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Financial Planning

Selecting a Fiduciary Is Often The Most Difficult Task of All

The wrong selection of a fiduciary — or correct selection that goes bad — creates litigation risk for all, including the fiduciary

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One need only look at the present amount of wealth stashed in personal trust funds — nearly $850 billion, or roughly one-half of the wealth in 401(k) plans — to confirm that the baby boomer generation will pass a staggering amount of wealth on to their children and grandchildren by means of such funds.

It is no surprise, therefore, that the selection of a fiduciary — be it an executor or trustee — may be the paramount decision when establishing an estate plan as part of the overall financial planning process. And the planner's ability to foresee and deal with issues involved in the transfer of wealth by means of a testamentary instrument may be even more important.

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It is important to explore contemporary considerations, case law and statutes that impact the selection and obligations of a fiduciary, as well as the ever increasing need for estate documents to adequately address the wealth transfer without exposing a fiduciary to litigation.

Statutory Considerations

In the 1950s, Professor Harry Markowitz received the Nobel Prize for his work in developing the modern portfolio theory, which has since revolutionized the way many people view investment returns. By no coincidence, trust investing has similarly undergone a transformation. The Uniform Principal and Income Act, first accepted in 1992, empowered the trustee to make adjustments between principal and income to create a "total return" for the benefit of both current trust beneficiaries and remainder beneficiaries.

In conjunction with the UPIA, the concepts of the "prudent man" and "prudent investor" grew. The prudent man concept allowed for each investment within the trust to be judged based on the investment's safety and return. This concept, however, did not address overall portfolio diversification and the fiduciary's conduct in maintaining the trust assets.

The logical outgrowth of modern portfolio theory, the UPIA and the shortcomings associated with the prudent man concept was the Prudent Investor Act, which was adopted in New Jersey in 1997. N.J.S.A. 3B:20-11.1, et. seq.

The Prudent Investor Act requires a fiduciary to diversify trust investments unless special circumstances exist otherwise. See *Robertson v. Central Jersey Bank & Trust*, 47 F.3d 1268 (C.A. NJ 1995). The act also imposes a standard of conduct upon the trustee relative to the investment decisions being made. No longer would each investment be viewed individually, but rather as part of a specific overall investment strategy.

Finally, the act contains provisions enabling the trustee to delegate certain fiduciary responsibilities, such as the hiring of an investment manager.

In 2001, New Jersey implemented its Uniform Principal and Income Act, enabling the trustee to adjust principal and income distributions to achieve many of the goals set forth in the UPIA. N.J.S.A. 3B:19B-1, et. seq. The law, which essentially creates default rules in the absence of express language in the trust document, allows a safe harbor for total trust returns of 4 to 6 percent.

These statutory changes have resulted in an increase of financial and legal responsibilities being heaped upon the fiduciary, which may only pale in comparison to the standards imposed by our courts.

Case Law Considerations

A fiduciary's foremost duty is to carry out the intentions of the client as expressed in the will or other testamentary instrument. As a natural corollary, the purpose of a testamentary instrument is to benefit its beneficiaries, not the fiduciary charged with carrying out its instructions. See 7 Alfred C. Clapp & Dorothy G. Black, *New Jersey Practice* §990, at 39 (3d ed. 1984).

Thus, the fiduciary's principal responsibility is to ensure that the estate is distributed in accordance with the will as expeditiously as possible. See *Howard Sav. Inst. v. Peep*, 34 N.J. 494 (1961) and *In re Trust of Duke*, 305 N.J. Super. 408 (Ch. Div. 1995).

Indeed, this obligation is an express statutory mandate as well under N.J.S.A. §3B:10-28, which states that an executor "shall proceed expeditiously with the settlement and distribution of a decedent's estate." Additionally, the fiduciary is required to discharge this duty of his own volition, without awaiting an order from a court.

As the Supreme Court noted in *Engle v. Siegel*, 74 N.J. 287 (1977), once litigation ensues with claims alleging that a fiduciary has departed from his obligations under the instrument in question, "a court's task is always to determine the intent of the testator."

Rather than through unyielding adherence to the language within the four corners of the instrument, courts undertaking such an inquiry are guided by the doctrine of probable intent. The *Engle* Court stated:

> While a court may not, of course, conjure up an interpretation or derive a missing testamentary provision out of the whole cloth, it may, on the basis of the entire will. Competent extrinsic evidence and common human impulses strive reasonably to ascertain and carry out what the testator probably intended should be the disposition if the present situation developed.

When determining the testator's subjective intent, courts must give "primary emphasis to [the testator's] dominant plan and purpose as they appear from the entirety of [the] will when read and considered in the light of the surrounding facts and circumstances." See *In re Estate of Dawson*, 136 N.J. 1 (1994). Ultimately, "the court's endeavor is to put itself in the testator's position insofar as possible in the effort to accomplish what he would have done had he 'envisioned the present inquiry.'" *In re Estate of Zahn*, 305 N.J. Super. 260 (App. Div. 1997)(quoting *Fidelity Union Trust Co. v. Robert*, 36 N.J. 561 (1962)).

It is no defense for a fiduciary to point out that boilerplate language in the testamentary instrument grants the fiduciary a measure of discretion, since that fact alone does not alter the court's inherent power to compel the fiduciary's action. While it is often argued, ineffectively, that discretionary power conferred upon a fiduciary is immune from the review of the court absent an abuse of that discretion, a conscientious review of the law reveals that New Jersey courts adhere to a more protective standard. See 7 Alfred C. Clapp & Dorothy G. Black, *New Jersey Practice* §1069 at 245 (3d ed. 1984).

Discretionary powers reposed in a fiduciary are of two main classes: those merely demanding that the fiduciary not act capriciously, and those termed "reasonable discretions," which hold the fiduciary to some objective standard. *City of Englewood v. Allison Land Co*., 45 N.J. Super. 538 (App. Div. 1957).

The *Allison Land* court further noted that the "strong tendency of the law is to construe every discretion so as to bring it within the second class, unless the construction is clearly unwarranted." Pursuant to this protective mandate, if there is any objective standard by which the reasonableness of the fiduciary's judgment can be tested, "the court will generally speaking, control the [fiduciary] if he acts beyond the bounds of a reasonable judgment."

Under the power vested by N.J.S.A. §3B: 14-21, a court may remove a fiduciary when, among other situations, "[h]e has embezzled, wasted or misapplied any part of the estate committed to his custody, or has abused the trust and confidence reposed in him." In addition to this express statutory grant, it has long been recognized that a court of equity may remove and replace a fiduciary pursuant to its inherent power and "paramount duty to see that trusts are properly executed." *Wolosoff v. CSI Liquidating Trust*, 205 N.J. Super. 349 (App. Div. 1985).

Ultimately, as the court in *Wolosoff* noted, a court may remove a fiduciary "for acts done in breach of the trust or detrimental to the welfare of the trust, for lack of honesty or reasonable fidelity to the trust, for acts done which have diminished or endangered the trust, or even to protect the trust against possible future jeopardy."

The most fundamental duty a fiduciary owes to the beneficiaries is that of loyalty. The *Duke* court noted that this standard of utmost fidelity required of a fiduciary forbids the fiduciary to occupy a position of trust if its interests conflict with the estate. Naturally, such actual conflicts of interests are clearly recognized as grounds for removal.

Furthermore, a court is not even required to wait until actual misconduct occurs or the conflict of interest has actually interfered with the fiduciary's obligations. Rather, a court may remove a fiduciary upon a potential conflict when it deems such action necessary to protect the estate.

In addition to the duty of undivided loyalty, there are several other duties imposed upon a fiduciary that find roots in both case law and the statutory considerations set forth above. For example, in the administration of the estate, an executor must observe the standards "that would be observed by a prudent man dealing with the property of another." N.J.S.A. §3B:10-26. As such, as the court stated in *In re Beales' Estate*, 13 N.J. Super. 222 (App. Div. 1951), the prescribed measure of duty "requires a fiduciary to exercise ... that decree of care and caution, skill, sagacity and judgment, industry and diligence, circumspection and foresight that an ordinarily discreet and prudent person would employ in like matters of his own and in the same or similar circumstances."

However, "if the personal representative has special skills or is named personal representative on the basis of representations of special skills or expertise, he is under a duty to use those skills." N.J.S.A. §3B:10-26. In addition to this standard of care, an executor is required to act in the best interests of the estate and must engage in the expeditious and efficient settlement and distribution of the estate's assets without awaiting involvement from the court. See N.J.S.A. §3B:10-23 and §3B:10-28.

Moreover, a fiduciary has a duty to protect the value of the estate from depreciation. Where the estate includes a controlling interest in a corporation, these obligations require the fiduciary to monitor the activities of the corporation and inspect the salaries of the officers.

Selection Process

This evolution of trust and estate law, be it statutory or by case law, coupled with the litigation matrix, lead to the inevitable question — who should be the fiduciary?

The oversimplified answer is that a family member, financial institution, lawyer, accountant or some combination of these options will work best — provided the trust document is drafted properly.

The correct answer, however, involves a thorough analysis of the client's assets, family dynamic, tax considerations and a good old-fashion dose of foresight.

• Closely held business.

The client's ownership of a closely held business immediately triggers a number of issues that must be resolved in the selection of the fiduciary and drafting of the testamentary instrument.

For example, is the business to be sold upon the death of the client, and if so, to whom? What is the sales price? Many times, the fiduciary will be beholden to an existing shareholder's agreement or other succession plan. In the absence of such a plan, the testamentary instrument should provide the fiduciary with guidance on the sale of the business, including how to obtain the sales price and what parties, if any, should be excluded from the sales process.

In addition, the document should address the financing of a sale, including direction on whether or not the fiduciary can accept installment payments or receive pledges of security. With respect to the sales price, the fiduciary should have the authority to retain appraisal services and should be given a safe harbor for selling the business within the appraised range.

If the business is to remain an asset of the trust or estate, does the fiduciary have a conflict of interest with the business? It is not uncommon for a client to name a business associate as a fiduciary in control of stock in a closely held business. Such a selection immediately brings forth issues involving conflicts of interest, and necessarily implicates the fiduciary's "unflagging and undivided duty of loyalty" noted above.

Fortunately, fiduciaries are not subject to the same conflict rules set forth for attorneys. With proper drafting, the client should acknowledge that a conflict may exist as a result of his selection of the particular fiduciary. The client, through the document language, should then provide guidance on those business issues for which the fiduciary is authorized to act or not act.

To insulate the fiduciary's decision, the client may also want to nominate a third party to intervene on particular business issues, such as the decision to sell or determine compensation. In no circumstance, however, should the language of a testamentary document create the possibility that a fiduciary is acting with an unrecognized conflict of interest.

• Diversification of trust assets.

A common underpinning to the UPIA, the Prudent Investor Act and our courts' holdings is that of diversification. In point of fact, the Prudent Investor Act imposes a duty upon the fiduciary to review the trust assets regarding a decision to retain or diversify within six months of receipt.

It should be clarified, though, that these are default rules imposing a duty of care in the absence of specific instruction by the testator. As attorneys, we are taught to avoid the application of default rules whenever and wherever possible. The same teaching should hold true in the drafting of estate documents.

If the client has sizeable real estate holdings, sufficient inquiry should be made to determine if the client would want those holdings sold upon his or her death. The same inquiry should be made regarding closely held business interests.

With marketable securities, a minimal level of planning dictates that the attorney advise the client of the Prudent Investor Act provisions, with an eye toward opting out of such provisions if warranted.

Conversely, the client may want the securities immediately sold, notwithstanding certain tax elections for alternate valuation. In recent years, it has been the authors' experience that the six-month diversification period set forth in the Prudent Investor Act has been used as a shield by fiduciaries who allowed stock portfolios to plunge without proper oversight.

Thoughtful planning, including a mandate to liquidate certain assets within set time periods, could avoid such instances.

• The family dynamic.

It seems almost too logical to require a discussion, but estate or succession planning as part of a comprehensive financial plan must involve a review of the family dynamic.

Which son is not in good graces? Which daughter-in-law is "controlling"?

While these questions may seem improper or difficult to ask of the client, the failure to explore these issues places the fiduciary and the plan in jeopardy.

Knowing the answers to these questions, by contrast, arms the planner with the ability to foresee potential litigation risks. In turn, the planner can arm the fiduciary with the proper testamentary language to address the family dynamic, including spendthrift trust provisions and trust protector powers.

In situations where the estate plan calls for an unnatural distribution of the assets, such as the favoring of one child to the detriment of another, additional considerations in the drafting of the testamentary documents are required.

For example, the client may execute a letter of intent — setting forth a detailed explanation for an unnatural distribution — in conjunction with the plan.

• Tax considerations.

A full analysis of the transfer and income tax considerations in an estate or succession plan is beyond the scope of this article. Nevertheless, tax considerations must be factored into all decisions related to the selection of the fiduciary.

Additionally, the scrivener must provide some level of flexibility when addressing taxation issues, mindful that gift and estate tax applications continue to evolve, subject to the legislative whim of changing administrations.

A final word of caution regarding litigation fees: American jurisprudence has a history and public policy adverse to fee shifting in civil lawsuits. However, judicial exception has permitted fee shifting in a variety of circumstances. And fiduciary breaches that rise to the level of tortious conduct, and that require corrective action necessitating the expenditure of court fees, constitute damages that allow for fee shifting.

The Court recently explained the justification for this carve-out in *In the Matter of the Niles Trust*, 176 N.J. 282 (2003), when it stated, "to hold otherwise would mean that [a tortfeasor] has shifted a substantial portion of the economic burden of his misdeeds to the victims — the beneficiaries of the trusts."

The wrong selection of a fiduciary — or correct selection that goes bad — creates risk to all, including the fiduciary appointed under an instrument of trust. ■