Does A Discretionary Trust Remove Fiduciary Duties A Trustee Owes Beneficiaries?

Roger McEowen (roger.mceowen@washburn.edu) – Washburn University School of Law
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Overview

Trusts are often used as part of an estate plan for various reasons. They can be established to take effect during life or be included as part of a will to take effect at death. They can be revocable or irrevocable. They can also be established as a "support" trust or as a "discretionary" trust. Support trust is a trust where the trustee's responsibility is to provide for the beneficiary's support such as food, clothing, and shelter. A discretionary trust, on the other hand, is a trust that has been set up to benefit one or more beneficiaries, but the trustee is given full discretion as to when, if any, trust principal and/or income, are given to the beneficiaries. With a discretionary trust, the trust beneficiaries have no rights to trust funds. But, can the trustee of a discretionary trust simply ignore the other beneficiaries? Is the trustee still accountable for the way the trust assets and income are handled?

The issue of the responsibility of a trustee to other beneficiaries of a discretionary trust – it's the topic of today's post.

Recent Kansas Case

Basic facts. The question of how a trustee relates to other beneficiaries of a discretionary trust came up in a recent Kansas case involving farmland and oil and gas interests. In *Roenne v. Miller, No. 120,054, 2020 Kan. App. LEXIS 72 (Kan. Ct. App. Oct. 2, 2020),* the decedent, at the time of her death, had five children and owned royalty interests in oil leases, farmland, a home, as well as cattle, farm equipment and other personal property. Her will devised a one-half interest in the farmland to a son that was named as trustee of her testamentary trust. The other one-half interest in the farmland was devised to another son for life with a remainder to his children. Upon this son dying childless, the remainder would pass to the trustee-son. All of her livestock and farm machinery along with certain personal property was bequeathed to these two sons equally. The non-trustee son then assigned his one-half interest in the farm assets and farmland to the trustee-son.

The decedent's will clearly specified that the other children were to have no interest in her farmland. The will directed that the balance of her estate, consisting solely of interests in oil royalties, passed to the testamentary trust. The trust gave the trustee "uncontrolled" or "exclusive" discretion over trust net income and principal, and provided specifics authorizations for the use of the trust income and principal. The trust also specified that the trustee was to "only act in a fiduciary capacity" and that the trustee "shall each year render an account of his administration of the trust funds hereunder that the same shall be available for inspection by any of the beneficiaries at any reasonable time." In addition, the trust specified that the trustee was liable for any failure to exercise reasonable care, prudence and diligence in the discharge of trustee duties.

At the time of the decedent's death, the farmland was encumbered by substantial debt. The trustee sold the decedent's home and used the proceeds to pay down debt on some of the farmland. Other of the farmland was foreclosed upon and the trustee's wife bought part of it at the foreclosure auction with the trustee's name later added to the title. The trustee did pay off a mortgage on one of the oil leases, but also distributed oil lease income to himself over a 19-year period in the amount of $1,300,000. No bank account was established for the trust and the trustee deposited the oil lease income directly into his personal account that he owned jointly with his wife. The oil lease income was used to pay down the substantial debt on the farmland and to pay farming expenses. While the trustee testified that his use of the oil income in such manner did not benefit the trust, he asserted that the would not have taken on the responsibility of executor and trustee unless he could use the oil income to service the debt on to pay off the farm debt and farming expenses. He testified at trial that he promised the decedent that he "would keep the farm intact whatever way I could." In 2013 and 2014, the trustee conveyed the mineral rights from the trust to himself personally as a beneficiary which effectively emptied the trust of assets.

Trial court. The other beneficiaries sued the trustee for negligently and fraudulently breaching his fiduciary duties as trustee by converting for his own use the trust income mineral interests. The trial court construed the will and trust together and determined that the decedent's intent was to give the trustee-son as much power as possible to use trust principal for the benefit of any beneficiary in any amount without limitation. Additionally, the trial court held that the trustee did not violate his fiduciary duty he owed as a trustee or commit fraud because he relied upon the terms of the trust and had sought out advice from an attorney that advised him that oil income could be used to service debt. He testified that accountants and bankers relied on the trust's terms in dealing with him and told him that he could use trust income in the manner that he did. In other words, because the trustee had uncontrolled or exclusive discretion over the trust, the trustee could not be held accountable to the other beneficiaries for his conduct.

Appellate court. On appeal, the plaintiffs contended that the trial court erred in ruling that the trust language granting the trustee uncontrolled discretion relieved the trustee of his fiduciary duties as a trustee on the basis that such a determination did not square with the law of trusts. The trustee maintained his argument that the trust was a discretionary trust and not a support trust. Consequently, the trust did not require the trustee to make disbursements to the other beneficiaries. Specifically, the trustee claimed that his conduct conformed to the "prudent investor rule" of Kan. Stat. Ann. §58-24a01, and did not violate his duty of loyalty under Kan. Stat. Ann. §58a-802 because the trust authorized him to transfer trust property to himself.

The appellate court reversed and remanded. The appellate court noted that the decedent's intent in creating the trust was paramount and that the language of the trust was unambiguous in creating a discretionary, as opposed to a support, trust. No single beneficiary had the right to a distribution. The trustee had the freedom to act in his capacity as trustee. As such, the appellate court noted that it could only interfere with that freedom in cases where the trustee abuses discretion, acts in bad faith or acts in a manner that is arbitrary and unreasonable as to amount to bad faith. A good faith reliance on the express provisions of a trust does not result in trustee liability for breach of trust. However, even with a fully discretionary trust, the trustee still has fiduciary duties to the beneficiaries of loyalty, impartiality and prudence in accordance with Kan. Stat. Ann. §58a-101 et seq. These statutory duties, the appellate court noted, cannot be superseded by trust language purporting to give the trustee "uncontrolled" discretion. A trustee, must still act in good faith and administer the trust for the benefit of the beneficiaries. While a grantor's intent is paramount, the law places limits on trustee conduct even in the context of a fully discretionary trust.

Concerning the duty of loyalty, the appellate court noted that Kan. Stat. Ann. §58a-802(a) requires the trustee to "administer the trust consistent with the terms of the trust and solely in the interests of the beneficiaries." The duty preserves the character of the fiduciary relationship between the trustee and the beneficiaries. The duty of impartiality is an extension of the duty of loyalty and is contained in Kan. Stat. Ann. 58a-803 which specifies that, "If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving all due regard to the beneficiaries' respective interests." Here, the trustee was one of the five beneficiaries and had a duty to act impartially with respect to the other beneficiaries. Depositing trust income in the trustee's personal account, the appellate court held, violated the duty of impartiality. The trust was intended to be for the benefit of all of the decedent's children, and the trustee's actions were inconsistent with that intent.

Concerning the duty of prudent administration, Kan. Stat. Ann. §58a-804 states that, "A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution."

The trust stated that the trustee could use trust income to pay farming expenses, convey mineral rights, and execute oil and gas leases. But, it gave such authorization to the trustee *only in his role as a fiduciary and not as a beneficiary.* The trust instrument was clear in stating, "All powers given to the trustee or trustees by this instrument are exercisable by the trustees only in a fiduciary capacity. No power given to the trustees hereunder shall be construed to enable any person to purchase, exchange, or otherwise deal with or dispose of the principal [or] the income therefrom for less than adequate consideration in money or money's worth." This is a key point. There was no indication in the trust language that the trustee could transfer all of the trust assets to his personal account as a beneficiary to operate his own personal farming operation. Doing so overrode his duties of loyalty and impartiality. Although the trustee argued he was relying on an oral promise to maintain the farm, the appellate court noted the mother could have given him all of the royalty interest income, like she did with the farm, in her will. There was no express trust language allowing the trustee to transfer everything to himself and his wife.

The appellate court held that despite language in the trust granting the trustee uncontrolled discretion to act, the trustee still had fiduciary duties to all of the beneficiaries. Those duties, the appellate court determined, had been breached. The trial court's focus solely on the discretionary language was in error. On remand, the trial court must address the trustee's statute of limitations defense, or any other equitable defenses, and remedies for a breach of trust including a money judgment or a specific sum for restitution.

Conclusion

The recent Kansas decision is a case study in what can go wrong with an estate plan. It illustrates the classic situation in the farm setting where the parent wants to benefit all of the children equally, but have the farm assets end up in the hands of a particular child. It's debatable whether the structure chosen to implement that plan was appropriate. However, when a trust is utilized, clients and potential trustees should be advised of the basics of trust law, the fiduciary duties that a trustee owes to the beneficiaries and that those statutory duties can't be extinguished by trust language. Apparently, some judges need to learn those basics also. In the Kansas case, voters have already turned the first-term trial court judge out of office when his present term is up.