U.S.TRUST

# DISCRETIONARY DECISIONS

2017 Fiduciary and Investment Risk Management Association (FIRMA)

May 24, 2017

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U.S. TRUST

Bank of America Private Wealth Management

# Disclosure

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# Discretionary Distribution Policy and Procedure

- Banks/Trust Companies should have a documented discretionary distribution policy and procedure
  - 12 CFR 9.5 - Policies and Procedures requires *A national bank exercising fiduciary powers shall adopt and follow written policies and procedures adequate to maintain its fiduciary activities in compliance with applicable law.*
  - 12 CFR 9.2 (b) defines Applicable Law as *the law of a state or other jurisdiction governing a national bank's fiduciary relationships, any applicable Federal law governing those relationships, the terms of the instrument governing a fiduciary relationship, or any court order pertaining to the relationship*.
- Policy/Procedure should include the review and approval of matters for which the Bank exercises its discretion prior to disbursements being made

# Discretionary Distribution Policy and Procedure

- A Trustee has a duty to use sound judgment when making and/or not making discretionary distributions, and should exercise that in conjunction with an understanding of the trust terms, grantor's intent and the best interest of all of the beneficiaries
  - The manner in which a Bank/Trust Company documents and exercises its discretion may vary, and may include:
    - Paper forms or systemic means to document the discretionary request and decision
    - Committee **or** Fiduciary Professionals may be involved in the review and decision of discretionary requests
    - Approval requirements may vary based on the amount of the proposed income and/or principal distribution or aggregate distributions made within the last 12-24 months

# Importance of a Discretionary Action Form

- A paper or system generated discretionary action form assists in the proper administration of a trust by clearly articulating and documenting the beneficiary's request, in addition to:
  - Referencing the dispositive provisions, and other beneficiaries that may be entitled to trust assets
  - Recap past distributions made from the trust to the beneficiaries
  - Referencing  beneficiary's other assets, when appropriate to consider (local law)
  - Referencing/documenting Co-Trustee approval/agreement
  - Evidencing the Trustee's decision, and rationale as necessary

# Importance of a Discretionary Action Form

- The discretionary action form provides a Trustee with a record that they exercised their discretion in a prudent fashion:
  - Evidences beneficiary's request was considered within the scope of the discretionary provision
  - Evidences consideration of whether the expense is properly payable from the trust, or more appropriately paid by the beneficiary, or another source
  - Evidences that the current request was considered with an awareness of all beneficiaries and their respective needs
  - Evidences appropriate review and decision of the discretionary request, along with relevant supporting documentation
- Information on the discretionary action form should be factual and is discoverable

# Benefits of an Automated Discretionary Distribution Process

- Benefits of a system-based discretionary form and approval:
  - Allows for account and beneficiary information to be pre-populated from the accounting platform
  - Provides ability to leverage the governing instrument's applicable provisions and summary of the request for future discretionary action forms, allowing for modification as necessary
  - Provides ability to automatically route the discretionary action form for approval based on management hierarchy or requested amount
  - Provides ability to tie approved discretionary action form to the money movement system

# Items to Consider Prior to Approving a Discretionary Distribution

- Prior to approving a discretionary distribution the Trust Officer and reviewer/approvers should:
  - Obtain written request of documented conversation with beneficiary
  - Review the trust's dispositive provisions … Don't assume
    - Determine/confirm that the beneficiary has a right to income and/or principal
    - Is income mandatory or discretionary, is there a 5x5 power?
    - Does the beneficiary's request fit within the terms of the trust?
      - Ascertainable standard – HEMS – Health, Education, Maintenance, Support
      - Broad discretion – welfare/best interests
      - Unique provisions - provide funds for education, business, first home, etc.

# Items to Consider Prior to Approving a Discretionary Distribution

- Are there other beneficiaries to consider?
  - Is it the Grantor's intent that one beneficiary be given priority over others (e.g. spouse)?
  - Is there a need to equalize distributions to all current beneficiaries?
- Is the Trustee precluded by the governing instrument or state statute from looking at beneficiary's other resources, and if so what does that include, e.g., marketable securities, home, illiquid assets?
  - How far must the Trustee dig?
  - What if the beneficiary refuses to provide other resource information?
- Does the request fit within the beneficiary's lifestyle or could it be considered excessive?
- Will the trust support the current beneficiary(ies) during his/her lifetime e.g., excessive distributions, depleting trust?
- Where applicable, is Co-Trustee supportive of discretionary distribution?
- Has Co-Trustee provided written agreement to the discretionary distribution?

# Grantor's Intent

- When establishing a trust, a grantor may provide the Trustee with "absolute" or "restrictive" discretionary powers.
  - In situations where the Trustee has "absolute" discretion, one without any limitations, they need to understand the grantor's financial objectives for the trust.[1]
    - Comfort
    - Benefit
    - Complete discretion of the Trustee
  - The grantor may create a trust with more "restrictive" language, also known as a support trust
    - Most common is the ascertainable standard of Health, Education, Maintenance and Support (HEMS)
    - Allows the Trustee to determine who should enjoy current and future benefits from the trust and, under what specific standard
    - Balances needs vs. extravagance
    - Some Trustees favor administering trusts with very specific standards

[1] Restatement (Third) of Trusts, §50 (2003)

# Grantor’s Intent

- Depending on the terms of the discretion, including the proper construction of any accompanying standards, the Trustee has a duty to understand the grantor’ purpose in creating the trust.[2]
  - When determining distributions, the Trustee must consider all relevant factors when the trust was created (e.g., grantor/beneficiary’s lifestyle, trust size, purpose, expected duration)
  - Some Trustees favor unrestrictive language while others favor the ability to make disbursements within the terms of the trust’s dispositive provisions
    - Trustee should be aware of tax consequences and administrative challenges associated with different discretionary standards

[2] Restatement (Third) of Trusts, §50 (2003)

# Review and Approval of Discretionary Distributions

- Trustee's exercise of discretion should be guided by the express terms of the trust, and to the extent not inconsistent with the document, the grantor's intent which may be gleaned from prior discussion with the grantor, beneficiary(ies) and Co-Trustee
- State law may provide guidance on the application of the HEMS standard
- Trustee should receive the discretionary request and any supporting documentation from the beneficiary, and should not coach beneficiary on how to submit a request that fits within the trust terms
- Trustee should review the beneficiary's request on its merits and in conjunction with the trust's discretionary provisions and grantor's intent
- Trust Officers are generally aware of the beneficiary's circumstances, however their judgment may be clouded by being too close to the beneficiary or not wanting to say "No" to a discretionary request

# Review and Approval of Discretionary Distributions

- Who may be involved in the review/approval of discretionary distributions other than the Trust Officer?
  - Committee
    - Pro: May result in a consistent decision-making process; can be good forum for training
    - Con: May be inflexible, and prolongs the approval process with scheduling logistics or follow up questions
    - Does the use of a Committee result in a better decision making process?
      - Group Think
      - Dominant personalities

# Review and Approval of Discretionary Distributions

- Fiduciary Professionals
  - May include management, Senior Trust Officer or other fiduciary experts (including trust counsel) with authority to review discretionary distributions
  - Pro:  Knowledgeable about fiduciary standards, and can quickly connect with Trust Officer on any follow up questions to provide timely and unbiased decision
  - Con: May not be fully aware of trust or beneficiary situation but able to make an unbiased and informed decision based on the information provided
  - Avoid opportunity to allow Trust Officer to shop for a “friendly” approver
  - Consider implementing approval structures based on the amount requested or paid within the last 12/24 months, for example at U.S. Trust the Trust Administrator and Trust Officer are vested with discretionary distribution approval limits. Requests in excess of $50,000 require the approval of a Regional Fiduciary Officer (RFO) and requests in excess of $250,000 require approval from the RFO manager.  The RFOs are an independent group and have a reporting structure outside of the client facing teams.
- Review and approval model must fit your organization

# Duties and Powers of a Trustee

- A Trustee has a fundamental duty to administer a trust with prudence, loyalty and impartiality for the current beneficiaries and remaindermen
- In order to exercise its fiduciary duty, a Trustee must administer the trust pursuant to its terms and purpose
- Powers held by the Trustee must be exercised, or not exercised, in accordance with their fiduciary duty
- Trustee has a fiduciary duty to consider the following when considering discretionary distributions:
  - Know all current beneficiaries and remaindermen
  - Understand the current beneficiaries' standard of living
  - Monitor and measure trust distributions to beneficiaries ensuring that they are not excessive or deplete the trust prematurely
  - If the distributions are exhausting the trust, consider reducing principal distributions

# Duties and Powers of a Trustee

- Engage in tough conversations with the beneficiaries (current and remaindermen) to ensure they understand the purpose and status of the trust
  - It may be more important that mom is able to stay in her home with 24 hour care and all parties understand that the trust will be exhausted, potentially limiting any funds that her children will receive following death
  - Consider if an Equitable Adjustment under the Uniform Principal and Income Act or Unitrust Conversion is appropriate
  - Continually review the trust instrument and don't assume you are aware of the provisions, e.g., focus on qualifiers May/Shall, has an event occurred that would impact administration

# Co-Trustees

- Within the Co-Trustee arrangement, Co-Trustees have a duty to act jointly (unless provided otherwise by the terms of the trust) and should not passively allow one Co-Trustee to take responsibility for decisions regarding administration/ investment of the trust
  - If Co-Trustee objects to a proposed decision, they have a duty to speak up and even petition the court for instruction
  - The governing instrument may vest an individual Trustee with certain rights, e.g., ability to determine distributions or be the final decision point
  - Be cautious of tax considerations if the individual Trustee is also a beneficiary of the trust and has broad discretion

# Quasi Fiduciaries Vested with Distribution Authority

- Increasing situations where individuals/entities other than the traditional Trustee may have authority to direct disbursement, e.g., Distribution Advisor, Trust Protector, Distribution Committee
  - Restatement (Third) of Trusts §75 (Tentative Draft) recognizes the ability of a grantor to give a third party the power to direct the actions of a Trustee.
- Generally, these individuals must act in accordance with the governing instrument and the best interest of the beneficiaries; they are generally liable for actions not made in good faith, <u>but</u> some statutes allow non-fiduciaries

# Quasi Fiduciaries Vested with Distribution Authority

- If the Trustee has concerns with the decisions or lack of decisions being made by these quasi fiduciaries, they may have a duty to communicate their concern
  - Section 185 of the Restatement (Second) of Trust provides "If under the terms of the trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of the power, unless the attempted exercise of the power *violates the terms of the trust or is in violation of a fiduciary duty* to which such person is subject in the exercise of the power."
  - Under the Uniform Trust Code §808(b), a Directed Trustee has the duty to monitor the actions of the trust advisor's exercise of power to ensure that it is not "manifestly contrary to the terms of the trust" or "the attempted exercise would constitute a serious breach of a fiduciary duty."

# Directed Trustee: Distribution Advisor/Trust Protector

- Distribution Advisors are becoming increasingly popular where the Administrative Trustee has authority to deal with administrative matters, custody, preparing/sending statements and preparing tax returns
- Distribution Advisor may have responsibility for investment and/or distributions
- Trust Protector is a very old concept that is growing in popularity; considered a fiduciary under UTC
  - Individuals may have broad powers to modify beneficiaries, direct trust distributions, modify governing law
- A Directed Trustee has a duty to follow the decisions/directions of the Distribution Advisor/Trust Protector, as such it is important that directions are clearly documented

# Advisory Committee

- The grantor may establish an Advisory Committee and grant the Committee authority to make distribution decisions.
  - Collectively, they may act closer to the grantor's intent and know the factors that should be considered
  - Maybe family members or business associates of the grantor and have a closer relationship with the beneficiary
  - Grantor may be alive and have some influence but avoiding control for tax reasons
- There is flexibility in the number of Advisory Committee members but a large one may become inflexible and prolong the decision-making process
- Trustee may or may not have a say in the decision-making process
- Trustee has a duty to follow the directions of the Advisory Committee, as such it is important that the directions are clearly documented

# Evidencing a Strong Discretionary Distribution Process to Beneficiaries and Support Partners

- Establish policy and procedure with clear expectations for trust professionals
- Implement a consistent process with the understanding that each account and discretionary request must be reviewed on its merit and approved prior to distributions being made
- Don’t just look at the current request but the prior distributions to the requesting beneficiary and all others entitled to distributions
- Maintain documentation of request, approvals and denials and keep it factual and don’t regret what you document
- Provide beneficiaries with the decisions on their request.   Be upfront when denials occur and have those difficult conversations
- Include a review of discretionary distributions in your administrative review process
- Consider including a line of business quality assurance review of discretionary distributions
- Compliance and Audit should include a review of discretionary distributions within their monitoring and testing programs

# Appendix

# Sample Compliance Testing Program

**Applicable Policy and Procedure:** Discretionary Distributions

**Law, Rule, Regulation (LRR):** 12 CFR 9.5, Policies and Procedures

**Frequency:** Annual

**Data Source & Contact Name:** Data Sampling team

**Population Description and Size:** Principal and income cash distributions $5,000 or greater in accounts coded as requiring a discretionary action form for time period January 1 - December 31, 2016.

**Sample Methodology and Size:** Statistical Sample - 100 accounts tested

**Test:**

- Question 1: Was the discretionary request appropriately approved prior to payment?
- Question 2: If required, confirm co-trustee approval obtained?
- Question 3: Have the discretionary provisions within the governing instrument been properly identified?
- Question 4: Does the governing instrument or applicable state law prevent the review of “Other Resources” information?
- Question 5: For multiple payments with a cash tickler does the expiration date coincide with that noted on the discretionary action form?
- Question 6: Is a W-9 (or a current W-8, if applicable) on file for any beneficiary who received a discretionary distribution?

*Information provided for illustrative purposes.*

# OCC Discretionary Distribution Examination Procedures [3]

Evaluate the bank's discretionary distribution processes.

- Is the decision-making authority for discretionary distributions expressly defined and communicated to all personnel?
- Are decisions fully documented and authorized by designated personnel or committees?
- Are distributions consistent with the guidelines established in the governing instrument? Consider the following:
  - Language in the governing instrument
  - Intent of the grantor
  - Need for the payment and the purpose for which it will be used
  - Needs of other beneficiaries
  - Size and duration of the fiduciary account
  - Number, ages, and standard of living of the beneficiaries
  - Other assets or sources of income available to the beneficiary
  - Tax consequences of a distribution

[3] Comptroller's Handbook, Personal Fiduciary Activities (February 2015)