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TRUSTS & ESTATES

The newsletter of the Illinois State Bar Association's Section on Trusts & Estates

In the May issue...

By Darrell Dies & Jacob Frost

This month's newsletter has several articles of interest to the estate/trust practitioner. Robert Held has submitted an interesting article about the Prudent Investor Rule in light of the recent case of *Carter v. Carter*. Thomas Bransfield and Darrell Dies have an appealing article regarding the ISBA Advisory Opinion No. 13-01 and the reasonableness of attorney fees. Gary Gehlbach provides a fresh perspective regarding equitable adoption as decided in the *DeHart* court. Tim Midura has some unique insights regarding the new Directed Trust and Decanting statutes. Finally, Phil Koenig provides a brief discussion regarding when to file a probate claim in light of *Water Tower Nursing v. Estate of Weil*.

We wish to express sincere thanks to each and every person that has helped make this newsletter a success by providing informative, substantive and practical articles. Members of the Trusts & Estates Section may now comment on the articles in the newsletter by way of the online discussion board on the ISBA Web site at <http://www.isba.org/sections/trustsestates/newsletter> and we welcome any comments from our audience. ■

Prudent investor rule chiseled away in *Carter v. Carter*

By Robert S. Held

The First District, in an opinion last year, effectively nullified – perhaps inadvertently – an element of the Prudent Investor Rule in Illinois. The ramifications are still being felt, but trust counsel and practitioners alike must be on notice: the duty of a trustee to remain impartial when investing marital trust assets has been eviscerated by *Carter v. Carter*.[1] An investment solely in tax-free municipal bonds for an entire trust was upheld without dissent in a ruling that was not filed under Sup. Ct. Rule 23.[2]

In *Carter*, the decedent's surviving spouse was the trustee and income beneficiary of a marital trust (a sub-trust created at the decedent's death to take advantage of the Internal Revenue Code's allowance for the deferral of tax on assets left to a surviving spouse).[3] The decedent's daughter was the remainder beneficiary of the marital trust who objected to her step-mother's singular investment. The surviving spouse had invested 100% of the marital trust in tax-free municipal bonds, she said, "to provide a good, safe income in a highly fluctuating and problematic market-place."[4]

The decedent's daughter brought a breach of fiduciary claim arguing that among other violations, the trustee had breached her duty of impartiality. The trustee's investment solely in bonds favored the trustee; it would provide a steady income (in nominal dollars) but would almost certainly not grow in value over time. Thus, the bond portfolio's purchasing power (after inflation), when inherited, could be far less than when the decedent died.

The Appellate Court correctly noted that its primary concern in interpreting a trust document is to ascertain the grantor's intent. Other than that observation, there is not a single portion of the court's analysis that is grounded in the Illinois statutes or relevant case law. The

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Court, instead, focused almost exclusively on one boilerplate provision of the trust. The trustee was authorized, as part of the provisions of the decedent's living trust "[t]o retain any property transferred to the trustee, regardless of diversification and regardless of whether the property would be considered a proper trust investment." In the *Carter* court's view, that language superseded (and nullified) the Prudent Investor Rule (the "Rule") requiring a trustee to pursue an investment strategy consistent with the trustee's duty of impartiality because the trustee's muni strategy was not "arbitrary or unreasonable."[5]

The Rule, developed decades ago, stems from modern portfolio theory—the effort to maximize return for a given level of risk of an entire portfolio. Essentially, a rational investor should consider how each asset class—and its proportion—affects the portfolio's expected return for a given level of risk. Effective in Illinois in 1992, the Rule provides that the trustee should diversify the investments of the trust unless the trustee believes it is in the interests of the beneficiaries and furthers the purposes of the trust not to diversify.[6] The Rule also requires that a trustee should pursue an investment strategy "consistent with the trustee's duty of impartiality."[7]

Until the decision in *Carter*, few thought that the boiler plate language quoted above, language in the form documents found in IICLE's Estate Planning Forms and Commentary, could nullify a trustee's duty of impartiality. In fact, the Rule in Illinois requires a settlor to expressly waive its provision if that is the settlor's intent. The Rule includes the following: "The provisions of this Section may be expanded, restricted, eliminated, or otherwise altered by express provisions of the trust instrument."[8] It appears that an implied waiver in *Carter* should not have been found.

While it is true that Illinois courts have consistently failed to understand the duty to diversify,[9] it is surprising that courts now are also willing to ignore the duty of impartiality. A fair reading of the Rule, the Restatement of the Law of Trusts or the conclusions of courts in other states facing similar questions should lead to what Professor Bogert and others have said for a century:

> [T]he trustee should endeavor to act in such a way that a fair result is reached with regard to the interests of the current or income beneficiaries and those who take possession of their interests at a subsequent date.[10] [T]he trustee must act impartially between the income and remainder beneficiaries in investment transactions.[11]

In short, by investing in tax-free municipal bonds, the trustee failed to balance the desire for income against the investment risk then allocated to the remainder beneficiary - the primary risk of a bond portfolio, inflation. While inflation is currently much lower, over the last 100 years price increases have averaged about 4%. During certain periods, like the ten-year period between 1972 and 1982, inflation insidiously eroded over one-half of the purchasing power of every dollar. Assuming only a 4% inflation rate and a 20-year investment in bonds, a remainder beneficiary could have the same purchasing power as a portfolio worth less than half its initial value. If the income beneficiary survives *25* years, the purchasing power is 37% of its initial value. And those calculations assume that interest rates are unchanged. In fact, if interest rates rise, the value of the portfolio at the income beneficiary's passing would be even less (as bond prices vary inversely to interest rates). A prudent investor would not invest in a way that ignores the eroding effects of inflation.

Further, it is difficult to imagine that the settlor contemplated that boilerplate language would allow the trustee to invest in assets in derogation of her duty of impartiality. In the *Carter* Court's view, the income beneficiary's welfare became foremost; the remainder beneficiary's rights, subordinate—and all based on one standard trust provision. Of course, the income beneficiary herself—if she lives long enough—will also discover the disadvantage of an investment exclusively in bonds. The income she is receiving today, again assuming a 4% inflation rate, may only buy her one-half of those goods and services 20 years down the road.

The old adage to not put all your eggs in one basket comes to mind. By creating a portfolio that balanced her desire for income with the need to protect against inflation, the trustee could have fulfilled her duty of impartiality, reduced the overall portfolio risk and created a higher expected return. Further, after creating a balanced portfolio she could have withdrawn a fixed percentage of the portfolio each year regardless of the income created by taking advantage of Illinois' Total Return Trust statute.[12]

A portfolio with several asset classes would also be more likely to serve the income beneficiary in the future by protecting the portfolio against inflation. It was in the income beneficiary's own interest to ensure that if she lives long, her purchasing power from the income is maintained. Ironically, in addition to helping herself, such a strategy would also fulfill her husband's wish that the portfolio (not 37% of it) would go to his daughter at his wife's passing. Practitioners, mindful of the *Carter* opinion, must now consider amending existing trust documents or advising their current clients of the altered landscape affecting the duties of a trustee. ■

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1. *Carter v. Carter*, 2012 IL App (1st) 110855, 965 N.E.2d 1146 appeal denied, 968 N.E.2d 1064 (Ill. 2012)
2. An order entered under Rule 23 is not precedential and may not be cited by any party except to support contentions of double jeopardy, *res judicata*, collateral estoppel or law of the case. Ill. Sup. Ct. R. 23
3. 26 USCA 2056
4. *Id.*
5. *Id.*
6. IL ST CH 760 § 5/5
7. *Id.*
8. *Id.* (emphasis supplied)
9. As the Court in *Cent. Nat. Bank of Mattoon* v. U.S. Dept. of Treasury, 912 F.2d 897, 902 (7th Cir. 1990), "This leaves the status of the duty to diversity in Illinois law in a fog . . ."
10. The Law Of Trusts And Trustees § 541
11. The Law Of Trusts And Trustees § 612
12. IL ST CH 760 § 5/5.3

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