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# THE PI LAWYER: DIFFERENT ANIMAL, SAME STRIPES

*By Adam F. Streisand**

## I. INTRODUCTION

California's adoption of the Uniform Prudent Investor Act and the Uniform Principal and Income Act (the "UPIAs") liberated trustees from slavish adherence to inflexible investment rules and management decisions as well as rigid adherence to allocating receipts and disbursements. Trustees now have greater flexibility to invest for total return in accordance with modern portfolio theory, rather than focusing on assets in isolation or applying strict rules on adjusting principal to income. Greater flexibility, however, translates into more opportunities for beneficiaries to second-guess trustees who exercise their newfound discretion.

Since California's adoption of the UPIAs, trusts and estates lawyers have seen the rise of a new type of "PI lawyer." Like a "personal injury" attorney, the new "prudent investor" or "principal and income" lawyer knows that a case with subjective standards has value. When a case involves the exercise of discretion and the vagaries of investment strategy, the court's analysis and decision necessarily involves some subjectivity. The PI lawyer likes those odds, especially if he or she can find a conflict or a little bias or hostility to throw into the mix.

So what can trustees do to try to ward off the PI lawyers? How can these fiduciaries defend themselves in litigation involving UPIA issues? Will the Legislature take action to rescue trustees? These are questions this article seeks to answer.

## II. THE PRUDENT INVESTOR RULE

Effective January 1, 1995, California adopted the Uniform Prudent Investor Act, defining what is commonly referred to as the prudent investor rule. Except as may be expanded or restricted by the trust instrument itself, "a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule."[1] The prudent investor rule requires that "[a] trustee shall invest and manage 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."[2] By its own language, this standard applies to both investment and management decisions of trustees.[3]

The prudent investor rule instructs trustees to make investment decisions based on modern portfolio theory, rather than on an inflexible asset-by-asset analysis: "A trustee's investment and management decisions respecting individual assets and courses of action 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."[4] In order to fulfill this mandate, the Probate Code provides guidance by enumerating a number of factors that trustees should consider in making investment and management decisions:

(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 and action plays within the overall trust portfolio;

(5) The expected total return from income and the appreciation of capital;

(6) Other resources of the beneficiaries known to the trustee as determined from information provided by 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 beneficiaries.[5]

One principle that emerges from these various duties is that a trustee must ordinarily strive to invest and manage trust assets in a manner that produces both reasonable income and adequate principal growth: "[t]he objectives of total return encompass not only income productivity but also returns to principal, with these competing interests being balanced in a way that is appropriate to the particular trust."[6]

In a split-interest trust, the beneficiary entitled to income differs from the ultimate remainder beneficiary. The tension between these conflicting interests can become a fertile ground for litigation. The income beneficiary has an interest in receiving as much current income from the trust as possible, because he will not benefit from the appreciation of principal. The remainder beneficiary has precisely the opposite objective. *The Restatement of Trusts* (*Third*) explains the trustee's duty in balancing these interests. It also notes what many income beneficiaries often overlook: that growth of the principal also tends to increase income flow over the duration of the trust:

> If by the terms of a trust the trustee is directed to pay the income to a beneficiary during a designated period and on the expiration of the period to pay the principal to other beneficiaries, the trustee is under a duty to the income beneficiary to exercise care not only to preserve the trust property but to make it productive of trust income so that a reasonable amount of income will be available to that beneficiary. The trustee is also under a duty to the remainder beneficiaries to exercise reasonable

> care to preserve the trust property, and this duty ordinarily includes a goal of protecting the property's purchasing power. In some trust situations the trustee may invest with a goal of increasing the real value of the principal. It is important to note that protection or growth of the purchasing power of principal also tends to preserve or enhance the purchasing power of the income flow over the duration of the trust.[7]

As noted previously, "[t]he settlor may expand or restrict the prudent investor rule by express provisions in the trust instrument."[8] In such case, "a trustee is not liable to a beneficiary for the trustee's good faith reliance on these express provisions."[9] When the trust instrument varies the requirements of the prudent investor rule, the trustee's "duty to administer the trust according to the trust instrument" takes precedence.[10]

In sum, the prudent investor rule liberated trustees from stifling rules that required making each asset productive of income while preserving purchasing power. Instead, the prudent investor rule made it possible for trustees to invest according to Modern Portfolio Theory for total return. As will be seen, however, greater discretion and flexibility has delighted PI lawyers and engendered increased litigation.

## III. FORMER AND CURRENT LAW REGARDING UNDERPRODUCTIVE TRUST ASSETS

Following the enactment of the Uniform Prudent Investor Act, there still remained certain vestiges of outmoded rules that impeded the ability of trustees to invest for total return. Former Probate Code § 16311, concerning underproductive assets, conflicted with the Prudent Investor Act, because it depended upon an asset-by-asset analysis. The former Uniform Principal and Income Acts of both 1931 and 1962,[11] as codified in former Probate Code § 16311, generally provided that if a trust asset had not produced average net income of at least one percent (1%) of its inventory value, upon its sale the income beneficiaries were entitled to receive from the sale proceeds an amount equal to the difference between the income actually received from the asset and a return of five percent (5%) per annum simple interest.[12]

In 1999, California enacted the Uniform Principal and Income Act of 1997, which among other things repealed former Probate Code § 16311. The new Act features a flexible approach more consistent with modern portfolio investing. Subject to certain conditions, a trustee now has discretion to reallocate part of trust principal to trust income if the trust's overall income yield is too low, or conversely, to reallocate part of trust income to trust principal if the trust's overall principal growth is inadequate.[13]

This change in the law reflects and implements California's endorsement of modern portfolio theory by allowing trustees to adopt investment strategies that focus on the overall productivity of a trust's investment portfolio, rather than on an asset-by-asset basis.[14] In other words, a lower rate of productivity on some assets can be compensated for by a higher rate on other assets such that the overall average rate of return on the trust's investments as a whole is appropriate. The prior law was inconsistent with portfolio theory investing, because it required the trustees to make each separate asset produce at least one percent of income.[15]

Trustees and beneficiaries advocated for the adoption of the prudent investor rule and the new provisions of the Uniform Principal and Income Act, particularly in light of the impressive growth in the equities markets in the mid to late-1990s. Even as dividend yields and interest rates declined rather dramatically, trustees theoretically could take advantage of the bull market and make appropriate adjustments under the new Act.

The unpleasant reality, however, is that this new discretion appears to have resulted in more litigation by dissatisfied beneficiaries. They complain about investment and management decisions that allegedly violate the trustees' duty of impartiality between income beneficiaries and remainder beneficiaries. If, as is commonly the case, the trustees have some conflict created by the settlor's estate plan, these complaints take on a sharper and more pointed tone, and pose potentially greater risk of liability.

## IV. THE CASE OF THE TRUST-CONTROLLED CORPORATION

One such common scenario is when the trustees are also directors of a corporation in which the trust owns a controlling interest. There is an obvious conflict, particularly if the trustees are receiving compensation as directors or are employed by the corporation and are receiving salary or other forms of compensation.

For example, the trustees' compensation from the corporation may be tied to performance. As a result, the trustees may have at least the appearance of a conflict because their self-interest is in the growth of the company, which may involve reinvesting earnings rather than declaring dividends. While the remainder beneficiaries may be pleased with these efforts, the income beneficiary is interested in receiving distributions of income in the form of dividends from the corporation. Enhancement in the value of property of the trust estate constitutes corpus, and, where income and remainder interests are in question, will eventually pass to the remainder beneficiaries.[16]

> Except for certain suggestions to the contrary in two or three jurisdictions, the rule everywhere recognized is that enhancements in the value of corporate stock which is held in trust, or otherwise subjected to income and remainder interests, constitute corpus, and are to be dealt with accordingly unless the will or trust instrument otherwise indicates or provides.[17]

Moreover, the net earnings of a corporation are not "income" to a trust that owns shares in the corporation unless the corporation declares dividends. Stated differently, the income beneficiaries of a trust are not entitled to the corporation's net earnings if no dividends are declared.[18] "[T]he beneficiary does not become entitled to income or profits until a dividend has been declared and

the amount separated from the capital of the corporation for distribution to its shareholders."[19]

No California statute or case imposes any specific requirement on trustees who also are board members of a trust-owned corporation as to the level of dividends the corporation must pay to the trust. In fact, California law does not squarely address what standard governs the dividend-setting decisions of trustee-directors in such circumstances. Nevertheless, while corporate directors' dividend decisions ordinarily are evaluated under the deferential business judgment rule,[20] the California Court of Appeal in *Estate of Feraud*[21] suggests that a higher standard applies when the trust is the controlling shareholder of a corporation or the trustees comprise a majority of the board of directors.

In *Feraud*, three trusts were the sole shareholders of a corporation. A trustee of all three trusts was also a director and officer of the corporation. The corporation's board of directors set a bonus policy for the trustee as a corporate officer. A trust beneficiary subsequently sought to surcharge the trustee for allegedly excessive bonuses. In holding that the trustee could be surcharged, the Court of Appeal explained that, because "the beneficial owners of the stock of the corporation in this case were the beneficiaries of the three trusts . . . [the trustee] was under a duty to these beneficiaries to administer the three trusts, including their principal asset, the Company, *solely* in their interests [citations], to use reasonable care and skill to make trust property productive [citation], and to pay the net income of the various trusts to the beneficiaries thereof. [Citation.]"[22]

The particular facts of *Feraud* are instructive. The bonus policy at issue provided the trustee with an annual bonus of two percent (2%) of the company's gross sales. During the time in question, gross sales (and thus the trustee's bonuses) increased significantly. The company's net income available for payment of dividends for the benefit of the trusts' income beneficiaries, however, either remained static or declined. On these facts, the court held that "the vice of [the trustee's bonus] arrangement . . . was that it was geared exclusively to gross sales and not at all to net profits, which was the primary concern of the life-income beneficiaries of the three trusts. . . . [I]t was this total lack of connection between the amounts of [the trustee's] yearly bonuses and the Company's yearly profits that made his bonuses unfair and unreasonable, at least with respect to the life-income beneficiaries."[23] The court then suggested that a bonus policy tied instead to the company's net income might be appropriate.[24] Thus, the court's rationale simply was that the particular bonus policy was unfair to the income beneficiaries and ignored their interests.

*Feraud* does not expressly hold that this same standard applies to corporate dividend-setting decisions by trustee-directors. In *Feraud*, however, "comparatively little of the net income of the Company was distributed . . . in dividends . . . ."[25] The court noted in a footnote that "[t]his policy of retention of earnings favored the remaindermen over the life-income beneficiaries, but these groups have apparently settled their differences."[26] While neither a thorough analysis of the issue nor a binding statement of law, this *dictum* may suggest that the *Feraud* court would have applied the same standard to dividend-setting decisions if the issue had been before it. To date, the *Feraud* standard has not been interpreted or applied by any subsequent California case.

The conclusion that a court may apply the *Feraud* standard in evaluating dividend setting decisions by trustee-directors in the future finds additional support in the fact that the prudent investor rule applies to a trustee's actions concerning both investment and *management* of trust assets.[27] Since trustee-directors' dividend setting decisions are an aspect of their management of trust assets, Probate Code § 16047(a) suggests that such decisions may be subject to the prudent investor rule.

*Feraud* teaches that it may be difficult for trustee-directors to make board decisions based solely on business judgment. In order to avoid the wrath of the PI lawyer's critiques, trustee-directors should be guided by the duties applicable to them as trustees under the Probate Code, including the duty of impartiality.

This conclusion does not mean, however, that every corporation owned by a split-interest trust has to produce income by declaring dividends. If other assets in the trust can generate a reasonable amount of income based on the value of the portfolio as a whole, this approach is consistent with the prudent investor rule. The problem can also be ameliorated by appointing a majority of independent, outside, and non-trustee directors. The trustees should still vote consistently with their trustee duties, even though they may be outvoted. While beneficiaries might still attempt to argue that the trustees could take action as majority shareholders to change the outcome, as long as the majority of outside directors has discharged its duties in good faith, the trustee-directors are in a very strong position to defend against such arguments.

## V. REALLOCATION VERSUS SURCHARGE

Assume now that a PI lawyer and his income beneficiary client file a petition to surcharge your trustee client. Assume further the PI lawyer may be able to prove at trial that the income generated from the trust was inadequate under the circumstances. Finally, assume that the corpus remains in trust. Why then should your client be surcharged? If your client breached a duty of impartiality by favoring the interests of the remainder beneficiaries, then the assets remaining in trust for the ultimate beneficiaries experienced undue growth. To surcharge the trustee would be to grant a windfall to the remainder beneficiaries when the windfall can simply be rectified by a reallocation to income. If the assets have not gone anywhere, then the appropriate remedy is to put the income beneficiaries and the remainder beneficiaries back in the positions in which they would have been if the portfolio had been properly balanced. A surcharge is just punitive and allows one class of beneficiaries to obtain an unwarranted benefit. Does authority exist to support a defense that the appropriate remedy is reallocation rather than surcharge?

One California case supports this approach. In *Copley v. Copley*,[28] the settlor created a revocable inter vivos trust that was fully funded at the time of his death. The corpus consisted of all the outstanding common stock of his corporation and 17.59% of the outstanding preferred stock.[29] On the settlor's death, the trust was equally divided between a marital trust and a non-marital trust so that each trust held an equal interest in the corporation.[30] The surviving spouse was co-trustee and sole income beneficiary of the marital trust and had a general power of appointment over its corpus.[31] Upon the settlor's death, the surviving spouse also became chairman of the board of directors and chief executive officer of the corporation.[32] Income from the non-marital trust was to be divided among three children and the surviving spouse.[33] The non-marital trust was burdened with two obligations: (1) to pay all death taxes, debts, and expenses of administrations, and (2) to pay settlor's first wife an annual fixed amount.[34]

The trustees obtained an appraisal of the corporation in order to calculate the amount of estate taxes that would be due. In order to raise sufficient cash to pay the taxes, assets of the non-marital trust had to be liquidated. To avoid selling stock in the corporation to outsiders, the trustees created and implemented a stock redemption plan based on the appraised value of the stock.[35] The IRS subsequently valued the corporation twice as high as the trustees' appraisal (which was also the value used to redeem stock from the non-marital trust).[36]

The trustees then implemented a second phase of the stock redemption plan using the new IRS value.[37] The second redemption was made *pro rata* from the marital and the non-marital trusts.[38]

Beneficiaries of the non-marital trust filed a petition to remove and surcharge the trustees, on the grounds that the trustees undervalued the stock in the first redemption.[39] The trial court concluded that the trustees breached their fiduciary duties and abused their conflicting interests and should be removed. The court further determined that because the stock was undervalued for purposes of the first redemption, the non-marital trust was obliged to sell many more shares than actually necessary to pay estate taxes and other expenses. This depletion in principal made a substantial difference in the income the beneficiaries might expect to receive from dividends as well as the value of the remainder as a voting block.[40]

Nevertheless, the court did not reach the conclusion that the trustees should be surcharged. Instead, the trial court ordered the marital trust to transfer some shares to the non-marital trust to bring the respective interests into proper proportion.[41] The trial court also ordered the trustees to transfer dividends received by the marital trust on the shares reallocated to the non-marital trust.[42] There is no indication that the trial court ever considered or expressed a view as to whether a surcharge would have been inappropriate, in that the marital trust would have received an unwarranted windfall. But that conclusion can be inferred from the court's decision to reapportion the stock between the two subtrusts, rather than to surcharge the trustees.

The trustees appealed from the trial court's ruling that they breached their duties, and from the court's order denying the trustees' request for fees. The Court of Appeal looked primarily at testator intent as expressed in the language of the trust. The Court determined that trustees had been given wide latitude and discretion in how to pay taxes and manage the assets.[43] The trust contemplated that the two subtrusts would each have half the shares and that the non-marital trust would bear the cost of taxes and other expenses so the marital trust would necessarily have a greater percentage of the corporation and a larger percentage of dividends.[44] Although the trial court had found the trustees in breach for using a low valuation of the stock without consulting potential buyers, the Court of Appeal recognized the tension between obtaining a valuation and trying to minimize taxes. Accordingly, the Court of Appeal reversed the trial court and found no breach in failing to call for a free market determination.[45]

The Court of Appeal also found no conflict of interest in the trustees, no breach of the trustees' basic fiduciary duties and no negligence in obtaining a low stock appraisal. It reversed the order removing the trustees and denying them fees. As for the remedy, the Court of Appeal affirmed the trial court's approach of equitable reapportionment. The Court's reasoning is instructive:

> Nevertheless, it is a general principle that a court of equity will give to the beneficiaries of a trust such remedies as are necessary for the protection of their interests…. [T]he remedy of specific reparation, though mislabeled a constructive trust, was appropriately applied here by the trial court. As the trustees informed the trial court, this was a logical and simple approach to remedy. Because of the use of a redemption price of $35 plus per share as adjusted by the later determined death tax valuation settlement, a disproportionately large number of shares was redeemed from the nonmarital trust…. This disproportionality resulted in an unfair, lower percentage (18.1 percent) interest in the corporation than the percentage (34.5+ percent) to which the nonmarital trust was equitably entitled. The unfairness and inequity of this result … permits the transfer ordered so as to make specific reparation. Thus, we uphold the trial court's award establishing a fair relative relationship between the two trusts' shareholding, and making the nonmarital trust whole.[46]

One could argue that the Court of Appeal was influenced by its conclusion that the trustees committed no wrongdoing. Nevertheless, the trial court determined that an equitable reallocation was more appropriate than a surcharge, even in finding that the trustees breached their duties. The Court of Appeal did not take issue with the court's approach and endorsed it as a sensible remedy to an obvious inequity, even if the trustees should not be found to have breached their duties. It in fact makes perfect sense that wrongdoing or not, if one class of beneficiaries has been inequitably benefited, the proper remedy is reallocation, not surcharge.

## VI. LEGISLATIVE SOLUTIONS

The UPIAs now provide trustees with greater flexibility to achieve better results for all classes of beneficiaries. But the new PI lawyers are all too content challenging trustees who exercise their newfound flexibility. As a result, trustees are reluctant to take advantage of their discretionary powers under the UPIAs. In the end, the flexibility of the UPIAs is precisely what undermines their efficacy. But help may be on the way.

The Executive Committee of the State Bar of California's Trusts and Estates Section recently approved proposed legislation that would add new §§ 16336.1 and 16336.2 to the Probate Code to authorize trustees to convert trusts automatically to a unitrust at 4%. The trustees may also administer the trust as a unitrust within a range of 3% to 5% if all beneficiaries consent, or the court grants a petition requesting such power. The proposed legislation would preclude further adjustments of principal to income under Probate Code § 16336 as long as the trust is being administered as a unitrust. The conversion features of the unitrust legislation are voluntary. Trustees are not required to convert their trusts to unitrusts. However, the legislation affords trustees a safe harbor for doing so.

If enacted into law, the unitrust legislation will help to ward off the new PI lawyers. The new legislation will eliminate the subjectivity involved when trustees invest for total return and use the power of adjustment between principal and income to balance out the returns as between income and remainder beneficiaries. The unitrust legislation dictates the amounts to be distributed to income beneficiaries (based on a percentage of the corpus). Trustees who convert to a unitrust will no longer have to decide for themselves what amount is appropriate to distribute to income beneficiaries. Trustees will be protected against challenges by PI lawyers as to the appropriate yield.

Moreover, the unitrust legislation, if enacted, will help align the otherwise often conflicting interests of income and remainder beneficiaries. Managing split-interest trusts when the interests of the beneficiaries are in constant conflict has always been a source of great uneasiness for trustees. If income will be distributed as a percentage of corpus, then income and remainder beneficiaries will have the same goal—both classes of beneficiaries will want to experience growth in the trust corpus.

Of course, the benefits of the proposed legislation should not be overstated. It will not mean the end to litigation or attacks by PI lawyers. But in a major switch, the same PI lawyers who argued that your trustee clients should have invested more in fixed income assets to generate greater income will argue the complete opposite in the future. Trustees and their counsel can count on seeing litigation by income beneficiaries who will now join forces with disgruntled remainder beneficiaries to claim that trustees are failing to invest appropriately in order to grow the corpus. Still, and despite the irony, trustees are far better off with a single goal supported by all beneficiaries to invest for total return. Unfortunately, it will take a few years for the proposed legislation to wind its way through the Legislature. If history is any guide, the proposal may undergo amendments whose effect can not be predicted by the author.

The bottom line: there remains a vibrant future in trust litigation, but this author believes the proposed unitrust litigation will go a long way relieve trustees of the stress of operating in the maelstrom created by the polarizing forces of income beneficiaries who want each asset to be productive of income and remainder beneficiaries who want growth of principal. Hopefully too, this article can be helpful to trustees and their counsel to ward off the PI lawyer in the interim.

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### ENDNOTES

1. Probate Code § 16046(a).
2. Probate Code § 16047(a).
3. Probate Code §§ 16046(a), 16047(a).
4. Probate Code § 16047(b).
5. Probate Code § 16047(c).
6. Restatement of the Law (3d ed. 1992) Trusts, § 181, comment a.
7. Restatement of the Law, *supra*, § 232, comment c.
8. Probate Code § 16046(b).
9. Probate Code § 16046(b).
10. Probate Code § 16000.
11. Uniform Principal and Income Act of 1931, § 11; Uniform Principal and Income Act of 1962, § 12.
12. Former Civil. Code § 730.12; Former Probate Code § 16311.
13. Probate Code § 16336; Uniform Principal and Income Act of 1997, § 104.
14. Probate Code § 16047(b).
15. Former Probate Code § 16311; *see also* California Law Revision Commission Comments to Probate Code § 16336.
16. W.W. Allen, Annotation, *Rights of Life Tenants and Remaindermen Inter Se Respecting Increase Gains, and Enhance Value of the Estate*, 76 A.L.R. 2d 162 (citing *In Re Eilert's Estate* (1933) 131 Cal.App. 409).
17. *Id*.
18. *Estate of Traung* (1947) 30 Cal.2d 811.
19. *Id*.
20. *See, e.g., Estate of Talbot* (1969) 269 Cal.App.2d 526, 537.
21. (1979) 92 Cal.App.3d 717.
22. *Id*. at 723 (italics in original).
23. 92 Cal.App.3d at 723.
24. *Id*.
25. *Id*. at 722.
26. *Id*. at 722 n. 3.
27. Probate Code § 16047(a).

28. (1981) 126 Cal.App.3d 248.

29. *Id*. at 260.

30. *Ibid*.

31. *Ibid*.

32. *Id*. at 263.

33. *Id*. at 260.

34. *Id*. at 261.

35. *Id*. at 265.

36. *Id*. at 266.

37. *Ibid*.

38. *Ibid*.

39. *Ibid*.

40. *Id*. at 267-268.

41. *Id*. at 268.

42. *Id*. at 268-269.

43. *Id*. at 270.

44. *Id*. at 272.

45. *Id*. at 273.

46. *Id*. at 282-83 (citations omitted).

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