TESTIMONY OF ELYSE E. ROGERS

concerning House Bill 326, Printer's No. 329
Session of 1995

Good morning. My name is Elyse Rogers. I am a partner with the law firm of Mette, Evans & Woodside in Harrisburg. I practice predominantly in the estate and business planning and estate administration areas. I have been in practice now for 11 years, and have been associated with Mette, Evans & Woodside for that entire time.

In the course of my practice, I have represented many people who have either established trusts, considered establishing trusts, or have provided in their wills for the establishment of trusts. I have represented persons who are or who will be beneficiaries of trusts. I represent a number of individuals who serve as trustee of one or more trusts. I have represented several financial institutions in their capacity as trustee. However, I have not served as general counsel to any trust company or to any bank with fiduciary powers. My objective in testifying here today is to provide the perspective of a practicing attorney who represents trustees, beneficiaries, and settlors of trusts as that perspective relates to trust portability in general and to House Bill 326 in particular.

Before testifying on the issues directly, I would like to elaborate for a moment on the duties of an attorney with respect to his or her clients as set forth in the Rules of Professional Conduct. We are prohibited from representing a client if the representation may be materially limited by our responsibilities to another client or to a third person, unless (i) we reasonably believe that the representation will not be adversely affected, *and* (ii) the client consents after full disclosure and consultation. The Comment to Rule 1.7 specifically targets loyalty as an essential element in the lawyer's relationship to a client. The comment indicates that loyalty is impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests.

I believe that almost all attorneys in Pennsylvania take the Rules of Professional Conduct very seriously. In the context of representing trustees, beneficiaries, or settlors of trusts, this means that we must represent our clients without regard to pressure from other potentially conflicting influences. This means specifically that we cannot fail to advise potential settlors with respect to choice of trustee, the advantages and disadvantages of individual vs. corporate trustees, and the ability of a beneficiary or another person to remove and replace trustees. This also means that we have a duty to discuss the advantages and disadvantages of trusts, including limitations upon flexibility. This is true without respect to the source of the referral of the client.

**Nature of a Trust**

Three things are required for a trust: a trustee, a beneficiary, and assets subject to the trust. Although an oral trust is possible as a matter of law, most trusts are subject to a written trust agreement between the trustee and the settlor of the trust.

Trusts, however, are more than mere contracts between settlors and trustees. The very names "trustee" and "trust" imply a relationship of confidence. Pennsylvania law has recognized the special nature of the trust relationship by imposing fiduciary duties on a trustee. A fiduciary is held to a standard not generally imposed on parties to a mere contract. The trustee has a duty not to act from self interest, and may not profit from dealing with trust property. The late Mr. Justice Cardozo said:

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545, quoted in Miller v. Hawkins, 416 Pa. 180, 205 A.2d 429, 436 (1964).

The forgoing is not to say that trustees, corporate and individual, are prohibited from receiving compensation for services rendered in connection with the administration of the trust. This is also not to say trustees are held to superhuman standards. For example, in the investment context, it is generally true that a trustee's standard of care is that which a prudent person would exercise in the management of his or her own assets. A trustee is not an insurer of the assets of the trust.

Neither the beneficiary, settlor, or the trustee "own" the assets in a trust. Rather, the rights of each are defined by the trust agreement. Generally, the settlor relinquishes the right (either during his/her lifetime or at the time of his/her death) to change the terms of the trust. The rights of the beneficiaries are defined and limited by the terms of the agreement; generally the rights of one beneficiary may conflict with the rights of other actual or potential beneficiaries of

the trust. The responsibilities of the trustee are defined not only by the trust agreement, but also by Pennsylvania law.

**Motives in Establishing a Trust**

I will not pretend that I can categorize for you all of the reasons why settlors may choose to establish a trust. However, motivations appear to fall into the following four primary categories:

1. Concerns about the ability of the beneficiary adequately to manage funds.

2. Concerns that the beneficiary may be victimized by other persons.

3. A "vision" for the funds that can be fulfilled only through use of a trust or other management vehicle.

4. Tax motivations.

**Management Abilities of the Beneficiary**

One common characteristic of human beings is that we like to be in control of situations, and we often believe, rightly or wrongly, that we do a better job of managing assets than others. This is particularly true when senior generations are evaluating the abilities of younger generations. Justified or not, many settlors simply do not have confidence in the ability of their beneficiaries to manage assets. A trust is the best way to protect beneficiaries from their own bad judgment, even if only with respect to assets in the trust.

Sometimes lack of confidence is temporary. Many settlors who are not tax motivated will create trusts for minors, with termination of the trust to occur upon the occurrence of certain events, such as the attainment of specified ages. Other times, lack of confidence will be permanent.

Closely related to concerns regarding management abilities are concerns regarding maturity and responsibility. I have never had a client who desired that his/her children or grandchildren live off the luxury of a trust fund without working and being self supporting. Most settlors have worked hard to accumulate wealth, and recognize the value of work and self sufficiency. Some settlors deliberately choose trust funds so that the ones they love will/must adopt a value system in sync with the settlor's.

### Possible Victimization of the Beneficiary

I cannot tell you how many times clients have expressed to me absolute confidence in a spouse, child (or grandchild), only to express grave concerns about others who might take advantage of the loved one. For these settlors, trusts are a way to protect a loved one and at least some of the loved one's (inherited) resources from designing persons. Often the most suspected person is the spouse of the loved one.

### Visionary Trusts

Visionary trusts take two forms: the family dynasty trust and the charitable trust. Here, the settlor has a vision that can be fulfilled only by setting forth specific rules regarding management of assets. Often combined with the vision is a lack of confidence in the beneficiaries of the trust (charitable or noncharitable) to "trustee" the assets as envisioned by the settlor. The management device selected is often a trust.

### Tax Motivations

Many trusts are established solely to provide estate and gift tax advantages. Tax advantaged use of the unified credit, the generation skipping transfer tax exemption, the marital deduction, and the charitable deduction often involve the use of trusts.

For some settlors, a trust will be attractive only for tax planning purposes. Some settlors would not be inclined to use a trust *except* to gain tax advantage. These settlors have no interest in restricting the beneficiary's rights with respect to the trust *or* the assets in the trust except to the extent necessary to gain the desired tax advantages.

Because of relevant provisions of the Internal Revenue Code, Regulations, rulings and cases, the choice of trustee, the "broadness" of the powers granted to the trustee, and the access of the beneficiary to the principal and income of the trust are interrelated.

For example, a beneficiary *can* serve as trustee of a trust only for the benefit of that beneficiary *if* the rights of the beneficiary are carefully tailored and limited. The right to income, invasion of principal limited to an ascertainable standard, and certain other rights with respect to principal will not cause tax problems.

An independent/not subordinate trustee is required if more than one beneficiary of the trust is eligible to receive benefits at the same time, or if the

settlor desires standards of principal invasion which are not limited to an ascertainable standard.

Because of the interrelationship between flexibility and choice of trustee, settlors must determine which is most important. Some will opt for greater flexibility and an independent trustee; others will opt for less flexibility so that the beneficiary or someone not independent of the beneficiary may act as trustee.

**House Bill 326**

Whatever the motivation for the establishment of a trust, its essential element is the independence of the trustee. To accomplish the objectives of a settlor, the trustee must make important ongoing decisions that (1) always reflect the directions of the settlor, who in many cases will be deceased, (2) balance the interests of the current income beneficiaries as opposed to those of future generations, and (3) frequently frustrate the expectations of one or more beneficiaries, as the settlor would have done if he or she were living.

This proposed legislation places a crucial aspect of a trust - the selection of the trustee - squarely in the hands of the income beneficiaries. This is contrary to existing law in Pennsylvania. I believe such power would be distressing to many settlors of trusts.

Votes Weighted in Favor of Income Beneficiaries.

Proposed Section 7122(a) not only gives income beneficiaries two votes to every vote of a remainderman, but also resolves ties in favor of the income beneficiaries. Because the interests of the income beneficiaries and the remaindermen almost always are in conflict, this creates a real possibility that the interests of the remaindermen will not be fairly represented.

A trustee, in the absence of contrary direction in the trust agreement, has duties both to the income beneficiaries and to the remaindermen. In a sense, the remaindermen are in need of greater protection because their interests are future, and because they often are unborn or young.

The interests of both current and future beneficiaries are important. One important aspect of the trustee's responsibilities is to safeguard the interests of the remainderman. In the context of investment decisions, this means prudent investment for reasonable income and reasonable growth. Trustee removal decisions weighted so heavily in favor of income beneficiaries could very well

provide trustees a subtle (or not so subtle) incentive to favor the interests of the income beneficiaries over the remainderman. This would be directly contrary to the interests of settlors. It would also undermine almost all of the reasons settlors establish trusts.

Appropriate Court.

House Bill 326 vests the court of common pleas with "jurisdiction" over removal and appointment procedures. This may or may not conflict with existing Section 711, which provides *inter alia* that the orphans' court division of the court of common pleas is to have jurisdiction over testamentary and intervivos trusts. At the very least, it creates a potential conflict, and/or vests jurisdiction in a judicial body which may not have familiarity with trusts. If a court has a separate orphans court division, all matters pertaining to trusts should be vested in that division.

Criteria Set Forth in Proposed Section 7122(b)(2)

The language used in proposed Section 7122(b)(2) is particularly troubling. A "special disinterested individual trustee" trying objectively to weigh what "sufficiently impaired", "sufficiently excessive", and "sufficiently substandard" means would be very frustrated.

Also troubling is the concept of a "working relationship" between income beneficiaries and trustees. Does this imply that income beneficiaries are *de facto* co-trustees with the trustee appointed by the settlor? The trustee assumes a high degree of responsibility to beneficiaries, as well as a responsibility to communicate with all beneficiaries, but does not co-manage a trust account with the income beneficiaries.

Insofar as trustee's compensation is concerned, the orphans court has, and has had, ultimate oversight with respect to trustee's compensation. 20 Pa. C.S.A. §7185 (court to allow trustee compensation that in the circumstances is reasonable and just) and §8111(b) (court to allocate trustees' compensation, etc. between income and principal) are two existing statutory provisions dealing specifically with compensation..

Finally, the investment standards applicable to the trustee have been well established in the law - the prudent man rule. "Sufficiently substandard" could mean any number of things which have nothing to do with long standing standards for investment of trust assets.

The primary problem with all of these criteria is that they are extremely subjective and could be applied arbitrarily and capriciously.

Multiple removal proceedings.

The proposed legislation limits removal proceedings to two in any five year period. This could be extremely disruptive for trust administration. For example, how could "sufficiently substandard" investment performance be measured in any meaningful way? What if the year is like 1987? or 1995 (at least year to date)?

Costs and Expenses.

Proposed Section 7122(g) insulates the income beneficiaries from any financial risks associates with removal of trustees. All costs are shifted to the trustee or to the remaindermen. This provision is extremely troublesome. In essence, a disgruntled income beneficiary could, on a regular basis, disrupt trust administration with no cost to himself or herself. All costs of the income beneficiary would be charged to principal or would be borne by the trustee. All expenses of the trustee would be borne by the trustee. No incentive is found within the four corners of the proposed legislation to encourage income beneficiaries to act responsibility. There is no downside to frivolous and repetitive complaints.

Notification Requirements.

The proposed legislation requires trustees of irrevocable trusts (whether or not institutional) to notify each sui juris beneficiary of the provisions of the proposed legislation. Mandatory renotification is required every five years.

Individual trustees of irrevocable trusts may be in no better position than beneficiaries to be aware of the requirements of this act. It is unfair to impose this burden on an individual trustee. Issues of fairness also arise in a corporate fiduciary context. Rarely does legislation, outside of notice in judicial proceedings, require a private, nongovernment actor to advise persons of either the current state of, or of changes in, the law.

**SUMMARY**

This legislation appears to be prompted by frustration on the part of income beneficiaries of trusts, frustration which is readily understandable and in some cases reasonable.

There have been great changes in the nature of the bank-customer relationship over the past ten years. As banks have consolidated, trust departments have consolidated and have become more remote from their clients and their beneficiaries. There appears (real or not) to be greater turnover in trust

officers. I have noticed growing dissatisfaction on the part of my clients with financial institutions as trustees. Some of this dissatisfaction is justified and most of it is not.

Many of my clients are reluctant to name financial institutions as trustees. All of my clients who name corporate or individual trustees would be aghast to know that the income beneficiaries could, virtually arbitrarily, vote them out of office. If a settlor wants to enable his or her beneficiaries to remove a trustee, the power to remove and replace trustees can specifically be granted to the beneficiaries.

I must seriously question whether the legislation that has been proposed is the appropriate remedy for changes in financial institutions as trustees. There are well-established provisions in Pennsylvania law with respect to removal and surcharge of trustees. There are also well established guidelines with respect to trustee compensation. This legislation will change well reasoned and long established provisions of law. To be the beneficiary of a trust is not and should not be equal to ownership of the trust. Income beneficiaries should not, at least not without due regard to the interests of remaindermen and the application of objective criteria, have the right to remove trustees unless the settlor of the trust has specifically granted that right to them. This legislation provides no objective criteria, and contains no incentive to income beneficiaries to invoke its provisions responsibly.

Frankly, if House Bill 326 were to become law, many attorneys who specialize in drafting wills and trust documents will probably attempt to eliminate its application to their clients' trust documents. It is also conceivable that many wealthy donors and estates will utilize the services of out-of-state banks not subject to Pennsylvania jurisdiction to avoid the potentially catastrophic and disruptive effects of House Bill 326.