

# Primer for a Trustee of a Revocable Trust

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## Introduction

A fairly well off client comes to you following the death of his or her spouse to discuss what should be done with their revocable living trust. You advise the client to prepare an estate tax return and a final income tax return. It is then time for either you or an attorney to discuss the terms of the couple's revocable living trust which usually require the funding of three trusts referred to as:

- 1) the Exemption Trust (an amount that can pass without being subject to estate tax),
- 2) the Marital Deduction Trust or QTIP Trust<sup>1</sup> (the rest of the decedent's community and separate property left in such a manner as to avoid the estate tax until the surviving spouse dies), and
- 3) the Survivors Trust (the other half of the community property and the survivor's separate property) which technically remains in the existing marital deduction trust.<sup>2</sup>

In many cases, the surviving spouse is both the beneficiary and the trustee of all of these trusts. As such, it is important to determine whether your client has fiduciary responsibilities to contingent beneficiaries such as the children when administering the Exemption and Marital Trusts.

## Who should advise the Trustee

Many surviving spouses acting in their trustee capacity of their spouse's trusts are probably unaware of their fiduciary responsibilities. Thus, the question becomes, should the attorney, accountant, financial advisor, insurance agent or a combination of the above provide advice to the trustee on such issues as:

• As trustee, what are my responsibilities?

• How should the three trusts be funded?

• How should the trust assets be invested (must the trust assets be diversified)?

• Do the children need to be informed about the existence of the trusts if they are the residuary beneficiary?

The answer to whether it is advisable for the estate to hire an attorney, accountant, financial planner or an insurance agent will depend on the facts and circumstances of each case and of each consultant's knowledge of the complex issues faced by a Trustee under California law. The following discussion is intended as a basic summary of some of the areas of California law related to the administration of trusts. It is not intended to be a definitive study of this area of the law which is constantly changing. However, the following discussion is a good starting point for obtaining a better understanding of a trustee's responsibilities under California law.

## California Law - Trustee Duties

The California Probate Code provides that a trustee of a California trust has a duty to administer the trust according to the terms of the trust and to the applicable California law.<sup>3</sup> Thus, a trustee should probably read the trust, a document that usually runs over 50 pages. The trustee of the irrevocable trusts also has to determine his or her responsibilities under the relevant provisions of the California Probate Code.

### Management of the Trust:

A trustee must control and preserve the trust property,<sup>4</sup> make the trust property productive,<sup>5</sup> separate trust property from other property not subject to the trust<sup>6</sup> and make sure that trust property is designated as trust property.<sup>7</sup> The trustee must also enforce claims<sup>8</sup> and defend the trust.<sup>9</sup> In performing these duties, the trustee may not delegate those acts that can reasonably be performed personally nor may a co-trustee delegate the entire administration of the trust to a co-trustee or other person,<sup>10</sup> except in the case of certain

investment and management functions.<sup>11</sup> If a trustee has a special skill, he or she has a duty to apply the full extent of that skill to the duties as a trustee.<sup>12</sup>

Except as otherwise modified by the trust, a trustee must administer the trust with the reasonable care and skill under the conditions then prevailing under which a prudent person acting in a like capacity would use to accomplish the purposes of the trust.<sup>13</sup> This standard of care does not appear to be affected by whether the trustee is compensated.<sup>14</sup>

### Investing Trust Assets - Beneficiary Conflicts:

California law provides that, in the absence of an explicit statement in the trust, if there are two or more beneficiaries, the trustee must invest and manage the trust property impartially, "taking into account the differing interests of the beneficiaries."<sup>15</sup> For this purpose, a beneficiary includes not only the current income beneficiary, but also any person who has any present or future interest, vested or contingent in the trust.<sup>16</sup> Thus, the trustee must consider not only the interest of the surviving spouse but also those of the remainder beneficiaries, often the children.

A trustee also has a duty not to use or deal with the trust property for the trustee's own profit for any purpose unconnected with the trust, or in any transaction in which the trustee has an interest adverse to the beneficiary.<sup>17</sup> However, the trust may provide that the trustee, who is also a beneficiary, may provide for such things as the free use of the family residence or such other common transactions that might otherwise violate the trustee's duty.

A similar rule states that the trustee has a duty to administer the trust "solely in the interest of the beneficiaries."<sup>18</sup> It then states that if the trustee is administering two trusts (such as a QTIP and

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an Exemption Trust) the trustee may sell or exchange property between the two trusts, if the sale or exchange is fair and reasonable with respect to "the beneficiaries of both trusts" and the trustee gives notice of all material facts related to the sale or exchange to all beneficiaries of both trusts.<sup>19</sup>

## Uniform Prudent Investor Act

### Prudent Investing Requirement:

Under the Uniform Prudent Investor Act,<sup>20</sup> except as modified in the trust instrument, a trustee who invests and manages the trust property must comply with the prudent investor rule.<sup>21</sup> There is little guidance on how to do this, as law simply states that the trustee must consider the purpose, terms, distribution requirements and other circumstances of the trust.<sup>22</sup> Moreover, investment and management decisions may not be made in isolation. Rather they should be made taking the entire trust portfolio into account as part of an overall investment strategy having objectives "reasonably" suited to the trust.<sup>23</sup>

Among the circumstances that the trustee should consider when making investment and management decisions of the trust's assets are:

- (1) general economic conditions;
- (2) inflation or deflation;
- (3) the expected tax consequences of investment decisions;
- (4) each investment within the overall context of the trust portfolio;
- (5) the total return from income and appreciation;
- (6) other resources of the beneficiaries known to the trustee as determined from information provided by the beneficiaries;
- (7) the needs for liquidity, regularity of income, preservation or appreciation of income; and
- (8) the assets' special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.<sup>24</sup>

Trying to take all of these objectives into account is probably more than most trustees are capable of. For example, must a trustee invest for capital appreciation as stated in item 5, or can the trustee simply invest in high yield bonds?

### Requirement of Diversification:

After taking all of these objectives into account, the statute provides that a trustee has a duty to diversify the investments of the trust, "unless under the circumstances, it is prudent not to do so."<sup>25</sup> A trustee apparently can not continue to hold the assets historically held by the decedent, since the law states that the trustee is required within a "reasonable time after accepting a trusteeship or receiving trust assets" to review the

assets and make and implement decisions to diversify the assets.<sup>26</sup>

Does this mean that if the trust is silent on the issue a relatively small estate will be required to sell the family residence or closely held business in order to diversify? The answer is not obvious from the statute. What if the trustee sells the house and invests in the stock market which subsequently goes down while the housing prices rise? Apparently this is considered prudent behavior, since the compliance with these diversification standards is determined in light of the facts and circumstances existing at the time of the trustee's decisions and not by hindsight.<sup>27</sup>

### Delegate Investment Decisions:

A trustee who is not skilled in investing may delegate the investment decisions to an investment advisor. In doing so, the trustee must use prudence in selecting an agent and the trustee must establish the scope and terms of the agency. The trustee must also periodically review the agent's overall performance.<sup>28</sup> The agent must act in a manner consistent with the purposes and terms of the trust.<sup>29</sup> The law states that a trustee who follows these rules is not liable to either the beneficiaries or the trust for decisions or actions of the agent to whom the function was delegated.<sup>30</sup> Thus, hiring a professional investment advisor (broker) may be a prudent decision if the trustee is concerned with possible lawsuits by beneficiaries regarding the trustee's investment decisions.

These prudent investor requirements apply both to trusts existing on the effective date of the statute and also to those created after the effective date of the statute.<sup>31</sup>

### Duty to Inform Beneficiaries

When a revocable trust becomes irrevocable, the trustee must notify all the beneficiaries and additional notice must be provided when there is a change of trustees.<sup>32</sup> The notification must be made by mail to the last known address of the beneficiary, unless the beneficiary can not be located after reasonable diligence or if the beneficiary is unknown to the trustee.<sup>33</sup> Notification must be made within 60 days of the time the

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trust becomes irrevocable or the time the trustee commences to serve as trustee.<sup>34</sup> If requested, the trustee must provide a copy of the trust to any beneficiary or any heir of a deceased settlor who requests it.<sup>35</sup>

The notification of the beneficiary must contain the identity of the settlor, the date of the execution of the trust, the name and address of each trustee, the address of the principal place of administration of the trust, any information required by the trust, notification that the beneficiary is entitled receive from the trustee a true and complete copy of the terms of the trust and a warning, set out in 10-point boldfaced type, or a reasonable equivalent thereof, that states the following:

**You may not bring an action to contest the trust more than 120 days from the date this notification by the trustee is served upon you or 60 days from the day on which a copy of the terms of the trust is mailed or personally delivered to you in response to your request during that 120-day period, whichever is later.<sup>36</sup>**

A trustee who fails to serve notice to a beneficiary is responsible for all damages, including attorney's fees and costs caused by that failure, unless the trustee made a good faith effort to comply with the notification requirement.<sup>37</sup> The terms of the trust can not waive this notice requirement, as such waiver is against public policy and therefore void.<sup>38</sup> The trustee may also serve notice to any person in addition to the beneficiaries without incurring any personal liability.<sup>39</sup> Once notification is received, a beneficiary must bring an action to contest the trust within the time period listed in the beneficiary notification, generally the later of 120 days from the date of notification or 60 days from the date of receipt of a copy of the trust.<sup>40</sup>

### Notice of Trust Administration:

Beginning July 1, 1991, trustees have a duty to keep the beneficiaries of the trust "reasonably informed of the trust and its administration."<sup>41</sup>

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## Trustee

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In addition, upon a reasonable request by a beneficiary, the trustee must provide a report regarding the assets, liabilities, receipts and disbursements.<sup>42</sup> In addition, the trustee must also provide particulars relating to the administration of the trust relevant to the beneficiary's interest, including the terms of the trust that describe or affect that interest.<sup>43</sup> These requirements do not begin until the trust becomes irrevocable.

### Accounting Requirement:

There is an accounting requirement which states that a trustee must account annually, at the termination of the trust, and upon the change of trustee to each beneficiary to whom income or principal is required or currently distributed.<sup>44</sup> In those cases in which the surviving spouse is the sole beneficiary and trustee, such as in many QTIP trusts, no accounting will be required. Even if the spouse is not the trustee, an accounting is not required if the living trust was executed prior to July 1, 1987.<sup>45</sup> In addition, the trust may waive the accounting requirement, unless the sole trustee is the decedent's spouse.<sup>46</sup> In those cases where an accounting is not required, a court may require an accounting if there is a showing that it is reasonably likely that a material breach of trust has occurred.<sup>47</sup>

### Scope of the Accounting:

If an accounting is required, it must contain the following information (for either the last fiscal year or for the period since the last accounting):

1. a statement of receipts and disbursements of principal and income;
2. a statement of the assets and liabilities;
3. the trustee's compensation;
4. the names of and the compensation received by agent's hired by the trustee;
5. a statement that the recipient of the accounting may petition the court to review the accounting and the actions of the trustee; and
6. a statement that claims against the trustee for breach of trust may not be made after the expiration of three years from the date the beneficiary receives an account or report disclosing facts giving rise to the claim.<sup>48</sup>

### Who can not be a beneficiary?:

Trustees are usually required to follow the terms of the trust and distribute property as prescribed by the trust or by state law. However, California law provides that no provision of any instrument is valid to make a donative transfer if the transfer is made to:

- (1) the person who drafted the instrument;
- (2) a person related by blood or marriage, a cohabitant with, or an employee

of the person who drafted the instrument (except as provided below).

(3) a partner or shareholder of a law partnership or corporation in which the drafter had an ownership interest;

(4) any person who had a fiduciary relationship with the transferor, including but not limited to a conservator or trustee, who transcribes the instrument or causes it to be transcribed;

(5) a person related by blood or marriage, a cohabitant with, or an employee of the person who transcribed or caused the instrument to be transcribed; or

(6) a care custodian of a dependent adult.<sup>49</sup>

There are exceptions which make an otherwise invalid transfer valid. Thus, a transfer is valid if the beneficiary is related by blood or marriage to or is a cohabitant with the transferee or the person who drafted the instrument.<sup>50</sup> Thus, it appears that "my daughter the attorney" can draft Mom and Dad's trust and still be a transferee. Other otherwise prohibited transfers will be permitted if the instrument is reviewed by an independent attorney who counsels the client about the nature of the transfer and signs and delivers to the transferor and the drafter a certificate essentially stating that the attorney has counseled the settlor and there does not appear to be any fraud, menace, duress, or undue influence. The certificate should contain the following:

### **CERTIFICATE OF INDEPENDENT REVIEW**

I, (attorney's name), have reviewed (name of instrument) and counseled my client, (name of client), on the nature of the transfer, or transfers, of property to (name of disqualified person) contained in such instrument. ... On the basis of this counsel, I conclude that the transfer or transfers... that would otherwise be invalid ... are valid because such transfer, or transfers, are not the product of fraud, menace, duress, or undue influence.<sup>51</sup>

Another otherwise invalid transfer will be valid if there is full disclosure of relationship and it is approved as required by statute.<sup>52</sup> In limited circumstances, the transfer will also be permitted if a court determines, upon clear and convincing evidence (excluding evidence by the prohibited transferee) that the transfer was not the product of fraud, menace, duress or undue influence.<sup>53</sup>

It does not appear that the trustee is under an affirmative duty to determine the validity of trust instrument's provisions as they relate to potentially prohibited transferees, unless the trustee has actual notice of the possible invalidity of the transfer.<sup>54</sup> Once notice is received, the trustee shall not be held liable for failing to make transfers, unless the validity of the transfer has been con-

clusively determined by a court.<sup>55</sup> The statute of limitations for commencing an action to prevent a prohibited transfer other than by will is the later of three years after the transfer becomes irrevocable or three years from the time the person bringing the action discovers, or reasonably should have discovered, the facts material to the transfer.<sup>56</sup>

### Trustees Duty to Determine Principal and Income:

Another duty of the trustee is to classify cash receipts and expenditures as either income or principal. This task is often informally delegated by the Trustee to the accountant who must follow the terms of the trust. California law effective January 1, 2000 generally adopted the (revised) Uniform Principal and Income Act.<sup>57</sup> The purpose of this discussion is simply to highlight a few issues that a trustee may not be aware of given the new law.

California law provides that unless the trust states otherwise, income is the return of money or property derived from the use of principal, including rent, cancellation of a lease, interest, accrued bond discounts, depletion, and certain receipts from unproductive property. Principal is the property held in trust for the eventual delivery to a remainder or income beneficiary and includes proceeds from the sale of principal, the repayment of a loan, proceeds of eminent domain, insurance proceeds, stock dividends or liquidating distributions, and profits received on the change of form of principal.

Some items can be either income or principal depending on facts and circumstances such as corporate distributions and receipts from the disposition of natural resources. Under the revised statute, income from a partnership is based upon actual distributions, not taxable income. Under one new provision, the trustee is given broad powers to adjust items between principal and income accounts to take into account the nature of the trust's investments.<sup>58</sup> Thus, if a trust's portfolio consists mainly of growth stock (and little current income), the trustee may allocate some of the capital gain to the income account.<sup>59</sup>

Some common provisions that are often misclassified as income rather than principal are receipts due, but not paid, at the time of death, accrued interest at the time of death and dividends payable before death but not received until after the death. For example, under the new law, only income actually received is payable to a beneficiary who dies. The beneficiary is not entitled to accrued income (unless the trust states otherwise).

As for expenditures, ordinary expenses incurred in connection with the administration, management or preservation of the trust property, recurring taxes and insurance are to be charged against

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income unless the trust instrument states otherwise. One half of the court costs of attorney's fees and other fees on periodic judicial accounting are charged to income, unless the court directs otherwise. Those trusts that have unusual items of income or expense should seek the advice of an expert in this area.

Trustees are advised to spend some time reviewing (learning) these new provisions. One article not specific to the California law which examines the provisions of the revised Act is Put Your Trust in Trustees by Albert D. Spalding.<sup>60</sup>

## Cutting off Creditors

In some cases, the decedent's assets may be subject to numerous known and unknown creditors. California law provides that a revocable trust is subject to the claims of the decedent's creditors to the extent that the decedent's estate is inadequate to satisfy those claims.<sup>61</sup> In order to cut off liability for those claims, a trustee may commence a notice to creditors by filing with the Superior Court in the county where the decedent resided<sup>62</sup> and serving notice to creditors and publishing notice in local newspapers in order to notify unknown creditors.<sup>63</sup>

The effect of proper notice to creditors through filing, publishing and serving notice is comparable to probating an estate and forces all claimants to file. Since failure to file a claim by whom either commences a legal proceeding or whom secures the surviving spouse's acknowledgment in writing of the liability of the surviving spouse,<sup>64</sup> bars the collection of that claim against the trust.<sup>65</sup> This protection is also afforded to any other trust set up by the decedent and to the trustees and the beneficiaries of the trusts.<sup>66</sup>

This procedure is not mandated, it is simply one choice for the trustee. Thus, the law does not impose any duty on the trustee to initiate the proceeding and the trustee is not liable for failure to initiate the proceeding.<sup>67</sup> However, if the procedure is not followed, a beneficiary of the trust to whom payment, transfer or delivery of trust assets is made, may be personally liable for unsecured claims to the extent of the value of the property received.<sup>68</sup>

This procedure does not affect the interests of the various trusts established by the decedent as against each other for the payment of the decedent's debts.<sup>69</sup> These provisions apply to deceased settlor's who die on or after January 1, 1992.<sup>70</sup>

## Conclusion:

California laws affecting trusts are very complicated and effect most aspects of trust administration. A trustee should attempt to gain as much knowledge of those laws or seek the counsel of skilled advisors to make sure they comply with those laws and the terms of the trust.

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## Endnotes:

- 1...Cal. Probate Code §16001.
- 2...In some cases, a will rather than a trust calls for the funding of similar testamentary trusts.
- 3...Cal. Probate Code §16000.
- 4...Cal. Probate Code §16006.
- 5...Cal. Probate Code §16007.
- 6...Cal. Probate Code §16009(a).
- 7...Cal. Probate Code §16009(b).
- 8...Cal. Probate Code §16010.
- 9...Cal. Probate Code §16011.
- 10...Cal. Probate Code §16012(a).
- 11...Cal. Probate Code §16012(c).
- 12...Cal. Probate Code §16014(a).
- 13...Cal. Probate Code §16040.
- 14...Cal. Probate Code §16041.
- 15...Cal. Probate Code §16003.
- 16...Cal. Probate Code §24.
- 17...Cal. Probate Code §16004(a).
- 18...Cal. Probate Code §16002(a).
- 19...Cal. Probate Code §16002(b)(1) and (2).
- 20...Cal. Probate Code §16002-16003, 16045-16054, Added by Stats. 1995, c. 63 (S.B. 222), §6.
- 21...Cal. Probate Code §16046(a) and (b).
- 22...Cal. Probate Code §16047(a).
- 23...Cal. Probate Code §16047(b).
- 24...Cal. Probate Code §16047(c)(1)-(8).
- 25...Cal. Probate Code §16048.
- 26...Cal. Probate Code §16049.
- 27...Cal. Probate Code §16051.
- 28...Cal. Probate Code §16052(a)(1)-(3).
- 29...Cal. Probate Code §16052(b).
- 30...Cal. Probate Code §16052(c).
- 31...Cal. Probate Code §16054.
- 32...Cal. Probate Code §16060 and §16061.7(a).
- 33...Cal. Probate Code §16061.7(b)(4).
- 34...Cal. Probate Code §16061(d).
- 35...Cal. Probate Code §16061.5(a).
- 36...Cal. Probate Code §16061.7(g).
- 37...Cal. Probate Code §16061.7(f).
- 38...Cal. Probate Code §16061.7(g).
- 39...Cal. Probate Code §16061.7(h).
- 40...Cal. Probate Code §16061.8.
- 41...Cal. Probate Code §16060.
- 42...Cal. Probate Code §16061.
- 43...Id.
- 44...Cal. Probate Code §16062(a).
- 45...Cal. Probate Code §16062(b).
- 46...Cal. Probate Code §16062(c).
- 47...Cal. Probate Code §16064(a).
- 48...Cal. Probate Code §16063.
- 49...Cal. Probate Code §21350(a)(1)-(6).
- 50...Cal. Probate Code §21351(a).
- 51...Cal. Probate Code §21351(b).
- 52...Cal. Probate Code §21351(c) providing for an approval procedure under Article 10 (sections 2580) of Chapter 6 of Part 4 of Division 4.
- 53...Cal. Probate Code §21351(d) applies to instruments executed by non residents, transfers to persons who drafted the document and instruments executed on or before July 1, 1993 by a resident of California.
- 54...Cal. Probate Code §21352.
- 55...Id.
- 56...Cal. Probate Code §21356(b).
- 57...Cal. Probate Code §16320 and following. (Adopted by AB 846, 1997)
- 58...Cal. Probate Code §16335 & 16336.
- 59...See §104 of the Uniform Act.
- 60...Journal of Accountancy, November, 1998.
- 61...Cal. Probate Code §19001(a).
- 62...If the decedent did not reside in California, the filing should be made where trust property is located or where administration of the trust takes place.
- 63...Cal. Probate Code §19003(a) and (b).
- 64...Cal. Probate Code §19330(a), (b).
- 65...Cal. Probate Code §19004(b).
- 66...Cal. Probate Code §19006(a).
- 67...Cal. Probate Code §19010.
- 68...Cal. Probate Code §19400.
- 69...Cal. Probate Code §19007.
- 70...Cal. Probate Code §19012.

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By David Stabbe Orange County/Long Beach Chapter

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