

The Uniform Prudent Investor Act: Foundation of Fiduciary Responsibility for Pooled Trusts

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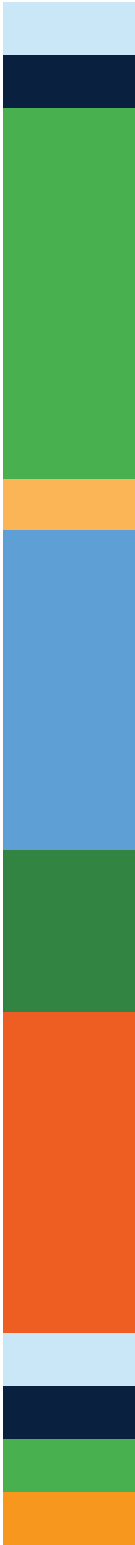


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1. Executive Summary

The Uniform Prudent Investor Act (UPIA) is a landmark statute that has provided valuable guidance for trustees since its approval in 1995. By stating that beneficiaries' portfolios should be viewed in their entirety rather than assessed on single investments, it instructed trustees to diversify investments in order to potentially reduce overall risk and increase returns. An update to the Prudent Man Rule, the UPIA redefined the concept of prudent investment and led to important changes reflected in Modern Portfolio Theory.

One defining principle involves widening the scope of investments to include multiple categories. This shift towards diversification, however, requires increased expertise on the part of trustees to understand which types are appropriate and how to best approach them. This paper aims to help trustees navigate the nuances of the UPIA and better understand how to use its guidelines to fulfill the trustee's duties of loyalty and impartiality to their beneficiaries.

The paper provides an overview of the UPIA, discusses beneficiary planning, and evaluates the principles of appropriate asset allocation, including multiple portfolios, socially responsible investing and tax considerations. It also covers unique asset management and the differences between delegated and directed investment advisory services. Case law affecting trustees is reviewed while providing Best Practice Tips applicable to all fiduciaries.

In summary, this paper covers the following:

The 6 Basic concepts of UPIA:

- 1) Modern Portfolio Theory, as a guiding approach, its value and the tools used to measure risk/return.
- 2) Prudence defined and the expectation that trustees owe a duty to beneficiaries to comply with the prudent investor rule.
- 3) Diversification as an expectation of the UPIA and of the law.
- 4) Delegation and its role and applicability.
- 5) Portfolio Construction, and the 8 considerations for asset selection.
- 6) Duty of loyalty and consideration and the requirement to act in the best interests of the beneficiaries.

A review of how **planning and budgeting** must work across multiple disciplines and factors to be fully complete. A look at how plans evaluate and represent the goals and specific, unique long term needs of the beneficiaries.

A discussion on how **asset allocation** should reflect the beneficiary's goals, financial plan or budget, risk tolerance, and investment horizon. Asset classes (equities, fixed income, cash, and alternatives) are a more important driver for returns than individual assets and therefore the focus for portfolio construction is on the relative weighting of these classes.

A look at how **multiple portfolios** with different asset allocations allow beneficiaries to match their specific circumstances and risk-return profile to an appropriate portfolio. Also included is a brief review of other factors to consider when selecting a portfolio such as socially responsible investing, tax considerations, and risk tolerance.

A legal framework for the fiduciary responsibility for **delegated vs directed** investment management and the factors to consider. Fiduciary duty and advisor review requirements are addressed so that appropriate delegation of responsibilities can be followed and documented.

A discussion on **unique assets** concludes that accommodating unique assets to promote the independence, welfare, and financial empowerment of the pool's beneficiaries is crucial to the ultimate mission of every pooled trust. However, the retention of such assets in trust and their prudent management can be administratively burdensome for PSNT administrators in addition to the potential liability associated with any mismanagement. A review of 5 different types of unique assets – real estate, vehicles, mineral rights, farmland/ranchland/commercial properties, and promissory notes – is presented.

2. Introduction

The primary duty of trustees is loyalty to their beneficiaries. This duty is especially relevant when addressing the investments of a Pooled Special Needs Trust (PSNT), a standalone Special Needs Trust (SNT), or any fiduciary arrangement. The oversight requirements for investments in any of these vehicles are further complicated by public benefits structures and regulations, diverse clientele, fiduciary liability, risk mitigation, and variable tax implications.

3. Uniform Prudent Investor Act

The Uniform Prudent Investor Act (UPIA) is widely considered the industry standard for investing fiduciary assets in vehicles, such as pooled or standalone special needs trusts, traditional trusts, and conservatorships/guardianships. Drafted by the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995, the UPIA replaced the Prudent Man Rule found in *Restatement (Second) of Trusts (Restatement of the Law Second, Trusts, American Law Institute © 1959) ("Restatement (Second)")*. It's important to briefly review guidance and terminology.

Modern Portfolio Theory

The shift from the Prudent Man Rule to the UPIA came about from universal changes in the investment industry that altered the definition of prudence in the fiduciary arena. A robust and widely accepted body of hypothetical and empirical data and practices led to the creation of what is now known as "modern portfolio theory" or MPT. This idea entails that a single investment should not be viewed in a vacuum; rather, it should be evaluated as part of a total portfolio, including its overall risk and return. The various elements of MPT show that an investor can construct a portfolio of multiple types of assets or asset classes that maximize returns while lowering risk or volatility. Some of the key measurement factors in MPT include:

- **Variance:** the difference between the average optimal investment return and volatility
- **Correlation:** the degree to which two investments move in relation to each other
- **Standard Deviation:** the statistical measure that when applied to the annual rate of return of an investment illustrates its historical volatility

- **Efficient Frontier Theory:** a framework for constructing a set of optimal portfolios offering the highest expected rate of return for a defined level of risk (introduced by Nobel Laureate Henry Markowitz)

Prudence

UPIA §1 (a) states that a “trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act]” unless otherwise directed by the trust instrument. The UPIA further explains the fundamental principles of prudent investing, many of which may also be found in the *Restatement (Third) of Trusts*, American Law Institute 2003) (“*Restatement (Third)*”). Prudence may be defined as follows:

- *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830) - “Observe how [people] of prudence, discretion, and intelligence manage 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 the capital to be invested.”
- *Uniform Probate Code §7-302 (1969)* - “The trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent [person] dealing with the property of another ...”
- *UPIA §2(a)* - “A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.”

The first defining principle may be found in UPIA § 2(b), which states that investments “must be evaluated not in isolation but in the context of the trust portfolio as a whole.” Here, the UPIA essentially instructs the trustee not to put total emphasis on any one holding; rather, the trustee should review an asset’s contribution to the entirety of the portfolio as a defining factor of its retention. For example, a trustee should certainly review the health and stability of XYZ stock on its own merits, but XYZ stock’s contribution to diversification and the overall portfolio structure is equally important.

UPIA § 2(b) indicates that the tradeoff between risk and return “reasonably suited to the trust” should be among the trustee’s chief considerations. Additionally, the UPIA lifts all specific investment category or type restrictions that were first promulgated in the Prudent Man Rule, allowing trustees more leeway in developing a prudent asset allocation that fits the needs of the beneficiary while adhering to the terms of the trust (see UPIA § 2(e)). The removal of these restrictions allows the trustee to take into consideration all investments of the trust, including annuities and beneficiary-occupied homes, for example, to properly balance the risk and return of the overall portfolio through asset allocation.

Diversification

Diversification of investments remains a key focus of the UPIA. UPIA § 3 begins with “a trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.” Put simply, diversification is a risk-management strategy that combines a wide variety of different investments and asset classes within a portfolio. In other words, don’t put all your eggs in one basket. Holding securities with similar correlations (e.g., holding Apple and Google stock) may not be as effective as holding a mutual fund or Exchange Traded Fund (ETF) that holds all securities within that sector (e.g., the technology sector) and mitigates the risk of those individual securities’ relative underperformance. Spreading risk over different types of asset classes will on average yield higher long-term portfolio returns while ultimately mitigating the risk of any individual holding within the portfolio. By spreading risk over a wide assortment of assets, diversification smoothes out any unsystematic risk events in the portfolio.

In his 1991 article titled “An Introduction to Modern Financial Theory 20” (*American College of Trust and Estate Counsel Foundation*, 1991), Jonathan R. Macey notes that “diversification reduces risk ... [as] stock price movements are not uniform. They are imperfectly correlated.” At its core, this means that the positive performance of an asset class will most likely neutralize the negative performance of others. As such, diversification only truly benefits PSNT clients when securities in the portfolio are not correlated and respond differently to market influences. This may be achieved not only by investing in different asset classes such as large capitalization (“large cap”), mid cap or small cap stocks, growth versus value stocks, mutual funds (by style, manager, category, etc.), and index-based funds, but also by

investing in diverse geographies (e.g., domestic versus international). Trustees may also wish to review the pros and cons of investing solely in one mutual fund manager. For example, it could be found that a trustee failed to properly diversify a portfolio by only investing in XYZ mutual funds, thus breaching their fiduciary duty should said mutual fund manager dissolve, underperform as a company, or even file for bankruptcy (see Lehman Brothers, 2008). Failure to prudently diversify may have dire consequences for the PSNT. In 2013, a Native American tribe sued the United States, seeking an accounting and asserting a claim for monetary losses and damages relating to an alleged breach of fiduciary duty by the Bureau of Indian Affairs (BIA). The Federal Court held *inter alia* that by keeping unreasonably large balances in relatively low-yield, short-term investments and failing to properly diversify the tribe's portfolio, the BIA breached its fiduciary duty to maximize the trust income. As such, the BIA was ordered to pay the tribe the investment income lost by its imprudent management. *Jicarilla Apache Nation v United States*, 112 Fed.Cl. 274 (2013).

Additionally, a 2012 New York State Appellate Court ruling found that a co-trustee of a testamentary trust violated both the prudent-person rule of investment and the Prudent Investor Act by maintaining a concentration of certain stock in trust for more than 20 years, warranting a surcharge of \$4,322,412.40 with statutory interest. The ruling continues on to state that the co-trustee "never formulated an investment plan for the trust that included diversification of [the] concentration of stock ... and failed to take steps to determine whether retaining non-diversified holdings was in the beneficiaries' best interests." *In re Hunter*, 955 N.Y.S.2d 163, 165 (N.Y. App. Div. 2d Dept. 2012).

Delegation

The last update to the UPIA regarding the Prudent Man Rule is significant in that it is designed to strike an appropriate balance between the advantages and hazards of delegation. The Prudent Man Rule forbade trustees from delegating investment and management functions to third parties. In UPIA § 9, these restrictions are lifted, and delegating these responsibilities is, in fact, encouraged. However, such delegation is subject to certain safeguards and continued trustee oversight, which comes with inherent liability. Delegated investment management and directed investment management are covered later herein.

Portfolio Construction

UPIA § 2 is the heart of the entire Act and is loosely patterned on Restatement Third: Prudent Investor Rule § 227. UPIA § 2(c) illustrates eight governing principles that all fiduciaries should consider in constructing a portfolio:

- 1) **General economic conditions:** the state of the domestic or global economy and how it may affect current and future performance.
- 2) **The possible effect of inflation or deflation:** the increase or decrease of the prices of goods and services.
- 3) **The expected tax consequences of investment decisions or strategies:** analysis of beneficiary and trust tax impact of investments including taxable income, step-up in cost basis, pass-through taxation, capital gains tax, appreciated gains or losses, carry forward losses, etc.
- 4) **The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property:** consolidated portfolio analysis with all assets of the trust included to properly assess risk, return, and diversification.
- 5) **The expected total return from income and the appreciation of capital:** the sum of the income (e.g., interest and dividends) generated by the portfolio, capital gains, distributions, and capital appreciation.
- 6) **Other resources of the beneficiary:** the assets outside of the trust, potential Social Security receipts or wages, annuity payments, etc.
- 7) **Needs for liquidity, regularity of income, and preservation or appreciation of capital:** beneficiary budgeting, Life Care Plan considerations, etc.

- 8) **An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries:** likely a non-productive trust property, such as a beneficiary-occupied residence, in a PSNT.

Duty of Loyalty and Impartiality

Finally, the UPIA stresses the duty of loyalty and impartiality: "A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries" (UPIA § 5). "Duty of loyalty" is perhaps the most pervasive principle throughout trust law. It requires the trustee to act exclusively for the benefit of the beneficiaries rather than for the trustee's own personal interest or in the interest of other third parties (see *Restatement Second* § 170, comment q, at 371). UPIA § 6 states that "if a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries."

It is important to note that "beneficiary" may in some cases refer to remainderpersons of the trust as well. For PSNT beneficiaries, this could mean the PSNT organization itself, Medicaid or the Social Security Administration or the ultimate remainderpersons named in the beneficiary's joinder agreement or trust document. As such, when the trustee owes duties to all such "beneficiaries," loyalty requires the trustee to take into account the interests of all parties when prudently investing and administering the trust. Also tied to these duties of loyalty and impartiality is UPIA § 7, which states that "in investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee." As such, a trustee must carefully consider the cost of investments (investment manager fees, internal fund costs, and the like) as unnecessary spending is at its core imprudent.

A vast majority of states have adopted the UPIA in some form or fashion. Therefore, all factors of the UPIA should be at the forefront of PSNT administrators' minds and investment decisions. Many PSNT administrators may not, however, have this type of investment expertise in house.

Best Practice Tips:

- 1) Keep a copy of the tenets and philosophies of the UPIA as a resource for all staff. (A full copy of the UPIA may be found in **Appendix A**).
- 2) Review your investment professionals and portfolios no less than annually to ensure UPIA compliance.
- 3) Consider annual training provided by the PSNT's investment professional to PSNT staff and Board of Directors on investment tenets.

4. Planning

A PSNT beneficiary will never achieve their goals or have their trust last long without appropriate planning. Both long-term and short-term beneficiary budgeting and planning are crucial to any beneficiary's investment strategy. The PSNT trustee will have to work across multiple disciplines, such as social work, psychology, and fiduciary representation to fully complete the beneficiary's plan. Plan considerations should include the goals and needs of the beneficiary; the beneficiary's unique family dynamics; whether the beneficiary has diminished capacity or special needs; the public benefits the beneficiary may be receiving, is entitled to, or may be eligible for in the future; and the costs and special circumstances involved in the beneficiary's life. The trustee should also educate and advocate for their beneficiaries. In order to do so, the trustee may require the combined services of a multitude of other professionals, such as case managers, public benefits planners, agents under power of attorney, conservators and/or guardians, and investment managers. Any professional involved in the beneficiary's planning procedure may not be entitled to confidential beneficiary information. Although there is a good faith effort to approach these issues in a cooperative matter, it is important for the trustee to recognize potential confidentiality and evidentiary issues.

Best Practice Tip: Remain cognizant of how and when to appropriately disclose the beneficiary's personal protected information.

No two beneficiaries' life goals and circumstances are alike; just as a trustee cannot properly assess a beneficiary's immediate and future needs without a budget or a plan, neither can an investment manager. A thorough assessment of a beneficiary's situation should occur before an investment plan is finalized. In addition to a standard annualized budget for a beneficiary, the following factors should be addressed in the beneficiary's financial plan to assist in the development of their investment strategy:

- Beneficiary disability and its specific costs and planning factors
- Age
- Life expectancy
- Lifestyle/Hobbies
- Employment (current and future)
- Cost of living
- Tax situation (current and future)
- Beneficiary education
- Beneficiary investment knowledge or experience
- Beneficiary risk tolerance
- Life Care Plan (LCP) - **Best Practice Tip:** Obtain both plaintiff's and defendant's counsel LCPs for more accurate planning when available
- Waiver program eligibility (e.g., LTC, HCBS, CC, TBI, Katie Beckett, etc.)
- Community Support Programs eligibility (e.g., HUD)
- Potential future funding opportunities
 - Family lifelong planning (testamentary) or inheritance - **Best Practice Tip:** Heavily discount such potential testamentary funding
 - Additional settlements or awards

Often overlooked in planning for beneficiary needs is a review of the beneficiary's current resources. The PSNT trustee should take into account all facets of the beneficiary's financial situation. For example, should a Structured Settlement Annuity be a part of the trust's funding (both initial and ongoing), it should be factored into the beneficiary's spending plan. In such cases, when reviewing the Structured Settlement Annuity's terms and payout schedules, a trustee may discover that more costly expenditures outlined in the beneficiary's LCP are actually contemplated and fully covered by scheduled lump sum annuity payouts. When funding a beneficiary's PSNT share in testamentary situations, the trustee may discover substantially appreciated legacy assets from a third party. In this case, consultation with a tax professional or investment advisor may be warranted in order to capture any step-up in tax cost basis opportunities or to develop a prudent liquidation strategy that will not be overly onerous to either the beneficiary or the pool as a whole. Simply accepting such appreciated assets "in kind" will not only disserve the current pool beneficiaries from a tax perspective (thus potentially creating a claim of breach of impartiality against the trustee), but may also botch the pool's overall asset allocation strategy by creating an overconcentration in the asset itself or asset allocation class.

Best Practice Tip: Review new joinders' assets with a tax professional or investment manager before acceptance.

When developing a financial plan with the beneficiary, the PSNT trustee should also focus on the beneficiary's passions, hobbies, and goals for their trust.

Best Practice Tip: Record all facets of a beneficiary's lifestyle and desires for future trust use.

At the beginning of the fiduciary relationship, in addition to accounting for the beneficiary's short-term goals for the trust (such as the likely request for the purchase of a house and a vehicle), the trustee should also focus on the beneficiary's long-term goals. These "Optimal Outcomes" focus on the ultimate goals and desires the beneficiaries have for their trusts, whether to provide for their lifetime, start a business, provide for college expenses, pay for annual vacations, or leave a legacy or inheritance for their desired remainderpersons, if applicable. Having these conversations with the beneficiary and, more importantly, recording them are critical in managing the beneficiary's expectations. For example, the

conversation between beneficiary and trustee is much more congenial when the trustee can say “I’m sorry that your SNT cannot afford to purchase you a Ferrari and also send you to college in five years, which you stated was one of your goals for your trust.”

The trustee should also budget for professional costs and fees for the beneficiary. Such costs may include trustee fees, investment advisory fees, tax preparation fees (both for the trust and the beneficiary as applicable), case management fees, and attorney fees. In the final stages of beneficiary financial planning, the trustee should do a cost/benefit analysis of all needs and desires of the beneficiary from the trust versus where such services may be provided for elsewhere. For example, the beneficiary may wish to pay privately for in-home caregivers, even though such services may be available to them through a Medicaid waiver program. A prudent trustee will review such expenditures with an eye towards trust longevity, even if the beneficiary insists otherwise.

Recent case law suggests that it is the SNT trustee’s duty to research all avenues of paying for such requests before approval in order to protect the trust’s longevity. In *Liranzo v. LI Jewish Education/Research*, No. 28863/1996 (N.Y. Sup. Ct. June 25, 2013), a corporate trustee privately paid for caregivers and other services that may have been available to the beneficiary through different public benefits programs. These payments were made at the request of the minor beneficiary’s parent. The trust was quickly depleted, and the trustee sought relief from the court when the trust became uneconomical to retain. The court concluded that the trustee should have sought out all available alternative avenues to pay for such services and directed the trustee to reimburse the trust almost \$176,000. Although there were other factors in *Liranzo*, this case certainly speaks to the duty of the trustee to protect a trust’s longevity, as well as to seek out all available public benefits for a beneficiary as appropriate. The same cost/benefit analysis should be applied in determining how to pay for beneficiary requests. The prudent trustee will properly research the most appropriate avenue (e.g., ownership versus lease) to pay for certain expenses, such as adaptive equipment, accessible vehicles, and housing.

Beneficiaries’ plans change, whether due to unforeseen circumstances or changes in their desires and needs. As such, any financial plan is variable and should be adaptable.

Best Practice Tip: Review each beneficiary's financial plan and budget no less than annually or more frequently as circumstances warrant.

Managing beneficiary expectations from the onset of the fiduciary relationship pays huge dividends throughout the lifetime of the trustee-beneficiary relationship. Typically, if the beneficiary feels like a part of the overall process, the inevitable bumps and hurdles throughout the trust's lifetime are easily overcome together. Without such a beneficiary-specific financial plan, it is nearly impossible to properly select an investment strategy for the beneficiary. Once complete, this financial plan is key in determining the beneficiary's asset allocation and investment strategy.

5. Asset Allocation

Asset allocation refers to how a portfolio's composition is structured over different asset classes to balance risk and reward and account for prudent diversification, a key principle outlined by the UPIA. The asset allocation for a beneficiary's portfolio should reflect the beneficiary's goals, financial plan or budget, risk tolerance, and investment horizon. A PSNT beneficiary's investment horizon is most likely defined by their life expectancy, as the trust is often their only significant financial resource.

When contemplating the proper asset allocation for beneficiaries, an investment advisor typically selects from three major asset classes: equities (stocks), fixed income (bonds), and cash or cash-equivalents. Other asset classes (alternatives, long-short funds, commodities, real estate, etc.) may also factor into the mix. All asset classes have inherently different levels of risk and return and will behave differently over time. "Determinants of Portfolio Performance" is the seminal paper on asset allocation (Gary P. Brinson, L. Randolph Hood & Gilbert L. Beebower (1995) Determinants of Portfolio Performance, *Financial Analysts Journal*, 51:1, 133-138, DOI).

The paper presents evidence that 93.6% of the total return variation in portfolios is due to asset allocation, and not to investment manager selection, individual security selection, or market timing. In other words, the actual selection of the securities within the portfolio (or the timing of their purchase or sale) is secondary to the way that assets are allocated between equities, fixed-income securities, and cash. L. Randolph Hood revisited this issue in the article "Determinants of Portfolio Performance—20 Years Later" and addressed a number of observations and reactions to the original publication. (L. Randolph Hood (2006) "Determinants of Portfolio Performance—20 Years Later": Author's Response, *Financial Analysts Journal*, 62:1, 11-12, DOI.) Randolph, on behalf of himself and his co-authors, reiterated in his later article that "the broad types of asset classes a fund includes in a portfolio and the proportions they represent have a profound effect on the variability of returns." (Id.)

Here again, the beneficiary's financial plan or budget should be a primary consideration in the selection of a proper portfolio asset allocation. For example, a beneficiary with an upcoming large purchase (e.g., home or vehicle) that will significantly deplete their trust's corpus may be better suited in a more conservative mix of cash and fixed income to minimize potential account volatility. Conversely, a young beneficiary with modest spending needs and a longer investment time horizon may be better suited with a heavier exposure to equities in their portfolio as they have more time to ride out the inevitable market fluctuations and potentially reap great returns over time. Certainly, age or time horizon should never be the sole determinant of a beneficiary's asset allocation. However, these factors may serve as a good starting point. When reviewing a pool's investment strategy, asset allocation, and overall prudence, an analysis of the ages of the pool's beneficiaries may be enlightening. A Sample Age Analysis of a pooled trust produced by True Link Financial may be found in **Appendix B**.

The overall industry standard for asset allocation and investment management today understandably revolves around retirement planning and wealth accumulation. While this is generally effective for most of the population, SNTs are typically meant to be "wasting trusts." That is, they are meant to be spent on the beneficiary during the beneficiary's lifetime to improve their quality of life, increase their financial empowerment, and bolster their overall happiness and security. As such, the investment approach for PSNTs should be very different from traditional institutional wealth management. The traditional approach to asset allocation simply builds a bridge between an individual's spending plan and their investment strategy. In a PSNT, the budgeting factors are individual, but the investments are collective. This makes selecting the most prudent asset allocation more difficult but not unachievable.

To overcome this challenge, the most qualified PSNT investment manager will combine individual beneficiary budgets and financial plans with a treasury-management approach to the entire asset pool wherein a subset of the pool's assets is used to satisfy all beneficiaries' spending needs, and the remaining funds are invested with an eye towards growth and longevity. This is also evidenced in PSNTs by beneficiary sub-accounts spending down over a fixed time horizon while in general, the pool itself continues to grow with an indefinite time horizon due in large part to new joinders. If the pool is managed holistically with proper asset allocation coinciding with known beneficiary budgeting, equity exposure for long-term

growth, careful cash management and prudent risk mitigation to preserve principal, and minimization of downside and volatility, the portfolio should ensure appropriate cash flow to cover liabilities even in adverse market conditions.

Multiple Portfolios

One type of asset allocation or portfolio strategy certainly does not fit all beneficiaries. For example, an Income with Growth asset allocation (in which less volatile fixed-income securities outweigh more volatile equity exposure, typically in a 70/30% allocation, respectively) may be suitable for a 55-year-old beneficiary with moderate discretionary distribution needs, but it may not be appropriate for a 6-year-old beneficiary with little to no discretionary distribution needs. Many PSNTs invest in the same way for all their beneficiaries, not taking into account their widely varying needs and situations.

While somewhat counterintuitive, the investment approach that appears “safest” or most conservative does not always equate to fiduciary best practice for all beneficiaries. The case of *In re: Mark Anthony Fowler Special Needs Trust*, No. 39729-3 (WA Ct. App. Feb. 8, 2011) outlines these asset allocation issues. This trust was established in 2000 from a personal injury settlement at which time Mr. Fowler was expected to live another 58 years. (Note here the need again to consider a beneficiary’s life expectancy and needs when developing an investment strategy by utilizing a Life Care Plan if available.) In 2008, the trustee submitted annual accounting to the court that showed a 12% loss in performance during the prior year. In fact, 2008 was a devastating year for most portfolios. The trustee in this case actually outperformed one of the trust’s applicable benchmarks (the S&P 500 Index) by 2.5% over the same time period. The SNT was invested in a typical Growth with Income strategy, with approximately 65% of its assets invested in equities. The trial court refused to approve the trustee’s accounting and ordered all of the trust’s assets to be invested in FDIC-insured money market vehicles with diversified institutions. The trustee’s investment specialist testified against this overly conservative approach, and the court-appointed guardian ad litem concurred with the trustee’s approach, finding that the trustee had invested the assets prudently. The Washington Court of Appeals reversed the lower court’s decision finding that “beneficiaries can be disserved by undue conservatism.”

To properly provide all beneficiaries of the pool with prudent investment options and mitigate fiduciary liability or risk, PSNTs should consider offering their beneficiaries multiple portfolio asset allocation options. PSNTs often use unitization to account for beneficiary activity and balances. As such, it is difficult to imagine multiple portfolios working efficiently and seamlessly within the same pool. Recall that most pooled trust documents are in place not only to allow for the pooling of beneficiary funds for investment purposes, but also to pool beneficiaries under the same legal terms, protections, and restrictions afforded by the trust vehicle itself. Therefore, opening different pools of asset allocation strategies under the same trust document is simply a question of PSNT operational mechanics.

Best Practice Tip: Review the pros and cons of offering multiple portfolio options within the PSNT.

Socially Responsible Investing

Investment advisors are often asked that socially responsible investing (SRI) be included in the PSNT's asset allocation. SRI is also called "sustainable," "socially conscious," "green," or "ethical" investing and is a strategy that considers both financial return and social or environmental impact. While a wonderful concept, SRI should be carefully considered before being included in a PSNT's asset allocation as it may not be consistent with the duty of loyalty prescribed in UPIA § 5. It may be construed that the PSNT trustee is advocating for the acceptance of potentially below-market returns, which are generally associated with SRI. Such a practice may be seen as a breach of loyalty to PSNT beneficiaries by favoring outside interests over the beneficiary's individual returns. In fact, in 1994, the U.S. Department of Labor issued an Interpretive Bulletin analyzing SRI issues as they relate to Employee Retirement Income Security Act accounts (which are also fiduciary vehicles) and indicated that trustees may invest only in conformity with prudence and loyalty standards. This Interpretive Bulletin 94-1, 59 Fed. Regis. 32606 (Jun. 22, 1994), codified as 29 CFR § 2509.94-1 (1994), requires "that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries ... to unrelated objectives."

Tax Considerations

The Tax Cuts and Jobs Act of 2017 introduced significant new tax planning considerations for beneficiaries. Itemized deductions subject to a 2% floor now include tax preparation fees, investment interest expenses, and grantor trust administration expenses (trustee fees, legal fees, accounting fees, etc.). Medical expenses are now deductible only if over 10% of a beneficiary's Adjusted Gross Income in 2019. And, most impactfully, the "Kiddie Tax" has been reintroduced to minors' (d)(4)(a) trusts, third party trusts for minors, Qualified Disability Trusts for minors, and Uniform Gifts to Minors Act (UGMA)/Uniform Transfer to Minors Act (UTMA) vehicles (see Internal Revenue Code (IRC) §652 and IRC §662). As such, trust income ("unearned" versus "earned"—see IRC § 911(d)(2)) in a minor's trust is taxed at the applicable trust tax rate of up to 37% (2019), as opposed to being taxed previously at the minor's parents' tax rate. The appropriate asset allocation may help mitigate these tax burdens.

Best Practice Tip: Identify minor beneficiaries within the PSNT and consult with a tax professional or investment advisor to develop the most prudent investment strategy for these beneficiaries.

Trust Longevity

In order to project a trust's longevity, an investment advisor will typically utilize a Monte Carlo simulation, which models the probability of different investment outcomes. These are not easy to predict due to the intervention of random variables, such as trade disputes, economic conditions, and company failures. Monte Carlo simulations ignore outside factors, such as macroeconomic trends, company stability, media hype, and sector performance data (cyclical or otherwise) to assume an efficient market. By removing such unknowable data and inserting beneficiary-specific financial plans or budgets coupled with projected inflationary data, a Monte Carlo simulation will assist both the trustee and the beneficiary in planning for the beneficiary's long-term financial stability. This exercise is crucial in generating peace of mind for the beneficiary and assisting the trustee in making appropriate plans and discretionary distribution decisions.

Risk Tolerance

Another primary driver in selecting the most appropriate portfolio for a beneficiary is the beneficiary's individual tolerance for market volatility, which is often referred to as the beneficiary's risk tolerance. Put simply, risk tolerance is the amount of variability or volatility in investment returns with which a beneficiary is comfortable. Having an accurate understanding of the beneficiary's ability to weather the inevitable up and down movements of the market is key to successful trust administration and beneficiary expectation management. If a beneficiary is constantly poring over market news and fretting about the security of their portfolio, it can be detrimental to both their mental and physical health. One of the main objectives of all PSNTs is to promote the well-being of its beneficiaries; selecting an inappropriate portfolio for a beneficiary is counter-productive to this goal.

Other factors affecting a beneficiary's risk tolerance include their time horizon, current or future earning capacity, other assets, and a potential inheritance. A PSNT beneficiary's investment time horizon may simply be their life expectancy, as their PSNT sub-account is often their only long-term resource. As mentioned previously, beneficiary short-term and long-term planning is crucial in determining the beneficiary's true investment time horizon. Beneficiaries with a longer investment time horizon may have the ability to take on greater risk because they have a longer time to recoup any potential short-term losses in their portfolio. As discussed later herein, beneficiary assets outside of the trust, such as real estate, should be taken under advisement as well. While beneficiary-occupied real estate may provide more stable growth in the long term for the beneficiary, short-term expenses, such as real estate taxes, insurance, utilities, and maintenance, must be considered in the planning process. Finally, as referred to above, any sort of inheritance that may be in the beneficiary's future should be discounted heavily, as it may never come to fruition.

It is important to emphasize that the investment management approach for PSNT beneficiaries should be quite distinct from traditional wealth management. In the majority of cases, special needs trusts are meant to be spent during the lifetime of the beneficiary to enhance their quality of life. In other words, SNTs are typically considered to be "wasting trusts" and not "wealth accumulation" vehicles, which are standard for traditional investment management. As such, a PSNT's investment management perspective should be centered around asset-liability matching, cash management, and appropriate fiduciary risk analysis.

Best Practice Tip: A PSNT should review how its portfolio incorporates beta (the amount of risk arising from exposure to general market conditions or movement)—as opposed to alpha (the active return of investments versus their applicable benchmark)—as this will play a critical role in a beneficiary’s risk tolerance. Typically, a portfolio that’s more focused on beta will provide a smoother, less volatile return over time, potentially easing a beneficiary’s misgivings in regards to often over-hyped media coverage of market conditions.

Many investment advisors offer Risk Tolerance Questionnaires to their clientele to properly assess each individual’s tolerance for market volatility. Traditional wealth management Risk Tolerance Questionnaires focus on the client’s age, time horizon to retirement, and comfort with market volatility.

Best Practice Tip: PSNT beneficiary Risk Tolerance Questionnaires should take into account other factors crucial to PSNT administration, such as beneficiary disability, life expectancy, LCP expenses, and beneficiary experience with investing overall. As discussed in the Multiple Portfolios section above, accounting for different beneficiaries’ risk tolerances in the context of pooled assets can be difficult. However, with a technologically savvy investment advisor who can aggregate beneficiaries’ risk tolerance levels in accordance with the pool’s investment offerings, this becomes simply a question of operational mechanics.

6. Directed and Delegated Investment Management

Most PSNTs do not have experienced investment professionals on staff. Therefore, the need to delegate or direct the investment advisory duty is paramount to the PSNT's and beneficiaries' continued success. UPIA § 9 states that "a trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances" and continues on to outline the specific parameters and oversight requirements by which a fiduciary should adhere. This section of the Act is largely modeled on *Restatement Third*, Prudent Investor Rule § 171. Additionally, the power to delegate is typically found within a broad set of trustee's powers drafted into the PSNT trust vehicle, in the governing state's Fiduciary Powers Act, or in the Uniform Trustees' Powers Act.

Delegated Investment Advisory

Section 9 of the UPIA makes it abundantly clear that even while delegating the investment function, the trustee still has a fiduciary duty (and therefore continued liability) to the trust and its beneficiaries. With respect to investment management delegation, UPIA § 9(a) states: "[T]he trustee shall exercise reasonable care, skill and caution in (1) selecting an agent." Trust law generally relies upon the duties of loyalty and impartiality to ensure prudent delegation of trust duties. Judicial and audit oversight functions may also protect the beneficiaries' best interests in these cases. In order to prudently select an investment advisor to whom the PSNT will delegate its investment responsibilities, the following factors should be reviewed:

- Past or pending legal actions against the investment firm
- Sample Investment Policy Statement
- Fee schedule
- Investment management agreement
- Staff experience
- SEC or state-specific registration
- Conflict of interest review
- Historical performance comparable to applicable benchmarks
- Soft-dollar arrangements with broker dealers
- Proprietary investment products
- Assets under management
- Insurance coverage
- Data security protocols
- Depth of knowledge in SNT-specific areas

The Office of the Comptroller of the Currency (OCC) is the federal regulatory agency that oversees nationally chartered trust companies. In the OCC Bulletin 2013-29 entitled “Third-Party Relationships: Risk Management Guidance,” the OCC has adopted an even firmer and more robust policy for oversight of trustee delegation. (www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html#). While the OCC does not typically oversee PSNT compliance, their guidelines are a wonderful resource for best practices. The Bulletin states that the “use of third parties does not diminish the responsibility of [the fiduciary] to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws” and that the trustee “should ensure comprehensive risk management and oversight of third-party relationship ... throughout the life cycle of the relationship.” The Bulletin recommends:

- Proper and thorough planning, due diligence in third-party selection, contract negotiation, ongoing monitoring, and independent reviews
- Risk management oversight in regard to client-protected information to include an assessment of the third party’s security
- Assessment of the third party’s financial condition, resilience, and succession planning
- Review of the third party’s insurance coverage and disaster recovery program
- Establishment and annual review of the third party’s performance via applicable benchmarks

While it is understood that most PSNTs will need to delegate the investment function of the trust, extensive vetting of the investment manager must occur to ensure the trustee has fulfilled their duty of loyalty and impartiality to the trust and its beneficiaries. Effectively delegating investment management to an advisor with specialized skills, experience, knowledge, and dedication to the SNT arena will greatly benefit all beneficiaries of the trust. However, delegation to an improper advisor without SNT-specific knowledge will not only be extremely detrimental to the beneficiaries but will also leave the PSNT itself open to risk and potential litigation.

Best Practice Tip: The PSNT Board of Directors or Investment Committee should perform a thorough review of multiple candidates before delegating investment management.

UPIA § 9(a)(2) states that the trustee also needs to exercise reasonable care, skill, and caution in “establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.” This clause reminds the trustee or fiduciary that the investment advisory agreement from the advisor must be carefully reviewed to ensure compliance with the trust’s terms and with the duty of loyalty to the trust and its beneficiaries. As an example, a trustee should not agree to an investment management agreement that fully releases the investment advisor from any and all harm or recompense, thus leaving the trust without recourse in the event of mismanagement. Additionally, the investment management agreement should be reviewed carefully for fee clauses that could potentially allow the advisor to charge an overall fee on assets under management while also collecting an internal fee on their proprietary mutual funds within the portfolio. This practice is commonly referred to as “double dipping.”

Best Practice Tip: Have outside counsel thoroughly review any investment management agreement before executing.

Finally, UPIA § 9(a)(3) states that the trustee has an ongoing duty to “periodically [review] the agent’s actions in order to monitor the agent’s performance and compliance with the terms of the delegation.” Fortunately, in these days of hyper-connectivity and internet access to information, ongoing reviews of the delegated investment advisor are less onerous than in the past. This ongoing monitoring is critical not only to ensure the trust’s beneficiaries are properly and prudently served but also to mitigate the risk and liability inherent in any delegation of trust duties. UPIA § 9(c) states that the delegating trustee “is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.” However, such release of liability is only valid to “a trustee who complies with the requirements ...” to prudently select, establish the scope of, and periodically review the advisor. Case law is littered with examples of trustees and fiduciaries who have been held personally liable for delegating investment management and never prudently reviewing the delegated advisor thereafter. The PSNT trustee should review the delegated advisor using the advisor selection criteria above as applicable, in addition to the following:

- SEC or state-specific annual qualifications/registration
- Adverse regulatory or legal actions, pending, or rulings
- Firm control person review (adverse regulatory/legal action)
- Disaster Recovery Program
- ADV Parts 1 and 2
- ADV/FINRA brochures

Best Practice Tip: Review the delegated investment advisor no less than annually for the above factors as well as comparable rates of return to applicable benchmarks. Keep all such review documentation on file.

Directed Investment Advisory

Many SNT trustees also look to directed trust arrangements as a vehicle to further insulate themselves from potential investment liability. For our purposes, a directed trust arrangement essentially “directs” the trustee to utilize the services of a named investment advisor, with purportedly no continued oversight or duties in respect to said advisor. The Uniform Directed Trust Act (UDTA) was drafted by the National Conference of Commissioners on Uniform State Laws in 2017. As is the case with the UPIA, most states have adopted the UDTA or something similar. The UDTA indicates that in a directed trust, the terms of the trust vehicle grant power to a person (sometimes known as a “trust protector,” “trust advisor,” or “trust director”) other than the trustee over some aspect of trust administration (e.g., investment duties). As such, because the directed trustee’s authority to act with respect to the investments of the trust is reduced or non-existent, the trustee’s fiduciary duty (and liability, potentially) is reduced as well. In common law, directed trust arrangements were noted in both Restatement (Second) § 185 and Restatement (Third) § 75.

A directed trust arrangement does not involve the delegation of a trustee's duty and is therefore not necessarily subject to the delegation oversight requirements previously mentioned. Nor is a directed trust arrangement a co-trusteeship wherein the agent shares in all matters of trust administration and fiduciary duties. Because the agent appointed via direction is vested with specific investment functions, the directed trustee has no perceived ability to act on these duties and, therefore, the trustee's potential liability is lessened. Typically, though, the trustee must continue to ensure there are no acts or failures to act on the part of the appointed investment advisor that would be considered grossly negligent or constitute willful misconduct. As such, some oversight by the directed trustee is implied within the UDTA. For example, if the appointed investment advisor directed all of the trust's holdings to be moved to an offshore bank of which they were an owner, the trustee would be obligated to review the prudence of such and potentially petition a court for instruction.

While directed trust arrangements appear to be a panacea for trustees looking to outsource investment management with reduced oversight requirements, it is important to note that not all oversight duties are completely removed from the trustee. In fact, the directed trustee provisions in the Uniform Trust Code (UTC) § 808 do not bifurcate the investment function and fully remove it from the trustee's fiduciary duties because the trustee will always be liable for the advisor's actions if these actions constitute a breach of trust. Additionally, while some states' directed trustee statutes relieve the trustee of notifying the beneficiaries of the actions of the appointed agent, common law may disagree. This is best illustrated in *Rollins vs. Branch Banking & Trust Co. of Va.*, 2011 WL 34037931 (Va. Cir. Ct. April 30, 2001). In this case, the trustee was directed to hold an individual security, which represented a large portion of the trust's overall portfolio (aka "overconcentration"). The security's value significantly declined, and the trust beneficiaries brought suit against the trustee for failure to diversify the investments, among other claims. The court found that the trustee was not liable for failure to diversify, as the trustee was directed to hold the asset in the trust vehicle. However, the court did find the trustee liable for breach of trust for failing to warn the beneficiaries of the impending decline of the investment.

Best Practice Tip: PSNTs should perform some form of review of directed investment advisors no less than annually, utilizing the above delegated advisor review criteria. Such reviews should remain on file.

7. Unique Asset Management

Inherent in all trust administration, but perhaps more so in the management of trusts for beneficiaries with special needs, is the oversight of atypical or “unique” assets held within a trust. This may be because some beneficiaries with special needs may have diminished capacity or may require the trust to hold unique assets due to their public benefits structure. Additionally, some beneficiaries with disabilities may be particularly subject to undue influence.

Accommodating unique assets to promote the independence, welfare, and financial empowerment of the pool’s beneficiaries is crucial to the ultimate mission of every pooled trust. However, the retention of such assets in trust and their prudent management can be an administrative nightmare for PSNT administrators in addition to the potential liability associated with any mismanagement. Of utmost importance in the management of unique assets is the ability to clearly and concisely report on their existence, their market value, and their holding nature (titling) to all stakeholders, including potential remainderpersons. While reporting duties to beneficiaries and remainderpersons vary state to state, some form of reporting on unique assets will mitigate potential trustee liability and create more documentation for courts or public benefits agencies.

Beneficiary-Occupied Real Estate

The overriding principles guiding unique asset management are perhaps best illustrated in the contemplated purchase of a trust-owned home for a PSNT beneficiary. When contemplating such a purchase, it is crucial to ensure that all economic factors have been taken into account. While permissible, using a majority of the beneficiary’s trust corpus for a home purchase is often unwise for a variety of factors. In doing so, the trustee has potentially violated their duty to diversify the assets of the trust as outlined throughout this paper. *Restatement (Third) § 90* recognizes this issue, noting that “efforts to achieve

diversification within the affected portion of the trust estate will be complicated” by holding real estate “especially [for] trustees of smaller trusts.”

Additionally, the trustee must ensure that such a purchase is sustainable long term and that the trust can still support the beneficiary's spending plan after the purchase is made. The industry standard for allocation of a trust-owned, beneficiary-occupied residence is 15-20% of the trust corpus, assuming that the remaining trust corpus can provide for the beneficiary's needs for their projected lifetime or needs.

Many beneficiaries see the purchase price of the home in relation to the size of their trust as the sole determining economic factor. It is the fiduciary duty of the PSNT trustee to inform the beneficiary of the other economic factors involved in home ownership, such as real estate taxes, upkeep expenses, insurance costs, and utility charges. All of these factors should be prudently accounted for in a home purchase plan (including rising inflation costs annually). Before committing to such a purchase, the trustee or the trustee's investment advisor should perform a Monte Carlo simulation with all relevant factors included to ensure the long-term economic viability of a home purchase.

Additionally, the PSNT trustee should take into account other less recognized factors when considering a home purchase:

- Beneficiary ability to maintain property
- Location safety
- Home accessibility (now and in the future)
- Proximity to beneficiary support services, therapy, doctor, hospital, etc.
- Beneficiary supports needed within the home
- Public benefits impact (if any)

Should the home be purchased in the name of the trust, the trustee maintains the ongoing duty to monitor the home for beneficiary appropriateness and prudence in the beneficiary portfolio's asset allocation. The trustee must also ensure the maintenance and upkeep of the residence as an asset of the trust. Failure to do so may create an improper or unsafe living situation for the beneficiary and create fiduciary liability for the trustee. A PSNT trustee should also be fully prepared for the difficult situation of having to evict a beneficiary and/or sell the residence if required to fund the beneficiary's long-term needs. Additionally, a professional valuation appraisal should be conducted on the residence from time to time not only to accurately reflect the value of the home on statements but also to ensure continued public benefits eligibility should the home's value escalate above appropriate limits. There is no substitute for the delegation of these functions to a local, knowledgeable, experienced, and properly vetted property manager.

Best Practice Tip: Delegate trust-owned, beneficiary-occupied residence oversight to a local, experienced property manager vetted in accordance with the recommendations made in OCC Bulletin 2013-29 Third-Party Relationships: Risk Management Guidance ("OCC Bulletin 2013-29"). (www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html#).

Vehicle Liens

Direct trust ownership of vehicles by PSNTs is inadvisable due to liability, insurance, and titling concerns. Auto accidents are inevitable. Even if driver records and liability were properly handled, a savvy personal injury attorney will always look for bigger pockets (in this case, the PSNT itself) in the event of accidents.

A vehicle lien in favor of the PSNT on a vehicle purchased by a beneficiary's trust is an excellent remedy. Such liens assist in documenting sole benefit (as necessary) and give the trustee recourse should the beneficiary attempt to sell the vehicle without trustee approval. Documenting the existence of such a lien in favor of the PSNT on a beneficiary's statement can potentially prevent unwarranted questions from public benefits agencies about beneficiary spending on oil changes, license plates, etc., and their sole benefit implications.

Best Practice Tip: List automobile liens on beneficiary sub-account statements.

Mineral Interests

Management and oversight of oil and gas, mineral, and water rights interests can be one of the most challenging aspects of trust administration. The task of prudently managing and supervising such holdings requires extraordinarily specialized skill sets not typically found in-house with most PSNT trustees. Because such interests are considered “depleting resources,” the simple procedure of receiving and depositing an income check from working interests of these types of assets requires adherence to the Uniform Principal and Income Act when allocating between principal and income as required by the trust vehicle and/or trust’s tax circumstances. Additionally, division orders or sale propositions can be extremely confusing to a non-professional in this arena. Other factors involved in the management and oversight of these assets include:

- Tax and legal evaluation
- Investment prudence
- Potential pool unitization complications
- Enhanced scrutiny and higher liability
- Complicated contract/leasing negotiations
- Ownership review for sole benefit issues

It is recommended that such assets be listed on the beneficiary’s sub-account statement to avoid complications and questions in terms of funding. For example, if such asset was not listed on a beneficiary’s statement but checks were being deposited from income derived from a working interest, a public benefits agency review may question these deposits as a commingling of first and third-party monies, or more detrimentally, as income to the beneficiary. As such, and as stated before, there is truly no substitute for the delegation of these functions to a knowledgeable, experienced, and properly vetted interest manager.

Best practice tip: Delegate oil and gas, mineral, and water rights management to an experienced interest manager vetted in accordance with the recommendations made in OCC Bulletin 2013-29.

Farmland, Ranchland, and Commercial Real Estate

Many of the same practices and tips above apply to the management of farmland, ranchland, and commercial real estate owned by a trust. However, these assets are also subject to complex titling, income payout structures, participation schedules and taxation, potentially complicating sole benefit determinations. Further compounding the difficulties with these assets are their inherent illiquidity and potential calls for capital to keep these business ventures afloat. Some of these same issues exist with closely held business interests and non-marketable securities. Restatement (Third) § 90, comment o, advocates for limited retention of these types of assets by stating that “real estate is a potentially valuable ingredient of a diversification strategy, especially in light of its limited covariance with publicly traded equity and debt securities.” However, *Restatement (Third)* § 90 continues, indicating that “it would not be prudent for a trustee to disregard the complexities, burdens and special risks associated with a decision to commit a portion of the trust estate to such investments.”

When considering whether to accept a closely held business interest, commercial real estate, or LLC/LLP into the trust, the ownership and partnership agreements must be carefully reviewed.

Best Practice Tip: Engage outside counsel to review ownership and partnership agreements. Should the trust have management duties (e.g., general partner), the delegation of management to a knowledgeable, experienced, and properly vetted business manager is highly recommended.

When a beneficiary's trust owns these types of assets, protecting their public benefits may become complicated. For example, a public benefits agency may inquire as to how capital call or funding distributions to these businesses qualify as being for the sole benefit of the beneficiary. Additionally, the PSNT trustee must analyze whether the potential ongoing

monetary drains on the trust are actually prudent investments in terms of asset allocation, beneficiary spending, and trust longevity.

Promissory Notes

It is not unusual for a PSNT trustee to encounter a situation wherein the issuance of a promissory note from a beneficiary's trust to a third party or to the beneficiary themselves can be a valuable tool. The trustee must take great care to preserve the beneficiary's public benefits in such cases. Recently, there have been many public benefits agencies nationwide taking exception to the issuance of promissory notes, leading them to suspend or outright deny beneficiaries' access to crucial benefits. In a survey of PSNT Executive Directors in 2019, the two primary reasons cited by public benefits were: 1) sole benefit concerns when monies are loaned to a third party, and 2) available/countable resource issues when the trustee has loaned the monies to the beneficiaries. While both of these situations are reasonably well covered in the Social Security Administration's Program Operations Manual System ("POMS") § SI 01140.300, it remains an ongoing issue. In order for a promissory note to be prudent and to maintain the duties of loyalty and impartiality to the beneficiary, the trustee must set an appropriate interest rate and payback/amortization schedule with the borrower.

Best Practice Tips: Engage outside counsel for the drafting of any promissory note to ensure that any creditor protection/spendthrift clauses of the trust are not violated. Set the promissory interest rate and payoff terms at current market rates and practices.

Finally, before accepting such unique assets into a PSNT or a standalone SNT, the trustee must thoroughly review and contemplate all aspects of such assets to ensure they are truly prudent holdings. These types of assets include, but are not limited to, closely held business interests, non-marketable securities, life insurance policies, promissory notes, LLCs/LLPs, commercial real estate, and tangible personal property.

Best Practice Tip: Delegate management, oversight, and valuation of these assets to experienced third-party managers vetted in accordance with the recommendations made in OCC Bulletin 2013-29 Third-Party Relationships: Risk Management Guidance (“OCC Bulletin 2013-29”). (www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html#).

Some other aspects the trustee should review before accepting such assets include:

- Effect on public benefits
- Funding of business interests
- Tax considerations
- Annual valuations
- Asset allocation/concentration of the investment relative to the marketable portion of the portfolio
- Pool unitization implications, if applicable
- Overall trust liability (e.g., environmental liability of commercial real estate)
- Partnership/ownership structure
- Appropriate access to information
- Principal and income accounting in conjunction with the Uniform Principal and Interest Act
- Life insurance policy review
- Safekeeping of agreements or tangible personal property
- Listing on statements

- Ongoing monitoring
- Third-party vendor monitoring

8. Conclusion

A PSNT trustee provides vital services and advocacy to beneficiaries with disabilities and makes more tangible differences in their lives than “traditional trust” trustees. In order to properly invest a PSNT’s assets, trustees should consider every precaution and best practice applicable herein to ensure risk mitigation so that they can continue to serve a community that deserves the assistance of dedicated and attentive fiduciaries. For easy reference, a full list of **Best Practice Tips** may be found in **Appendix C**.

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Any views or opinions expressed are solely those of the author and do not necessarily represent those of True Link Financial Advisors, LLC.

Appendix A

Uniform Prudent Investor Act

The Uniform Prudent Investor Act was drafted by the National Conference of Commissioners on Uniform State Laws and by it approved and recommended for enactment in all the states at its 103rd annual conference in Chicago, Illinois, July 29 - August 5, 1994.

Approved by the American Bar Association, Miami, Florida, February 14, 1995

The Committee that acted for the National Conference of Commissioners on Uniform State Laws in preparing the Uniform Prudent Investor Act was as follows:

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Uniform Prudent Investor Act

Section 1. Prudent Investor Rule

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

Section 2. Standard of Care; Portfolio Strategy; Risk and Return Objectives

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

- (1) general economic conditions;
- (2) the possible effect of inflation or deflation;

- (3) the expected tax consequences of investment decisions or strategies;
- (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
- (5) the expected total return from income and the appreciation of capital;
- (6) other resources of the beneficiaries;
- (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

Section 3. Diversification

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

Section 4. Duties at Inception of Trusteeship

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

Section 5. Loyalty

A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Section 6. Impartiality

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Section 7. Investment Costs

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

Section 8. Reviewing Compliance

Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

Section 9. Delegation of Investment and Management Functions

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

- (1) selecting an agent;
- (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
- (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

Section 10. Language Invoking Standard of [ACT]

The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this [Act]: “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 man rule,” “prudent trustee rule,” “prudent person rule,” and “prudent investor rule.”

Section 11. Application to existing trusts

This [Act] applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this [Act] governs only decisions or actions occurring after that date.

Section 12. Uniformity of Application and Construction

This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among the States enacting it.

Section 13. Short Title

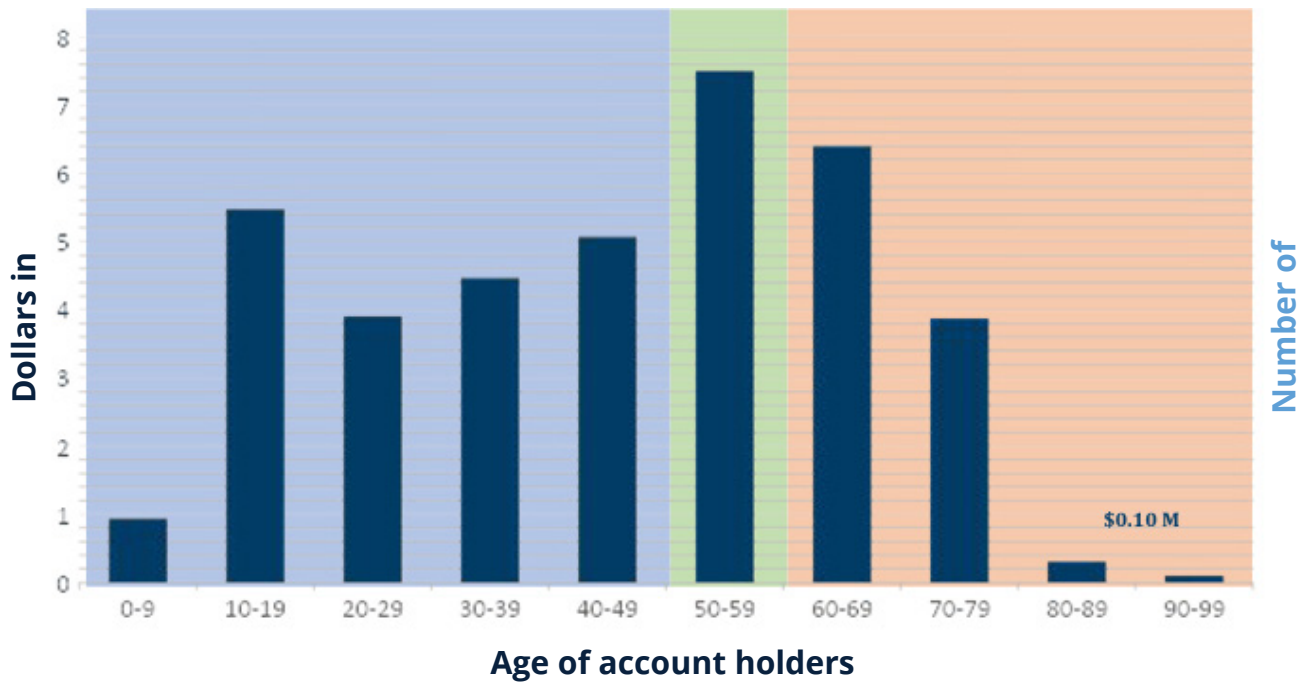
This [Act] may be cited as the “[Name of Enacting State] Uniform Prudent Investor Act.”

Section 14. Severability

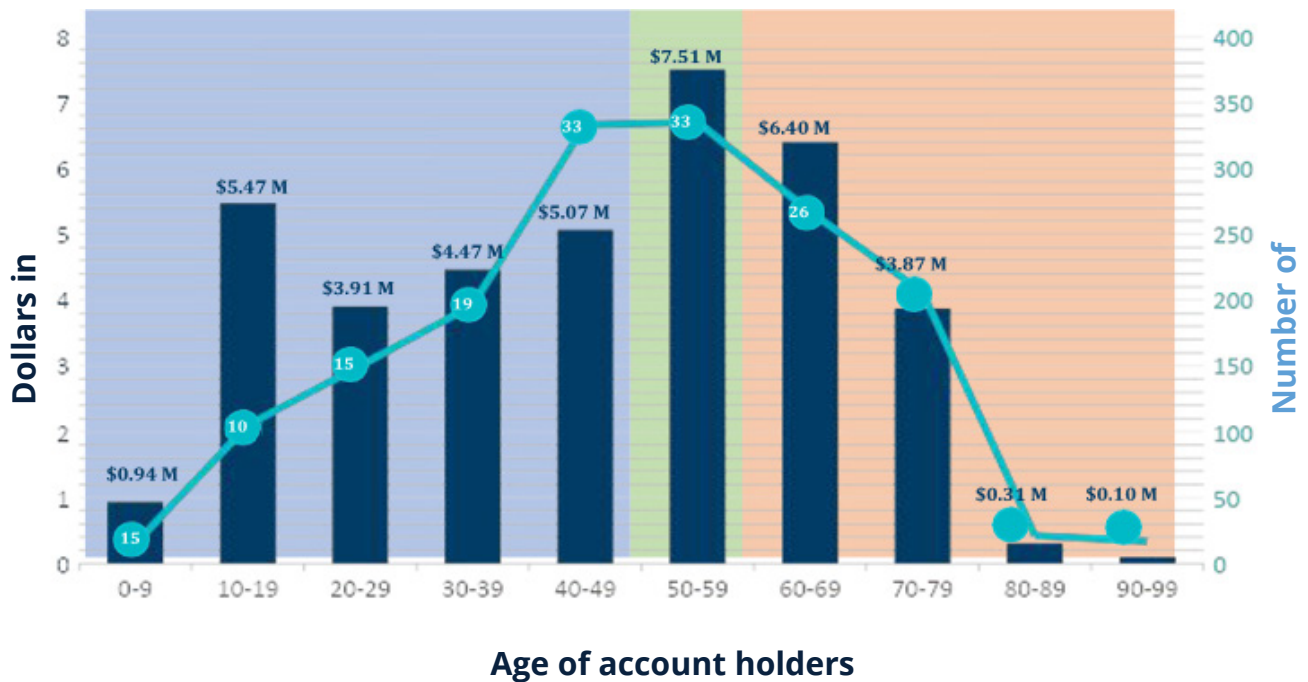
If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

Appendix B

Pooled Trust Beneficiary Age Analysis



Account Values by Beneficiary Age



Source: True Link

- Strategic differentiation based on beneficiary age groups
- 52% of trust assets below age of 50
- 20% of trust assets in subaccounts of beneficiaries 50-59
- 28% of trust assets in subaccounts of beneficiaries age 60 and older

Transition to risk-based options

- 1) Finalize decision to transition to multiple risk-based options.
- 2) Redefine Investment Policy Statement.
- 3) Determine suitable beneficiaries for each portfolio's options based on age and other factors (to include beneficiary annual budget or spending expectations and beneficiary risk tolerance).
- 4) Conduct analysis on asset transition/rebalance across multiple factors.

Appendix C

Best Practice Tips

Uniform Prudent Investor Act

Keep a copy of the tenets and philosophies of the UPIA as a resource for all staff (a full copy of the UPIA may be found in **Appendix A**).

Review your investment professionals and portfolios no less than annually to ensure UPIA compliance.

Consider annual training provided by the PSNT's investment professional to PSNT staff and Board of Directors on investment tenets.

Planning/Confidentiality

Remain cognizant of how and when to appropriately disclose the beneficiary's personal protected information.

Planning/Life Care Plan

Obtain both plaintiff's and defendant's counsel LCPs for more accurate planning when available.

Planning/Potential Beneficiary Inheritance

Heavily discount such potential testamentary funding.

Planning/Beneficiary Existing Assets

Review new joinders' assets with a tax professional or investment manager before acceptance.

Planning/Optimal Outcomes

Record all facets of a beneficiary's lifestyle and desires for future trust use.

Asset Allocation/Multiple Portfolios

Review the pros and cons of offering multiple portfolio options within the PSNT.

Asset Allocation/Tax Considerations

Identify minor beneficiaries within the PSNT and consult with a tax professional or investment advisor to develop the most prudent investment strategy for these beneficiaries.

Asset Allocation/Risk Tolerance

A PSNT should review how its portfolio incorporates beta (the amount of risk arising from exposure to general market conditions or movement) as opposed to alpha (the active return of investments versus their applicable benchmark) as this will play a critical role in a beneficiary's risk tolerance.

Asset Allocation/Risk Tolerance

PSNT beneficiary Risk Tolerance Questionnaires should take into account other factors crucial to PSNT administration, such as beneficiary disability, life expectancy, LCP expenses, and beneficiary experience with investing overall. As discussed in the Multiple Portfolios section, accounting for different beneficiaries' risk tolerances in the context of pooled assets can be difficult. However, with a technologically savvy investment advisor who can aggregate beneficiaries' risk tolerance levels in accordance with the pool's investment offerings, this becomes simply a question of operational mechanics.

Directed and Delegated Investment Management/Delegated Investment Advisory

The PSNT Board of Directors or Investment Committee should perform a thorough review of multiple candidates before delegating investment management.

Have outside counsel thoroughly review any investment management agreement before executing.

Review the delegated investment advisor no less than annually for the above factors as well as comparable rates of return to applicable benchmarks. Keep all such review documentation on file.

Directed and Delegated Investment Management/Directed Investment Advisory

PSNTs should perform some form of review of directed investment advisors no less than annually, utilizing the above delegated advisor review criteria. Such reviews should remain on file.

Unique Asset Management/Beneficiary Occupied Real Estate/Mineral Interest

Delegate trust-owned, beneficiary-occupied residence oversight to a local, experienced property manager vetted in accordance with the recommendations made in OCC Bulletin 2013-29 Third-Party Relationships: Risk Management Guidance (“OCC Bulletin 2013-29”) [www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html#].

Unique Asset Management/Vehicle Liens

List automobile liens on beneficiary sub-account statements.

Unique Asset Management/Promissory Notes

Engage outside counsel for the drafting of any promissory note to ensure that any creditor protection/spendthrift clauses of the trust are not violated. Set the promissory interest rate and payoff terms at current market rates and practices.

Unique Asset Management/Farmland, Ranchland, Commercial Real Estate

Engage outside counsel to review ownership and partnership agreements. Should the trust have management duties (e.g., general partner), the delegation of management to a knowledgeable, experienced, and properly vetted business manager is highly recommended.