policy can be established, with assent of the individual co-trustee, to move to a more growth-oriented asset mix (up to 60% equities and alternative assets), managed for total return. The current beneficiary would receive distributions based on 4% of the start-of-year portfolio value. In such an instance, the current beneficiary can be indifferent as to the source of returns to the trust, because current distributions are set by formula each year, regardless of whether the payment comes from traditionally-defined income or appreciation.

Based on expected average returns for the asset classes employed, a total return of 6.5% to 7.5% over a normal market cycle seem reasonable, covering current distributions, fees, and an allowance for growth.

POTENTIAL ADVANTAGES:

1. Over a market cycle, if the portfolio grows then the amount of distributions grows, regardless of specific income flows (as traditionally defined).
2. Remainder beneficiaries are likely to have a greater corpus distributed.
3. Current beneficiary has automatic increases when the portfolio grows.
4. Fixed formula eliminates controversy.
5. Establishes commonality of interest: growing the portfolio provides a benefit to both the current and remainder beneficiaries. Potentially reduces family friction, and potentially reduces friction between the corporate trustee and the individual trustee.

DISADVANTAGES

1. Distribution based on total return, hence valuation of corpus, is likely to be more variable than distribution of income as traditionally defined.
2. In periods when market valuations drop, current distributions will take a hit.

KEY TASKS FOR BOB BANKS:

1. Careful reading of trust instrument and advice of trust counsel. If instrument does not specifically prohibit unitrust, then it can be employed.
2. If trust is to be operated as unitrust, then trustees must release Power to Adjust.
3. Corporate Trustee should make a clear explanation of benefits and risks to both parties, so that neither feels that the other receives preference. This conversation should be documented by call report or by a “recap letter” from corporate trustee to both the individual trustee and the current beneficiary.
4. Care must be taken in establishing and communicating asset allocation policy. (We require that the co-trustee sign off on policy allocation.) Rebalancing on a regular basis, a discipline of paring back winners that can mitigate (but not eliminate) market volatility.

APPENDIX: EXCERPTS FROM FS 738.104

(4) If paragraph (3)(d), paragraph (3)(e), paragraph (3)(f), or paragraph (3)(g) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee is not permitted by the terms of the trust.

(5)(a) A trustee may release the entire power to adjust conferred by subsection (1) if the trustee desires to convert an income trust to a total return unitrust pursuant to s. 738.1041.

(b) A trustee may release the entire power to adjust conferred by subsection (1) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power will cause a result described in paragraphs (3)(a)-(e) or paragraph (3)(g) or if the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (3).

(c) A release under this subsection may be permanent or for a specified period, including a period measured by the life of an individual. Notwithstanding anything contrary to this subsection, a release of the power to adjust pursuant to paragraph (a) shall remain effective only for as long as the trust is administered as a unitrust pursuant to s. 738.1041.

(6) Terms of a trust that limit a trustee's power to adjust between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power to adjust conferred by subsection (1).

(7) Nothing in this chapter is intended to create or imply a duty to make an adjustment and no inference of impropriety shall be made as a result of a trustee not exercising the power to adjust conferred by subsection (1).

(8) With respect to a trust in existence on January 1, 2003:

(a) A trustee shall not have the power to adjust under this section until the statement required in subsection (9) is provided and either no objection is made or any objection which is made has been terminated.

1. An objection is made if, within 60 days after the date of the statement required in subsection (9), a super majority of the eligible beneficiaries deliver to the trustee a written objection to the application of this section to such trust. An objection shall be deemed to be delivered to the trustee on the date the objection is mailed to the mailing address listed in the notice provided in subsection (9).

2. An objection is terminated upon the earlier of the receipt of consent from a super majority of eligible beneficiaries of the class that made the objection, or the resolution of the objection pursuant to paragraph (c).

(b) An objection or consent under this section may be executed by a legal representative or natural guardian of a beneficiary without the filing of any proceeding or approval of any court.

(c) If an objection is delivered to the trustee, then the trustee may petition the circuit court for an order quashing the objection and vesting in such trustee the power to adjust under this section. The burden will be on the objecting beneficiaries to prove that the power to adjust would be inequitable, illegal, or otherwise in contravention of the grantor's intent. The court may award costs and attorney's fees relating to the trustee's petition in the same manner as in chancery actions. When costs and attorney's fees are to be paid out of the trust, the court may, in its discretion, direct from which part of the trust they shall be paid.

(d) If no timely objection is made or if the trustee is vested with the power to adjust by court order, the trustee may thereafter exercise the power to adjust without providing notice of its intent to do so unless, in vesting the trustee with the power to adjust, the co