2005

KANSAS BANKERS ASSOCIATION TRUST CONFERENCE

OCTOBER 7, 2005
MANHATTAN, KANSAS

NEW CHALLENGES IN TRUST DESIGN AND INVESTMENT - IS ANYTHING BETTER THAN A UNITRUST INVESTED IN INDEX OR EXCHANGE-TRADED FUNDS

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I. TRUST DESIGN AND INVESTMENT -- THE TRADITIONAL, COMFORTABLE, AND INEFFECTIVE MODEL (THE "TRADITIONAL MODEL")

A. *The Consume Income and Conserve Principal Paradigm of Private Trusts.*

1. The principal of most early (Seventeenth Century) trusts consisted of land. Land produced either rent or crops. Permanent principal and predictable income generally resulted.

2. A clear distinction existed between income and principal, separating different kinds of wealth. One kind of wealth, income, was intended for consumption. The other kind of wealth, principal, was intended for conservation.

3. The design of early trusts, therefore, in which income was to be distributed to one person, the income beneficiary, and principal to another, the remainderman, were premised on this clear distinction between two kinds of wealth. This distinction remains the general model for trust design today; that is, income to A, and following A's death or a term of years, principal to B. This arrangement also is consistent with most of our clients' views of trusts: "I want my wife to have the income from the trust and my kids to have the remainder when my wife is gone." Because this arrangement is both traditional and

expected by our clients, trust documents are usually drafted accordingly, much to the satisfaction of attorneys (simple, thoughtless, and inexpensive) and institutional trustees (simple, generally thoughtless, and easy to administer under uniform principal and income acts).

B. ***The Consume Income – Conserve Principal Paradigm is Both the Progenitor and Progeny of the Original Prudent Man Rule.***

1. The Harvard College Rule

> "... to observe how men 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." *Harvard College, The Avery, 9 Pick. 10 (26 Mass.) 446, 461 (1830).*

This rule established the precedent for trust investment guidelines that prevailed for over a century. The rule endorses the distinction between two kinds of wealth - income and permanent principal. Although the rule does not preclude speculation, it seems to require that speculation not occur with "permanent ... capital." The rule moreover focused on the importance of income and the safety of invested capital. The consume only income and conserve capital paradigm was perpetuated. As a result, trustees and courts interpreting trusts continued the distinction between wealth in the form of income and wealth in the form of principal.

a. Although the Harvard College Rule seems inflexible by today's standards, it was viewed in the Nineteenth Century as a flexible departure from the previously accepted standard that established a list of prudent investments and prohibited speculation. The flexibility of the Harvard College Rule was, however, eroded during the post-Civil War period in which several courts, including the New York Court of Appeals, established lists of certain kinds of investments that were considered prudent. All others were considered imprudent. Many courts and state legislatures followed with the "Legal List Rule." The Legal List Rule generally limited trust investments to government and "safe" corporate bonds. The Great Depression, however, punctured the concept of "safe" bonds in that not only did the value of bonds greatly diminish, but the recovery of bond prices trailed the recovery of equity prices after the Depression.

2. The first model prudent man statute was drafted in 1942 as an attempt to return to the greater flexibility of the Harvard College rule, and generally adopted the language of that rule. Kansas first adopted the Prudent Man Rule in 1949.

3. The next generation of the Prudent Man Rule occurred in 1959, as a part of the Restatement (Second) of Trusts, which provided as follows:

> "... to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and amount and regularity of the income derived therefrom."

Restatement, Second of Trust, Section 227, (1959).

This Rule focused, by its terms, on the "amount and regularity of income, while preserving the nominal value of the trust property as principal." Prudence was measured by an asset-by-asset analysis. The Rule continued the distinction between wealth measured by income and wealth measured by principal. The emphasis on income reflected a bias toward the income beneficiary and led to often inflexible trust investment and asset allocation policies such as, for example, sixty percent fixed income investments and forty percent equities. The Prudent Man Rule continued the "no speculation" prohibition from the earlier rules.

C. *__The Prudent Man's Imprudence -- Why the Traditional Model was Ineffective.__*

1. The Prudent Man Rule's distinction between wealth measured by income and wealth measured by principal, and the perpetuation of the consume income-conserve principal paradigm, created numerous problems for those whose lives were affected by trusts, particularly trust beneficiaries. Among those problems were, and unfortunately still are, the following:

a. Thoughtless drafting of trust documents with little attention to the probable human (spending) needs of beneficiaries.

b. Thoughtless investment strategies by trustees who felt insulated from criticism because they did not speculate and because they maintained a comfortable asset allocation of, for example, sixty percent equities and forty percent bonds. Such a comfortable arrangement precluded the need to study, consider, and implement asset allocation and investment strategies required by Modern Portfolio Theory, and, consequently, disappointed remaindermen, particularly in times of inflation.

c. Institutional trustees became more and more subject to criticism, particularly from money managers who were not constrained by the fiduciary principles of the Prudent Man Rule.

d. Trustees attempted to maximize current income to please income beneficiaries, and thereby prejudiced remaindermen interested in principal appreciation;

e. Because trustees were, and continue to be, required to be impartial, investment arrangements required by the Prudent Man Rule resulted in a "... duty to disappoint equally."[1] The income beneficiary was disappointed by the trustee's need to maintain the purchasing power of the trust principal by investing in equities, and the remaindermen were disappointed by the trustee's need to invest in fixed-income assets to meet the income beneficiary's spending requirements. In the Nineteenth and early part of the Twentieth Century the duty to disappoint equally could perhaps be avoided because inflation generally was not a factor in eroding trust principal ("wealth"). In other words, net income could be considered excess investment return that could be consumed, while still conserving the trust's wealth. However, as inflation became a way of life (21% in 1971), equal disappointment of income beneficiaries and remaindermen from the consume income, conserve principal paradigm was inevitable. No longer could the fruit (income) be eaten without also stunting the growth of the tree (principal). One prominent commentator has stated:

> "Whenever a fixed sum of money is payable at or after a particular time in the future, the portion of the interim investment return - whether it be called interest or premium or dividend, or whatever - is, *in part*, a form of

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[1]Robert B. Wolf, *Defeating the Duty to Disappoint Equally - The Total Return Trust,* 32 Real Prop. Real Prob. & TR. J. 46 (1997); *also available in* ACTEC NOTES, Summer 1997, at 46 [hereinafter Wolf, *Defeating the Duty*].

> compensation for the anticipated lower purchasing power of the dollars that will be received in the future. Accordingly, when one spends all of one's "income" in an inflationary environment, one is spending one's "capital" just as surely as if an acknowledged asset were liquidated and the proceeds consumed.. Looked at the other way around, spending an appropriate portion of realized capital appreciation is no more an "invasion of capital" than spending a comparable portion of the interest payments from a bond with a fixed payment at maturity."[2]

f. Remaindermen generally were even more disappointed by the traditional model than income beneficiaries, for the following reasons:

(i) Income beneficiaries most often are adults, more vocal, and probably closer to the trustee than are the remaindermen. For example, the income beneficiary is a surviving spouse and the remaindermen are children, or the income beneficiary is a child and remaindermen are grandchildren.

(ii) Income beneficiaries seem to measure their entitlement to trust distributions based not on what fairly can be allocated to the production of income, but to the beneficiary's spending requirements, either real or perceived. When the drafting attorney has not probed for the settlor's wishes regarding the spending needs of the beneficiary, the trustee may face the wrath of a disappointed income beneficiary who believes the settlor intended to take care of all of the beneficiary's perceived spending requirements. If the trustee acquiesced in the income beneficiary's de-

[2]William L. Hoisington, Study Outline, American Bar Association Real Estate, Probate and Trust Section Mid-Year Meeting (2000). (on file with the author).

mands, the remaindermen received greatly reduced principal at the end of the trust term.

g. Because income beneficiaries were favored, the predictability of income distributions often resulted in asset allocations that ensured predictability, such as a portfolio of intermediate Treasury Bonds with "laddered" maturities. Such a portfolio provided a more certain and predictable distribution pattern, and probably a larger distribution than dividends from a well diversified portfolio of high grade stocks with a comparable market value. A large allocation to bonds therefore was viewed as a way to blunt the criticism that might otherwise be directed at trustees by income beneficiaries.

h. The emphasis against investing in speculative assets deterred trustees from investing in modern sophisticated investment vehicles that could benefit the portfolio as a whole. Such modern investment vehicles were also discouraged by the prior rule's focus upon scrutinizing each asset in the portfolio, rather than the portfolio as a whole. Trust settlors have been lead to believe, both by traditional concepts of "live on income and preserve principal" and professional advice that those persons for whom the settlor's financial support is most important (spouse vs. children or children vs. grandchildren) should receive all of the trust's income. Settlors were seldom advised that income is not simply excess investment return that may totally be distributed to income beneficiaries without loss of overall value of principal. A myth was thus created that still may have widespread acceptance.

i. Income beneficiaries of long-term trusts often failed to understand that greed today meant less income tomorrow. To the extent that trust investment decisions failed to protect against inflation, the trust principal was eroded and the amount to be distributed to the income beneficiary tomorrow likely would be less than it is today. Consequently, an income beneficiary's greed or unrestrained spending needs not only jeopardized the return to the remaindermen, but also the return to the income beneficiary himself or herself.

j. The tax laws adopted the artificial distinction between income and principal. In order to comply with those laws, trusts continued to make such distinctions. The following are examples:

(i) In order to qualify for the marital deduction, the surviving spouse must be entitled to all of the income from the trust.

(ii) A trust is allowed an income tax deduction for its distributable net income for federal income tax purposes.

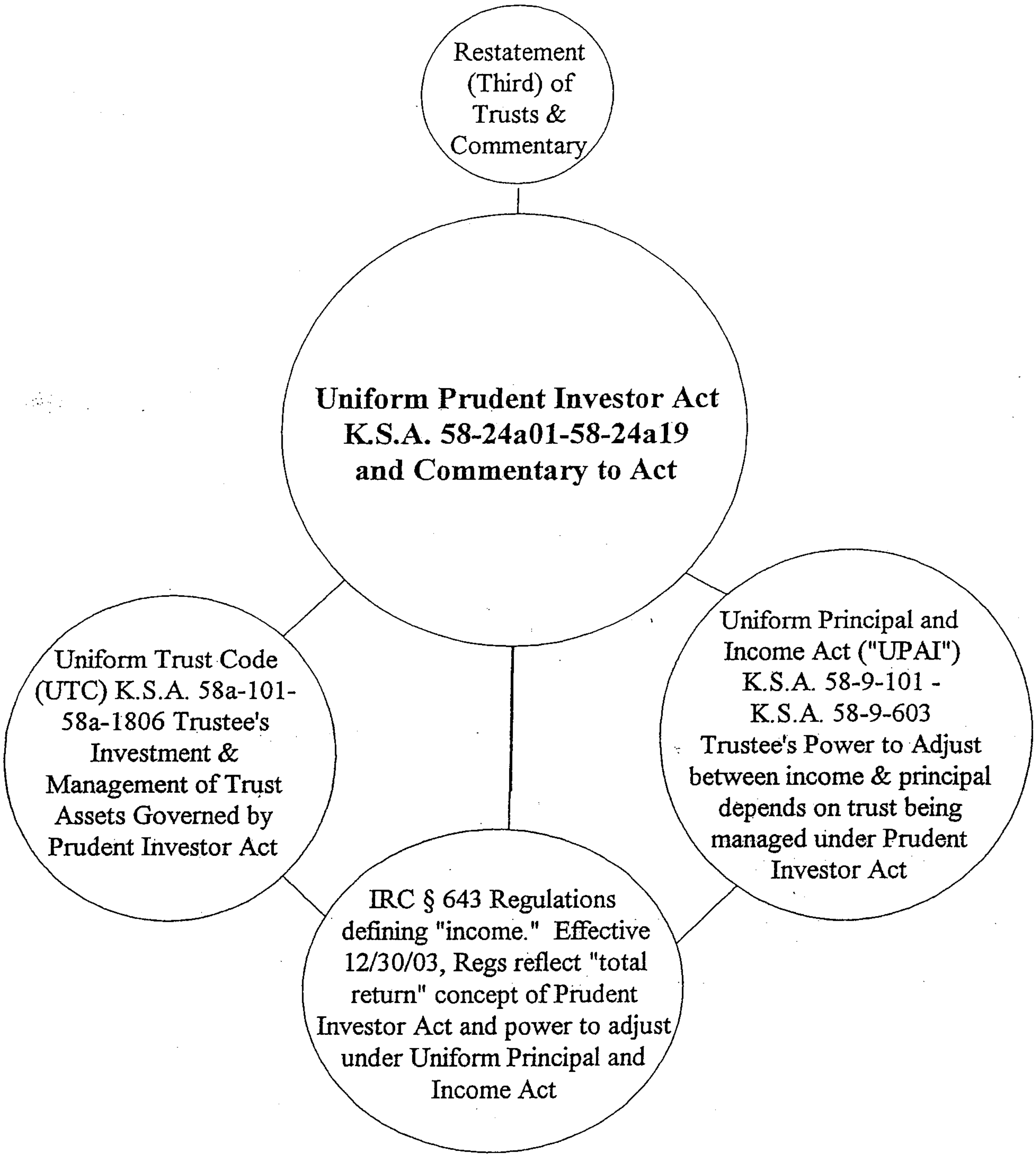
(iii) QSST rules require that all income be distributed.

k. Because the tax laws caused the availability of important benefits to be determined by the distinction between income and principal, trust documents continued to maintain this distinction to avoid jeopardizing such benefits, including, most prominently, the marital deduction.

II. LEGISLATIVE RESPONSE TO THE TRADITIONAL MODEL (THE "LEGISLATIVE RESPONSE")

THIS IS THE LAW

IGNORE IT AT YOUR PERIL



A. *General Statutory Response.*

The Legislative Response to the Traditional Model is an amalgam of the following three acts, all promulgated by the National Conference of Commissioners on Uniform State Laws: the Uniform Prudent Investor Act (1994), codified in Kansas as K.S.A. 58-24a01-24a19; the Uniform Principal and Income Act (revised in 1997), codified in Kansas as K.S.A. 58-9-101-9-603; and the Uniform Trust Code (2000), codified in Kansas as K.S.A. 58a-101 - 58a-1106. The overwhelming national acceptance of the Uniform Prudent Investor Act and the Uniform Principal and Income Act, and the growing acceptance of the Uniform Trust Code, caused the United States Treasury Department to reconsider the tax definition of "income," resulting in new regulations issued under I.R.C. § 643 on December 30, 2003. This amalgam of legislation is interrelated and interdependent. The trust drafting, managing and investing communities must understand these laws and the principles and the empirical studies and rules from which they have evolved in order to change the focus from the traditional model to a new model mandated by the Legislative Response.

B. *Third Restatement of Trusts.*

Although not law, the Restatement (Third) of Trusts enunciated the Prudent Investor Rule, which has been codified as a part of the Prudent Investor Act. Because the Prudent Investor Act controls a trustee's investment and management decisions under the Uniform Trust Act and a trustee's ability to adjust between principal and income under the Uniform Principal and Income Act, the Restatement and its several hundred pages of commentary are an indispensable tool in the interpretation and application of the Legislature Response, which replaced the rigidity of the Prudent Man Rule with an investment standard based upon the following five "Principles of

Prudence:" (1) sound diversification is fundamental to risk management and is therefore ordinarily required of trustees; (2) risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer; (3) trustees have a duty to avoid fees, transaction costs, and other expenses (taxes) that are not justified by needs and realistic objectives of the trust's investment program; (4) the fiduciary duty of impartiality requires a balancing of the elements of return between production of current income and the protection of the purchasing power of trust principal; and (5) trustees may have a duty as well as the authority to delegate as prudent investors would.

These five Principles of Prudence are to be followed under the umbrella of "Duties of Care, Skill and Caution." A comment in Sections 227(d) and (e) of the Restatement defines these overarching duties as follows:

> "The duty of care requires the trustee to exercise reasonable effort and diligence in making and monitoring investments for the trust, with attention to the trust's objectives. The trustee has a related duty of care in keeping informed of rights and opportunities associated with those investments.
>
> The exercise of care alone is not sufficient, however, because a trustee is liable for losses resulting from failure to use the skill of an individual of ordinary intelligence. This is so despite the careful use of all the skill of which the particular trustee is capable. On the other hand, it follows from the requirement of care as well as from sound policy that, if the trustee possesses skill greater than that of an individual of ordinary intelligence, the trustee is liable for a loss that results from failure to make reasonably diligence use of that skill.
> In addition to the duty to use care and skill, the trustee must exercise the caution of a prudent investor managing similar funds for similar purposes. In the absence of contrary provisions in the terms of the trust, this requirement of caution requires the trustee to invest with a view of both the safety of the capital and securing a reasonable return."

Commentators have suggested that if "care" involves analysis and investigation before committing trust assets to particular investments, if "skill" involves demonstrated expertise in financial economics and the statistical and quantitative methods of Modern Portfolio Theory, and if "caution" involves an unbiased and critical examination of the likely monetary effects of asset management decisions, then the fiduciary or the agent of the fiduciary must demonstrate competency in these areas.[3]

C. *Total Return Investing. The Prudent Investor Rule and Modern Portfolio Theory.*

These Principles of Prudence and the overarching duties care, skill, and caution are part of a process implementing the transition from the traditional model to an investment regimen based on the principle of total return investing. Total return investing abandons the rigid distinction between income and principal that dominated the traditional model and replaces it with a concept of investing for total return, regardless of the form, whether dividends, rent, interest, or capital gain, of that return.[4]

D. *The Prudent Investor Rule -- General Concepts.*

1. The Prudent Investor Rule adopts the principle of total return investing. The Rule has been codified in Kansas as the Kansas Uniform Prudent Investor Act. The Act applies to fiduciaries, which are defined in K.S.A. 58-24a01 as including a "personal representative, trustee, executor, administrator, successor personal representative, or

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[3]Luther J. Avery & Patrick J. Collins, *Managing Investment Expenses: Trustee Duty to Avoid Unreasonable or Inappropriate Cost,* ACTEC NOTES, Fall 1999, at 123–36.

[4]WENDELL S. SIMON, THE PRUDENT INVESTOR ACT: A GUIDE TO UNDERSTANDING (Naborn Publishing Co. 2002).

special administrator." A fiduciary is also one who "... performs substantially the same function" as the described capacities. Because under the Kansas Durable Power of Attorney Act an attorney-in-fact is a fiduciary, an attorney-in-fact is probably subject to the Prudent Investor Act. Moreover, the breadth of the words "and a person performing substantially the same function," could arguably include attorneys, accountants, investment managers, or anyone who assumes or to whom is delegated the function of dealing with trust management and investment.

2. The Prudent Investor Rule is a default rule; that is, it may be expanded, restricted, eliminated, or modified by the provisions of a trust. K.S.A. 58-24a01(b). Consequently, to the extent a fiduciary acts in reasonable reliance on the provisions of a trust, the fiduciary is not liable to the beneficiary. Because the Prudent Investor Rule is a default rule, attorneys drafting trusts should discuss with settlors the general requirements of the Prudent Investor Rule and whether the settlor wishes to have the rule "expanded, restricted, eliminated, or otherwise altered." A settlor's guidance is essential, for example, with respect to retaining the family farm, with respect to providing generously for the income beneficiary even at the expense of the remaindermen, or with respect to not selling the family business even if the trust's assets are not diversified.

3. The Prudent Investor Rule, which, as stated, involves investing trust assets in accordance with the five Principles of Prudence under the umbrella of care, skill and caution, is grounded in the empirical evidence and conclusions of Modern Portfolio Theory. Consequently, if the trustee is to meet the Principles of Prudence under the umbrella of care, skill and caution, a trustee, and probably the trustee's advisors and

attorneys who draft trust instruments must have a passing familiarity with Modern Portfolio Theory. The requirement for such familiarity is affirmed by the Reporters for the Restatement[5] and the Act[6] who have emphasized that Modern Portfolio Theory establishes a significant underpinning of the Prudent Investment Rule. Although not all trust investment management decisions must be based on Modern Portfolio Theory, without an understanding of Modern Portfolio Theory the trustee may be vulnerable to criticism for failure to invest in accordance with the Prudent Investor Rule.

4. Because the Prudent Investor Rule endorses Modern Portfolio Theory and the Prudent Investor Act codifies several of its fundamental tenets, anyone who drafts trust documents, administers trusts, or provides financial or investment management services to trustees should have at least a rudimentary understanding of Modern Portfolio Theory.

E. ***Modern Portfolio Theory.***

Modern Portfolio Theory refers to the extensive empirical research and analysis since the early 1950's that describe and explain performance of investment assets in public, transparent, and liquid markets.

1. Important tenets of Modern Portfolio Theory include:

a. Risk is inherent in all investments. An investment's return is unpredictable. Consequently, prudence requires management of risk. The risk of

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[5]Edward C. Halbach, *Introduction* to RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE (1992).

[6]SIMON, *supra* note 4, at 35.

an investment is its volatility or the unpredictability of its future value. In other words, what is the likelihood that the sum of what an investor will receive from an investment (periodic income plus ultimate sales proceeds) will be $X more or less than its price today?

b. Return generally is unpredictable and therefore difficult to manage (note, the unpredictability of return ["all investments are risky, as stated in the *Harvard College* case] does not mean that a trustee can de-emphasize return--to the contrary, the Prudent Investor Act requires an overall investment strategy having risk and return objectives consistent with the settlor's human and financial goals). For example, risk and return strategies will be different in a trust in which the settlor's goal is generously to support a surviving spouse from a trust in which the settlor's goal is to maximize the growth of principal for future generations, such as the dynasty trust.

c. Risk is classified into two components: firm-specific, systemic (systematic), or uncompensated risk; and market, non-systemic, or non-compensated risk.[7] Firm-specific or uncompensated risk generally involves risk limited to a specific company, such as the risk that a dynamic chief executive officer may die, that the books may be cooked, as in Enron, or that the particular market in which the company does business is more noise than substance, as in the Dot-Com exuberance. Market, or compensated risk, pertains to the risk to which any

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[7]*See generally* JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY (Am. Coll. Tr. & Estate Council Found., 2d ed., 1998).

company in a particular market might indiscriminately be subject. Examples would be the risk associated with a Presidential assassination, an unexpected pronouncement by Alan Greenspan, the outbreak of War, or a general economic malaise. These risks affect all companies in almost all markets, and are therefore called "market risks."

(i) Firm specific, or uncompensated risk, can generally be eliminated by diversification of a trust's portfolio, as required by K.S.A. 58-24a03. Diversification generally requires investments across asset classes and within each asset class. This requirement is based on the principle that the volatility (unpredictability) of a portfolio can be reduced by combining different investments that tend to go up and down independently of each other (thus said to have "low correlations or negative variance correlation" with each other).[8] Stated another way, as described by Nobel Prize winner Harry M. Markowitz, when investments are combined together in a portfolio, a "correlation structure" is formed among the investments according to the movements in their respective market prices. The term[9] "covariance" is used to describe this correlation structure. Investments in a portfolio with dissimilar movements in their market prices have "low" or "negative"

[8]Managing Investments and Distribution Policy Risks with Intergenerational and Other Long-Term Trusts, Section of Real Property, Probate and Trust Law, American Bar Association Annual Meeting (2001).

[9]Harry M. Markowitz, *The Early History of Portfolio Theory: 1600-1960*, FIN. ANALYST J., July-August, 1999, at 5–16; SIMON *supra* note 4, at 43.

covariance to each other, or low correlation, and investments in a portfolio with a similar movements in their market prices have "high" or "positive" covariance with each other. Consequently, effective trust portfolio diversification does not depend only on the number of investments, but, more importantly, on the ways in which and degrees to which the responses of investments to economic events tend to neutralize one another through negative or low covariance. Because uncompensated risk can be essentially eliminated through diversification, an investor who does not diversify is not compensated or rewarded for taking such risk.

(ii) Market, or compensated risk, which generally consists of approximately thirty percent of the portfolio risk (uncompensated risk consists of the remaining seventy percent of such risk), typically cannot be avoided by an investor who invests in the stock market.[10] Because this risk cannot be avoided, a tenet of Modern Portfolio Theory is that the market compensates an investor for such risk. Consequently, a higher rate of return corresponds to a higher market risk. If risk, in the form of price volatility, is high, a higher rate of return for an investment is expected because of its lower market price. The market for that asset therefore generally responds by providing a return that varies directly with the asset's

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[10]SIMON, *supra* note 4, at 151.

volatility.[11] Modern Portfolio Theory thus emphasizes, as does the Prudent Investor Rule, the importance of analyzing risk and return in portfolio management. As stated by a prominent commentator on the Prudent Investor Rule:

> "Price variability or market volatility (*i.e.*, "risk") seems to be a reflection of the collective uncertainty of investors regarding future returns. In any event, the more volatile the past market price for a particular asset or asset class, the lower the current price and the higher anticipated profit. It follows then that, if price variability (= uncertainty, = "risk") is positively correlated with real future returns, the ratio of the two elements (the so-called "risk/reward ratio") should be a useful predictor of *relative* future market price appreciation.
>
> The empirical evidence supporting the correlation of price volatility and realizable returns with respect to most publicly traded investment assets is so great that no prudent trustee can ignore it."[12]

Modern Portfolio Theory thus holds that the only way to obtain a higher rate of return is to hold a riskier asset or portfolio of assets. Decisions regarding market risk/reward can be managed by an investor who selects investments that are consistent with the chosen level of risk and projected reward. In some portfolios, the level of risk that may achieve a projected substantial return may be justified. In most trusts, however, projected return is measured by the spending needs of the beneficiary, as stated by or inferred from the settlor. Consequently, the level of market

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[11]RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE, § 227 cmt. e (1992); *see also* MACEY, *supra* note 7, at 15–17.

[12]William Hoisington, *Practical Applications of the Prudent Investor Standard,* 56 N.Y.U. Institute on Federal Taxation § 29.03[2] (1998).

risk that the trustee may assume will be determined by the spending needs of the beneficiary. In other words, if a beneficiary's spending needs are substantial in relationship to the trust "income," the trustee should not invest in speculative assets whose income is small and price volatility is great.

d. Capital markets are efficient. This so-called "Efficient Capital Market Hypothesis" states that modern secondary markets are generally highly efficient because prices of the assets sold in that market fully reflect all available information about those assets. The theory holds that when new information about the assets being sold becomes available, the price of those assets almost instantaneously reflects the new information. In other words, all investment assets generally available to investors in a transparent market are most of the time fairly priced.[13] Thus, according to Burton G. Malkiel, whose 1973 book, *A Random Walk Down Wall Street*, contributed to both academic and professional thinking on efficient markets,

> "... neither technical analysis (an analysis of past price patterns to determine the future) nor fundamental analysis (an analysis of a company's earnings, dividends, future prospects, etc. to determine a stock's proper value) will help an investor to achieve returns greater than would be obtained by buying and holding one of the broad stock market indices. The Efficient-Market Theory is associated with the idea of a "random walk," which is a term loosely used in the finance literature to characterize a price series where all subsequent price changes represent random departures from previous prices. The logic of the random-walk idea is that if the flow of information is unimpeded the information is immediately reflected in stock prices, and then tomorrow's price change will reflect only tomorrow's

[13]MACEY, *supra* note 7, at 38.

> news, and will be independent of the price changes today. That news is by definition unpredictable, and, thus, resulting price changes must be unpredictable and random. As a result, prices fully reflect all information and even uninformed investors buying a diversified portfolio at the tableau of prices given by the market will obtain a rate of return as good as that achieved by the experts."[14]

If the Efficient Market Hypothesis has merit, neither experts nor amateurs can consistently "beat the market." Passive, rather than active, investing should, therefore, be preferred. Passive portfolio management investing includes investing in index mutual funds and exchange-traded funds, the goal of which is to match the return of the particular market to which the fund is indexed. Passive investing does not, for example, mean investing only in the S&P 500 Index, as the S&P 500 is not a true diversified portfolio, since it seeks to duplicate the large cap market and therefore weights stocks by their market value. Consequently, passive portfolio managers are not inactive but are engaged in ensuring that their investment portfolio holds (directly or indirectly) a mix of individual securities that, in the aggregate, approximates the securities traded in several broad markets or combination of markets. Active portfolio managers, however, invest in each time period in investments the manager believes offer the best chance of maximizing portfolio values; in other words, beating the market by stock picking and market timing. Active investing, therefore, focuses on spending time and the owner's money

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[14]Burton G. Malkiel, *The 1998 Joseph Trachtman Lecture—An Update on Modern Financial Theory*, ACTEC NOTES, Fall 1998, at 127. For a contrasting view that states that behavioral finance as well as other factors cause markets to be at best, only somewhat efficient, see Dominic J. Campisi & Andrew Sombronski, *Of Delegated and Double Dipping*, TRUSTS AND ESTATES, April 2003, at 61.

attempting to determine the probable future returns that may be realized from owning particular investments generally in shorter time periods ("Market Timing"). Market timing appears not to be supported by empirical evidence, and is generally considered to be inconsistent with Modern Portfolio Theory.

e. There should be little distinction given to whether distributions from invested assets flow from dividends and interest payments or harvested equity appreciation. Harvesting equity appreciation through long-term capital gains may be preferable when distributions, particularly from interest, are taxed at ordinary income rates. This tenet of Modern Portfolio Theory seems to have become even stronger as a result of the fifteen percent tax on qualified dividends.

f. A particular investment must be viewed only as it relates to an entire portfolio, and not in isolation. A particular investment must also be viewed as it increases the return or decreases the risk to the portfolio as a whole.

F. ***How are the Tenets of Modern Portfolio Theory Reflected in the Prudent Investor Act?***

1. A trustee's performance is not measured by the performance of each investment in the portfolio; rather, the trustee's performance is measured by the portfolio as a whole. Individual investments are not important in isolation, but where and how they fit into the trust portfolio as a whole. Under prior rules, a trustee was responsible for losses of individual investments, even though the overall portfolio prospered. Under the Prudent Investor Rule, a loss with respect to an individual investment ordinarily does not put the trustee at risk. A loss to the portfolio as a whole, however, may subject the

trustee to criticism, particularly if the loss is a result of an uncompensated or nonmarket risk (failure to diversify).

2. A trustee must develop an overall investment strategy having risk and reward objectives reasonably suited to the trust. As indicated in a Prefatory Note to the Uniform Prudent Investor Act, the investment of trust assets requires the trustee's central consideration to be the tradeoff between risk and return. A dynamic and flexible process has therefore replaced the static and inflexible Prudent Man Rule. This dynamic flexible process is to be the centerpiece of trust investing in which prudence is tested by process and not by performance. Prudence is to be measured primarily by the process to which investment strategies are "...developed, adopted, implemented and monitored. Prudence is demonstrated by the process through which risk is managed rather than by labeling of specific investment risk as either prudent or imprudent. Investment products and techniques are essentially neutral; none should be classified prudent or imprudent per se. It is the way in which they are used, in how decisions as to the use are made that should be examined to be determine whether the prudent standard has been met."[15]

The emphasis of the Prudent Investor Rule on process, rather than results, seems contrary to the entire focus of contemporary investing. Periodicals, pundits, and prognosticators all focus on return. We judge investment advice by whether the stock goes up or down. The Prudent Investor Rule, on the other hand, follows Grantland Rice's admonition that "it is not whether you win or lose, but how you play the game that counts." A trustee

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[15]BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE 111 (Oxford University Press ed., 1986).

whose policies and procedures follow the dictates of the Prudent Investor Rule will win, even if the portfolio value loses. A trustee who does not follow the policies and procedures of the rule may lose, even if the portfolio wins. Although this result seems counterintuitive and perhaps wrong, ordinarily the trustee whose policies and procedures follow the dictates of the Prudent Investor Rule will outperform the trustee whose policies and procedures do not. As noted by Simon in *The Prudent Investor Act: A Guide to Understanding,* at chapter note 306:

> "... much of the investment process required by the Act relates to substantive tasks that require, in appropriate situations, an understanding of current investment principles, including Modern Portfolio Theory. A professional trustee is presumed to have this knowledge..."

No longer can the trustee simply invest and manage trust portfolios according to comfortable past practice. Now trustees must establish and follow a procedurally and substantively prudent process for each trust and tailor an individual portfolio for it accordingly. This may prompt professional trustees to reassess whether they can continue to justify "cookie cutter" trust portfolios in which the same investment strategy is used for most trust portfolios. In identifying risk and reward objectives reasonably suited to the trust, as required by K.S.A. 58-24a02, a trustee must undertake the following: identify the settlor's objectives, both financial and human; and establish a prudent trade off between risk and return for the particular trust, with emphasis on the required return to meet the spending needs of the beneficiary, assuming the spending needs of the beneficiary can be identified. Although most commentators believe the spending needs of the beneficiary should drive the allocation and asset strategy of the trust portfolio, at least one commentator has asserted that spending decisions should be governed by the trust investment results, which flow from its investment policies and asset allocations.[16]

3. A trustee must estimate expected return, a task of critical importance when a unitrust, as explained later in this outline, is used. Both historical data and forecasting may be used, although neither has proven to be particularly successful in estimating return. The Monte Carlo Simulation, a statistical software tool, can, and should in the case of a unitrust, be used to estimate return. Tens of thousands of calculations must occur in order to obtain reliable data upon which to project the return of a unitrust portfolio that will favorably interact with the trust's distribution requirements. Monte Carlo software involves simulation modeling that creates a model to imitate various real life situations. Monte Carlo software introduces certain random variables and employs a "random number generator" that assigns values randomly to each variable over and over to simulate what might happen in the future. Monte Carlo software depicts the future value of a portfolio as a full range of possible dollar values derived from "an uncertain bracket return-generating bracket process," proving through time and subject to unpredictable future events. Including within this range is the pricing path that is most likely (but not guaranteed) to carry out the settlor's objectives.[17]

4. The trustee must identify the risk that can be assumed by the trust, in view of the settlor's human and financial objectives. In all instances the trustee must diversify to

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[16]SIMON, *supra* note 4, at 304.

[17]*Id.* at 181; *see also* Patrick J. Collins & Josh Stampfli, *Promises and Pitfalls of Total Return Trusts*, 27 ACTEC J. 205 (2001).

eliminate, to the extent possible, uncompensated risk and manage compensated risk. Compensated or market risk should seldom be avoided by a trustee because to do so would seem clearly to violate the trustee's duty of impartiality by investing in a market in which there is no risk and consequently probably little future reward in the form of portfolio appreciation. In unique situations, however, market risk may be avoided, particularly if the settlor's stated human objectives are to ensure, at all costs, the support of the life income beneficiary and total return investing is not possible through either a unitrust approach or the use of the power to adjust under the Uniform Principal and Income Act.

The trustee's responsibility in establishing an overall investment strategy having risk and reward objectives reasonably suited to the trust, as required by K.S.A. 58-24a02, must start with asset allocation. Asset allocation provides a method for allocating trust funds among asset classes within a portfolio. As stated in § 227 of the Restatement, Comment g, pages 25-26, "asset allocation decisions ... deal with a categories of investments to be included in a trust portfolio and the portions of the trust estate to be allocated to each. These decisions are subject to adjustment from time to time as changes occur in economic conditions or expectations in the needs or investment objectives of the trust." Asset allocation procedures involve determining how the portfolio will be divided among various investment classes, such as stocks, bonds, real estate, or cash. Within the various classes further allocation occurs by determining, for example, whether stocks should be invested in small cap stocks, large cap stocks, value-oriented stocks, or stocks emphasizing the payment of dividends. After asset allocation has been determined, investment strategies are employed to implement the allocations. Investment strategies involve selecting specific investments to be included within each asset class. The Restatement Commentary explains that "asset allocation decisions are a fundamental aspect of an investment strategy and a starting point in formulating a plan of diversification."[18]

The process of asset allocation should also involve a determination of the degree of market, or compensated risk, appropriate to the trust. Modern Portfolio Theory would seem to require, that, unless the settlor's human and financial objectives dictate otherwise, a sensible long-term trust investment portfolio would be reasonably liquid and allocated among short-term cash and equivalents, bonds, or common stocks. More sophisticated investments could also be considered, including REITs and other sophisticated investments if the risk-return analysis dictates. History and most empirical studies show, however, that the primary asset allocation should be common stocks, which, since 1926, have offered the highest average returns of any major asset class.

If the asset allocation involves a substantial commitment to common stocks, the trust investment strategy must be considered. As previously described in this Outline, investment strategy may include either active investing or passive investing, or perhaps both. Neither is mandated by the Prudent Investment Act; however, the bias of the Act, particularly in its Commentary and its progenitor, the Restatement, seems clearly to favor passive investing. Passive investing does not, as previously explained, mean only investing in, for example, Vanguard's S&P 500 Index Fund. If a trustee concludes that the return expectations of a particular active investment strategy will justify the extra costs, including

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[18]RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227, cmt. g, 25–26.

additional taxes, that often result from such strategies, the trustee will have the burden to justify the additional costs of that strategy, particularly if the strategy does not result in a performance that exceeds the performance of typical passive investment strategies. As Hoisington as pointed out, "*The question is not whether professional portfolio managers may add value to the investment process, but whether they actually do considering their compensation, accelerated tax liabilities due to frequent changes in portfolio holdings, and other transaction costs.*"[19]

A trustee who, after a careful risk-reward analysis and a determination of the human and financial objectives of the settlor, believes that an active investment strategy should be pursued, should, before pursuing such strategy, vigorously apply to the proposed strategy the two-part test suggested by the Restatement Commentary. That test is as follows:

(1) What are the extra costs, taxes and risks of the proposed active investment strategy?

(2) Can such costs, taxes and risks be justified by realistically evaluated return expectations?

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[19]Hoisington, *supra* note 12, § 29.03[7]. But see Dominic J. Campisi and Patrick J. Collins, *"Index Returns as a Measure of Damages in Fiduciary Surcharge Cases,"* 140 TR. & EST. 18 (June 2001), (positing that index funds are not efficient in many markets and that asset allocation studies show selecting multiple asset classes provides improved returns and less volatility than relying on the S&P 500 Index). Campisi and Collins suggest that active management involving selecting multiple asset classes, including the over-weighting and under-weighting of those classes, is a responsibility that most trustees should delegate to other managers, particularly if allocations to REITs are part of the allocation. *See also* ROGER C. GIBSON, ASSET ALLOCATION 157 (3d ed. 2000). Although REITs have a low correlation with stocks and bonds, their tax-suitability must be considered because they usually do not qualify for the fifteen-percent tax rate on qualified dividends.

These are not the tests of professors and pundits. They are, rather, the tests that will be applied by courts after the unrelenting plaintiff's lawyer has finished endless interrogatories, depositions, and cross-examination. A lawyer for the plaintiff or a class of the plaintiffs will have read the Reporter's General Note to Restatement § 227, which states "the greater the trustee's departure from one of the valid passive strategies, the greater is likely to be the burden of justification for selecting the proposed active strategy and also the continuous monitoring of that strategy." Although neither the Prudent Investor Act nor the Restatement mandates passive trust investing, a trustee who has not considered passive investing in establishing the process of prudence may be at risk.

Simon, in his book on The Prudent Investor Act, cites the following as evidence supporting the prudence of passive investing:

(1) The zero sum nature financial markets means that all passively managed money invested in a particular market will earn the market return. In contrast, fifty percent of all actively managed money in a market (whether invested in mutual funds, separate accounts or other investment vehicles) will always earn a return less than the market return. This is a simple mathematical fact.

(2) The cost and taxes associated with passive investing are relatively lower. A one percent annual reduction in cost and taxes, compounded over twenty years, will make a huge difference in the value of a trust for a future generation.

(3) Passive funds are broadly diversified so they are relatively lower risk. In contrast, actively managed portfolios are less diversified because they are comprised of investments that differ from the market portfolio..

(4) Passive funds do not experience style drift.

(5) Passive funds are not subject to "Manager Risk."

Although the bias of the Prudent Investor Act and the Restatement from which it evolved are in favor of passive investing, bonds may have a place in many portfolios, particularly portfolios for trusts of short duration where the volatility of the equities markets may jeopardize the beneficiaries who need predictability, or, perhaps, dollars to pay estate taxes or similar expected obligations. Because, however, even the nominal value of bonds and cash equivalents may be difficult to maintain because of taxes, costs, and inflation, such investments should generally be employed only to decrease volatility as needed by the demands of the trust, with the recognition that over the long term such investments will decrease the future spending power of the trust principal.

5. In addition to reflecting many of the tenets of Modern Portfolio Theory, the Prudent Investor Act also describes eight circumstances that a fiduciary must consider in investing and managing trust assets, to the extent relevant to the specific trust and its beneficiaries. The circumstances are not inclusive of all circumstances that must be considered. They are representative only and reflect a part of the process that any trustee must use in determining how to invest and manage trust assets. The eight circumstances described in K.S.A. 58-2408(c) are as follows:

(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 who are eligible to receive discretionary payments of trust income or principal assets;

(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.

These circumstances should be on every trustee's check list for each trust administered by that trustee. The answer to each should be documented and each should relate to the unique human and financial needs anticipated by the settlor and demonstrated by the trust's beneficiaries.

Although this Outline will not analyze each of the eight circumstances, several of them are particularly important in making the transition from the Traditional Model to trust design and investment required by the Legislative Response. They are as follows:

a. The possible effects of inflation and "the expected total return from income and the appreciation of capital." must be considered. This consideration seems to require that an attorney drafting a trust must in each instance weigh whether to use a total return trust or at least include language in the trustee's powers emphasizing the expectation that the trust will be invested for total return. The concept of total return has been briefly explained previously in this Outline and will be discussed further as trust design issues are analyzed.

b. The requirement that a trustee consider tax consequences of investment decisions or strategies, coupled with the requirement of K.S.A. 58-24a07 that a trustee may only incur costs that are appropriate and reasonable in relationship to the assets, the purposes of the trust, and the skills of the trustee declare, with unmistakable clarity, that wasting a beneficiary's money is imprudent.

c. Controlling management expenses must be a consideration in the trustee's decision whether to use active or passive investment practices. Can a trustee justify a full fee even though the trustee has invested trust assets in mutual funds for all or a portion of the trust's investment portfolio? As stated by Campisi and Sobronsky, *supra,* the answer is a resounding "No," according to several pending class actions against Bank of America and LaSalle Bank. Campisi and Sobronsky argue, however, that the answer may not be quite so clear. They assert that active management through mutual funds which have specialists with funding and incentives to seek information and the execution skills to act on such information may be prudent. If, however, the trustee itself purports to have these skills, and nonetheless invests substantially all of the trust's assets in mutual funds, the trustee may be "double dipping." On the other hand, if the trustee retains asset allocation responsibility and delegates implementation strategy to sub-managers, double dipping may not occur and the trustee's fee may not need to be reduced.

d. The trustee's obligation to avoid unnecessary taxes should range from simple tax planning such as avoiding the maximum trust tax bracket by distributing distributable net income to choosing portfolio strategies that maximize after-tax returns. After-tax returns should become a part of asset allocation decisions, particularly with the new fifteen percent federal tax rate on qualified dividends. Asset allocations that emphasize stocks paying substantial dividends should seem to be favored, particularly for trusts such as bypass trusts that often accumulate income. A small tax savings can make a big difference. Passive investment strategies generally result in fewer taxes than active investment strategies. Reducing taxes, although not a mandate in all circumstances, should involve a trustee's considering the use of tax sensitive investment strategies, such as the following:

(i) The use of "tax managed funds," which commonly sell stocks with high cost basis, aggressively harvest losses, and impose exit penalties to discourage redemptions. Such funds may, however, ultimately have a day of reckoning.

(ii) Low-turn over, structured semi-passive equity strategies (e.g., index fund mixes and "SPDRS").

(iii) Use of low turnover strategy to avoid capital gains and concomitant costs.

G. ***<u>Delegation of a Trustee's Investment and Management Functions Under the Prudent Investor Act. K.S.A. 58-24a09</u>***.

The Prudent Investor Act permits, and may demand, delegation of investment and management functions. The ability to delegate represents a dramatic change from the Prudent Man Rule.

1. The author has been interested in the subject of delegation under the Prudent Investor Act for several years. See letter dated August 22, 2000, attached as Appendix 1.

2. FINANCIAL PLANNERS AND ADVISORS, TAKE NOTE. THIS IS WHERE YOU MAY BECOME A FIDUCIARY. The Kansas Prudent Investor Act's rules pertaining to delegation are significantly more erroneous than the delegation provisions of the Prudent Investor Act as promulgated by the National Conference Commissioners of Uniform State Laws in 1994. The Uniform Rule does not include the requirements set forth in K.S.A. 58-24a09(a)(2) and (3). The Kansas Act increases the breadth of both subsections 58-24a09(b) and (c). Trustees and delegees of either trust investment or management functions, or both of them, must not limit their understanding of the delegation provisions of the Prudent Investor Act to general statements published by trade groups pertaining to the Prudent Investor Rule. The Kansas Act is significantly broader than the Uniform Rule and that breadth must be analyzed, understood, and followed if a trustee chooses to delegate investment and management functions, or if a delegee chooses to accept that delegation. Because of its importance, K.S.A. 58-24a09 is set out in full, below:

> "**Delegation of investment and management functions**. (a) A fiduciary may delegate investment and management functions that a prudent fiduciary of comparable skills could properly delegate under the circumstances. For a fiduciary to properly delegate investment functions under this subsection, the fiduciary shall:
>
> (1) Exercise reasonable care, skill and caution in selection of the investment agent, in establishing the scope and specific terms of any delegation and in periodically reviewing the investment agent's actions in order to monitor overall performance and compliance with the scope and specific terms of the delegation;

(2) conduct an inquiry into the experience, performance history, errors and omissions coverage, professional licensing or registration, if any, and financial stability of the investment agent; and

(3) if a trust, send written notice of such trust's intention to begin delegating investment functions under this section to each beneficiary eligible to receive income from the trust on the date of the initial delegation at lest 30 days before such delegation. This notice shall thereafter, until or unless each beneficiary eligible to receive income from the trust at the time are notified to the contrary, authorize the fiduciary to delegate investment functions pursuant to this section.

(b) In performing a delegated function, an investment agent shall be subject to the same standards that are applicable to the fiduciary.

3. The authority for a trustee to delegate became necessary under the expansive investment universe provided by the Uniform Prudent Investor Act. Because under Uniform Act no investment strategy, product, or technique is imprudent per se, trustees may lack the skill required by the Act to invest in accordance with such strategies, products, or techniques. If the use of such strategies, products, and techniques is determined to be appropriate under the Act, particularly under two-part test described on page 27 above, the trustee may be obligated to delegate management authority. The duty of some trustees to delegate, however, does not necessarily mean that all trustees are entitled to delegate, particularly if delegation does not result in a reduced trustee's fee.[20] Moreover, because anyone with "ordinary intelligence" can serve as a trustee, the Act recognizes that notwithstanding ordinary intelligence, advice and direction may be essential to meet the requirements of the Act, including the requirement that the trustee must analyze the risk-return aspects of trust investing, develop an asset allocation model, and implement that model through a prudent investment strategy.

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[20]*But see* Campisi & Sombronski, *supra* note 14.

4. Even though a trustee may delegate, the trustee must still exercise care and skill in all matters, including the selection of the delegee and monitoring the delegee's overall performance and compliance with the scope and specific terms of the delegation.

5. Obviously if a trustee is required to monitor the delegee's specific performance and compliance with the scope and specific terms of the delegation, there must be a stated scope and specific terms of the delegation. A written delegation agreement or letter would therefore seem to be essential.

6. The Prudent Investor Act establishes different standards for trustees, in recognition that anyone of ordinary intelligence can serve as a trustee. Thus, an amateur trustee will be held to the standards of an amateur, and a corporate trustee which professes investment expertise will be held to a higher standard than a non-corporate trustee. The Restatement, in describing delegation, states:

> "The standards of trusteeship are neither excessively demanding nor monolithic. They should neither preclude service by conscientious family members and friends, nor permit casual inattentive behavior by trustees who can, because of their expertise, meet a higher than ordinary standard of conduct and competence."[21]
>
> The comment continues by stating that:
>
> "in certain circumstance a trustee may have the duty to delegate authority to others as a prudent investor would do in the circumstances."

[21]RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992).

Hoisington concludes that "*a corollary to the delegation imperative is that fiduciaries possessing appropriate investment skills may not delegate. ...* thus it becomes axiomatic the delegation itself is a fiduciary obligation that cannot be treated lightly."[22]

7. Although the trustee may seek advice in selecting a delegee, the trustee may not delegate the duty to exercise care, skill and caution in selecting the delegee. Not only must the trustee who wishes to delegate investment or management functions personally exercise reasonable care, skill and caution in selecting the investment agent and periodically reviewing the investment agent's actions to determine if the investment agent has complied with the Prudent Investor Rule, but the trustee must also, pursuant to K.S.A. 58-24a09(a)(2) "conduct an inquiry into the experience, performance history, errors and omissions coverage, professional licensing and registration, if any, and financial stability of the investment agent." Documentation of each aspect of required inquiry seems essential.

8. Neither the Restatement nor the Prudent Investor Act provides detailed guidelines for the task of periodically reviewing the delegee's actions and monitoring the delegee's performance to determine compliance with the terms of the delegation and the Prudent Investor Act. Guidelines are suggested in Simon's book on the Prudent Investor Act, at page 151. Simon also suggests the use of an "asset allocation audit," for the

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[22]Hoisington, *supra* note 12, § 29.03[5]. Several ERISA cases punctuate Hoisington's axiom that "...delegation itself is a fiduciary obligation that can not be treated lightly." *In re, WorldCom, Inc. ERISA Litigation*, 263 F. Supp. 2d 745 (S. D. N. Y. 2003) held that the fiduciary (Merrill Lynch) might be liable when it followed investment instructions to invest employee funds in WorldCom stock at a time a prudent trustee should have known that WorldCom's decision to continue to offer stock to its employees as an investment option was imprudent or otherwise in violation of WorldCom's obligations under ERISA. *See also In re Enron Corp. Sec., Derivative & ERISA Litig.*, 284 F. Supp 2d 511 (S.D. Tex. 2003).

purpose of managing the policy for selecting a delegee and managing the manager. Managing the manager, according to Simon, at page 152, measures the impact of actions taken by the investment manager selected to implement the portfolio's asset allocation. This is not a perfunctory duty that the trustee can summarily assign to an administrative staff person to check off items on an outline. It seems rather, to require, the responsibility of seasoned trust officers who fully understand that the trustee is responsible for an investment manager's actions if the trustee has failed properly to select and monitor the delegee. If, however, the trustee fulfills these tasks and sends written notice of the trustee's intention to delegate investment functions to each beneficiary eligible to receive income from the trust at least thirty days before the delegation, the trustee should not be liable to the beneficiaries or to the trust for the decisions or actions of the delegee. Otherwise, the delegee's decisions and actions will be imputed to the trustee. This is a powerful reason why a trustee must have a written delegation arrangement with the delegee. If no written arrangement exists, the scope of the delegation will not be defined, and the protection of K.S.A. 58-24a09(d) will probably not be available.

9. In determining past experience and performance of the delegee, and periodically reviewing the investment delegee's actions, the trustee must be conscious of the investment strategy chosen by the delegee to implement the trust asset allocation policy. If the asset allocation policy generally requires a passive investment program, and the delegee undertakes active investment with resulting additional costs and taxes, the trustee must act to cause the delegee to comply with the asset allocation arrangement or terminate the delegee. This responsibility would extend to a mutual fund selected by the

trustee or the delegee, as a mutual fund would appear to be a delegation of investment functions, particularly in the implementation of the asset allocation policy of the trust.

10. The act not only imposes a burden on trustees in exercising the delegation function, but imposes a burden on the delegee itself. K.S.A. 58-24a09(b),(c) & (e) provide as follows:

> (b) "In performing a delegated function, an investment agent shall be subject to the same standards that are applicable to the fiduciary.
>
> (c) An investment agent shall be liable to each beneficiary of a trust and to the designated fiduciary to the same extent as if the investment agent were a designated fiduciary relationship to the exercise or non-exercise of the investment function.
>
> (e) By accepting the delegation of a trust function from the fiduciary of a trust that is subject to the law of this state, an agent submits itself to the jurisdiction of the courts of this state."

These sections should give pause to investment managers who eagerly wish to take on the trust investment functions of a trustee of a private trust. By accepting delegation, the delegee owes a duty of care to execute the terms of the delegation, and probably the investment management functions of the trustee, equal in magnitude to that of the trustee. Any attempt by the delegee to exculpate itself from such liability is probably void as against public policy.

11. The trustee must be vigilant when delegating investment or management functions, and should carefully consider whether to sign standardized agreements that are common among investment managers. Not only do such agreements usually contain exculpation clauses, but they most certainly will contain agreements for the mandatory arbitration of disputes. The United States Supreme Court, in *Rodrigues DeQuijas v.*

Shearson American Express, Inc.,[23] held that such arbitration clauses are enforceable and federal preemption generally excludes state courts from being a proper forum for resolving disputes between the investment advisor and the customer. Because federal preemption may therefore override K.S.A. 58-24a09(e), which states that a delegee will submit to the jurisdiction of the courts of Kansas, the trustee who executes an investment management agreement that provides for mandatory arbitration may, and probably would be, liable for not exercising reasonable care, skill, and caution in selecting the investment manager and in establishing the scope and specific terms of the delegation.

H. *When is Compliance with the Uniform Prudent Investor Act Determined?*

K.S.A. 58-24a08 states that "compliance with the Prudent Investor Rule is determined in light of the facts and circumstances existing at the time of a fiduciary's decision or action, and not by hindsight." Monday morning quarter backing, which faults the quarterback who failed to score a touchdown even though the play was properly called and executed, is not permitted under the Prudent Investor Rule. If the process, as described in the trustee's written play book, is carefully followed and implemented, a trustee should escape surcharge even if the trustee's performance is disappointing. As previously stated in this Outline, however, if the trustee follows the play book as described by the Prudent Investor Act, as defined by Modern Portfolio Theory, performance should at least equal appropriate benchmarks against which the trustee's performance reasonably may be judged.

A recent example of a trustee not following the play-book (internal trustee review protocol) is *In re the Estate of Janes,* (1997), 90 N.Y.41, 659 N.Y.S.2d 165, in which Lincoln

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[23] 490 U.S. 477, 109 S.Ct. 1917 (1989).

First Bank, N.A. was surcharged for failing to diversify a concentration of 71% of trust assets in Kodak stock. The language of the prestigious New York Court of Appeals is instructive:

> "Notably, there was proof that petitioner (1) failed initially to undertake a formal analysis of the estate and establish an investment plan consistent with the testator's primary objective; (2) failed to follow the petitioner's own internal trustee review protocol during the administration of the estate, which advised special caution and attention in cases of portfolio concentration of as little as 20%; and (3) failed to conduct more than routine reviews of the Kodak holdings in this estate, without considering alternative investment choices, over a seven-year period of steady decline in the value of the stock." *Janes*, 681 N. E. 2d at 339.

I. ***Damages for Breach of the Prudent Investor Rule.***

A thorough discussion of damages is beyond the scope of this Outline. It should not, however, be a matter of disinterest for trustees. Generally, the Uniform Trust Code permits damages to be awarded for the greater of "(1) the amount required to restore the value of the trust property and trust distributions to what they would have been had the breach not occurred; or (2) the profit the trustee made by reason of the breach." The issue of damages is discussed in the following materials: Halbach, *supra*, at page 43; *Campisi, Goodwill Hunting: Making Trust a Pleasure Not a Pain*, proceedings of the Section of Real Property, Probate, and Trust Law, American Bar Association, 2001 Annual Meeting; and Simon, *supra*, Chapter 17.

J. ***Advance Directives and Exculpatory Provisions.***

1. *McGinley v. Bank of Am., N.A.* 279 Kan. 426, 109 P.3d 1146 (2005) "The Case for Advance Directives."

a. *McGinley* Facts.

(i) In November, 1990, Marie McGinley, age 79, created a revocable trust, naming Bank of America as trustee. The trust agreement was drafted by Mrs. McGinley's attorney, and included as part of its initial principal 1,541 shares of Enron stock. The trust agreement gave to the trustee broad powers to manage, in addition to powers conferred by law (at that time, the Kansas Uniform Trustees' Powers Act). The trust, however, reserved to the grantor the following: "...during the lifetime of Grantor, [s]he shall be consulted by the Trustee as to any purchase or sale, and the Trustee shall abide by the Grantor's decision unless, in the sole opinion of the Trustee, the Grantor is incapable of managing [her] affairs, in which event the decision of the Trustee as to all investment matters shall be final and conclusive."

(ii) Approximately seven months after the trust was established, Mrs. McGinley signed a form letter, apparently prepared by the bank, which was delivered to the bank by Mrs. McGinley's husband. Although the court uses the word "delivered," a better word probably would be "returned." The letter was a directive entitled "Direction by Power Holder to Retain Securities," and stated the following:

> "I understand that you do not monitor the securities, and I hereby agree to exonerate, indemnify and hold the Bank harmless from any and all loss, damage and expense sustained or incurred by the Bank for continuing to retain these securities as assets of this account. I also relieve the Bank from any responsibility for analyzing or monitoring these securities in any way. I hereby bind all beneficiaries of the designated account, my heirs, my executors, and my assigns to the terms of this letter. This release and indemnification will remain in force and effect until my death, my disability (as determined in accordance with the trust agreement) or my written revocation of this letter."

The letter refers specifically to 1,541 shares of Enron corporation stock. If evidence was produced at the district court level regarding discussions between the bank and Mrs. McGinley regarding the meaning and consequences of the letter, the discussions were not mentioned in the court's opinion.

(iii) The court's opinion was silent as to Mrs. McGinley's investment experience, knowledge of business matters, or the extent of her assets other than the Enron stock.

(iv) The Enron stock increased in value from the time the trust was established to a high in December, 2000, of $789,687.50, and represented approximately 77% of the total market value of the trust. The opinion is silent as to the value of the Enron stock at the time the trust was established or its percentage at that time of the trust's total market value. By March, 2001, the Enron stock amounted to 66% of the total market value of the trust, and at its nadir on December 31, 2001, to 2% of the market value of the trust assets, with the stock then having a value of $4,800.00.

(v) Mrs. McGinley at no time revoked or changed the investment directive letter or amended the trust in a manner in which the trustee's investment authority was changed.

(vi) On January 3, 2003, Mrs. McGinley sued the bank, and on March 22, 2004, the district court granted the bank summary judgment.

(vii) Several Kansas statutory changes occurred from the time the trust was established until litigation was commenced, as follows:

A. 1990 – The Uniform Trustees' Powers Act was enacted in Kansas. Section 17-5004 of that act applied the Prudent Man Rule to a trustee's investment duties. The Prudent Man Rule, then in effect, was included as part of K.S.A. §17-5004(c) which provided as follows:

> "In acquiring, investing, re-investing, exchanging, retaining, selling and managing property of a trust which is revocable or amendable, a trustee following written directions regarding the property of the trust that are received by the trustee from the person or persons then having the power to revoke or amend the trust...shall be deemed to have complied with the foregoing standards provided in subsection (a) [Prudent Investor]. A trustee is authorized to follow such written directions regardless of any fiduciary obligations to which the directing party may also be subject."

B. 1993 – The Prudent Man Rule was changed to The Prudent Investor Rule, which added to K.S.A. 17-5004(a)(2), the following:

> "If a trust, the provisions of this section [prudent investor rule] may be expanded, restricted, eliminated or otherwise altered by express provisions of the trust instrument. *The fiduciary is not liable to a beneficiary for the fiduciary's reasonable and good faith reliance on those express provisions."* (emphasis added).

The 1993 change reiterates the language of K.S.A. 17-5004(c), pertaining to revocable trusts and a trustee's protection from liability if the trustee follows written directions of the grantor of the revocable trust.

C. 2000 – Kansas replaced the Prudent Investor Act with the Uniform Prudent Investor Act, found at K.S.A. 58-24a0–24a19. Section 58-24a02(g) reiterates the revocable trust language quoted above as a part of K.S.A. 17-5004(c), although this language did not become a part of the Kansas version of the Uniform Prudent Investor Act until 2001.

D. 2003 – Kansas adopted the Uniform Trust Code, which replaced the Uniform Trustees' Powers Act. K.S.A. 58-a1106 (a)(5) states "An act done before the effective date of the act is not affected by this act."

b. *McGinley* Issues.

(i) Did the bank breach its fiduciary duty to Mrs. McGinley?

(ii) Was the bank negligent in failing to supervise its employees with respect to trust assets?

(iii) What law applied to the bank's and Mrs. McGinley's actions?

c. The Kansas Supreme Court's Decision.

The court enunciated two principles:

- A trustee which reasonably and in good faith relies upon express provisions of a trust instrument, including those which alter the Prudent Investor Rule, is not liable to a beneficiary for breach of trust to the extent that the breach resulted from the reliance.

- A trustee which follows written directions regarding the property of the trust that are received from the grantor of a revocable trust shall be deemed to have complied with the Prudent Investor Rule and is authorized to follow such written directions.

The court explained how these principles were applicable to the *McGinley* facts by emphasizing that the trust agreement essentially eliminated the Prudent Investor Rule by stating that the trustee shall abide by the grantor's decision regarding the purchase or sale of trust property. The court further stated that Mrs. McGinley, pursuant to language drafted by her own attorney, intended to carve out from the trustee's general investment powers the exclusive authority to herself regarding all purchases and sales of trust assets. This authority was exercised in the letter "delivered" by Mrs. McGinley to the bank directing the bank to retain the Enron stock and relieving the bank from any responsibility to monitor or analyze the stock. The court concluded, emphatically, that under applicable statutes the bank complied with both the Prudent Man and the Prudent Investor Rules as a matter of law.

The court held that Mrs. McGinley's reservation of investment authority to herself in the trust, coupled with the letter directing the trustee to hold Enron stock without responsibility to monitor or analyze that stock, eliminated Mrs. McGinley's argument that the bank's failure to explain the contents and consequences of the letter constituted a breach of trust for which the bank should be liable. The court pointed to language in the letter pertaining to the bank being released of liability as meaning Mrs. McGinley was aware that there were risks associated with the letter and its effect as releasing the bank from liability with respect to the Enron stock. Although Mrs. McGinley argued that the exculpatory provision in the letter was invalid because the bank abused its fiduciary relationship by not explaining the consequences of the letter, the court dismissed Mrs. McGinley's argument by stating that "McGinley provides no relevant authority for her argument..."

The only authority apparently offered by Mrs. McGinley was the reference to section 222 of the Second Restatement of Trusts and to K.S.A. 58a-1008, which limit the breadth of exculpatory provisions. The Kansas Supreme Court held, however, that those authorities are applicable *only if exculpatory provisions are placed by the trustee in the trust instrument*. The case of *In re Estate of Saxton,* 712 N.Y.S. 2d 225 (App. Div. 2000), apparently was not brought to the attention of the court. In *Saxton,* the New York Appellate Division held that a corporate trustee should be surcharged for investment breaches even though a written investment directive signed by all beneficiaries expressly approved all of the trust assets being held in a single stock. The Appellate Division held that the trustee had a duty to inform the beneficiaries of the consequences of such an agreement, and stated:

> "Prior to the instrument being prepared and its subsequent distribution to respondents, not a scintilla of evidence indicates that the petitioner fully apprised Saxton or respondents of the effects that their execution of the [investment directive agreement] would have on their legal rights or how their direction to hold the entirety of the trust corpus in IBM stock would

> fall short of what would have been required of a prudent corporate trustee." *Saxton*, 712 N.Y.S. 2d 255 at 231.

Perhaps the New York Court in *Saxton* was not asked, as was the Kansas court in *McGinley*, to determine that a written directive prepared by the trustee that exculpates the trustee from investment decisions would not be subject to limitations on exculpation because it was not a part of the trust itself. This distinction made by the Kansas Supreme Court in *McGinley*, however, seems artificially precarious, and should not be considered to be an unqualified endorsement of enforceability of exculpation directives that are not a part of the trust instrument.

The plaintiff in *McGinley* also apparently failed to direct the court's attention to *Rawlings v. Branch Banking & Tr. Co.*, 56 Va. Cir. 147 (2002), in which the court permitted a case to proceed to trial by stating that the fiduciary possessed a duty, of which it could not rid itself, to warn or impart the beneficiary of any knowledge the fiduciary may have affecting the beneficiary. This duty existed despite the trust agreement's giving to the beneficiaries the power to direct investments and a Virginia statute generally protecting a trustee when a third party has the right to direct investments.

e. Lessons from *McGinley*.

(i) Do not include exculpatory language in the trust agreement, particularly if drafted or caused to be drafted by the trustee. Any exculpatory language should be included in a supplemental letter, or "advance directive," as in *McGinley*. Although the *McGinley* distinction is tenuous, the court holds that K.S.A. 58a-1008, pertaining to exculpatory provisions, is applicable only with respect to the trust document itself, and does not "...concern letters issued in accordance to trust provisions that had been drafted [the trust provisions, not the letter] by grantor's own legal counsel." Although this is precisely the court's holding in *McGinley*, it seems strained because although the trust agreement stated that Mrs. McGinley was to be consulted by the trustee as to any purchase or sale and the trustee was to abide by Mrs. McGinley's decision, the supplemental letter included significantly broader language than "purchase or sale," and the letter was not drafted by Mrs. McGinley's attorney, but by the bank on its own form.

(ii) Investment directions and exculpatory language in a separate advance directive to the trustee should specifically relieve the trustee from any responsibility for analyzing or monitoring securities that the settlor intends for the trustee to retain.

(iii) Do not rely on the general language of the Uniform Trust Code regarding provisions in a trust that give the trustee authority to retain assets initially transferred to the trust by the settlor.

(iv) *McGinley* should be considered authority only with respect to revocable trusts during the lifetime of the settlor and during the time the settlor is not incapacitated.

(v) Do not include in exculpation provisions an exception for the trustee's negligence (the trustee is exculpated except for its own negligence). The plaintiff in *McGinley* apparently alleged negligence only in terms of the trustee's negligent failure to supervise its employees. The plaintiff apparently did not allege that the bank's failure to communicate the effect and consequences of the directive and its failure to seek reaffirmation of the directive even though the value of the trust's Enron stock had plummeted were independent acts of negligence.

(vi) Ignore *McGinley* other than as a defense for a trustee's prior action. It should not be a guide for prudent administration and management of trust investments. To the contrary, as the court stated:

> "Clearly the better practice for the Bank would have been to have communicated to McGinley the letter's contents and effect before she signed it and to have notified her of evolving circumstances, e.g. steady decreases in Enron's value which reduced the investment portfolio's overall worth, or steady increases, the desirable, which unbalanced the portfolio."

K. *The Uniform Principal and Income Act, K.S.A. 58-9-101-58-9-603.*

1. The Uniform Principal and Income Act was adopted by the Kansas Legislature in 2000. The Act is the subject of a comprehensive article in the Kansas Bar Journal.[24] Newberry And Sullivan thoroughly explore the contours of the Act in their article. This Outline will, therefore, cover only that portion of the act pertinent to the Legislative Response to the Traditional Model. As previously discussed in this Outline, the shortcomings of the Traditional Model are many, but may be summarized by stating that the old rule promised to disappoint life income beneficiaries and remaindermen equally, but seldom succeeded in equal disappointment; one was typically more disappointed than the other. Both were certain to have some disappointment, however, because of the tension between investing for income for the income beneficiary and investing for principal growth for the remaindermen. This fact, compounded by the traditional limitations caused by the artificial distinction between income wealth and principal wealth, resulted in an almost impossible burden for trustees. Section 58-9-104 of the Kansas Uniform Principal and Income Act ameliorates the trustee's burden by giving to trustees discretion to re-characterize principal to income and income to principal so long as *"... the trustee invests and manages the trust assets as a prudent investor, pursuant to K.S.A. 58-24a02." (the Prudent Investor Act).* The Uniform Principal and Income Act appears to be an attempt to implement the transition to the Prudent Investor Rule, particularly that part of the rule that emphasizes

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[24]C. David Newberry & D. Thad Sullivan, *An Accounting Primer for Estate Planning, Probate and Trust Counsel (The New Kansas Uniform Principal and Income Act)*, 71 J. KAN. BAR ASS'N, June/July 2002, at 51.

investing for total return, rather than achieving a certain level of income in the form of dividends, rents, interest, and other accounting income to benefit the income beneficiary. Because modern prudent investing requires investing for total return, with no distinction between income and principal, K.S.A. 58-9-104 would permit the trustee, if the rules of that section are followed, to transfer funds from principal to income for distribution to the income beneficiary, or, on the other hand, if the trust produces substantial income and little capital appreciation, to transfer income to principal so long as the estate tax marital deduction is not jeopardized.

2. K.S.A. 58-9-104 gives to a trustee the power to adjust between principal and income if the following exist:

- The trustee invests and manages the trust assets under the Prudent Investor Act;
- The trust terms describe the amount that may or must be distributed to a beneficiary by referring to the trust income; and
- The trustee determines after applying the rules of § 58-9-103(b) that the trustee is unable to administer the trust impartially, based on what is fair and reasonable to all of the beneficiaries. § 58-9-103(b) provides, however, that if the terms of the trust or will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries, that intention controls.

3. If the requirements of § 58-9-103(b) exist, § 58-9-104 describes the factors a trustee should consider to determine if the power to adjust should be used and if so, to what extent. Those factors are as follows:

- The nature, purpose, and expected duration of the trust;
- The settlor's intent (query, can intent be determined from extrinsic sources or must it be determined from the trust itself?);
- The beneficiary's identity and circumstances;
- The need for liquidity, regularity of income, and preservation and appreciation of capital;
- The kind of assets held by the trust and whether those assets have unique characteristics;
- The trust accounting income and assets that are not readily available to distribute;
- Whether the trust gives to the trustee the power to invade principal, accumulate income, or prohibit the trustee from invading principal or accumulating income;
- The actual and anticipated effects of economic conditions on principal and income and effects of inflation and deflation; and
- Anticipated tax consequences of an adjustment.

These factors should carefully be reviewed and the results of the review documented before the trustee exercises the power to adjust.

4. The Uniform Principal Income Act describes several situations for which a trustee may not exercise a power to adjust. They are as follows:

- If the income of a marital trust would be reduced, thus jeopardizing the marital deduction;

- The actual value of an income interest in a trust will be reduced thereby jeopardizing a federal gift tax annual exclusion;
- If the adjustment would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets, as would be the case with a GRAT or CLAT (fixed annuity) or GRUT or CLUT (fixed fraction);
- Any amount permanently set aside for charity would be reduced;
- If possessing or exercising the power to adjust would cause a person to be treated as a grantor for income tax purposes, if the person would not have otherwise been treated as the grantor;
- If possessing or exercising the power to adjust would cause the trust assets to be included in the power holder's estate for federal estate tax purposes;
- If the power to adjust is made by a trustee who is a beneficiary of the trust, even though the power to adjust could be exercised by a co-trustee or the exercising co-trustee is not a beneficiary; or
- If the adjustment would benefit the trustee directly or indirectly and the trustee is not a trust beneficiary.

Most of these prohibitions would not be applicable to a normal private trust with an independent trustee. Even if the trustee is not independent, many of these prohibited powers could be exercised by a co-trustee or perhaps pursuant to court order. The direction provided by §§ 58-9-103 and 58-9-104, taken together, require the trustee to allocate first according to the trust, then according to any discretionary powers under the trust, then according to the normal allocations under the Uniform Principal and Income Act, and finally, if the allocation does not fulfill the trustee's obligation to treat beneficiaries impartially, an adjustment may be made under § 58-9-104(a) and the trustee may distribute a portion of the total return from the trust arising from appreciation of principal by allocating principal to distributable income.

5. The power to adjust may be released pursuant to K.S.A. 58-9-104(e). The potential mischief caused by the power to adjust should be reviewed by the attorney drafting the trust and, more particularly by the trustee administering the trust. For example, if the power to adjust might diminish the actuarial value of the income interest in the trust for which the income beneficiary's estate may be eligible to claim the IRC § 2013 credit for tax on prior transfers when the income beneficiary dies within ten years after the death of the person creating the trust, the trustee should consider releasing the power to adjust so that the income interest can be valued without taking into account the power to adjust.[25]

6. The power to adjust is available even to trusts that limit the power of a trustee to make adjustment between principal and income unless the terms of the trust clearly state that the trustee shall not have the K.S.A. 58-9-104(a) power to adjust. Consequently, attorneys drafting trust documents should discuss with their clients whether the client wishes for the power to adjust to be applicable, or whether the client wishes to

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[25]Terry L. Turnipseed, *Tools for Better Balancing the Interests of Income Beneficiaries and Remaindermen*, 28 TAX MGMT. EST., GIFTS & TR. J. 244, 247 (2003).

specifically prohibit that power so that strict and traditional accounting distinctions between income and principal will apply.

7. Although the power to adjust clearly facilitates trust investment and distribution policies, and reduces the difficult burden of impartial treatment of beneficiaries that prevailed under the Traditional Model, when to use the power and how to use the power remain problematic. Examples in the Uniform Principal and Income Act, as drafted by the Uniform Commissioners, illustrate pedestrian situations. More difficult situations, however, remain unanswered. The trustee might find the decision to adjust relatively simple when needed to compensate for a decrease in accounting income caused by an increase in the proportion of trust assets allocated to stocks in response to the Prudent Investor Rule. Similarly, a trustee could easily determine that during a period of high inflation with high interest rates, a portion of the interest should be considered to be a return of capital and added to principal. The tough question, however, is what amount, as a percentage of assets, must be distributed or added to principal. The decision involves considerations of whether shifting what otherwise would be principal to distributable income may jeopardize the future principal of the trust, particularly if the trustee's objective is to maintain the inflation-adjusted asset value of trust principal. The Turnipseed article in *Tax Management of Estates, Gifts, and Trusts Journal,* cited above, offers valuable guidance in locating resources that might be helpful to a trustee in analyzing whether to exercise the power to adjust.

8. A trustee using the power to adjust is protected to the extent that the provisions of Uniform Principal and Income Act are followed, in that K.S.A. 58-9-103(b)

states that "a determination in accordance with this act is presumed to be fair and reasonable to all of the beneficiaries." Moreover, the power to adjust is a discretionary power to the same extent as the power to allocate assets between stocks and fixed-income securities under the Prudent Investor Act is a discretionary power. Because the decision-making process is discretionary, which generally means that the decision is in accordance with one's own judgment rather than the judgment of another, the courts will usually abide by the trustee's decisions.[26]

9. If, according to some commentators, the spending needs of the beneficiary should properly be determined by the trustee and drive the trustee's investment decisions, a trustee should quantify the beneficiary's spending needs or at least establish a dollar range for those needs. This is not a change from current trust policy, which would require the trustee to invest in a way that the beneficiary's spending needs would be met by trust income. In other words, invest in bonds or other assets that historically produce greater income than stocks. The coalescence of the Prudent Investor Act and § 58-9-104 of the Uniform Principal and Income Act now however permits the trustee to invest in a way that may produce significant capital appreciation, even though accounting income is reduced. The trustee can exercise its authority to adjust by transferring funds from principal to income to meet the spending requirements established for the income beneficiary. The apparent simplicity of deciding to exercise a trustee's power to adjust is deceptive, however, in that the trustee must also make the analysis described in Paragraph II G.7, at

[26] E. James Gamble, "UPIA, Unitrust & UTOPIA—Distributions to Beneficiaries in the Brave New World of Total Return," Study Outline, ACTEC Annual Meeting (1999).

page 46, above, as to whether transferring accounting principal to income will jeopardize the inflation-adjusted value of the trust principal.

10. The adoption of the power to adjust provisions as a part of the Uniform Principal and Income Act punctuates the ineffectiveness of the Traditional Model, which artificially distinguished between income and principal. In the absence of this distinction, the power to adjust would not be required.

L. ***Uniform Trust Code - K.S.A. 58a-101 - 58a 1106***.

If any doubt remains as to a trustee can ignore the Uniform Prudent Investor Act and Modern Portfolio Theory, it is conclusively and unmistakably answered by K.S.A. 58a-901 of the Kansas Uniform Trust Code, which provides as follows:

> "Notwithstanding any provisions of the Kansas Uniform Trust Act to the contrary, [the Kansas Uniform Prudent Investor Act and amendments thereto] shall govern the investment and management of trust assets."

M. ***Regulations Issued under I.R.C. § 643, Defining Income for Federal Income Tax Purposes***.

Final Treasury Regulations were issued on December 30, 2003, under § 643 of the Internal Revenue Code, with an effective date of January 2, 2004. The Regulations were long awaited by many trustees because earlier regulations, and perhaps the Code itself, failed to recognize total return investing and the blurred distinction between income and principal. A detailed analysis of the § 643 Regulations is beyond the scope of this Outline and probably the patience of its readers. The Regulations are tedious, and fortunately, several excellent articles exist which carefully dissect the § 643 Regulations and offer planning and drafting guidance.[27] The new Section 643 Regulations cannot be ignored as grist only for accountants because they affect trust drafting and administration as well as fiduciary income tax returns.

The Section 643 Regulations generally provide that income continues to be defined under traditional income and principal allocation rules in which ordinary income is allocated to trust accounting income and capital gains are allocated to trust principal. Because total return investing blurs the traditional line between income and principal, the Section 643 Regulations authorize such blurring if there is a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax exempt income, capital gains, and appreciation. Such a reasonable apportionment exists if the following conditions, generally stated, are met:

- The terms of the governing instrument must not prohibit such blurring;
- Applicable state law defines income to include a unitrust definition, which under Reg. § 1.643(b-1) must be a unitrust amount of no less than three percent and no more than five percent of the fair market value of the trust assets;
- Applicable local law specifically authorizes a power to equitably adjust, as is provided in K.S.A. 58-9-104 (remember that the power to equitably adjust is available only if the trustee invests and manages the trust assets under the Prudent Investor Act); *or*

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[27] Laura Howell-Smith, *Using a Unitrust or a Power to Adjust Under the Section 643 Regs.*, 31 EST. PLAN. 496 (2004); Barbara A. Sloan, *643 Regulations: Use of Non-Charitable Unitrusts and Other Issues Raised Under the Final Regulations*, 30 ACTEC J. 33 (2004); Jonathan M. Blattmacher & Mitchell M. Ganns, May 17, 2004, *Tax Notes.*

- Allocation to income of capital gain is made either pursuant to the terms of the trust instrument, applicable local law, *or* pursuant to a reasonable and impartial exercise of discretionary power granted to the fiduciary by applicable local law *or* by the governing instrument.

Kansas lacks a statute broadening the definition of "income," to include a unitrust interest. Until the Kansas Legislature broadens the definition of income to include a unitrust interest, as has Missouri,[28] the Section 643 Regulations give Kansas trustees total certainty in defining income in a total return trust only if the trustee exercises the power to adjust under K.S.A. 58-9-104. The Section 643 Regulations offer to Kansas trustees another, but less certain, opportunity to blur the traditional income and principal distinction by permitting a trustee to define income as including both income and capital gain if the trustee's discretion to make the allocation is authorized under local law or the governing instrument (if not prohibited by local law) and the trustee reasonably and impartially allocates realized capital gain to income. This opportunity does not exist if the governing instrument does not permit discretionary distributions of principal. Because most unitrusts provide an ordering rule for distributions (first from net income, next from net realized short-term capital gains, next from net realized long-term capital gains, and next as necessary from principal) a trustee of such a unitrust should be able to use a total return investing approach and be reasonably comfortable that distributable net income will include capital gain if the trustee is consistent in applying the ordering rule.[29]

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[28] MO. ANN. STAT. §§ 469.401(8), 469.411 (2004).

[29] Opinions differ among commentators as to how comfortable a trustee should be. Compare, for example, JEROLD I. HORN, FLEXIBLE TRUST AND ESTATES FOR UNCERTAIN TIMES 59 (Am. Law Inst.—Am. Bar Ass'n 2003), "An ordering system ...would seem, in the context of

The definition of income under the new Section 643 Regulations also affects marital deduction unitrusts. Until the promulgation of the Regulations, a marital deduction unitrust generally required the trustee to distribute a unitrust amount that in no instance would be less than the trust's accounting income in order to satisfy the marital deduction income standard provided in Regs. § 20.2056(b-5)f. The Section 643 Regulations state that the income interest of the surviving spouse is met if the spouse is entitled to income that is defined by a local law that permits a reasonable apportionment between the interest of life income and remainder beneficiaries of the total return trust and that meets the requirements of Regs. § 1.643(b-1).[30] Except for a trustee's power to adjust in Kansas, there is no statute providing for such a reasonable apportionment between the interest of the life income beneficiary and remaindermen of the total return of the trust. Such a statute exists in Missouri which statutorily defines the unitrust amount of no less than three percent and no more than five percent of the trust principal. Until a similar provision exists in Kansas law, a question remains whether a unitrust arrangement for a marital deduction trust can be effective to ensure the surviving spouse all of the trust income in the absence of a provision the trust instrument requiring the trustee to distribute the greater of the unitrust amount or the trust's net income.

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a private annuity trust and a private unitrust, to have no economic substance apart from tax results. Arguably, therefore, the inclusion in the governing instrument of the ordering system would seem ineffective to determine the income-tax complexions of distributions from private annuity trusts and private unitrusts to annuitants and unitrust recipients."; with Robert B. Wolf, *Estate Planning with Total Return Trusts: Meeting Human Needs and Investment Goals Through Modern Trust Design*, 36 REAL PROP. PROB. TR. L.J. 193 (2001) [hereinafter Wolf, *Estate Planning*], positing that the proposed § 643 Regulations approve of an ordering arrangement, either in the governing instrument or pursuant to the trustee's exercise of discretion, consistently applied.

[30] Treas. Regs. §§ 20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1).

III. TRUST DESIGN AND INVESTMENT REQUIRED BY THE LEGISLATIVE RESPONSE TO THE TRADITIONAL MODEL

A. *Objectives in Designing Trusts that Meet the Requirements of the Legislative Response to the Ineffective Traditional Model. We must take notice of the legislative responses.*

The Kansas Legislature has responded to the ineffective Traditional Model by codifying the Uniform Prudent Investor Act, the Uniform Principal and Income Act, and the Uniform Trust Code. Any one of these legislative responses should motivate the trust and estate community to take notice. All three of them require that we not only take notice, but that we also do something. The question of what we are to do depends largely upon the objectives we seek to accomplish in order to comply with the new legislation. Suggested objectives are as follows:

1. We must understand thoroughly the settlor's human and financial goals in establishing the trust, and be certain the settlor understands alternatives, including the opportunity to elect out of the Prudent Investor Act and the power to adjust under the Uniform Principal and Income Act.

2. The trust should be a form of total return trust, as described in more detail below, that permits the trustee to invest trust assets for the highest total return compatible with the risk acceptable to the settlor, the trust, and the trust's beneficiaries.

3. The trust should address the issue of impartiality and attempt to reconcile the interests of the current income beneficiary, the trustee, and the remaindermen with respect to the investment of trust assets.

4. The trustee must be able to allocate both traditional income and principal (trust wealth) impartially even in periods of unusual, and perhaps unpredictable, volatility.

5. The trust should require distributions to the current income beneficiary to be as smooth as reasonable so long as "smoothing" can be accomplished without jeopardizing the inflation-adjusted growth of trust principal.

6. If the settlor has particular objectives for the beneficiary or beneficiaries, the trust must describe those objectives.

7. If the trust is to hold assets that the settlor would not want subject to diversification, such as a closely held family business or farm, the trust should so state.

B. ***Design Alternatives***.

Trust design alternatives appear to include the following:

1. Do nothing;
2. The traditional total discretionary trust;
3. An annuity trust with an index payout;
4. A unitrust;
5. A "Give-Me-Five" unitrust, as proposed by Jerald I. Horn[31]; or
6. A "protected nest egg trust" ("PNET"), which can incorporate the features of either a discretionary trust, an annuity trust, or a unitrust.

C. ***Design Alternatives and the Total Return Trust***.

The alternatives described in Paragraph B above, are all consistent with the concept of a total return trust. A total return trust blurs the artificial distinction between income and principal and reduces, and may eliminate, the problems associated with that artificial distinction. Because a

[31]Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trust: Drafting and Administration, Including the "Give-Me-Five" Unitrust*, 33 REAL PROP. PROB. & TR. J. 1 (1998).

total return trust invests for total return of the entire portfolio in a manner consistent with the Prudent Investor Act, the trustee need not be concerned with meeting the almost impossible burden of achieving the objectives of the income beneficiary for income and the objectives of the remaindermen for growth of the trust's principal. The total return trust must, however, be accompanied by a distribution arrangement that allows the income beneficiary's distributions to be defined by something other than traditional accounting income. If trusts are drafted today that provide the "income to A remainder to B" distribution pattern, the trustee continues to have the burden of achieving impartiality, and in order to do so, the trustee must probably utilize the power to adjust under K.S.A. 59-9-104. Whether and under what circumstances a trustee will elect to exercise the power to adjust remains uncertain. Consequently, to achieve the total return objective for both investment and distribution, persons drafting trusts should select from among alternatives 2 though 6, set out above and described in more detail below.

D. ***Discussion of Design Alternatives***.

1. Traditional Discretionary Trusts.

a. Description and Uses.

(i) A suggested form of the traditional discretionary trust is included in Appendix 2. The traditional discretionary trust gives to the trustee discretion, either total or partial, in making distributions of traditional income and principal to the beneficiary. Many discretionary arrangements are possible, depending upon the settlor's objectives and the needs of the beneficiaries. For example, a trust may provide for all income to be distributed to the income beneficiary with the trustee having either total discretion or discretion based on certain standards, including an ascertainable standard if needed for tax-sensitive trusts. The use of ascertainable standards has in Kansas, at least until 2004, been considered as causing the trust to be vulnerable to a beneficiary's creditors because if the beneficiary could enforce the distribution standard, so could the beneficiary's creditors. Under a 2004 Amendment to K.S.A. 58a-411(d), a beneficiary's creditor may not compel a distribution if the trustee has discretion subject to a standard for distribution. The Amendment does not, however, define the standard and uncertainty perhaps continues to exist as to whether a beneficiary's creditor can compel distribution under an ascertainable and objective standard. A total discretionary trust, however, avoids this problem and should insulate the trust assets from the beneficiary's creditors and in some instances should enable the beneficiary to qualify for government assistance. In some situations the totally discretionary trust may be the only alternative because of the settlor's concern regarding a beneficiary's ability to handle money or a beneficiary's impairment, including impairments caused by addictions.

(ii) A total discretionary trust is not inconsistent with the concept of total return, particularly if trustee's powers specifically include language authorizing the trustee to invest for total return and to make allocations without meeting traditional definitions of income and principal.

The power to make allocations must, however, be used carefully in tax-sensitive trusts, particularly when the trustee is also the beneficiary.

(iii) Because a trustee of a totally discretionary trust has the ability, in the trustee's discretion, to make distributions of income and principal to the beneficiary, the trustee can distribute principal in such a way that mimics the total return concept. In other words, a trustee can, upon the exercise of its discretion, distribute in much of the same manner as a trustee would in either a unitrust or an annuity trust depending on the circumstances of the trust income and capital gains and the needs and circumstances of the beneficiary.

(iv) Totally discretionary trusts are often used in credit-shelter and dynasty trusts to leverage the applicable credit amount or the GST exemption. Such trusts often give to the trustee discretion to sprinkle or spray income and principal among the beneficiaries, including in the credit-shelter trust to the surviving spouse. If the trustee does not use its discretionary authority to make distributions, the credit-shelter or GST trust, which should be exempt from either future estate tax or GST tax will grow because trust can be invested in equities as opposed to the traditional model which would have required the distribution of income to a life beneficiary, thus probably eroding the ultimate trust value that could otherwise have grown as either estate tax or GST tax free.

(v) If invasion of principal is subject to the trustee's unrestricted discretion, the trustee should not use bonds to provide for the income beneficiary's needs. The total return concept used with a totally discretionary trust should be the appropriate response to such power since it protects a long-lived life beneficiary from the impact of inflation and offers some prospect of preservation of principal for the remaindermen. On the contrary, using a 50/50 equity-bond mix in such a trust to generate income will benefit neither class of beneficiary.

b. Problems with total discretionary trust include the following:

(i) Selection of the trustee is essential and must carefully be considered by the settlor.

(ii) The trustee may be reluctant to exercise discretion, particularly in the absence of standards provided by the settlor.

(iii) The trustee should be given authority not to act as well as to act.

(iv) The total discretionary trust offers flexibility for both investing and distributing, but may be inappropriate when family tension exists or when income and estate tax planning is important.

(v) A total discretionary trust provides no distribution predictability for the beneficiary for the remaindermen.

(vi) The trustee of a total discretionary trust is handicapped from the beginning in being unable to determine a distribution pattern that will not undermine the long-term inflation-adjusted value of the trust because if and when the trustee's discretion will be exercised are unpredictable.

c. The total discretionary trust is the only form of alternative total return trust that does not give the beneficiary some enforceable distribution right with respect to the trust property. Consequently, if the settlor is concerned about the beneficiary having distributions from the trust that are not controlled by another person (either the trustee or the trust advisor), only a discretionary trust will achieve the settlor's objective. Other alternatives may partially achieve such objectives, particularly when an independent trustee is designated who can act if a beneficiary's creditors jeopardize enforceable distributions. In such situations, an independent trustee can be named to act and the beneficiary's enforceable distribution rights can be withdrawn. An example of such an arrangement is described as a part of the PNET Trust form in Appendix 9. Examples of discretionary trust alternative arrangements are provided in Appendices 3 and 4.

2. <u>The Annuity Trust</u>.

a. This alternative is designed using the charitable remainder annuity trust as a model. The purpose of the annuity trust arrangement is to provide a predictable and fixed annual payment to the beneficiary. Settlors often understand such a fixed payment when it is described as a "stipend." If the annual annuity payment is linked to an index that reflects inflation, such as the Consumer Price Index (CPI), the stipend will grow with inflation. Because, however, the CPI is not correlated with investment return, and in fact may be inverse to investment return, some safeguard should be used to prevent the annual increase measured by the CPI growing faster than the appreciation of the trust's portfolio. For example, in 1974 inflation was 21% while the total return for large company stocks was minus 41.13%. Without a safety valve provision, a private annuity trust during that period of time linked to CPI would have been required to liquidate assets to make annuity payments at a time when stock prices were substantially depressed. The annuity trust form in Appendix 5 contains a safety valve by giving to the special trustee the power to adjust the stipend payments for the purpose of ensuring that, to the extent reasonably achievable, the annual payments and CPI increases will be adjusted to enable that trust principal to be adequate to provide for the beneficiary's support, health, and maintenance during the beneficiary's lifetime.

b. Other important aspects of the indexed annuity trust are as follows:

(i) The indexed annuity trust is a total return trust in that the annual distributions may be made from either income or principal.

(ii) The indexed annuity trust should contain an ordering rule describing the source of distributions. Distributions are made first from ordinary income, next from capital gains realized by the trust, and if both ordinary income and realized capital gains are insufficient, from other trust property. An alternative might be to require the second level of distributions to be from short-term capital gain. This ordering rule is important for income tax purposes. Kansas, unlike several other states, does not have a statutory ordering rule for annuity or unitrusts. Moreover, the new § 643 regulations do not specifically cover an indexed annuity trust, although they do cover unitrusts in a manner helpful to taxpayers. Because indexed annuity trusts are not covered by the new § 643 regulations, one must hope that the ordering rule set out in the trust agreement will be respected for income tax purposes.

3. Total Return Unitrust

a. The total return unitrust is a private non-charitable trust using the charitable remainder unitrust as a model. The charitable remainder unitrust rules are described in I.R.C. § 664, and describe trusts that annually pay out a fixed percentage of their portfolio market value to the income beneficiary or beneficiaries. As Robert B. Wolf states, the total return unitrust "... provides a trust partnership between the current beneficiary and the remaindermen, facilitates total return investing and creates expectations in the income beneficiaries that are likely to be fulfilled. By directing the trustee to payout a specific percentage of the trust set forth by the grantor or testator, this type of trust instrument removes the great difficulty in fulfilling the duty of impartiality."[32] The total return unitrust permits the trustee to invest in any form of asset, including assets that generate disproportionately large interest when interest rates are high, disproportionately large dividends when dividends are high, and disproportionately large capital gains when the stock market is strong but when interest rates are low. Because the current

[32]Robert B. Wolf, Extract from Total Return Trust Meeting Human Needs and Investment Goals Through Modern Trust Design, ACTEC Meeting on Total Return Trusts (2001).

beneficiary is entitled to a percentage of the value of the total trust assets on an annual basis, no distinction exists between distributing income or principal, as the unitrust blurs the historical and artificial line between the two. Because the distinction is blurred, the trustee is able to meet its duty of impartiality and invest without regard to disappointing either or both the life beneficiary and the remaindermen. Although both may be disappointed by poor trust performance, particularly if the Prudent Investor Act is not followed, a total return unitrust causes what is good for the life beneficiary to be good for the remaindermen, and vice versa. The trustee's investment decisions are not artificially drawn into the short-term needs of the life income beneficiary, although as previously described with respect to the Prudent Investor Act, those needs may require asset allocations that help ensure that in times of bad market conditions portfolio assets will not have to be liquidated to meet the unitrust payout requirement. In other words, volatility of the portfolio must be considered, even in a unitrust regime. An impressive, informative, and daunting body of research and writing is available with respect to total return unitrusts. The most prominent materials are those produced by Robert B. Wolf, William L. Hoisington, Professor Joel C. Dobris, and Jerald I. Horn. The materials are described in the Bibliography attached to this Outline. Two forms of total return unitrusts are set out in Appendices 6 and 7. Additional form material and suggestions for drafting total return unitrusts are included in many of the materials produced by Messrs. Wolf, Hoisington, and Horn.

b. Other aspects of the total return unitrust are as follows:

(i) Because Modern Portfolio Theory and the Prudent Investor Act dictate that a substantial portion of a trust portfolio should be allocated to equities, volatility will occur. Because the amount of the annual unitrust distribution to the beneficiary will no doubt fluctuate because of that volatility, a "smoothing" arrangement is recommended, to provide greater predictability for distributions to the life beneficiary. Smoothing may be accomplished by causing the annual percentage of market value to be determined on the basis of the three or more year rolling average, rather than using the market value only of the current year of distribution.

(ii) The importance of the payout rate, even with a smoothing rule, cannot be understated. If the payout rate is too high, the inflation-adjusted value of the trust will decline, and the remaindermen will be disappointed. When it is too low, the life beneficiary will be disappointed, unless the trust is fairly large. Substantial research and analysis have occurred with respect to an appropriate distribution percentage. Many states, including Missouri, which have adopted unitrusts statutes, provide annual distribution percentage ranges. Most commentators, and a substantial body of analysis, generally have concluded that a unitrust distribution percentage of from three to five percent will provide a greater return to the life beneficiary than would an income only trust, and will protect the inflation adjusted value of the trust for the remaindermen. The Internal Revenue Service has adopted a similar three to five percent unitrust rule in the new §

643 Regulations. For analysis of the appropriate payout or percentage distribution rate, see the materials cited at Note 33.[33] An appropriate payout of percentage distribution rate must also be determined under the same analysis as required for the trustee's exercise of its power to adjust under K.S.A. 58-9-104, as previously discussed in this Outline with regard to the use of Monte Carlo and similar simulation analyses.

(iii) As described with respect to the annuity trust arrangement, a safety valve may be needed to ensure that the trust's principal will survive the duration of the trust, the distribution rate may be changed to accomplish the settlor's goals and to protect the inflation adjusted value of the trust principal. Only an independent trustee should have this authority and if given, used to avoid emasculation of the trust principal and not to react to the vicissitudes of the stock market. If an independent trustee is used, the trust should describe the standards for naming and replacing the independent trustee.[34]

(iv) Another safety valve that might be considered would be for an independent trustee to have discretionary authority to make additional distributions of trust principal to avoid unnecessary hardship to the benefi-

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[33]Wolf, *Estate Planning*, *supra* note 29; Hoisington, *Modern Trust Design: New Paradigms for the Twenty-First Century*, 31 Phillip E. Heckerling Inst. on Est. Plan. § 600 (1997); Wolf, *Defeating the Duty*, *supra* note 1; Horn, *supra* note 31; Turnipseed, *supra* note 25 at 244; Collins and Stampfli, *supra* note 17.

[34]See Appendix Form 4.

ciary or to provide for the beneficiary in times of unexpected financial or health crises.

(v) The total return unitrust is not without critics and commentators who advise caution in the face of the rush to unitrust conversions.[35] Among the criticisms and notes of caution are the following:

(a) The modeling for unitrust distributions often involves large pooled investment funds, which might be deceptive if a trust portfolio consists of even a large number of individual stocks.

(b) Selling index fund shares to make unitrust distributions is easy because the asset allocation need not significantly change. On the other hand, if the portfolio consists of individual stocks, selling such stocks to make unitrust distributions may disrupt the trust's asset allocation.

(c) A unitrust is not the answer to poor portfolio performance, particularly of a proprietary mutual fund. Shifting to a unitrust format might please current income beneficiaries by increasing distributions, but if performance does not improve, the repeated principal invasions to satisfy the current beneficiary will exacerbate the problem of past under performance.

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[35]Garland, *The Problems with Unitrusts,*, J. PRIVATE PORTFOLIO MGMT. (Spring 1999); Campisi, *Goodwill Hunting, Making Trusts a Pleasure Not a Pain - Advice from the Litigators*, Study Outline, Spring, 2001, ACTEC Meeting; Campisi & Sombronski, *supra* note 14; Alvin J. Golden, *Total Return Unitrusts: Is This a Solution in Search of a Problem*, 28 ACTEC J. 121 (2002).

(d) Projections are precarious. Average annual return statistics from the past cannot be projected into the future, particularly because actual performance has substantial year-to-year variations, even with smoothing. Consequently, the effect of a down year is to reduce total return in subsequent years, even if the rate of return goes back to the average. As Campisi points out, "one needs to subtract from average returns one-half of the variance. For example, if a trust drops in value 10%, a 10% return for the following year will only bring it back to 99, i.e., 110% of 90. If one ignores this effect, you will overstate returns substantially."[36]

(e) Volatility creates additional risks for a unitrust that regularly prunes equities to fund annual percentage distributions. If selling equities impairs principal for later income distributions, the trustee may be at risk. As Campisi warns,

> "... if your investments are tanking, the unitrust distribution scheme will only sink you further. You need to assure that you have some basis for predicting the returns you use to sell the [unitrust] concept. At a minimum, avoid statistics on historic performance which are based on reinvested dividends and which ignore tax obligations. Since beneficiaries need to be paid and governments demand tax payments, such statistics improperly compound real world returns. You must also factor in trustee fees since otherwise you will overstate disposable income and ignore the impact of reductions of principal from fee distributions. Since you may be using such statistics to sell the modifications to beneficiaries and the

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[36]Campisi, *supra* note 35.

> court, make sure you are being meticulous in your projections and assumptions."[37]

(f) Because predictions are precarious, and history shows that the stock market will be volatile, the total return unitrust should probably include provisions permitting an independent trustee to reduce the annual percentage distribution if volatility causes pruning, pruning reduces principal, and neither the life beneficiary nor the remaindermen can be pleased.

(g) Campisi concludes,

> "If you are going to actively manage the unitrust portfolio, make sure you understand the inter relationship of the anticipated total return and the unitrust distributions. Upping the dividend rate by a half percent over the S&P 500 may not be a great advantage if you set the distribution rate too high and your value investment strategies lag growth strategy. If a proprietary fund or active portfolio falls behind the index funds for a few years, make sure you reassess whether the professorate may be right. If they are, and you disregard them, expect to hear them as expert witnesses at the surcharge trial."[38]

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[37] *Id.*

[38] *Id.*

4. Jerald I. Horn's "Give-Me-Five" Unitrust.

a. Jerald I. Horn in several articles[39] and his recent book,[40] which the author of this Outline recommends highly to anyone drafting wills and trusts in today's complex drafting environment, has developed and perfected the concept of a unitrust which authorizes, but does not require, a percentage distribution of up to five percent of the trust property each year. The income beneficiary has the right to exercise the withdrawal power which may be defined as either a pecuniary amount or as a fractional share of the trust property, and can be satisfied either in cash or by the distribution of specific trust property. Horn's model provides flexibility in calculating the withdrawal amount either as of the date that the withdrawal power is exercisable or as of the date that the withdrawal power lapses.

b. Advantages of the Give-Me-Five Unitrust include the following:

(i) Because the lapsing withdrawal right is within the so-called five and five rule of IRC § 2041(b)(2), even if the power holder permits the withdrawal right to lapse, the trust assets or percentage of trust assets to which the power extended will neither be includable in the power holder's estate for estate tax purposes nor be a gift for gift tax purposes.

(ii) Because the power holder has control of whether to withdraw the five and five amount, which may be expressed as 1/20 of the trust

[39]Horn, The Impact of the Prudent Investor Rule on Drafting and Administration of Wills and Trusts, Study Outline, Part D, ABA Section of Real Prop. Prob. Tr. L., 7th Annual Spring C.L.E. and Committee Meeting (1996); Horn, *supra* note 31.

[40]HORN, *supra* note 29.

principal, the power holder can, for example, leverage a bypass trust or a GST exempt trust by not exercising the withdrawal right and "growing" a trust not subject to either estate tax, in the case of a bypass trust, or GST tax, in the case of an exempt GST trust.

(iii) Because the withdrawal right permits the power holder to withdraw a fraction, rather than a pecuniary amount, the transfer can be satisfied without gain to the trust which would not be the case if the distribution were in satisfaction of a required pecuniary amount.

(iv) As with other unitrusts, the distribution arrangement blurs the traditional distinction between income and principal. Consequently, a trustee can comply with the Prudent Investor Act and Modern Portfolio Theory seeking total return for trust investments.

(v) Because a five percent withdrawal right represents, in effect, the same economic value as would an income only distribution arrangement in a trust that generates a five percent income return, the beneficiary can be assured of a return at least comparable to an income only return but under a unitrust concept that gives to the beneficiary the right to control whether, and to a certain extent when, to receive the five or five distribution.

c. Disadvantages of the Give-Me-Five Unitrust include the following:

(i) The five percent distribution percentage may be too high if in fact the beneficiary exercises the withdrawal rights. Although the flexibility of the Give-Me-Five unitrust recommends its use, care should be taken to use the arrangement only if there is reasonable certainty that the beneficiary will not exercise the withdrawal right. If the beneficiary in fact annually exercises the withdrawal right, the five percent distribution rate may cause diminution of principal to the extent that the inflation-adjusted value of the trust cannot be sustained.

(ii) Potential income tax problems exist in that the holder of a right to withdraw is deemed for income tax purposes to own (a) all the ordinary income that is subject to the power and (b) all income, ordinary and capital gain, that are attributable to the principal that is subject to the power.[41] Consequently, even if the power holder fails to exercise the power, the power holder may be taxed because even though the right to withdrawal lapses, the power holder is deemed to own, for income tax purposes, all of the income attributed to the property the power holder had the power to withdraw. Horn, however, suggests several approaches for ameliorating this problem, and concludes that even though a potential problem exists, it may have a silver lining for transfer tax purposes in that the power holder can permit the trust to grow even more than it otherwise would have grown by paying income tax on that portion of the trust that is not withdrawn. If the trustee were to pay the income tax on that portion, higher trust income tax rates would probably apply and the principal of the trust would not grow as rapidly as if the income tax on the property (a

[41] I.R.C. § 687(a)(1).

percentage of the trust) with respect to which the withdrawal right existed were left into the trust were subject to trust income tax. A recent Revenue Ruling[42] eliminates the uncertainty over whether the power holder's paying income tax on trust income not distributed to the power holder constitutes a gift to the trust's remaindermen. This Revenue Ruling also has significant consequences for grantor trusts, particularly intentionally defective grantor trusts.

d. An example of the "Give-Me-Five" unitrust is at Appendix 8.

5. <u>The Protected Nest Egg Trust ("PNET")</u>.

The Protected Nest Egg Trust and its acronym are the author's description of a trust that incorporates features from both the total return unitrust and Horn's Give-Me-Five unitrust. Although the PNET trust does not necessarily need to involve the Give-Me-Five withdrawal arrangement, and instead could provide for a mandatory annual percentage distribution, the Give-Me-Five feature provides greater flexibility. Although the PNET trust may be subject to many variations depending upon the particular needs of the settlor and beneficiaries, the author has found it most effective for settlors with substantial estates whose children have established themselves financially and who, both because of their independent financial success and the probable inheritance from their parents, may need protection from creditors and other predators.

Creditor protection is, however, only one objective of the PNET trust. Other important objectives are as follows:

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[42]Rev. Rul. 2004-64, 2004-27 IRB 7.

a. The beneficiary may be named as the trustee, and is responsible for trust management and investments, in much the same manner as if the beneficiary received the trust assets outright rather than in trust.

b. The PNET trust is tax efficient in that the beneficiary-trustee's powers are limited to avoid the trust property from being included in the beneficiary's estate for federal estate tax purposes.

c. The beneficiary-trustee is given the authority to designate an independent trustee who can make discretionary principal distributions, or in certain circumstances, can terminate the trust if no reasonable justification exists for the trust to continue.

d. If the PNET trust is drafted in the Give-Me-Five format, the beneficiary can, by not exercising his or her withdrawal right, leverage the trust for future generations, although the beneficiary may be required to pay income tax on the portion of the trust with respect to which his or her withdrawal right lapsed.

e. The beneficiary can be given a limited power of appointment over the trust property to ensure that the needs of his or her children or grandchildren are determined not by the settlor, but by the beneficiary, who will no doubt be closer to the needs of his or her children or grandchildren than was the settlor.

The author has found substantial client acceptance to the PNET concept. Although most settlors do not want a child's entire share of the settlor's estate to be left in a PNET format, a certain percentage of the child's share can be left in the PNET format. If, for example, a child's share is Two Million Dollars and the child has independent assets from his or her own financial success, a settlor might consider disposing of one-half of the child's share, or One Million Dollars, in a PNET trust, thus creating the "protected nest egg."

Appendix 9, includes a letter to clients describing the PNET arrangement. The letter is general and intended preliminary to acquaint the client with the PNET arrangement. A more detailed explanation should accompany the draft of the trust when it is presented to the client. Appendix 10 includes an example of a PNET trust.

6. Variations on Design Alternatives.

The five design alternatives described above can be varied, combined, and modified to meet the settlor's objectives and the beneficiary's probable needs. Among such variations are the following:

a. If the settlor wishes only to provide the remaindermen with the initial nominal value of the trust and is not concerned about the erosion of true value because of inflation, the trust could provide that all accretions to the principal of the trust are to be distributed to the current beneficiary, whether those accretions are in the form of interest, dividends, or capital gains. The remaindermen would thus receive the same sum of money that was initially placed in the trust. This arrangement might be called a "reverse unitrust," in that the settlor has determined not to protect the remaindered's interest in the inflation-adjusted value of the trust principal, but rather give all growth, whether in the form of accounting income or capital gains to the income beneficiary.

b. If the settlor wishes to ensure constant and predictable growth of principal for the remainder, the trust could require the trustee annually to add to the trust principal a fixed percentage of the trust value and pay the rest to the current beneficiary. Under this approach, the principal of the trust would increase at some stipulated rate, for example five percent per year, with the balance going to the current beneficiary. This arrangement might be referred to as a "reverse annuity trust."

c. If the settlor wishes to maintain the trust principal's inflation-adjusted value, the trust could provide that a current beneficiary would receive all trust return, including accounting income and capital gains, in excess of the annual consumer price index. A potential problem with this arrangement is, of course, that the total return of the trust may be less than the consumer price index, as occurred in the early 1970's.

E. ***The Irrevocable Life Insurance Trust - Fitting a Square Peg (the Irrevocable Life Insurance Trust) Into a Round Hole (Prudent Investor Act).***

1. A prominent arrow in the estate planner's quiver is the unfunded irrevocable life insurance trust ("ILIT"). If properly drafted, established, and administered, the ILIT provides to the settlor the opportunity to make annual exclusion gifts to the ILIT for the purpose of paying insurance premiums and to avoid inclusion of the insurance proceeds in the settlor's taxable estate. The unfunded ILIT generally holds one or more of the many life insurance products available on the market today, including traditional whole life and universal life products, term products, and variable products. The policy usually is the trust's only asset, other than the trust's temporarily retaining the settlor's annual contributions to the trust to pay policy premiums. The ILIT is, however, a trust, and because of

estate tax constraints, the trustee is not the settlor and often is a bank or trust company. The trustee of an ILIT often assumes that its only responsibility is to hold the policy, give Crummey notices, and distribute the insurance proceeds following the death of the insured. Such a limited view of an ILIT trustee's responsibility, however, is not consistent with the Prudent Investor Act, as there is nothing in the Act specifically stating that an ILIT trustee is exempt from the principles of prudence under the Act.

2. The following represents a summary of concerns and considerations pertaining to fitting the "square peg" of an ILIT into the "round hole" of the Prudent Investor Act.

a. What is a Trustee's Role in Policy Selection? Often the policy acquired by the ILIT or contributed to the ILIT by the settlor is selected because the settlor's golfing buddy sells life insurance. Life insurance policy selection can be bewilderingly complex and often requires analysis by an insurance professional.[43] The complexity of policy selection for ILIT can be even more daunting because of the use of variable life (separate account products) which are primarily regulated as securities and only secondarily as life insurance. Under variable life policies, the account is generally invested in mutual funds that must be tested by the Prudent Investor Act.[44]

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[43] *See, e.g.*, AMERICAN SOCIETY OF CLU & CFC, IQ—UNDERSTANDING THE ILLUSTRATION PUZZLE (1993); AM. BAR ASS'N REAL PROP. PROB. & TR. L. SEC., LIFE INSURANCE DUE CARE, CARRIERS, PRODUCTS AND ILLUSTRATIONS (2d ed., 1994).

[44] Lawrence J. Rybka, *Insurance Policy Selection for Irrevocable Life Insurance Trusts: New Challenges for Trustees and Advisors*, TRUSTS AND ESTATES, Feb. 2002, at 44.

b. Existing Trusts With Whole Life Policies and The Prudent Investor Act.

The trustee of a mature ILIT holding a whole life policy must consider the diversification requirement of the Prudent Investor Act and the impact of inflation on the policy and its potential proceeds. Because whole life policies (general account products) generally are invested in assets that provide little growth potential, even maintaining the inflation-adjusted value of trust principal becomes problematic.

Trustees of such trusts may be vulnerable to criticism from, and perhaps lawsuits by, disappointed beneficiaries.[45]

c. How is the Policy Monitored? Trustees typically charge modestly for ILIT. Modest fees often are the result of modest services, or vice versa. Can a trustee of an ILIT provide modest services and at the same time meet the requirements of the Prudent Investor Act, particularly in a trust with a variable policy in which not only must the underlying assets held in the policy's accounts be monitored, but the policy performance must also carefully be reviewed to determine if the purposes of the policy, often described in initial policy projections, have been met. A trustee holding a lapsed policy would seem to be a vulnerable target for a surcharge action. Similarly, a trustee explaining to a settlor that a policy will lapse unless the settlor significantly increases annual contributions to the trust, perhaps in

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[45] *Id.*; Mark A. Teitelbaum, NATIONAL UNDERWRITER LIFE AND HEALTH, May 17, 2004, at 38.

excess of the settlor's annual gift tax exclusion, will lack popularity. The duties of care, skill, and caution under the Prudent Investor Act would seem to require most ILIT trustees to delegate policy analysis and performance review to life insurance professionals. Most ILIT trustees can, but often do not, analyze the selection and performance of variable accounts held by a variable policy. Most trustees cannot, however, analyze the performance of the policy itself and should probably retain an insurance professional to do so. The insurance professional to whom policy performance review is delegated may, however, become a fiduciary and therefore subject to standards of the Prudent Investor Act.

d. Variable Life Insurance Premiums - a Disguised Unitrust Payout? A poorly designed ILIT holding a variable policy is subject to many of the same risks as a poorly designed unitrust. If a unitrust annual payout percentage is too high, pruning equities to fund the annual percentage distribution reduces trust principal for later distributions.[46] Similarly, if a variable life insurance policy is invested in equities, and the accounts must be pruned in a down market to pay the premiums, the ability of the remaining accounts to cover future premium payments is jeopardized. If such a situation occurs, the trustee may face a policy lapse unless the settlor increases annual contributions for premium payments. If the settlor declines to make such contributions, a policy lapse may occur.

e. ILIT Design Suggestions. An ILIT must be drafted to recognize its unique asset structure. The settlor should specifically state that the ILIT is intended

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[46] *See* text accompanying *supra* note 37.

to hold one or more life insurance policies and perhaps waive the requirement of diversification under the Prudent Investor Act. The trustee should have no independent obligation to make premium payments if annual contributions from the settlor are inadequate to make such payments. Consideration should be given to appointing a special trustee for policy selection and annual policy performance review. If policy selection and analysis are to be delegated, consideration must be given to the costs of delegation. The trustee's fee structure must be determined accordingly. If a variable policy is obtained, the trust should contain provisions regarding the settlor's expectations with respect to trust investments, and the trustee's asset allocation and investment strategy decisions must be made in accordance with the requirements of the Prudent Investor Act.[47]

The ILIT will continue to be a square peg to fit into the round Prudent Investor Act hole. With proper drafting, policy selection, and policy maintenance, and ILIT trustee can, however, be a prudent investor under the Prudent Investor Act.

IV. CONCLUSION

The Kansas Legislature has replaced the Traditional Model for trust design and investment with the Prudent Investor Act, the Uniform Principal and Income Act, and the Uniform Trust Code. Whether one agrees or disagrees with the validity of the empirical data and the academic analysis that support the Legislative Response to the Traditional Model, the Legislative Response is the law and attorneys, trustees, and their investment and financial advisors must not only familiarize themselves with the law, but also must implement the law in their trust design and

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[47] See discussion at Page 25.

investments. Our clients and our insurance carriers expect us to do nothing less. Trial lawyers are waiting, and are hoping that we will do less.

APPENDICES

NOTE: THE FOLLOWING FORMS ARE FOR GENERAL INFORMATION AND DISCUSSION PURPOSES ONLY. IF TAKEN OUT OF CONTEXT AND USED WITHOUT BEING PLACED IN THE APPROPRIATE CONTEXT, INCLUDING INTERRELATED DISPOSITIVE, ADMINISTRATIVE, AND TAX PROVISIONS, UNINTENDED CONSEQUENCES MAY RESULT.

2000 RICHARD L. ZINN LETTER

I have revisited the delegation provisions of the new Kansas Prudent Investor Act as they pertain to bank trustees delegating investment functions to investment managers unrelated to the bank. I enclose a copy of the Act, which was passed this year by the Kansas Legislature. Section 9 of the Act describes the conditions under which the delegation of investment functions can occur. Some commentators believe that the Act may prohibit a corporate trustee holding itself out as providing investment management services from delegating investment functions to a third party.

Notwithstanding this view, the grantor of a trust may expand, restrict, eliminate, or alter the provisions of the Act. I believe the language I have included in the several Section 2503(c) Trusts we have recently created restrict or alter the provisions of Section 9 of the Act. We may, however, wish further to restrict the limitations on delegation, by expressly authorizing or directing the corporate trustee to delegate investment functions to your office.

Such a delegation must, however, carefully be considered. I shall appreciate your input on the following:

1. To whom specifically should the delegation be given?

2. Should the trustee be authorized to revoke that delegation at its discretion? I believe such a revocation authority is probably essential for the same reasons that removing a trustee is essential.

3. Should we not require the grantor of the trust to state in writing, at the time the trust is prepared, that he or she wishes for such a delegation to be made?

4. Should not the delegation be accompanied by a formal agency agreement and delegation letter, together with a statement of investment policies, similar to those enclosed?

5. Should the trust agreement specifically waive the notice requirement of Section 9(a)(3) of the Act?

We have discussed what appears to be trend toward the bifurcation of trust management on the one hand, and the investment of trust assets on the other. The Prudent Investor Rule does not, however, contemplate that this bifurcation can occur lightly, particularly if the trustee is a corporate trustee that provides investment management services as a part of its trust business. Consequently, if bifurcation is to occur, it must occur by drafting and specific authorization from the grantor who has participated in a discussion of the questions set out above.

Another issue to consider is the adoption, by the Prudent Investor Act, of the modern portfolio theory, which generally endorses the efficient market theory. Trustees will perhaps, therefore, have more and more incentive to focus on investments, such as index funds, that tend to mimic the market as a whole. Such a focus will emphasize passive investment strategies. Investment fees and capital gains taxes resulting from frequent sales must be considered. Consequently, a trustee using a strategy of active investment must justify the increased cost in terms of an increase in expected investment returns. These conclusions, both actual and implied from the Prudent Investor Act, seem to require trust language that the combined fees of the trustee and an investment manager to whom investment decisions have been delegated must be reasonable. Whether "reasonable" means that the combined fees shall not exceed the single fee that the trustee would have charged for having investment management responsibility remains problematic.

I understand that all of this is time consuming and seems to intrude into the relationships we have with our clients. I believe, however, that if we address these issues as a part of initial planning discussions, and provide the client with an opportunity fully to understand the issues, everyone involved in the process will be protected, and client will, in the long run, be better served.

DISCRETIONARY TRUST

(NO DISTRIBUTION STANDARDS)

Trust for Settlor's Son. Any distribution of Trust Property under Article ___ to Settlor's son, _________________________, ("**Settlor's Son**"), shall be held in trust as the Son's Trust, and administered and distributed as follows:

1. **Discretionary Income and Principal Distributions**. The Trustee may pay to or apply for benefit of Settlor's Son such amounts, including all income and principal as the Trustee from time to time in the Trustee's sole and absolute discretion deems necessary or advisable, considering or not considering resources otherwise available to Settlor's Son.

DISCRETIONARY TRUST

(ASCERTAINABLE DISTRIBUTION STANDARD WITH BENEFICIARY HAVING A GENERAL POWER OF APPOINTMENT)

Trusts for Son

A. **Trust for Son**. The Trustee shall hold, administer, and distribute any property, other than tangible, nonbusiness personal property, distributable to Settlor's son, __________________, ("**Settlor's Son**") as a separate trust (the "**Son's trust**"), as follows:

1. Until Settlor's Son attains the age of thirty (30) years, the Trustee may pay to or apply for the benefit of anyone or more of the living members of the group consisting of Settlor's Son and Settlor's Son's descendants (collectively with Settlor's Son, "the Beneficiaries"), such amounts of net income and principal of the Son's Trust as the Trustee may, from time to time, in the Trustee's sole and absolute discretion deem necessary or advisable, taking in to account the Beneficiaries' income from all sources known to the Trustee, for the generous support, maintenance, health, education, comfort, and welfare of any of the Beneficiaries, without the necessity of equalization among them at any time. Settlor particularly desires that any of the Beneficiaries be given the best education he or she is capable of receiving, after considering a Beneficiary's aptitude, ability, and commitment. Education shall include, but shall not be limited to, study at public or private grammar or high school, college, university, or vocation, technical or other educational institution; and education expenses, which may include transportation, meals, lodging,

books, equipment, supplies, tuition, fees, and similar expenses. In addition, Settlor desires that the Trustee, in appropriate circumstances, assist Settlor's Son with the purchase of a residence, investment in a business, a profession or a similarity productive endeavor through loans, direct distributions, or other methods, to the extent the Trustee determines to be advisable.

2. After Settlor's Son attains the age of thirty (30) years, the Trustee shall pay all of the net income of the Son's Trust to Settlor's Son in convenient installments, at least semi-annually, during Settlor's Son's life, and shall distribute to Settlor's Son, such portions of the principal of the Son's Trust as Settlor's Son shall, from time to time, request by signed instruments delivered to the Trustee during Settlor's Son's life, not exceeding in the aggregate, however, one-third (1/3) in value thereof before Settlor's Son shall have attained the age of thirty-five (35) years. For purposes of this Paragraph A.2., the value of the principal of the Son's Trust shall be its value at the time Settlor's Son attains the age of thirty (30) years.

3. After Settlor's Son attains the age of thirty-five (35) years, the Trustee shall distribute to Settlor's Son such portions of the principal of the Son's Trust as Settlor's Son shall, from time to time, request by signed instrument delivered to the Trustee during the Settlor's Son's life, not exceeding, however, two-thirds (2/3) in value thereof before Settlor's Son shall have attained the age of forty (40) years. For purposes of this Paragraph A.3., the value of the principal of the Son's Trust shall be its value at the time Settlor's Son attains the age of thirty-five (35) years.

4. After Settlor's Son attains the age of forty (40) years, the Trustee shall distribute to Settlor's Son such portions or all of the principal of the Son's Trust as Settlor's Son shall, from time to time, request by signed instruments delivered to the Trustee during Settlor's Son's life.

5. If Settlor's Son dies before the Son's Trust is fully distributed, such trust, as then constituted, shall be distributed to, or in trust for the benefit of, such person or persons, including Settlor's Son's estate, upon such conditions and estates with such powers, in such manner, and at such time or times as Settlor's Son appoints and directs by will or a trust established by Settlor's Son and in force at the time of Settlor's Son's death specifically referring to this power of appointment. To the extent that Settlor's Son does not effectively exercise this power of appointment, then upon Settlor's Son's death, the Trustee shall distribute such Son's Trust, successively and alternatively, as follows:

a. To Settlor's Son's then living descendants, per stirpes;

b. If Settlor's Son has no then living descendants, to Settlor's then living descendants, per stirpes;

c. If neither Settlor's Son nor Settlor has any then living descendants, the such Son's Trust shall be distributed in accordance with the provisions of Paragraph B.2.(v) of Article IV, except the time or times for distribution and survivorship shall be determined by reference to the date of death of Settlor's Son, rather than the date of death of Settlor's wife.

6. Any tangible, nonbusiness personal property held by the Trustee in a separate trust under this Paragraph A, shall be held by the Trustee for the benefit of the

beneficiary of such trust, and the Trustee may deliver all or part of such tangible, nonbusiness personal property to the beneficiary before the beneficiary attains age forty (40) years, as the Trustee in the Trustee's sole discretion shall determine, without further responsibility.

DISCRETIONARY TRUST

(ASCERTAINABLE STANDARD AND STATEMENT OF SETTLOR'S INTENTION)

At the discretion of the Trustees, the Trustees may pay to or use for the benefit of Settlor's son, ____________________________, ("**Settlor's Son**"), or his descendants (Settlor's Son and his descendants are referred to collectively as the "**Beneficiaries**," or individually as "**Beneficiary**"), so much of the income and principal as the Trustees, in the Trustees' sole discretion, determine from time to time to be required, in addition to the Beneficiaries' income from all other sources known to the Trustees, for their reasonable support, comfort, health, and education, including college, post-graduate, or professional training, adding any excess income to principal. Notwithstanding the foregoing, without in any way limiting the absolute discretion of the Trustees, Settlor intends that the trust property be held and distributed primarily for the benefit of Settlor's Son, and that no distributions be made to Settlor's Son's descendants if funds are not adequate to provide a reasonable level of support and comfort for Settlor's Son.

3. In the exercise of the Trustees' discretion to make income or principal distributions to the Beneficiaries or use principal for the sole and exclusive use of the Beneficiaries, Settlor desires that the Trustees in appropriate circumstances assist the Beneficiaries with the purchase of a residence, investment in a business, a profession, or a similarly productive endeavor through loans, direct distributions, or other methods, to the extent the Trustees determine to be advisable.

4. Notwithstanding anything to the contrary in Paragraphs A.2 and A.3 of this Article, the Trustees shall, in exercising the Trustees' discretion to make income or principal distributions to the Beneficiaries, take into account Settlor's strong desire that

each Beneficiary be a productive and self-supporting member of society so long as the Beneficiary is not so disabled as to prevent the Beneficiary from being productive and self-supporting. In determining whether a Beneficiary is productive and self-supporting, the Trustees shall consider the following:

a. Whether the Beneficiary has become so disabled, either mentally or physically or both, that the Beneficiary is unable to earn amounts approximately equal to the amounts the Beneficiary had earned, or was capable of earning, in the discretion of the Trustees, prior to such disability.

b. Whether the Beneficiary requires funds for scientific, educational, or charitable purposes, if in the discretion of the Trustees such purposes are in the best interest of the Beneficiary and the general public, and the Beneficiary is being a productive member of society in the pursuit of such purposes.

c. Whether the Beneficiary is pursuing a career which is socially productive but which does not produce a substantial monetary reward, such as an artist, a musician, or a teacher.

d. Whether the Beneficiary does not receive an adequate income by reason of the Beneficiary's obligation to care for one or more family members, including the Beneficiary's spouse, children and other relatives, and if the Trustees determine, in the Trustees' discretion, that such obligation reasonably precludes the Beneficiary from receiving an adequate income.

e. Whether any other situation exists which, in the Trustees' discretion, justifies payments to the Beneficiary, provided that the Trustees determine that such payments are in accordance with Settlor's overall desires regarding the productivity of a Beneficiary as a member of society.

INDEXED ANNUITY TRUST

(GENERATION SKIPPING)

ARTICLE __

The Benny Beneficiary Annuity Trust

The part of the Remaining Trust Property distributed to the Trustee of the Benny Beneficiary Annuity Trust shall be divided by such Trustee into two separate trusts. One such trust, which shall be called the Benny Beneficiary Exempt Trust, shall be the fractional share of the Benny Beneficiary Annuity Trust having a numerator equal to Settlor's Available GST Exemption and having a denominator equal to the value finally determined for United States Estate Tax purposes of the Benny Beneficiary Annuity Trust. The other such trust, which shall be called the Benny Beneficiary Non-Exempt Trust (the "**Non-Exempt Trust**"), shall be the remainder of the Beneficiary Annuity Trust.

A. **Administration and Distribution of the Benny Beneficiary Exempt Trust**. The Benny Beneficiary Exempt Trust (the "**Exempt Trust**") shall be held, administered, and distributed as follows:

1. **Distributions from Exempt Trust**. So long as the Non-Exempt Trust shall be adequate to enable the Trustee to pay the Annuity Amount, as defined in Paragraph B of this Article V, from the Non-Exempt Trust to Benny Beneficiary's Son, ________________________, the Special Trustee may distribute, in the Special Trustee's sole and absolute discretion, to Settlors Son's descendants, without the need to equalize among such descendants, all or part of the current net income of the Exempt Trust. The distribution of current net income shall be for the purpose of the maintenance, support,

health, or education of Settlor's Son's descendants, and the Special Trustee shall consider the other income and resources of Settlor's Son's descendants in making such distributions. Notwithstanding the foregoing, however, the Special Trustee, in making any discretionary distribution of income to any of Settlor's Son's descendants, shall be guided by Settlor's strong desire that the presence of a trust for such person, and, in particular, distributions from such trust, shall not impair the motivation of such person to become productive and self supporting. Settlor requests, but without imposing any legal obligation on the Special Trustee, that the Special Trustee shall consider whether the descendant is productive, mature, and responsible before making any distribution of income to such descendant. In addition to the distributions of income to Settlor's Son's descendants, the Special Trustee may make the distributions from the Exempt Trust as are authorized under Paragraph C of this Article V. The Trustee's determination of whether the Non-Exempt Trust shall be adequate to enable the Trustee to pay the Annuity Amount from the Non-Exempt Trust to Settlor's Son shall take into account not only whether the Non-Exempt Trust is adequate to pay current Annuity Amounts but also whether the Non-Exempt Trust shall be adequate to reasonably ensure that the Annuity Amount will be available during Settlor's Son's lifetime, as Settlor intends that distributions to Settlor's Son's descendants from the Exempt Trust shall not be made if such distributions shall jeopardize payment of the Annuity Amount from either or both the Exempt Trust and Non-Exempt Trust during Settlor's Son's lifetime.

2. **<u>Payment of All or Part of the Annuity Amount From Exempt Trust</u>**. Settlor intends that the Annuity Amount shall be paid first from the Non-Exempt Trust. If,

however, the Non-Exempt Trust shall not be adequate to enable the Annuity Amount to be paid wholly from the Non-Exempt Trust, the Trustee shall distribute to Benny Beneficiary ("the Beneficiary") from the Exempt Trust that amount necessary to cause the full Annuity Amount to be available for distribution to the Beneficiary in accordance with the provisions of Paragraph B of this Article. The determination of whether the Non-Exempt Trust is adequate to enable the Annuity Amount to be paid wholly from the Non-Exempt Trust shall be made by the Trustee, but if the Beneficiary shall for any reason assert that the Trustee's determination of adequacy is improper, the determination of adequacy shall be made by the Special Trustee whose determination shall be final and binding on the Beneficiary and any other person or persons interested in either the Benny Beneficiary Exempt Trust, or the Benny Beneficiary Non-Exempt Trust.

B. **Administration and Distribution of the Benny Beneficiary Non-Exempt Trust**. The Trustee of the Non-Exempt Trust shall hold, administer, and distribute the Non-Exempt Trust as follows:

1. **Distribution of Non-Exempt Trust During Benny Beneficiary's Lifetime**. During Benny Beneficiary's lifetime, the Trustee shall distribute to, or directly for the support of the Beneficiary at convenient intervals amounts that annually shall aggregate $50,000.00 (the **"Annuity Amount"**).

(a) **Annuity Amount During the First Year of Non-Exempt Trust**. The Annuity Amount for the first calendar year during which the Non-Exempt Trust is funded shall be increased by a percentage of the Annuity Amount that is equal to the percentage increase in consumer prices between January 1, 2004, and

January 1 of the first calendar year during which the Non-Exempt Trust is funded, as reflected in the percentage increase in the Consumer Price Index For All Urban Consumers ("**CPI-U**"), not seasonally adjusted, during such period or by the percentage increase during such period in such other independently maintained cost of living index as the Special Trustee, hereinafter named, determines in good faith more accurately reflects increases in the cost of living of the Beneficiary during such period.

(b) <u>**Annuity Amount During Second and Succeeding Years of Trust**</u>. The Annuity Amount for the second and each succeeding calendar year following the funding of the Non-Exempt Trust shall be the Annuity Amount for the immediately preceding calendar year increased by a percentage of such Annuity Amount that is equal to the percentage increase in consumer prices in the preceding calendar year, determined as of the end of such preceding calendar year (year-over-year), as reflected in the Consumer Price Index For All Urban Consumers ("**CPI-U**"), not seasonally adjusted, or in such other independently maintained cost of living index as the Special Trustee, hereinafter named, determines in good faith more accurately reflects increases in the cost of living of the Beneficiary during the preceding calendar year.

(c) <u>**Annuity Amount During Short Year**</u>. In the event of a short year that may occur during the first and last years of the Non-Exempt Trust's existence, the Trustee shall pro-rate the aggregate Annuity Amount on a daily basis, but in no event shall the Beneficiary be required to return to the Trustee any overpayment made in a short year.

(d) <u>**Adjustments in Annuity Amount**</u>. The Special Trustee may, in the Special Trustee's reasonable discretion, reduce the Annuity Amount payable to the Beneficiary for the purpose of ensuring, to the extent reasonably attainable, that the principal of the Non-Exempt Trust when considered with the principal of the Exempt Trust, shall remain adequate to provide both income and principal for the reasonable support, maintenance, and health of the Beneficiary during the Beneficiary's expected lifetime.

C. <u>**Provisions Applicable to Both the Benny Beneficiary Exempt Trust and the Benny Beneficiary Non-Exempt Trust.**</u>

1. <u>**Additional Distributions to the Beneficiary**</u>. Following the end of the first calendar year in which the Exempt Trust and the Non-Exempt Trust (together, the **"Trusts"**) are funded, in whole or in part, the Special Trustee shall have the authority to determine if the Annuity Amount and all other financial resources then available for the support of the Beneficiary that are reasonably ascertainable by the Special Trustee are sufficient, in the aggregate, in the good faith judgment of the Special Trustee, to provide adequately for the Beneficiary's reasonable support, maintenance, and health. If the Special Trustee determines that such amounts and resources, in the aggregate, are insufficient to provide adequately for the Beneficiary's reasonable support, maintenance, and health, the Special Trustee shall distribute to, or cause the Trustee to distribute to, or use for the support of, the Beneficiary as much of the property of the Trusts as, when added to such

amounts and other financial resources, will, in the good faith judgment of the Special Trustee, provide adequately for the reasonable support, maintenance, and health of the Beneficiary. Any additional distributions made to the Beneficiary pursuant to this paragraph C shall be made from the Non-Exempt Trust, even to the extent of exhausting such Trust, before any additional distributions shall be made from the Exempt Trust. Notwithstanding the forgoing, however, Settlor does not intend for the discretionary distributions to the Beneficiary to exceed, when added to the Annuity Amounts from the Trusts, the Dollar Limit during any one calendar year of the Trusts, and neither the Trustee nor the Special Trustee shall cause the aggregate distributions made during any calendar year to exceed the sum of One Hundred Thousand Dollars ($100,000.00), except other than when the Special Trustee determines an excess is required to protect the health of the Beneficiary. The Dollar Limit shall be adjusted as follows:

(a) **Dollar Limit During the First Year of Trusts**. The Dollar Limit for the first calendar year during which the Trusts are funded (either in whole or in part) shall be One Hundred Thousand Dollars ($100,000.00) increased by a percentage of the Dollar Limit that is equal to the percentage increase in consumer prices between January 1, 2004, and January 1 of the first calendar year during which the Trust's are funded, as reflected in the percentage increase in the Consumer Price Index For All Urban Consumers ("**CPI-U**"), not seasonally adjusted, during such period or by the percentage increase during such period in such other independently maintained cost of living index as the Special Trustee determines in good faith more accurately reflects increases in the cost of living of the Beneficiary during such period.

(b) <u>**Dollar Limit During Second and Succeeding Years of Trusts**</u>. The Dollar Limit for the second and each succeeding calendar year following the funding of the Trusts shall be the Dollar Limit for the immediately preceding calendar year increased by a percentage of such Dollar Limit that is equal to the percentage increase in consumer prices in the preceding calendar year, determined as of the end of such preceding calendar year (year-over-year), as reflected in the Consumer Price Index For All Urban Consumers ("**CPI-U**"), not seasonally adjusted, or in such other independently maintained cost of living index as the Special Trustee determines in good faith more accurately reflects increases in the cost of living of the Beneficiary during the preceding calendar year.

(c) <u>**Dollar Limit During Short Year**</u>. The Dollar Limit during a short year of the Trusts shall not exceed a pro-rated (on a daily basis) portion of the Dollar Limit otherwise applicable to such year, but in no event shall the Beneficiary be required to return to the Trustee any overpayment made in a short year.

2. <u>**Additional Distributions to Reduce Income Tax**</u>. The Special Trustee shall have the discretion to make such additional distributions from the Trusts that the Special Trustee determines, in the Special Trustee's sole discretion, shall reduce the aggregate income tax liability of the Trusts and the Beneficiary. The authority given to the Special Trustee by this paragraph C.2 is discretionary only, and Settlor intends that distributions made for the purpose of reducing income tax liability if the Special Trustee

determines that such distributions shall be contrary to Settlor's intention that distributions to the Beneficiary shall generally be limited only to the extent reasonably necessary to provide for the Beneficiary's maintenance, support, and health.

3. **Source of Distributions**. All amounts distributed from the Exempt and Non-Exempt Trusts shall be made first from ordinary income of the Trusts for Federal Income Tax purposes for the year of distribution and, if and to the extent such ordinary income is insufficient from any net capital gains realized by the Trusts for Federal Income Tax purposes for the year of distribution, and if any to the extent such ordinary income and realized capital gains are insufficient, from the other property of the Trusts.

UNITRUST PRECEDED BY DISCRETIONARY TRUST UNTIL

BENEFICIARY ATTAINS AGE THIRTY

(SMOOTHING PROVISIONS)

Trusts for Grandchildren and Persons Under Age Thirty (30)

A. **Disposition of Grandchildren's Trust**. Any trust created by this Agreement that is to be held, administered, and distributed in accordance with this Article pertaining to Grandchildren's Trusts, shall be held, administered, and distributed as follows:

1. At the discretion of the Trustee, the Trustee may pay to or use for the benefit of that grandchild of Settlors for whom the trust is established (the "**Beneficiary**") so much of the income and principal as the Trustee determines, in the Trustee's sole discretion, from time to time to be required, in addition to the Beneficiary's income from all other sources known to the Trustee, for the Beneficiary's reasonable support, comfort, and education, including college, post-graduate, or professional training, adding any excess income to principal.

2. In the exercise of the Trustee's discretion to make income or principal distributions to the Beneficiary or use principal for the sole and exclusive use of the Beneficiary, Settlor desires that the Trustee in appropriate circumstances assist the Beneficiary with the purchase of a residence, investment in a business or professional enterprise, or other worthy enterprise through loans, direct distributions, or other methods, to the extent the Trustee determines to be advisable.

3. After the Beneficiary attains the age of thirty (30) years:

a. The Trustee shall pay to the Beneficiary in each tax year of the Trust an amount equal to two percent (2%) of the average of the fair market values of the Trust's assets as of the close of the last business day of the Trust's three (3) previous tax years (or such lesser number of tax years as are available for the first three (3) tax years of the Trust) (the "Distribution Amount"). In the case of a short tax year, the distribution shall be calculated as set forth in Paragraph A.3.b. of this Article. In the case of contributions to or distributions from the Trust, including the initial funding, the Distribution Amount shall be determined as set forth in Paragraph A.3.c. of this Article.

b. For a short tax year, the Distribution Amount shall be based upon a prorated portion of the Distribution Amount as described above, comparing the number of days in the short tax year to the number of days in the calendar year In which the short tax year is a part. If the short tax year shall be the initial tax year of the trust, the prorated portion of the Distribution Amount shall be based on the fair market value of the Trust's assets at the date the Trust is initially funded.

c. In a tax year in which assets are added to or distributed from the Trust (other than the Distribution Amount) such tax year may be referred to as the ("Adjustment Year"), the Distribution Amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to two percent (2%) times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which shall be the number of days from the contribution or distribution to the end of the calendar year and the denominator shall be the days in the calendar year. In addition, the year-end values for the two tax years preceding the Adjustment Year shall be increased by the amount of such addition or decreased by the amount of such distribution, for purposes of determining the Distribution Amount for years following the Adjustment Year.

d. All computations of the Trust's fair market value, or the value of any contribution or distributions as set forth in this Paragraph A, shall include accounting income and principal, but no accrual shall be required. If the Trust includes assets for which there is not a readily determinable market, the Trustee shall adopt such method of valuation as the Trustee considers reasonable in the Trustee's discretion under the then existing circumstances.

e. The Distribution Amount from the Trust shall be paid first from net accounting income, next from net realized short-term capital gains, next from net realized long-term capital gains, and next, as necessary from the principal of the Trust.

f. In addition to the Distribution Amount, the Trustee's authority to make discretionary distributions of principal, as such discretion is provided in Paragraph A.1. and A.2. of this Article, shall continue after the beneficiary attains the age of thirty (30) years.

g. Following the Beneficiary's attaining age thirty-five (35) years, the Distribution Amount shall be increased to four percent (4%) of the average of the fair market values of the Trust's assets, in the manner described in Paragraph A.3.a. of this Article.

4. After the Beneficiary attains the age of forty (40) years, the Trustee shall distribute to the Beneficiary such portions or all of the principal of the Trust as the Beneficiary shall from time to time request by signed instruments delivered to the Trustee during the Beneficiary's life.

5. If the Beneficiary shall die before the Beneficiary's trust shall have been fully distributed, the Beneficiary's trust shall be distributed to, or held in trust for the benefit of, such person or persons among Settlor's descendants, upon such conditions and estates, with such powers, in such manner, at such time or times as the Beneficiary appoints and directs by will, specifically referring to this limited power of appointment. Subject to Paragraph B of this Article, to the extent that the Beneficiary does not effectively exercise the Beneficiary's limited power of appointment, upon the Beneficiary's death the Trustee shall distribute the Beneficiary's trust successively and alternatively, as follows:

a. To the Beneficiary's then living descendants, per stirpes;

b. If the Beneficiary has no then living descendants, to the then living descendants, per stirpes, of the Beneficiary's parent who was a child of Settlor.

c. If neither the Beneficiary nor the Beneficiary's parent who was a child of Settlor shall have then living descendants, then to the parent of the Beneficiary who was a child of Settlor, if such parent shall then be living.

d. If neither the Beneficiary nor the Beneficiary's parent who was a child of Settlor has then living descendants and if the Beneficiary's parent who was a child of Settlor shall not then be living, then to Settlor's then living descendants, per stirpes.

e. If there are no then living persons among the classes described in Subparagraphs A.5.a., A.5.b., A.5.c., and A.5.d., then the Beneficiary's trust shall be distributed in the same manner as the Balance of Remaining Trust Property is to be distributed in accordance with Paragraph __________ of Article ___ if Settlor is not survived by Settlor's spouse or by any of Settlor's descendants.

DISCRETIONARY TRUST CONVERTED TO UNITRUST AFTER TEN YEARS (CREDITOR PROTECTION OBJECTIVES) BENEFICIARY CAN ACT AS TRUSTEE UNDER LIMITED CIRCUMSTANCES. INDEPENDENT TRUSTEE HAS POWER TO EXTEND TRUST TERM IF NEEDED TO PROVIDE CREDITOR PROTECTION

Distribution of the Betsy Beneficiary Trust

The Betsy Beneficiary Trust shall be held, managed, invested, reinvested, and distributed as follows:

A. **Distribution of Trust During Ten-Year Period.** During the period commencing with the date of this Trust Agreement and ending ten years after such date (the "**Ten-Year Period**"), the Trust shall be held, managed, invested, reinvested, and distributed as follows: the Independent Trustee shall distribute to or for the benefit of any one or more of Betsy Beneficiary ("Betsy") and her then living descendants, as much of the net income and principal of the Trust as the Independent Trustee determines to be appropriate for any purpose, annually adding to principal any undistributed income. Distributions made pursuant to this Paragraph A. may be made unequally and may be made to one or more beneficiaries and not to others. Notwithstanding the foregoing, however, the power of the Trustees to distribute income and principal shall be subject to the limitations contained in Paragraph I of Article VI entitled "Special Limitations on Powers of Interested Trustee."

B. **Distribution of Trust Following Ten-Year Period.** Following the Ten-Year Period (which period following the Ten-Year Period shall be called the "Unitrust Period"), the Trust shall be held, managed, invested, reinvested, and distributed as follows:

1. **Distribution Amount**. The Trustees shall pay to Betsy in each tax year of the Trust an amount equal to four percent (4%) of the average of the fair market value of the Trust's assets as of the close of the last business day of the Trust's three (3) previous

tax years (the "Distribution Amount"). In the case of a short tax year, the distribution shall be calculated as set forth in Paragraph B.1.a. of this Article. In the case of contributions to or distributions from the Trust, the Distribution Amount shall be determined as set forth in Paragraph B.1.b. of this Article.

a. For a short tax year, the Distribution Amount shall be based upon a prorated portion of the Distribution Amount as described above, comparing the number of days in the short tax year to the number of days in the calendar year In which the short tax year is a part. If the short tax year shall be the initial tax year of the trust, the prorated portion of the Distribution Amount shall be based on the fair market value of the Trust's assets at the date the Trust is initially funded.

b. In a tax year in which assets are added to or distributed from the Trust (other than the Distribution Amount) such tax year may be referred to as the ("Adjustment Year"), the Distribution Amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to four percent (4%) times the fair market value of the assets contributed or distributed (as of the date or dates of the contribution or distribution), multiplied by a fraction, the numerator of which shall be the number of days from the contribution or distribution to the end of the calendar year and the denominator shall be the days in the calendar year. In addition, the year-end values for the two tax years preceding the Adjustment Year shall be increased by the amount of such addition or decreased by the amount of such distribution, for purposes of determining the Distribution Amount for years following the Adjustment Year.

c. All computations of the Trust's fair market value, or the value of any contributions, or distributions as set forth in this Paragraph B, shall include accounting income and principal, but no accrual shall be required. If the Trust includes assets for which there is not a readily determinable market, the Trustees shall adopt such method of valuation as the Trustees consider reasonable in the Trustees' discretion under the then existing circumstances.

d. The Distribution Amount from the Trust shall be paid first from net accounting income, next from net realized short-term capital gains, next from net realized long-term capital gains, and next, as necessary from the principal of the Trust.

2. __**Additional Discretionary Distributions**__. In addition to the Distribution Amount, the Independent Trustee's authority to make discretionary distributions of principal, as such discretion is provided in Paragraph A of this Article, shall continue following the expiration of the Ten-Year-Period. If, however, Betsy shall have exercised her discretion to remove the Independent Trustee following the Ten-Year Period, no additional discretionary distributions of income or principal shall be made, and any such distribution shall be subject to the ascertainable standards set forth in Paragraph B.3.

3. __**Additional Ascertainable Standard Distributions.**__ In addition to the Distribution Amount, Betsy, if acting as the sole Trustee, may distribute to herself so much of the principal as Betsy, in her fiduciary capacity, determines, from time to time to be required, in addition to Betsy's income from all other sources, for Betsy's reasonable

support, maintenance, health, or to enable her to maintain her accustomed standard of living.

4. **Change of Unitrust Percentage.** Notwithstanding anything in this Paragraph B to the contrary, Settlors give to the Independent Trustee the discretion to change the percentage upon which the Distribution Amount shall be determined if the Independent Trustee determines such a change is necessary.

C. **Independent Trustee's Discretion to Extend Ten-Year Period**. Settlors give to the Independent Trustee, prior to the expiration of the Ten-Year Period, the unrestricted discretion to extend the Ten-Year Period (the "**Extended Ten-Year Period**") if the Independent Trustee determines that termination of the Ten-Year Period and the availability of distributions during the Unitrust Period might expose any of the trust property, whether income or principal, to Betsy's creditors, including Betsy's spouse. Although the right to extend the Ten-Year Period shall not prevent Betsy's removal of the Independent Trustee. If Betsy shall remove the Independent Trustee prior to the expiration of the Ten-Year Period, Betsy shall designate another Independent Trustee whose sole discretion shall determine whether and when to extend the Ten-Year Period and when the Extended Ten-Year Period shall end. Settlors intend that the authority and discretion given to the Independent Trustee pursuant to this Paragraph C shall provide to Betsy the continued benefit and enjoyment of the trust income and principal by protecting such income and principal from Betsy's creditors. If Betsy shall fail to designate a successor Independent Trustee to succeed the Trustee she has removed, and such failure shall continue for sixty (60) days following such removal, a successor Independent Trustee shall be designated in the manner set forth in Paragraph E of Article VIII of this Agreement.

GIVE ME FIVE FRACTIONAL SHARE UNITRUST

A. **Requested Distribution ("Give me Five")**. If Settlor's child is living immediately before the end of the calendar year, the Trustee shall pay to Settlor's child such fractional share (not to exceed one-twentieth), if any, of the Trust Property as Settlor's child last directs in writing before the end of the year. [As soon as possible after each taxable year of Settlor's child, except to the extent (if any) as the Independent Trustee in its sole and absolute discretion last directs in writing before the end of the year, the Trustee shall pay to Settlor's child (i) the amount (if any) by which the income tax liability of Settlor's child for the year is increased because, as a right of one or more lapses of rights granted according to the receding sentence, Settlor's child is deemed, according to Subpart E of Subpart J of Chapter 1 of Subtitle A of the Code, to own any of the Trust Property for purposes of determining the United States Income Tax of Settlor's child, and (ii) the amount (if any) by which the income tax liability of Settlor's child is increased because the Trustee must pay according to this sentence.]

B. **Additional Distributions**. The Trustee shall pay to Settlor's child so much, or all, if any, of the Trust Property as the Independent Trustee in its sole and absolute discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the Trust.

C. **Statement of Settlor's Intention with Respect to Child's Trust**. The Child's Trust is primarily for the benefit of Settlor's child for whom the Trust is created, and Settlor would approve (but not direct) the exercise of each power (determined as if this sentence did not exist) to the maximum extent and favor of Settlor's child.

D. **Distribution at Death of Settlor's child**. Limited power of appointment with right of Independent Trustee to give to Settlor's child a general power of appointment if necessary for GST planning purposes.

Must include GST provisions, including right to sever into two trusts. This authority is necessary because if the Independent Trustee does not grant a general power of appointment, and only a portion of Settlor's GST exemption can be allocated to the Child's Trust, the Trust must be severed into a zero inclusion ration trust and a one inclusion ratio trust.

Independent Person may be named by Settlor's child to appoint Independent Trustee.

Power to Remove. An Independent Trustee is named by the independent person, Settlor's child must retain the right to remove. See attached.

Settlor's child may designate a successor to himself or herself, but in no instance will an Independent Trustee be appointed other than by an independent person unless appointed initially by Settlor.

"PNET" CLIENT EXPLANATION LETTER

Mr. and Mrs. Sam Settlor

1 PNET

Anywhere, USA

Dear Mr. and Mrs. Settlor:

As we discussed at our meeting, the Trust for your son could be in the form of what I refer to as a Protected Nest Egg or "PNET" Trust. A PNET Trust is intended to give to a child substantial control over a trust created for his benefit, while at the same time protecting the trust property from creditors and predators. Protection of the trust assets should also extend to claims of a spouse in the event of a divorce. To provide such protection, the trust requires an Independent Trustee to act with the child in making discretionary distributions of trust principal. The child is given the power to designate the Independent Trustee of his trust. If the child could make discretionary distributions to himself, the trust would not be protected from the claims of his creditors. The Independent Trustee must be a bank, a trust company, or an individual unrelated to the child.

A PNET Trust generally provides that the child, as the beneficiary, is to receive annual distributions of what is referred to as a "unitrust" amount. The unitrust amount could, for example, be five percent of the value of trust principal. The value of the trust principal will be determined annually, thus allowing the unitrust amount to move with inflation. If, for example, the PNET Trust principal were $1,000,000.00 the unitrust amount would be $50,000.00. The unitrust amount blurs the distinction between income and principal and in effect provides an annual stipend to the beneficiary that is unrelated to the actual amount of income generated by the trust. The blurring of the distinction between income and principal eliminates the tension between the income beneficiary and the proposed remaindermen of the trust. This tension is created by the income beneficiary wishing to have more income at the expense of the remaindermen who wish to have growth of the trust principal irrespective of the amount of income produced by the trust.

The Independent Trustee of a PNET trust is authorized to make discretionary payments above the unitrust amount. If your son had this authority, the principal of the trust would not be protected from his creditors. The Independent Trustee generally is authorized to distribute the entire trust principal if the continuation of the trust no longer is needed to achieve creditor protection or estate tax avoidance.

Your son would be named the primary trustee of his PNET Trust. An Independent Trustee is not initially named. Instead, your son is given the power to designate an Independent Person who would appoint the Independent Trustee. Please also note that the Independent Trustee's powers generally are limited specifically to those powers granted to the Independent Trustee. The Independent Trustee would not, therefore, have any powers to act in matters other than specifically stated in the trust agreement. The child, as the primary Trustee of his trust, will continue to manage the trust property, but would designate an Independent Trustee to make discretionary distributions. A PNET Trust therefore gives the child significant involvement in the administration, investment, and distribution of the trust property.

I shall look forward to your comments and questions regarding the possible PNET Trust for your son.

Cordially,

BARBER EMERSON, L.C.

Richard L. Zinn

RLZ/aco
Enclosure

PROTECTED NEST EGG TRUST ("PNET") INCLUDING PROVISIONS FOR DESIGNATING INDEPENDENT TRUSTEE

ARTICLE V

Trusts for Children and for Persons Under Age Thirty-Five (35)

A. **Trusts for Children**. The Trustee designated in Paragraph E.2 of Article VIII or such Trustee's successors shall hold, administer, and distribute the share created under Paragraph C of Article IV to be held by such Trustee for the benefit of each of Settlor's children as a separate trust (the "**Child's Trust**") as follows:

1. **Requested Distribution By Settlor's Child**. If Settlor's child is living immediately before the end of the current calendar year of the Trust, the Trustee shall pay to Settlor's child such fractional share (not to exceed one-twentieth), if any, of the Trust Property as Settlor's child directs in writing before the end of such year. As soon as possible after each taxable year of Settlor's child, except to the extent (if any) as the Independent Trustee in its sole and absolute discretion last directs in writing before the end of the year, the Trustee shall pay to Settlor's child (i) the amount (if any) by which the income tax liability of Settlor's child for the year is increased because, as a result of one or more lapses of rights granted according to the preceding sentence, Settlor's child is deemed, according to Subpart E of Subpart J of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986, as amended from time to time (the "**Code**"), to own any of the Trust Property for purposes of determining the United States income tax of Settlor's child, and (ii) the amount (if any) by which the income tax liability of Settlor's child is increased because the Trustee must pay according to this sentence.

2. **Additional Distributions**. The Trustee may pay to Settlor's child so much, or all, if any, of the Trust Property as the Independent Trustee in its sole and absolute

discretion determines to be advisable from time to time, considering or not considering resources otherwise available, for any purpose or reason whatsoever, including the termination of the Trust.

3. **Statement of Settlor's Intention with Respect to Child's Trust**. The Child's Trust is primarily for the benefit of Settlor's child for whom the Trust is created, and Settlor would approve (but not direct) the exercise of each power (determined as if this sentence did not exist) to the maximum extent in favor of Settlor's child.

4. **Distribution at Death of Settlor's Child**. Upon the death of Settlor's child for whom such Child's Trust is created, the Child's Trust shall be distributed to, or in trust for the benefit of, such person or persons among Settlor's descendants, upon such conditions and estates, with such powers, in such manner, at such time or times as such child appoints and directs by will or a trust agreement established by such child and in force at the time of such child's death, specifically referring to this power of appointment. To the extent that such child does not effectively exercise this limited power of appointment, such Child's Trust shall be distributed as follows:

a. To such child's then living descendants, per stirpes subject, however, to the provisions of Paragraph B of this Article V;

b. If such child shall have no then living descendants, then to Settlor's then living descendants, per stirpes, provided, however, that if such descendant shall be a child of Settlor, such distribution shall be made outright and free of trust to such child; if such descendant shall be a grandchild of Settlor, such distribution shall be made to such grandchild subject to the provisions of Paragraph D of Article IV; and if such descendant shall not be a child or a grandchild of Settlor, such distribution shall be made to such descendant subject to the provisions of Paragraph B of this Article V.

2. **Trustee of Children's Trusts**. Any child of Settlor for whose benefit a trust has been created under Paragraph A of Article V shall act as Trustee of such trust. In the event that such child for whose benefit a trust is created under Paragraph A of Article V shall be unable to act as Trustee, such child may by written, acknowledged instrument, delivered to his successor, appoint his successor. If such child shall resign or is unable or refuses to act and he has not designated a successor Trustee, ______________________________, shall act as Trustee of any such trust.

3. **Trustees of Grandchildren's Generation-Skipping Trust, Grandchild's Trust, and Trusts for Persons Under Age Thirty-Five (35)**. Settlor's children shall have the authority to designate, by written, acknowledged instrument, the Trustee or Trustees of the Grandchildren's Generation-Skipping Trust, any Grandchild's Trust, and Trusts for Persons Under Age Thirty-Five (35), provided, however, that Settlor's child who is the parent of the grandchild for whose benefit a Grandchild's Trust is created shall not act as Trustee of such Grandchild's Trust.

F. **Special Trustee**. The ______________________________, shall act as a Special Trustee, if required, under Paragraph A.2.b of Article IV and Paragraph I of Article VI of this Agreement.

G. **Special Power to Remove Independent Trustee**. Any child of Settlor shall have the power to remove, at any time and from time to time, the Independent Trustee of any trust created under Paragraph A of Article V for such child's benefit, by a written, acknowledged instrument delivered to the Independent Trustee to be removed, and the further power by a written, acknowledged instrument, delivered to an Independent Person, to request that such Independent Person appoint a successor to such removed Independent Trustee.

H. **Failure to Name Successor Trustee**. If any Trustee resigns or is unable or refuses to act, and no successor Trustee is named herein, a corporation authorized under the laws of the United States or of any state to administer trusts may be appointed as Trustee by the judge of the court in which Settlor's will shall be or could have been properly admitted to probate. No successor Trustee shall be personally liable for any act or omission of any predecessor Trustee, nor shall any successor Trustee be required to examine any accounts, records or acts of any previous Trustee.

I. **Powers and Liability of a Successor Trustee**. Any Successor Trustee shall have all the title, powers, and discretion of the Trustee succeeded, without the necessity of any conveyance or transfer. No Successor Trustee shall be personally liable for any act or omission of any predecessor Trustee. No Successor Trustee shall be required to inquire into or take any notice of the previous administration of the Trust, and any Successor Trustee shall account solely for those assets actually received from a predecessor Trustee.

J. **Independent Trustee.** For purposes of this Agreement, an Independent Trustee shall be either an eligible bank or trust company or an eligible individual, defined as follows:

1. To be eligible, a bank or trust company must (a) have trust powers, (b) be located and authorized to conduct business in a state in the United States that recognizes trusts, and (c) have a combined capital and surplus in excess of one million dollars.

2. To be eligible, an individual must be a person: (a) who is over the age of thirty (30) years, and otherwise has full rights and capacity; (b) who resides in the United States of America; (c) who is experienced in business, finance, accounting, investments, law, or trust management, and (d) who is neither a beneficiary of such trust nor related to

such a beneficiary who is then living, in the following classifications: (i) spouse, ancestor, lineal descendent, brother or sister, nor (ii) an employee of such beneficiary or of any corporation, firm, or partnership in which (A) such a beneficiary is an executive or (B) the stock or other holdings of such a donor or beneficiary in such corporation, firm, or partnership are significant from the viewpoint of voting control. If at any time after becoming an Independent Trustee of any trust under this Agreement, an individual or bank or trust company ceases to meet the eligibility requirements of an Independent Trustee, such Independent Trustee shall be treated for all purposes as having resigned as a trustee of such trust.

K. **Power of Independent Trustee to Grant General Power of Appointment**. In addition to the duties and obligations of an Independent Trustee, as otherwise provided in this Agreement, any Independent Trustee shall have the power and authority to grant, with respect to any trust created under this Agreement that has an inclusion ratio greater than one-tenth (1/10) (a "non-exempt trust") for generation-skipping transfer tax purposes, to the beneficiary of such trust a general power of appointment exercisable on the beneficiary's death in favor of the beneficiary's probate estate, which exercise shall be only with the prior written approval of the Independent Trustee. The power of appointment granted to the beneficiary shall apply to the largest fractional share of the non-exempt trust possible without thereby causing the combined federal estate and generation-skipping transfer tax arising on such beneficiary's death to be greater than what they would have been if such power of appointment did not exist on the beneficiary's death. In exercising the Independent Trustee's power and authority under this Paragraph K, the following shall apply: The Independent Trustee is authorized in such Trustee's sole discretion with respect to all or any part of the principal of any trust created under this Agreement (including a pecuniary amount), by an instrument filed with the Trustee of the trust created for such lineal descendant, (i) to limit a general power of appointment of a lineal descendant of Settlor of a trust created under this Agreement provided under this Paragraph K, as to all or part of such principal at any time prior to the death of such lineal descendant by narrowing the class to whom such lineal descendant may appoint the property subject to such appointment, so as to convert such power into a limited power of appointment; (ii) to eliminate such power for all or any part of such principal as to which such power was previously created at any time prior to the death of the lineal descendant; (iii) irrevocably to release the right to limit or eliminate such power; and (iv) to divide such lineal descendant's share of such trust principal into two fractional shares based upon the portion of such lineal descendant's share of such trust that would be then includable in the gross estate of such lineal descendant holding such power if he or she died immediately before such division (in which case the power shall be over the entire principal of one share and over no part of the other share), and each such share shall be administered as a separate trust unless the Independent Trustee (other than any beneficiary) shall in the Independent Trustee's discretion thereafter combine such separate trusts into a single trust which such Independent Trustee is authorized to do. In authorizing such action, Settlor desires, which is not binding on the Independent Trustee, that a general power of appointment will be kept in effect when the Independent Trustee determines the inclusion of the property subject to such power in such lineal descendant's gross estate may achieve a significant savings in transfer taxes by having an estate tax rather than a tax imposed under Chapter 13 of the Code on the property subject to the general power, and may also permit a greater use of the exemption from the generation-skipping transfer tax provided under Section 2631(a) of the Code, of such lineal descendant or such lineal descendant's spouse. Settlor directs that the Independent Trustee's decisions under this Paragraph K shall be absolutely binding on all beneficiaries of any Trust and of the lineal descendant's estate and that the Independent Trustee shall incur no liability by reason of any adverse consequences of such decisions to any beneficiary.

L. **Designation of Independent Trustee**. A child of Settlor for whose benefit a Child's Trust is created under Paragraph A of Article V, if such child is acting as Trustee of such Trust, or the then acting Trustee if Settlor's child is not acting as Trustee, may designate in writing, delivered to the Independent Person, an Independent Person to appoint an Independent Trustee for such Child's Trust. If there is a corporate trustee then serving, such corporate trustee shall be the Independent Trustee. If no corporate trustee is then serving, the Independent Person may designate the Independent Trustee. No Trustee shall be qualified to be an Independent Trustee unless such Trustee shall also be an Independent Person. "Independent Person" at any particular time with respect to any trust shall mean any person, including an entity, that meets the following requirements:

1. has no beneficial interest (other than as a potential appointee under a power of appointment held by another), present or future, vested or contingent, direct or indirect, in such Trust;

2. cannot be benefitted, to any extent gratuitously, by the exercise or nonexercise of any power given a Trustee by this Agreement or by law;

3. is not (a) a beneficiary, (b) a spouse, former spouse, ancestor, descendant, sibling or employee of a beneficiary (or a spouse or former spouse of a beneficiary), (c) a corporation or other person, or an employee of a corporation or other person, in which the stock or other holdings of a beneficiary, (or a spouse or former spouse of a beneficiary) and the Trust are significant from the viewpoint of voting or other control, (d) a subordinate employee of a corporation or other person in which a beneficiary (or a spouse or former spouse of a beneficiary) is an executive or (e) any party, not described in (a) through (d) of this Paragraph L.3, that is, or if nonadverse (within the meaning of Section 672(b) of the

Code), would be, a "related or subordinate party," with respect to a beneficiary, within the meaning of Section 672(c) (after application of Section 672(e)) of the Code;

4. is not controlled, directly or indirectly, within the contemplation of income or any transfer tax, by any person that, according to the portion of this sentence preceding this Paragraph L.4, is ineligible to be an Independent Person; and

5. under the United States Internal Revenue laws in effect at such time can alone (as though the only trustee), to such extent as some person described in the portion of this sentence preceding this Paragraph L.5 could alone (as though the only trustee), possess and exercise each power given a Trustee by this Agreement or by law

a. without causing any attribution of the Trust Property to any person (whether personally or as deemed transferor or otherwise) for purposes of income or any transfer (including without limitation gift, estate and generation-skipping) tax before the person becomes entitled to receive it outright (or, because of a power granted in or according to this instrument to the person as a beneficiary, the person becomes entitled to pay it to the person or the estate, creditors or creditors of the estate of the person) or it is paid, or for the benefit of, the person;

b. without otherwise causing any generation-skipping transfer; and

c. without causing any deemed sale or exchange, or transfer to any foreign trust, of any of the Trust Property.

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