Covert Compliance

WHERE THERE'S A WILL, THERE'S A WAY

BARBER & BARTZ
ATTORNEYS AT LAW

Learning Objectives

Exploration of how discretionary authority, entity structuring, and statutory allocation powers are weaponized to negatively impact beneficiaries

Overview

- Fiduciary misconduct is not always overt.
- Trustee can comply with the letter of the law while frustrating grantor intent.

Hidden Harm

- Covert compliance deprives beneficiaries without clear illegality
- Harm emerges only after prolonged under-distribution.
- Courts’ deference to trustees compounds the problem.

Trustee Discretion: A Double-Edged Sword

- Modern trusts grant broad discretion for “health, education, support, and maintenance.
- Trustees can interpret “support” narrowly, denying legitimate needs.
- Courts rarely override unless clear bad faith is shown.
- Result: inequitable outcomes cloaked in legal correctness..

Example of Discretion Misuse

- Trustee limits “comfort and support” to essentials only.
- No distributions for education/travel despite high returns.
- Income beneficiary struggles; remainder beneficiaries prosper.
- Legislative solution: minimum distribution benchmarks.

Entity Structuring to Restrict Access

- Trustees increasingly hold assets via LLCs, corporations, partnerships.
- Purpose claimed: efficiency or liability limitation.
- Effect: reduced transparency and liquidity for beneficiaries.

Illustrative Scenario

- Trustee forms LLC, names self manager.
- Retains profits for “growth”; distributes only illiquid membership interests.
- Collects management fees – double compensation.
- Beneficiary has no meaningful recourse.

Recharacterizing Income As Principal

- Trustees exploit flexibility under the Oklahoma Uniform Principal and Income Act (OUPIA).
- Can shift earnings from income to principal, reducing distributions.
- Courts often uphold decisions absent clear abuse.

Case Study: Will of Helyn W. Kline

- Trustee reclassified capital appreciation to principal.
- Income beneficiary received minimal annual income.
- Court found no wrongdoing – grantor intent thwarted.
- Example of lawful conduct producing inequitable results.

The Illusion Of Fiduciary Compliance

- Trustee appear compliant: timely filings, proper records, no self-dealing.
- Yet beneficiaries are starved of support.
- Example: trustee collects 1.5% fee + LLC manager pay while denying distributions

Drafting Strategies

- Clarify Discretionary Standards
  - Define “support”; require objective criteria
- Restrict Trustee Control of Entities
  - Independent manager approval; transparency mandates
- Limit OUPIA Adjustments
  - Written justification; distribution floor (e.g. 3-4% of FMV).

Sample Protective Clause

The Trustee shall not allocate income to principal in any year the income beneficiary receives less than 4% of trust fair market value, unless otherwise ordered by a court.

Litigation Tools

- Focus on economic substance over form.
- Use forensic accounting to company asset growth vs. distributions.
- Expert testimony to model reasonable total-return policy.
- Tie inequitable results to breach of fiduciary duty.

Conclusion and Reform

- Abuse often hides behind “technical compliance.”
- Needed reforms:
  - Greater transparency in entity layering.
  - Oversight on OUPIA reallocations.
  - Presumed bad faith when distributions < 3% without explanation.
- Attorneys must scrutinize discretion as rigorously as overt misconduct.

BARBER
& BARTZ
ATTORNEYS AT LAW

525 South Main Street, Suite 800
Tulsa, OK 74103-4511
Phone: 918-599-7755 • **Fax:** 918-599-7756
www.barberbartz.com