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Discretionary Distributions and Other Fiduciary Exercises of Discretion

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Fiduciary Duties to Beneficiaries

- Duty of Loyalty
  - The trustee shall administer the trust with undivided loyalty to and solely in the best interests of the beneficiaries
  - Generally, conflicts of interest are impermissible unless authorized by the trust instrument; the transaction is approved by the court; or the beneficiary consents to the trustee's conduct, has ratified the transaction or has released the trustee
  - See NJSA 3B:31-55
- Duty of Impartiality
  - The trustee shall act impartially in investing, managing and distributing the trust property, giving due regard to the beneficiaries' respective interests
  - See NJSA 3B:31-56
- Prudent Administration
  - The trustee shall exercise a discretionary power in good faith, in accordance with the trust's terms and purposes and the interests of the beneficiaries, as a prudent person would, exercising reasonable care, skill and caution
  - See NJSA 3B:31-54, -57

Discretionary Distributions: Process

- Two different approaches used by institutional trustees:
  - Individual client advisor responsibility or decision by one senior trust professional
    - Benefits:
      - More efficient use of firm's resources
      - Perception that the decision is more "personal"
  - Committee decision-making
    - Bessemer's approach: advisor discretion only up to the lesser of $10,000 or 5% of the trust's fair market value in any calendar year
    - Benefits:
      - Consistency
      - Application of different skill sets and viewpoints
      - Enhanced risk management

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Information to Evaluate

- Copy of trust instrument and review of the trust's terms
- Statement of assets and income
- Summary of prior requests for distribution
- History of the account value over time
- Written request if an adult beneficiary
- A budget and/or invoices or receipts in certain circumstances
- Implication Model (Monte Carlo simulation)
- Asset allocation
- Discussion of tax consequences (income tax, GST tax)
- Co-trustee approval in writing

Distribution Standards

- Types:
  - Ascertainable standard
    - IRC §2041(b)(1)(A): health, education, maintenance and support
    - Specific standard that the beneficiary can sue to enforce
    - Often used to insure that beneficiary-trustee does not incur negative tax consequences (see NJSA 3B:11-4.1)
  - Broadest discretion:
    - In the trustee's sole/absolute/uncontrolled discretion or as the trustee determines
    - Reduced likelihood of court intervention
  - In between: as many varieties as attorneys can create:
    - Emergency
    - Happiness
    - Best interests
    - Welfare
    - To allow a beneficiary to make gifts

Special Considerations: Other Resources

- Options in the governing instrument regarding whether the trustee should consider the beneficiary's other resources: mandatory, discretionary, prohibited
- When the instrument is silent: look to state law
  - Common law: generally, unless the trust provides otherwise, the trustee should not consider a beneficiary's other assets and income and the beneficiary has a right to look first to the trust assets
  - Law is evolving (e.g., Restatement Third of Trusts, § 50, cmt.e)
- Information to be reviewed if mandatory

Special Considerations: Override of Duty of Impartiality

- Trust instrument negates or modifies duty of impartiality
- Variations:
  - Interests of the current beneficiary (e.g., a spouse) should be considered without regard to the interests of potential remainder beneficiaries
  - Trust for the benefit of a named beneficiary and his or her descendants but "primary" consideration shall be given to the needs of the named beneficiary OR trustee shall first make distributions to child, but may make distributions to child's descendants if child does not need the assets
    - Trustee would likely want a statement from the "primary" beneficiary that he or she does not need and does not plan to request a distribution

Special Considerations: Distributions "For the Benefit Of"

- Trusts often allow distributions to ***or for the benefit of*** the beneficiary
- Common circumstances warranting distributions for the benefit of a beneficiary:
  - Beneficiary is a minor or is otherwise incapacitated
  - Beneficiary has difficulty paying his or her expenses or managing his or her funds
  - Substance-abuse concerns

Special Considerations: Letters of Wishes

- Written guidance to the trustee not contained in the instrument itself, providing instructions to the trustee or a clarification of the settlor's views and intentions
- Most often used with broadly discretionary trusts
- Pros and cons of putting the precatory "wishes" in the trust instrument
- Challenges:
  - Letter conflicts with the provisions of the trust instrument
  - Should the letter be disclosed to the beneficiaries?
  - If a question arises regarding an unambiguous trust term, the letter could be considered "extrinsic" evidence and deemed irrelevant
  - But if an ambiguity exists, outside evidence of the grantor's intent could be relevant

Other Fiduciary Exercises of Discretion

- Exercises discretion not only over distributions but also over other material discretionary powers, which include (but are not limited to):
  - Purchase or sale of "special assets" (e.g., precious metals, private equity, venture capital, real estate, horses, tangibles, life insurance, etc.)
  - Merger or severance of a trust
  - Amending or "decanting" a trust
  - Settling an account non-judicially
  - Discretionary allocations between income and principal
  - Granting or revoking a power of appointment
  - Turning off "grantor trust" status
  - Borrowing or lending
  - Change situs or law governing administration
  - Resignation
  - Appointment of additional or successor trustees
  - Exercise of power to adjust (or in some states, election to convert to a unitrust)

Making Changes

- Amending, decanting, merger or severance
- Frequent uses:
  - Modernize administrative provisions, including to allow for succession of trustees
  - Divide trusts by family branch
  - Segregate particular trust assets

Granting or Revoking a Power of Appointment

- Trust instruments often give the trustee the power to grant or revoke a general power of appointment, or to modify a limited power of appointment to become a general power
  - Rationale: inclusion of the assets in the beneficiary's estate for estate tax purposes may provide tax benefits (e.g., use of beneficiary's GST exemption or step-up in basis of assets)
- Considerations:
  - Request of the beneficiary
  - Information that should be considered: beneficiary's assets, state of domicile, current estate plan including lifetime gifts, personal circumstances of the beneficiary

Borrowing or Lending

- Loans:
  - Can be investment decisions: loans to third parties or even beneficiaries at prevailing market interest rates
  - In certain circumstances, loans can be distribution decisions (e.g., made in lieu of a distribution and for a purpose that is within the discretionary distribution standard)
    - Common uses: short-term financing, preservation of trust assets for future beneficiaries
- Borrowing:
  - May facilitate distributions to beneficiaries without the need to sell trust assets and incur income tax consequences
  - Note: duty of loyalty issues if a trust with a corporate trustee borrows from itself or an affiliated entity
    - Trust instrument or state law should authorize such borrowing

Power to Adjust Between Income and Principal

- A trustee may adjust between principal and income by allocating an amount of income to principal or principal to income if the trust describes what may or must be distributed to the beneficiary(ies) by referring to the trust's income and the trustee determines that it is unable to administer the trust impartially based on what is fair and reasonable to all beneficiaries
- Adjustment between 3-5% (NJSA 3B:19B-4.a)
- Allows the trustee to invest for total return
- Assessment of the statutory factors
- NOT a distribution decision
  - Example
  - No letter of request from the beneficiary required

Factors to Consider in Exercising Power to Adjust

- NJSA 3B:19B-4.b requires consideration of the following factors:
  - Nature, purpose and expected duration of the trust
  - Intent of the settlor
  - Identity and circumstances of the beneficiaries
  - Needs for liquidity, regularity of income and preservation and appreciation of capital
  - The assets held in the trust; their composition; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor
  - Net amount allocated to income and the increase or decrease in the value of the principal assets
  - Whether and to what extent the trust gives the trustee the power to or prohibits the trustee from invading principal or accumulating income
  - Actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation
  - Shifting of economic interests or tax benefits that arise from elections and decisions regarding tax matters; imposition of income
  - Anticipated tax consequences of the adjustment

Revocable Trusts

- Generally, the same considerations and fiduciary duties apply
- BUT:
  - The duties of the trustee are owed exclusively to the settlor while the trust is revocable (NJSA 3B:31-44)
  - In practice, the trustee may not need to exercise its discretion if the settlor is directing the trustee: the trustee may follow a direction of the settlor that is contrary to the trust instrument (NJSA 3B:31-61.a)

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