Playing with Matches: Avoiding the Trustee Risks You Didn't Know Existed

FIRMA 32nd National Risk Management Training Conference
April 2018

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This outline was originally published in the materials for the 2017 Heckerling Institute on Estate Planning. Materials Revised March 2018.

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I. To Lend or Not to Lend? That's a Tricky Question

A. Why Would A Trustee Make Loans to a Beneficiary?

Loans are one of the most commonly used tools in the estate planning arena. If a trust does not permit an outright distribution of principal, for example, the trustee may still be able to lend trust assets to the beneficiary in order to make funds available. In some cases, loans are preferable to outright distributions because a beneficiary has a large, but currently illiquid taxable estate, and the loan is a way to provide liquidity without increasing the beneficiary's estate tax liability.

A secured loan may offer needed assistance to a current beneficiary while preserving assets for remainder beneficiaries. The loan may provide that upon the death of the borrower-beneficiary, such individual's estate is liable for making payments on the loan and only if such estate is insolvent should the remaining balance be deducted from the beneficiary's share of trust assets.

And then there are the concerns about giving a beneficiary too much money for a home or business venture with no strings. A loan will assist a beneficiary while still requiring the beneficiary to contribute to the purchase for which he or she is using the loan. Individuals often create trusts to avoid giving large sums of money outright to others. In the right circumstances, loans may be useful to protect this intent.

Where there are multiple beneficiaries and needs arise at different times, a loan for down payment on a home, for example, may keep the playing field more even in the eyes of other beneficiaries. Trustees have a difficult job balancing personalities with multiple-beneficiary trusts, and a loan can enable the trustee to give the beneficiary use of the liquidity without making an outright distribution that would exceed such beneficiary's "share" of the trust assets in the eyes of other watchful beneficiaries.

B. Look Before You Leap - Considerations When Making a Loan to a Beneficiary

It should seem an obvious first question, but many trustees do not take the time to consider who else might need to approve the loan from the trust. Most trust agreements grant co-trustees the power to delegate signature authority to just one of the trustees. If properly documented and if the requisite number of trustees have approved the transaction, a delegation generally is acceptable.

The problem of proper authority arises with modern trust law, and with directed trusts in particular. Many trust agreements will divide out traditional trustee roles among multiple parties, for example, authorizing one trustee to act on administrative and investment matters and another on distributions (directed and directing trustees). As some of the statutes allowing for division of trustee duties are unclear, and because a trust agreement is not always written as clearly as the drafter believes, it is important to check whose signature actually is required on the loan documents or any related approvals of the fiduciary action.

Most people think of loans as a category of transaction. In reality, when a trustee makes a loan, the trustee is making an investment decision. It is important, therefore, to consider whether the loan is a good investment or, at the very least, an investment consistent with the purposes of the trust and the investment standard required by the trust agreement and applicable law. For example, if the trust was earning 4% a year and the loan is at an annual interest rate of 2%, is the trustee justified in reducing the investment return? Another pitfall with loans is that they may cause the trustee to have a concentrated position. If the trustee is lending more than 10% of the assets to the beneficiary, consider whether the trust permits retention of a concentrated position either by its express terms or by virtue of its purposes. The following are a few of the basic questions to consider in determining whether the loan is a prudent investment:

- Would the beneficiary be able to obtain the loan in the market?
- Are the terms of the loan between the trustee and beneficiary similar to or very different than those available from a third party in the marketplace?
- Will the loan cause a concentrated position of assets? If so, does the trust expressly waive the duty of diversification or otherwise allow for holding that particular concentration?
- Is the interest rate higher or lower than the rate of return on the assets prior to the loan?
- Could other current beneficiaries or remainder beneficiaries complain that the assets should have been invested in something more productive or more liquid? If so, are there clear purposes of the trust that allow deviation from the "more prudent" investment due to the benefit that the loan affords to the beneficiary?

If the beneficiary were looking to obtain a loan in the marketplace, at a minimum she would be asked to provide the prior three years of income tax returns. The trustee does not necessarily need to ask the beneficiary to list every account it has with account numbers and statements. Performing some due diligence, however, is prudent for the trustee in order to protect itself from liability for having made the loan if the beneficiary defaults. Asking for a couple years' worth of tax returns and an asset statement is not a particularly onerous burden on the beneficiary and may allow the trustee to spot something that raises a red flag regarding lending to the beneficiary.

Almost all trusts have spendthrift clauses that prohibit a trustee from distributing trust assets to a beneficiary's creditors in satisfaction of the beneficiary's obligation. A trustee who properly contractually binds the trust on a loan, pledge, or guaranty should be able to make good on that contract without running afoul of the spendthrift clause. With respect to the beneficiary, however, the trustee may not be able to collect against the beneficiary's future share to repay a loan due to the spendthrift clause. Some state expressly permit a trustee to charge a beneficiary's share with a loan made to the beneficiary from the trust, which should resolve the issue. But many states do not have this statutory resolution of the issue, and so the trustee must carefully consider whether and how it may bind the borrower-beneficiary.

Another issue with loans that should seem straightforward, but is often overlooked, is whether the trustee actually has authority under the trust instrument or statute to make a loan to a beneficiary. Most trust statutes or trust agreements permit lending, and a general discretionary authority to make investments probably covers lending with interest. Several states have statutes that specifically address lending to a beneficiary and charging the beneficiary's share of the trust for the loan. Wisconsin law, for example, specifically allows a trustee to makes loans to a beneficiary on terms the trustee considers "fair and reasonable under the circumstances".[1] The statute further states that the trustee will have a lien on distributions to the beneficiary for loans made pursuant to the statute.[2]

Even if a trustee does not have statutory authority to charge a beneficiary's share, the trustee may have discretionary authority to do so based on equitable principles. In *In re Lunt*,[3] the court applied the doctrine of recoupment to allow the trustee to exercise its power to make distributions within its discretion to set off the failure of a debtor-child to pay back a loan from a trust of which he and his siblings were the remainder beneficiaries. The debtor brought suit against the trustee, arguing that since he had declared bankruptcy and the principal balance on the note was discharged, his share could not be reduced by the amount of principal and

[1] Wis. Stat. 701.0816(18).
[2] Wis. Stat. 701.0816(18).
[3] 477 B.R. 812 (Bankr.D.Kan 2012).

interest he would have paid to the trust under the note. The trust provided for unequal distributions of income to the children, however, and the court found that while the bankruptcy operated as an injunction against enforcing the note against the debtor personally, it did not stop the trustee from offsetting the debtor's share using recoupment. "In bankruptcy, recoupment is an equitable doctrine that allows one party to a transaction to withhold funds due to another party where the debts arise out of the same transaction." The court determined that the debt arose out of the same transaction, and therefore the trustee's use of recoupment was proper.

Trustees who act properly within their authority should be protected and have proper recourse against the debtor-beneficiary, as in *Lunt*. In order to limit liability for loan transactions, a trustee needs to understand the scope of its duties and powers and be sure it is not exceeding the bounds of its authority. The following are questions a trustee should ask before deciding to enter into a loan transaction with a beneficiary (or any other party, for that matter):

- Do the trust agreement or applicable law authorize the trustee to make loans?
- What are the minimum requirements for the loan?
- How much due diligence is required regarding the borrower's ability to pay?
- Is interest required?
- Must the trustee receive collateral?
- Even if the trust agreement and applicable law do not require security, is it prudent for the trustee to secure the loan anyway?
- Is there a UCC filing, mortgage recording or other action that should be taken to preserve the trustee's priority on the collateral?

Often a beneficiary requests a loan to purchase a specific asset, such as real property or a business interest. It may be prudent for the trustee secure the loan with such asset or interest. Other times, however, the beneficiary may be requesting a loan to finance a risky investment or to start a business. Interests in such an entity likely will be worth next to nothing in the event the investment fails, and may put the trustee in a position of having to defend why it made a loan against such a terrible asset. Is it therefore a better decision to simply make a distribution to the beneficiary where one is allowed?

In *Conant v. Lansden*,[4] for example, the trustee would have been better off not making the loan. In that case, the trustee made multiple loans to a company in which the trust had an interest. The loans were made to "preserve the trust assets" by keeping the company from going out of business. The trustee made a series of loans, and the first loans were held to be prudent because there was no indication that the company could not pay back the loans. After the borrower failed to pay back one of the loans, however, the trustee made two more loans to the defaulted borrower. The trustee was held to have breached its fiduciary duty on later loans because the company had gone out of business by the time the later loans were made. Specifically, the court felt it was a very bad idea to have made new loans to the company after the company had failed to pay back a preceding loan. The court found that the later loans were "hazardous and wholly unsuitable for trust funds." The trustee's actions to make the loans to preserve the trust property were not questioned, but at the point that one of the loans went unpaid, the trustee should have exercised judgment not to throw good money after bad.

If the trustee decides that it needs or wants security, the trustee must consider whether the security will be sufficient to cover the balance of the loan and whether the trustee will be able to collect on the asset without significant expense. If the trustee is not required to collateralize, presumably taking security that is worth less than the full amount of the loan would be in the trustee's general discretion in determining the terms of the loan. Considering the value and liquidity of the collateral also is part of the process in deciding whether security is

[4] 341 Ill. App. 488, (Ill.App.Ct. 1950).

worthwhile. If the trustee will have to spend significant funds or time to collect an asset, or if the asset is not easily sold or does not produce income, does the trustee really want to accept that collateral? The trustee should consider obtaining a formal valuation of the collateral, not only to determine whether there is sufficient value to cover the loan, but also to demonstrate that the trustee has exercised appropriate due diligence. Sometimes trustees are satisfied with the beneficiary's word regarding the value of the collateral, but this can be risky. A formal valuation by a professional third party may protect the trustee if the collateral fails. Depending on the situation and the type of asset, the collateral may need to be revalued throughout the life of the loan. While the appraisal may not be necessary for certain types of assets and loans, it should be considered throughout the relationship.

And perhaps one of the most important considerations for a trustee is to ask itself how far it is willing to go to secure the loan in the event the beneficiary defaults. For a prudent investor, there may be a duty to take action to collect on the defaulted loan or to seize the security. However, a trustee is in a uniquely uncomfortable position when lending to a beneficiary because it must balance its fiduciary duties to the beneficiary with its duties as a lender and to the other beneficiaries, either current or remainder. Depending on the trust provisions, the trustee may be able to make a distribution to the beneficiary in the amount of the outstanding balance. However, other current or remainder beneficiaries may dispute the prudence of the distribution. Before making the loan, the trustee should ask itself the following questions:

- If there is an incurable default, will you take action to collect on the loan?
- Are you willing and able to seize the collateral, if any?
- Are you willing to take the beneficiary to court to collect on the beneficiary's personal assets?
- Would I just make a distribution to the beneficiary to pay off the loan?
- Who is going to sue me if I don't collect, who is going to sue me if I do collect, and who is going to sue me if I make a distribution to pay off the loan?

If the trustee determines that it would simply make a distribution or forgive the loan in the event a beneficiary defaults, the trustee may want to consider foregoing the loan and just making an outright distribution in the first place.

C. Special Considerations for Corporate Fiduciaries

A corporate fiduciary often wears multiple hats with respect to a beneficiary. The institution may be the trustee, and it may also be an investment advisor, personal banker or lender to the beneficiary as well. A corporate financial services institution must follow certain laws and regulations when making loans. A corporate fiduciary should consider how much it should deviate from its ordinary loan procedures when making a loan with assets of a trust of which it is trustee.

Although the precarious nature of the conflict position should seem obvious, banks have sometimes charged forward with little disregard for the landmines ahead. In *Smith v. First Nat'l Bank*,[5] the bank had been working with Judy's family for many years and was acting as trustee of a trust for the benefit of Judy.

The bank had also lent money to a couple named the Smiths for the purchase of a bar. The bar did not do well and the Smiths defaulted on their loan. The bank initiated foreclosure proceedings.

In an effort to not lose money on the loan to the Smiths, the bank convinced Judy to purchase the bar for $200,000 without telling her it had only appraised for $130,000. In fact, the bank made it appear like Judy was getting a good deal by telling Judy the bar had been listed for $250,000. Judy took out a loan from the bank for the purchase price as well as repairs and improvements. These loans were secured by an assignment of Judy's beneficial interest in the trust of which the bank was trustee.

[5] 254 Ill.App.3d 251 (Ill.App.Ct. 4th Dist.1993).

After a few years, the bar failed again and Judy had to sell the bar, incurring a loss. Judy sued for breach of fiduciary duty, and the bank argued it owed no fiduciary duty because the transaction was not related to its position as trustee. The court, however, found that the fiduciary duty extends to transactions (1) suggested by a trustee, (2) which make the trustee a creditor of the beneficiary, and (3) which give the trustee a security interest in the trust. By using the interest in the trust as security for the loan, the bank caused its fiduciary duty to extend to the bar transaction. As a result of this extension of the trustee's fiduciary duty, the trustee engaged in self-dealing by proposing and encouraging Judy to purchase the bar. The court summed up the risk as follows: "When the trustee does benefit from a transaction with the beneficiary, the transaction is presumed fraudulent and such presumption may only be overcome by clear and convincing proof the transaction was fair and the trustee did not breach its duty of loyalty to the beneficiary."

A similar issue to the multiple hats concept relates to the higher standard to which financial institutions generally are held by the courts. For example, *some* courts have held banks liable in cases where a bank officer promised to make a loan but did not keep the promise.[6] It is easy to see such liability extending to the case of a trust officer speaking with or e-mailing a beneficiary. To protect against claims of promised loans, most states have enacted statutes requiring a written agreement for a purported loan commitment to be enforceable. However, some courts have held that e-mails are a sufficient "written agreement" to satisfy these credit agreement acts.

D. Putting It In "Right"ing

When making the loan, the documents should address any and all steps necessary to give the trustee the authority and the ability to collect on the loan. If the beneficiary has a revocable trust, for example, the trustee may want to ensure the loan documents specifically provide that the beneficiary's revocable trust asset are clearly available to repay the loan. This might involve adding in language providing for collection from the revocable trust, having the beneficiary sign the loan both individually and in the beneficiary's capacity as trustee of the revocable trust, or by having the revocable trust sign as a guarantor of the loan.

To speed the collection process if the beneficiary dies or defaults, the loan documents should be clear on what constitutes a default on the loan, whether there is a cure period, and whether there is a penalty. Having a loan become immediately due and payable upon the beneficiary's death or other default can save the trustee time and money by accelerating the process for obtaining a judgment, and allowing the trustee to move quickly and inexpensively to collection. A sample default clause might look like this:

> *Any one or more of the following shall constitute an event of default hereunder (each, an "Event of Default"):*
>
> *(a) default in the payment of interest or principal hereunder when the same shall have become due and payable;*
>
> *(b) Borrower becomes bankrupt or admits in writing an inability to pay Borrower's debts as they become due, makes an assignment for the benefit of creditors, consents to the appointment of a trustee or receiver, or files for relief in bankruptcy, or other proceedings for relief in equity or under any acts of Congress or any laws of any state of the United States relating to the relief of debtors;*
>
> *(c) a trustee or receiver is appointed for Borrower or for part of Borrower's property without its consent; or*

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[6] *See e.g. Coastland Corp. v Third. Nat'l Mortg. Co.*, 611 F.2d 969 (4th Cir.1979); *Landes Const. Co. v. Royal Bank of Canada*, 833 F.2d 1365 (9th Cir.1987); *Wait v. First Midwest Bank/Danville*, 142 Ill.App.3d 703 (Ill.App.4 Dist. 1986); *Bolus v. United Penn Bank*, 363 Pa.Super. 247 (Penn. 1987).

(d) bankruptcy or insolvency proceedings, or other proceedings for relief in equity or under any acts of Congress or any laws of any state of the United States relating to the relief of debtors are instituted against Borrower or are consented to by Borrower.

In the case of any such Event of Default, then the entire unpaid principal balance of this note, together with all accrued and unpaid interest thereon, shall forthwith become immediately due and payable without notice.

Other provisions that a trustee might wish to consider include a non-waiver clause so the trustee does not have to seek enforcement immediately upon default if the trustee believes the beneficiary-debtor might get back on track with payments. Promissory estoppel may still be an issue if the trustee waits too long, however, relieving the immediacy of action by the trustee to preserve its rights under the note may be particularly helpful when the borrower is a beneficiary. Such a clause might look like this:

No delay or omission on the part of Lender in exercising any right or remedy hereunder shall operate as a waiver of such right or remedy, and no waiver of any right or remedy hereunder on any one occasion shall be construed as a waiver of any such right or remedy on any other occasion. None of the terms or provisions of this Note may be waived, altered, modified or amended except as the parties may agree in writing.

1. Signing Without Signing Away Your Life

Under the common law of many states, a trust is not a separate legal entity, but rather, a contractual arrangement between the grantor and trustee. Consequently, when a trustee enters into a contract with a non-beneficiary third party, the contract is between the third party and the trustee, as opposed to being a contract between the third party and the trust. The trustee is personally liable for any issues that arise regarding the contract unless some provision of the trust instrument provides that the trustee is not personally liable or unless the trustee has obtained an agreement from the third party to look only to the funds of the trust. The latter typically is in commercial loan documents, though this language often is omitted in private loan documents. It is not sufficient for avoidance of personal liability that a trustee merely disclose that he or she is acting as trustee. Rather, the contract itself must be clear that the trustee is not bound in his or her individual capacity.

Conversely, in states that have adopted the Uniform Trust Code, the trustee is not personally liable on a contract that the trustee entered into in the trustee's capacity as a fiduciary as long as the trustee disclosed the fact that he or she was entering into the contract as trustee. Under the Uniform Trust Code, the trustee has provided the necessary disclosure if he or she signed the contract "as trustee" or otherwise referenced the trust. As of the date of this writing, slightly more than half of the states and the District of Columbia have adopted the Uniform Trust Code in some form or another.[7] The Uniform Trust Code provides:

(*a) Except as otherwise provided in the contract, a trustee is not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administering the trust if the trustee in the contract disclosed the fiduciary capacity.*

(b) A trustee is personally liable for torts committed in the course of administering a trust, or for obligations arising from ownership or control of trust property, including liability for violation of environmental law, only if the trustee is personally at fault.

[7] As of October 2016, the following jurisdictions have adopted the Uniform Trust Code: Alabama, Arizona, Arkansas, District of Columbia, Florida, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, Wyoming. http://uniformlaws.org/LegislativeFactSheet.aspx?title=Trust Code

(c) A claim based on a contract entered into by a trustee in the trustee's fiduciary capacity, on an obligation arising from ownership or control of trust property, or on a tort committed in the course of administering a trust, may be asserted in a judicial proceeding against the trustee in the trustee's fiduciary capacity, whether or not the trustee is personally liable for the claim. § 1010.[8]

The issue of whether a trust is capable of being a legal owner is one that arises in the estate planning context. In the case of *Presta v. Tepper*,[9] Tepper and Presta were business partners with three partnership contracts that dealt with the buy-out of a partner upon death. Two of the three contracts were entered into by Tepper and Presta as trustees of their revocable trusts.

Tepper died, and his wife took the position that Tepper's trust was the partner in the latter two agreements that had been signed by Tepper of trustee of his revocable trust. Therefore, she argued, it was the revocable trust that was the partner and not Tepper, so there had been no death to trigger the buy-out. She argued she could not be compelled as trustee to sell the interests in the two later-dated partnerships because the trigger had not occurred. The court disagreed.

The fundamental flaw in Renee's argument is that it assumes a trust is an entity, like a corporation, which is capable of entering into a business relationship such as a partnership. It is not. It has long been established under California law that an express trust of the type created by Presta and Tepper is merely a relationship by which one person or entity holds property for the benefit of some other person or entity....

Following a line of cases holding that "an ordinary express trust is not an entity separate from its trustees," the court rejected the arguments of Tepper's surviving spouse and held that the sale on death was triggered in all three partnership agreements by the death of Tepper. The court even rejected the argument that the trust was recognized as a distinct taxpayer with its own taxpayer identification number, and therefore must be a separate entity for legal purposes, stating that "the tax status of these trusts is nothing more than a reflection of their essential purpose: to establish a special category of property ownership by which the property is divided between the trustee who holds record title and controls it, and those who are entitled to receive its benefits."

To be safe, a trustee seeking to avoid personal liability for loans to beneficiaries should be certain that the loan documents clearly state that the trustee is entering the contract "not individually, but solely as trustee" of the named trust. Similarly, when the trustee executes the loan, the trustee's signature line should make a similar indication that the trustee is signing only as a fiduciary. The trustee's signature block should do more than merely disclose that an individual is signing "as trustee." Rather, the signature block should indicate that the trustee is not signing in his or her individual capacity, but solely as trustee of the trust. In addition, the loan documents themselves should include a provision in which the parties agree that the trustee is not personally liable for the contract. For example:

This note has been executed by the undersigned trustee, not personally, but solely as trustee, in the exercise of the power and authority conferred upon and vested in him, as such trustee, and this instrument has been executed in performance of the undersigned's obligations under the trust.

2. To Secure Or Not To Secure? That's a Good Question

It would seem straightforward to answer the question as to whether a trustee should secure a loan. If there are assets to take as security, why would a trustee not do so? In the case of a loan to enable a beneficiary to purchase a home, for example, taking a mortgage will enable the borrower-beneficiary to deduct to deduct the

[8] Limitation on Personal Liability of Trustee., Unif.Trust Code § 1010.
[9] 179 Cal.App.4th 909 (Cal.App.4 Distr. 2009).

interest if the loan meets the applicable requirements. In that instance, collateralizing the loan operates to the benefit of both the trust and the borrower.

In general, if a trustee determines that it is going to make a loan and take back security for the loan, that would seem to indicate the trustee believes the security will provide some value and perhaps the loan is less risky. The trustee may not realize, however, that by securing the loan, the trustee could be imposing upon itself a duty to perform a greater level of due diligence to avoid fiduciary liability. If collateral or a guarantee is offered, the trustee also may be lulled into a false sense of security, and may make a loan that would not be prudent in the first place.

In *Estate of Ralph W. Collins*,[10] the trustees were a business partner and a lawyer of the decedent under whose will the trust was created. The trust had about $50,000 to invest, and lawyer-trustee thought it would be a good idea to lend the money to his real estate developer client who was looking for a $50,000 loan. Lawyer-trustee believed this to be a good idea despite the fact that he knew real estate developer's previous lender had withdrawn from making the loan. The property for which the loan was made was already subject to a $90,000 first deed of trust.

Both the lawyer and the business partner knew the property had been sold for $107,000 two years before the time period when they were making the trust loan. The trustees asked two real estate brokers from the area about possible values for the property, and those brokers indicated that property in the area where the collateral property was located could go for a price per acre that would value the property as high as $180,000. The trustees, however, did not actually have the property appraised. The representatives of the developer told the trustees that the company was not in default on other loans and had no pending lawsuits. Unfortunately, the trustees took no further action to confirm that the real estate developer had no foreclosures or lawsuits filed against it. In fact, there were six notices of default and three lawsuits pending. The trustees did obtain and review an unaudited financial statement for the company that indicated it had a net worth of more than $2 million.

Based on the information they gathered, the trustees decided to lend the $50,000 to the real estate developer. In addition to a subordinated second deed, the developer also pledged 20% of its stock as security. The trustees never obtained possession of the stock, placed it in escrow, or placed a legend on the certificates to indicate that the stock was pledged. The individual owners of the real estate development company and their spouses also made personal guarantees, but the trustees did not obtain personal financial statements from any of them before accepting the guarantees.

Within a short period of time, the real estate developer defaulted on the loan, the holder of the first deed of trust foreclosed, and the trust lost the entire investment (including an extra $10,000 in costs in an attempt to forestall the foreclosure and save the investment). The court outlined multiple actions trustees should take: reasonable diversification of assets, avoiding second or junior mortgages at almost all cost, and ensuring proper valuation of collateral.

The court concluded that the trustees failed in performing these tasks. First, the trustees invested almost the entire trust corpus in a company they were aware had problems. Second, the loan was secured by a second deed of trust which the trustees were aware likely would be insufficient to cover the loan. Finally, the trustees made the investment without adequate investigation of financial viability of either the company or the individual guarantors. Although the trustees expended some effort on investigation, securing a loan that never should have been made in the first place did not save them from breach of duty.

> *We think it apparent that defendants violated every applicable rule. First, they failed totally to diversify the investments in this relatively small trust fund. Second, defendants invested in a junior mortgage on unimproved real property, and left an inadequate margin of security. As noted, the land had most recently sold for $107,000, and was subject to a first trust deed of $90,000. Thus, unless the land was worth more than $140,000, there was no margin of security at*

[10] 72 Cal.App.3d 663, 139 Cal.Rptr. 644 (1977).

all. Defendants did not have the land appraised; the only information they had was the opinion of a real estate broker that property in the area - not that particular parcel - was going for $18,000 to $20,000 an acre. Thus, any assumption that the property was worth about $185,000 - and therefore the $140,000 in loans were well-secured - would have been little more than a guess.[11]

Of interest in the court's comments above regarding *Estate of Ralph W. Collins* is the analysis of loan-to-value ratio. A commercial lender typically will lend approximately two-thirds of the value of collateral. While a loan between a trust and beneficiary might exceed the marketplace ratio, particularly if the loan is consistent with the intent of the grantor and the purposes of the trust, a trustee should consider how far from the norm it is straying and should perform proper due diligence in support of its decision.

Sometimes the loan is properly made, but the trustee fails to take security where it should have done so. *The Matter of Anne Hamilton Killian Trust*,[12] is such a case. Pursuant to the trust agreement governing the trust in that matter, the trustee could distribute income and principal to Joan for her health, education and maintenance. Upon termination, the trust would be distributed to Joan's children, one of whom was Todd. During her lifetime, Joan requested multiple loans from the trustee to improve her personal residence, and the trustee issued those loans at an interest rate of ten percent.

At some point, a hearing was held regarding the trustee's annual reports to which Todd had filed objections. The trial court ordered that the loans be secured by a mortgage on the property before it would approve the annual report, and the trustee argued the court's order was an inappropriate challenge to his discretion as fiduciary. The appellate court disagreed with the trustee and found that the trial court was within its jurisdiction and authority to order that the loans be secured.

During the case, Todd had also argued that the trustee should have considered Joan's other property and income before making the loans to her. The trust document stated that the trustee needed to consider Joan's other property and income when distributing income and principal to her, so the court clarified that only in the case of a distribution, and not for a loan, would the trustee need to consider these other sources of income. To combat the investment argument, Todd argued that the loans were not a prudent investment of trust assets. However, the court held that since the trust document mentioned "maintaining the beneficiaries in a manner to which they have become accustomed to living and assisting them in the purchase of a home," the trustee had discretion to determine how best to support and maintain the beneficiaries.

Based on the language of the trust, the court noted the trustee potentially could have made an outright distribution of the amount loaned but chose instead to make a loan to preserve the trust corpus as well as provide for Joan. The only fault the court found with the trustee's actions was failure to secure the loan. Although on the surface it seems like making a secured loan to Joan was the easier route for the trustee, would the trustee have been found to have made a mistake if he had simply exercised his discretion to make a distribution to Joan?

E. Not "Interest"ed? That May Be a Problem

Original Issue Discount ("OID") is a type of interest required to be reported on loans when no interest payments or insufficient interest payments are required or made during the life of the loan. The complex provisions governing OID are found at Internal Revenue Code §§ 1271-1275.

Sufficiency of interest payments is determined relative to the Applicable Federal Rate. For example, if no interest is paid during the loan, OID is simply the total interest payments that should have been paid were the appropriate Applicable Federal Rate applied to the length and terms of the loan.

Typically, OID is taxable at the time the loan is made and is equal to the total of the interest payments over the life of the loan. In the case of a loan in which the lender knows the borrower will make no payments

[11] *Id.* At 670-71.
[12] 519 N.W.2d 409 (Ct.App.Iowa 1994).

until the maturity of the loan, this is easy to calculate. However, OID can be incurred during the life of the loan or only during certain time periods in which payments and/or interest are not actually paid. For example, if a beneficiary misses a loan payment or simply fails to make an interest payment, OID can be incurred on just that one payment. Calculating this periodic OID can be complicated as OID (if the rules are applicable) is reported daily and is prorated.

There are various exceptions to the OID rules pursuant to Internal Revenue Code §1272. These exceptions include:

- Loans less than $10,000.
- Loans with "qualified stated interest" which is interest that is unconditionally payable or will be "constructively received."
- De minimis exception: OID is treated as zero if the total OID is less than (a) ¼ of 1% of the stated redemption price at maturity, multiplied by (b) the number of whole years until the loan is due.

The rules governing OID are complex and a more in-depth discussion is beyond the scope of these materials. Trustees that decide to make a loan should consult with a knowledgeable tax advisor regarding appropriate interest rates, frequency of payments and tax reporting with respect to the loan.

A. Covering Your…Trustee

There are a few basic guidelines for making loans to beneficiaries that, if they are followed, should protect any trustee. Of course, real life and trust purposes may make deviating from these guidelines perfectly sensible in certain circumstances. Before a trustee decides to move forward with a loan, it should consider whether it falls outside these guidelines and, if so, whether it can justify that deviation.

- The loan would be considered prudent if it were being made to a third party.
- With the loan in the trust portfolio, the duty to the beneficiaries is property balanced with the duty to make prudent investments.
- If the loan would not necessarily be a prudent loan made in the everyday course of business, and if the trust instrument does not expressly authorize the "imprudent" loan, the other beneficiaries have consented in writing to the transaction in a document that also releases the trustee from liability for making the loan.

In states that allow virtual representation agreements, it is possible to get beneficiaries with current and remainder interests to sign off on the trustee's actions either by approving of the action itself or by clarifying language in the trust that would allow the trustee to take such action. The documentation of beneficiary approval should contain a release of the trustee for engaging in the transaction. If one or more necessary parties to the approval is unwilling to release the trustee, then that is a signal to the trustee that it should reconsider its willingness to make the loan. In fact, that red flag is precisely the circumstance that should cause a trustee with authority to make a distribution to the beneficiary to revisit whether making a loan really is the best course of action.

Several states specifically address approval of trustee transactions and have procedures to limit a trustee's liability. In Indiana, for example, a trustee may provide written notice to beneficiaries with respect to any proposed action under the Uniform Principal and Income Act and will not be liable to current or future beneficiaries with respect to the proposed action if no beneficiary objects within the specified timeframe.[13] In addition, the Indiana Trust Code provides that a trustee is not liable to a beneficiary for a breach of trust to the extent that the beneficiary consented to or ratified the trustee's actions at a time that the beneficiary knew the

[13] Ind. Code §30-2-14-16.

beneficiary's rights and all material facts relating to the breach.[14] Several other states have adopted rules similar to those of Indiana, however, it is important to check the applicable state statutes for compliance with any special requirements needed to make the consent or ratification effective. California, for example, has very specific rules and typeface specifications for its beneficiary notices.[15] The notice must be in 12-point boldface type and contain certain language pursuant to the statute.

The common law of most states incorporates the concepts of consent and ratification, so even in states without statutory consent provisions, it may be prudent to give the beneficiaries the material information about a transaction and to obtain written approval. As a general rule, beneficiaries may be barred from pursuing a claim for breach of fiduciary duty if they consented to the actions of a fiduciary. For consent to be valid, the beneficiaries must be legally competent adults and the trustee must disclose the material facts of the transaction.

In order to improve the effectiveness of any consent signed by the beneficiaries, the fiduciary seeking consent should advise the beneficiaries to obtain independent counsel to advise them with respect to the breach transaction and what they are being asked to sign. For example, counsel was effective to uphold consent despite a beneficiary's limited understanding in *Stephan v. Equitable Sav. & Loan Ass'n.*[16] In *Stephan*, the court upheld the beneficiary's consent despite her limited capacity to understand the breach transaction. Citing to the Restatement, the court stated:

> *It is true that consent by a beneficiary does not preclude him from holding a trustee liable for breach of trust if such consent was induced by improper conduct of the trustee or if the trustee has an adverse interest and the transaction is not fair and reasonable. In this case, however, while it may be true that Mrs. Stephan was a person of limited understanding and experience and that defendant did not inform her of all of the rights which she may have had, it appears that during this entire period from 1941 to 1953 she was acting under the advice of an attorney.*

In order to prove proper disclosure of material facts, a fiduciary should provide a written statement or letter to the beneficiaries setting forth the details of the transaction. Consent by a beneficiary will not bar a breach of fiduciary duty claim if the beneficiary is incapacitated, does not know of his rights or material facts of the transaction, or was improperly induced by the trustee to provide consent. If a beneficiary is not sophisticated or if a transaction is particularly complex, insisting on separate representation for the beneficiaries may be in the fiduciary's best interests.

F. Parting Is Such Sweet Sorrow

The death of a beneficiary who owes money to the trust requires the trustee to review the loan and consider what steps must be taken to ensure the loan is repaid by the deceased debtor-beneficiary. The trustee needs to consider any applicable creditor claims periods and whether action needs to be taken in probate court or another forum. The original loan documents should be checked to see if they address the lender's rights upon the beneficiary's death and if they prescribe certain procedures that must be followed in order to collect.

Assets and obligations of a revocable trust are not always subject to a court-supervised probate proceeding, so separate steps may need to be taken to collect against the decedent beneficiary's revocable trust assets. Claims against a revocable trust generally need to be brought in court within a certain time period following the beneficiary's death. In many jurisdictions, it is important to file a claim against the decedent's estate if a probate estate is opened, as the rights against the revocable trust may be lost if this step is not taken.

G. I've Got Your Back – Securing the Beneficiary's Third Party Loan

[14] Ind. Code §30-4-3-19.
[15] Cal. Prob. Code § 16461.
[16] 522 P.2d 478, 487 (Or. 1974).

Some trust agreements have extensive administrative provisions that explicitly discuss the extent of a trustee's ability to pledge assets for or guarantee loans to a beneficiary by a third party. Even if a trustee is authorized to pledge or guarantee, it may not be advisable under statutory or common law fiduciary duty concepts. The duties of loyalty and impartiality, in particular, impact the determination by a trustee as to whether to exercise its discretionary power to pledge or guarantee a loan to a beneficiary.

A trustee has a duty of impartiality, which means that unless the trust states otherwise, the trustee owes the same fidelity to all beneficiaries, including contingent beneficiaries, and all trustee actions need to be weighed against that standard. Some trusts allow the trustee to give preference to certain beneficiaries, and so that express right to be partial can weigh in favor of assisting a preferred beneficiary by securing that beneficiary's third party loan with trust assets.

A trustee also has a duty of loyalty, which means that all of the trustee's actions have to be for the benefit of the beneficiaries rather than for the trustee's own gain. If the trustee has any relation to the third-party lender, the trustee would be advised to seek consent of the other beneficiaries prior to making the guarantee in order to avoid a claim of self-dealing. Even where a transaction may seem fair on its face, the court can be harsh to a trustee who breaches the duty of loyalty.

In *Bullock v. BankChampaign, N.A.*,[17] Randy was trustee of a trust that his father had created for the benefit of Randy and his four siblings. During his trusteeship, Randy made multiple loans to himself and his mother, jointly. All the loans were repaid with six percent interest. Eventually, Randy's siblings sued him for breach of fiduciary duty. While the court did not find that Randy had "malicious motive in borrowing funds from the trust," the loans were clearly self-dealing. The court ordered Randy to pay to the trust the "benefits he received from his breaches." Randy tried to liquidate his interest in the assets he had purchased with his mother, but was unable to do so and ultimately filed for bankruptcy. The new trustee, BankChampaign, opposed his effort to obtain a bankruptcy discharge of his debt to the trust. The bankruptcy court held that Randy's debt to the trust fell within an exception as a "debt for defalcation while acting in a fiduciary capacity." Randy appealed the case through multiple courts until it reached the Supreme Court. The Court had to determine whether "defalcation" applies in the absence of a finding of ill intent or evidence of a loss of trust principal. Randy argued that not only did he repay the loans, but he did so at a 6% interest rate, so there was no loss to the trust and no malicious intent. The Supreme Court, however, disagreed and held that his self-dealing was "objectively reckless", causing it to fall under the defalcation exception. As a result, Randy's debt to the trust was not discharged in bankruptcy.

Securing third party loans to a beneficiary also brings into play the trustee's duty to invest prudently. Is providing a guarantee or pledge on behalf of a beneficiary a prudent action? The answer may be yes, but the issue must be considered as it relates to the trust as a whole. As when the trustee is making a loan, it may want to mitigate risk by requesting tax returns and a financial statement from the beneficiary to demonstrate that it has done its due diligence to determine whether the beneficiary is at least a reasonably likely to repay the loan on his own.

Lastly, should the trustee be charging the beneficiary for providing the guarantee or pledge of assets? Even where a trust expressly permits such a guarantee or pledge, does the situation call for an exchange of value before the trustee puts trust assets at risk for the sake of the beneficiary?

II. ***Kettle* If You Do, *Dumont* If You Don't**

It is well-known that a trustee has a basic duty to cause the trust property to produce income. Many trustees believe that they are satisfying their fiduciary duty as long as the trust produces some income and sees a positive level of return on its investment. Merely increasing the balance sheet, however, is not the sole standard for judging the prudence of a trust's investment portfolio.

[17] 133 S. Ct. 1754 (2013).

Investment of the trust portfolio also brings to bear the trustee's duty of impartiality, which encompasses the requirement that the trustee balance the investment portfolio to achieve fairness in both growth and income. To determine how the interests should be balanced, the trustee must consider, at a minimum, the purposes of the trust, the terms of the trust instrument, and distribution requirements outlined in the trust.

The trustee's duty of loyalty often is implicated in the investment arena as well. Particularly where a trustee is in a conflict position, such as a trustee who is an officer or director of a company whose stock is held by the trust, it can be difficult for the trustee to remove her own wishes from the equation and to consider solely what is in the best interest of the trusts and its beneficiaries.

A. Prudent Investor Rule

The historical rule governing investment of trust property was known as the Prudent Man Rule, and mandated that a trustee preserve the trust property and make it productive. Ultimately, the Prudent Man Rule was replaced by the more flexible Prudent Investor Rule, which allows a trustee greater flexibility in investments and more broadly considers the purposes of the trust and the in determining the prudence of the trust portfolio.

In essence, the Prudent Investor Rule requires a trustee to preserve the trust property and to make it productive while acting with reasonable care, skill, caution and undivided loyalty to the beneficiaries. Acting with good intentions is not enough, and these duties generally require a trustee to educate itself regarding investments and/or to seek expert advice in areas where the trustee lacks sufficient expertise to make a proper analysis on its own. Legislatures in many states have formally adopted the Prudent Investor Rule, while courts in other jurisdictions have referred to the Rule as articulated in the Restatement of Trusts in their decisions. Those trustees in jurisdictions that have adopted the Restatement's version of the Prudent Investor Rule are given the benefit of consideration of the performance of the investment portfolio as a whole.

The Restatement approach also judges a trustee's investment choices at the time the choices are made, not later in time based purely on the result of an investment portfolio. In fact, the courts often refer to this distinction in timing of the review of an investment decision when issuing rulings in trust investment cases.

Section 90 of the Restatement (Third) of Trusts suggests a list of characteristics a trustee should consider in examining a contemplated investment. In the cases discussing the propriety of a trustee's investment decisions, the courts often look at the trustee's process in making decisions and the documentation maintained by the trustee with respect to the work that it did in evaluating a prospective investment. Therefore, a trustee may wish to consider incorporating the suggested elements into an investment review checklist as part of the trustee's risk management plan. The Restatement's "Characteristics A Trustee Should Consider In Examining A Contemplated Investment" are as follows:

- Expectations concerning the investment's total return, and also the amount and regularity of the income element of that return whenever the beneficial interests or purposes supported by the trust are affected by distinctions between trust accounting income and principal.
- The degree and nature of risks associated with the investment and the relationship of its volatility and characteristics to the diversification need of the portfolio as a whole.
- The marketability of the investment, and the relation between its liquidity and volatility characteristics and the amount, timing, and certainty of the trust's cash flow or distribution requirements.
- Transaction costs (including tax costs) and special skills associated with the acquisition, holding, management, and later disposition of the particular investment.
- Any special characteristics of the investment that affect its risk-reward tradeoffs and effective return, such as exposure to unlimited tort liability, the presence and utility of tax advantages, and the maturity dates and possible redemption provisions of debt instruments.

The Uniform Prudent Investor Act (UPIA) is a resource that courts often look to in making decisions on investment propriety in fiduciary cases. The UPIA overlaps significantly with the investment provisions of the Uniform Trust Code. Since its acceptance, the UPIA has been adopted in whole or in part in a majority of the states.[18] The UPIA standard evaluates fiduciary prudence in the investment context on the basis of the portfolio as a whole, rather than by judging individual investments.[19] The UPIA specifically notes that the standard varies depending on the particular skill level of the trustee with respect to investments, a concept often iterated in case law. Corporate fiduciaries are therefore generally held to a higher standard for making reasonable investment choices than are individual trustees. The UPIA, like the Restatement, sets forth a list of items that a trustee must take into account under the Act when determining a proper investment portfolio for a trust:

- General economic conditions
- The possible effect of inflation or deflation
- The expected tax consequences of investment decisions or strategies
- The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property
- The expected total return from income and the appreciation of capital
- Other resources of the beneficiaries
- Needs for liquidity, regularity of income, and preservation or appreciation of capital
- An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries

This last item from the UPIA checklist, in particular, tends to play a significant role in the cases where beneficiaries challenge the investment decisions of a trustee. Both in the context of trust loans and in diversification cases, the concept of grantor intent and special purposes of the trust have been reviewed when analyzing an investment that deviates from the norm. From a risk management perspective, trustees may want to consider documenting their thoughts about or information relevant to grantor intent when making a decision to hold a concentrated position or to make a loan to a beneficiary.

B. Diversification of the Trust Portfolio: *Kettle* If You Do, *Dumont* If You Don't

It is a core concept of fiduciary law that a trustee generally has a duty to the beneficiaries to diversify the trust portfolio. This duty is not absolute, however, and is subject to modification by specific directions provided in the trust instrument. The extent of the duty and the factors considered in deviation also vary among jurisdictions.

Historically, the directions of a settlor to retain a particular asset or to invest the trust estate in a specific way were honored by the courts, even when the trust experienced losses as a result. More recent cases, however, indicate a trend in the courts that the directions of a settlor regarding investments are to be considered in light of reasonable investment policy and are not inviolate. In short, trustees must be careful not to neglect the basic duty to engage in reasonable analysis of a trust's investment situation, even when the terms of a trust may clearly dictate an investment policy. Trustees that blindly follow the directions in a trust instrument without considering

[18] According to the National Conference of Commissioners on Uniform State Laws, as of November 2016, states that have adopted the UPIA in whole or in part include: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, U.S. Virgin Islands, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming. No legislation is pending in the states that have not enacted the UPIA

[19] Unif. Prudent Investor Act §2(a), 7B U.L.A. 289 (1994) §2(b).

the circumstances of the market and the beneficiaries can find themselves in court, as evidenced by two well-known cases regarding single stock positions, *In re Will of Dumont*[20] and *In re Estate of Kettle.*[21] Both of these trustees were held liable, even though they had taken opposite actions regarding the stock position and the directions of the trust instrument.

In *Dumont*, the express language in the Will permitted the corporate fiduciary to retain the estate's single stock position in Kodak. The trustee did not diversify for the first 44 years of the trust and then hurriedly sold off the stock over a nine-month period starting in 2002. This failure to diversify occurred despite negotiations with the beneficiaries in 1997 and court action by the beneficiaries in 1998 objecting to the trustee's accounts on the basis of losses incurred due to "improper retention of a near 100% concentration in Kodak stock and overall mismanagement of the trust estate." In December 2001, the trustee made an official determination that a compelling reason existed to sell stock.

The court focused on the "compelling reason" language of the Will and determined that the trustee had breached its fiduciary duty with respect to the concentrated position. Specifically, the court found that the trustee had improperly interpreted the meaning of the phrase "compelling reason" as it was used in the governing instrument. In addition to its error in interpreting the governing instrument, the trustee also got itself into trouble by failing to maintain adequate records. The court noted that the trustee's complete lack of documentation regarding the investment performance of the trust's assets was a breach of trust in itself. As a result of the finding of breach of duty, the court awarded damages in excess of $20 million.

Although this case was overturned on appeal on February 3, 2006, the reversal was based on technical deficiencies and not on the substantive issues. For this reason, the admonishments of the surrogate court continue to be a valid warning to trustees. Fiduciaries often assume that their job is made easier when the governing instrument provides specific instruction regarding trust investments; the truth of the matter is that the opposite is often true and the trustee has a harder job of balancing express direction with reasonable behavior. Putting faith in the belief that express investment direction in a trust instrument places the trustee in a protected position is an unfortunate oversight that may lead to substantial liability. The words of the *Dumont* court may be better guidance for trustees faced with narrow investment direction. These words of guidance are as follows:

> *Where a fiduciary is administering an estate under directives of a retention clause, it is incumbent upon that fiduciary to develop a uniform understanding of the testator's words, basing such a definition on the input of an experienced team of industry professionals, preferably under the guidance of in-house legal advice. It is also critical that the fiduciary's actions reflect an understanding that a retention clause does not exculpate itself from poor judgment and laziness, but instead that a retention clause almost requires a greater level of diligence and work, as prudent management of the estate will demand a delicate balancing act.*

There is perhaps no better evidence of this difficulty than the comparison of Dumont to a strikingly similar case where the trustee did the opposite of the Dumont trustee and also ended up being found responsible for breach of duty. Similar to the facts in *Dumont*, the Will at issue in *Kettle* provided that the executor and trustee should retain a single stock position unless there was a compelling reason to dispose of the stock. The decedent's will stated "I note that I am particularly desirous that my TRW, Inc., securities be retained by my Executrix and by my Trustee unless compelling reasons arise for the disposal thereof." Two months after receiving the stock, the trustee decided to sell the stock in the interest of diversification.

The testator's widow, claiming breach of trust, filed suit to compel the trustee to repurchase the stock and also sought removal of the trustee. Once again, the phrase "compelling reason" caused difficulty for a trustee. The court held that the "trustee acted in breach of its trust when it sold the stock", as the stock was a good investment at the time it was sold and the trustee failed to show a compelling reason for sale (diversification apparently not being a compelling reason) as required by the express request of the testator.

[20] 791 N.Y.S.2d 868 (Surr.Ct. 2004).
[21] 73 A.D.2d 786 (N.Y.App.Div. 1979).

As these two cases demonstrate, it is important for a trustee to review the applicable state law to determine whether there is a mandatory duty to diversify the assets of a trust notwithstanding a waiver of the duty in the governing instrument. Although courts have sometimes interpreted certain terms in a trust to relieve the trustee of the duty to diversify, courts will not always exonerate the trustee from all liability.

A third similar case further drives home the landmine represented by the diversification issue. Also a case dealing with Kodak stock, *Matter of Janes*,[22] was a case where the co-executor bank was found liable for what the court determined was a negligent failure to diversify the estate's assets. The estate's total value was more than 70% invested in Kodak stock. Despite declines in the stock price, the bank only sold some of the stock. The sales only reduced the concentration to 50% of the estate's value being invested in Kodak stock.

The court found that the bank had sufficient information within a very short time after the testator's death to understand the risk involved with the concentrated position, and that the bank should have sold the stock. Instead of engaging in a plan of diversification, however, the bank proposed only a sale of a small number of shares to raise cash for expenses of administration.

Part of the issue in the case is that the testator's wife had only a high school education and had no business training or experience. The bank held only a few meetings with the testator's wife about the retention of the stock, and the bank never communicated with the charitable beneficiaries regarding the investments. Several months after the last meeting with testator's wife, the value of the Kodak plummeted. A mere one year later, the stock was worth less than half of its value at testator's death.

The bank initiated a court proceeding to have its accountings approved. The testator's wife and the Attorney General (on behalf of the charities) filed objections. The appellate court upheld the lower court's finding of liability based on the bank's "initial imprudent failure to diversify as well as for its subsequent indifference, inaction, nondisclosure, and outright deception in response to the prolonged and steep decline in the worth of the estate."

In 2005, the Ohio Court of Appeals directly asked "Does a trustee have a duty to diversify the assets of a trust when the language of the trust authorizes retention of a specific asset..?" In the case *Wood v. U.S. Bank, N.A.*,[23] the court answered the question by holding that a trustee does have a duty to diversify when there is retention language unless there are "special circumstances."

In *Wood*, the trust specifically granted the trustee the power "[t]o retain any securities in the same form as when received, including shares of a corporate Trustee..., even though all of such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash uninvested as they deem advisable or proper." The initial composition of the trust was 82% in one stock and 18% in a second stock. The corporate trustee recommended selling some assets to raise cash to pay taxes and expenses of the estate, but their plan involved selling mostly the 18% stock. This left the trust with an 86% concentration of one stock and 14% concentration of the second stock.

The beneficiaries agreed to the plan, but as the 86% stock kept rising in value, one of the beneficiaries asked the corporate trustee to diversify. She and her advisors did not make a written request to the trustee, and the trustee did not diversify. It should be noted that the 86% stock was stock in the corporate trustee's own institution. The stock began to plunge and it was estimated that the failure to sell some of the stock and diversify caused losses to the trust of approximately $770,000.

Reversing the lower court decision and remanding the case, the Ohio Court of Appeals cited to the Restatement Third of Trusts for the proposition that a broad generalization does not relieve a trustee of its duty to diversify. Specifically, it opined:

[22] 223 A.D.2d 20 (N.Y. App. Div. 1996), aff'd, 681 N.E.2d 332 (N.Y. 1997).
[23] 828 N.E.2d 1072 (Ohio App. 2005)

> *We hold that to abrogate the duty to diversify, the trust must contain specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent. The authorization to "retain" here was not sufficient - it only authorized the trustee to retain its own stock - something it could not otherwise do.*

Additionally, the court cautioned against sloppy drafting. The retention clause cited above was described as "unfortunate wording" because the positioning of the phrase "advisable and proper" made it unclear as to whether the phrase was intended to apply to all assets or only the cash. The grammatical interpretation would have applied to the cash only, but the court was not forced to determine that issue for its ruling. "Luckily, our holding makes it unnecessary to construe this language; but we caution that this type of fuzzy drafting can create problems."

Ten years later, the *Puhl* beneficiaries cited to *Wood* in their efforts to sue the trustee for breach of fiduciary duty relating to retention of the entire trust portfolio in six stocks that the settlor specifically had mandated be held during her lifetime despite lack of diversification.[24] The argument put forth by the beneficiaries was that *Wood* "stands for the proposition that trustees have a duty to diversify even if the trust language authorizes retention of certain assets." Finding that *Puhl* was distinguishable from *Wood*, the court hinged its decision on the fact that the trust at issue in *Puhl* specifically authorized the trustee to retain assets "regardless of lack of diversification". The trust in *Wood* was silent on diversification, and the court felt that difference was key to defining the trustee's duties.

These two cases are a good reminder how important it is to look at what the trust actually says and to not assume fiduciary duties are waived unless mentioned explicitly in the trust instrument. They are also a good reminder about the importance of careful drafting.

Trustees must always exercise good faith in performance of their duties, and, as *Wood* demonstrates, good faith is not the same as good intentions. The lesson to be learned from this case is that a settlor who wants to waive the duty to diversify should say so expressly. The risk of a general retention clause or a clause that is not sufficiently clear is too great for a trustee who chooses not to diversify. Where there is such general or unclear language, a trustee should consider nonjudicial settlement agreements or a court action to clarify its duties and avoid the liability of making the wrong interpretation.

III. All's Fair In Love and Business

Fewer than one-third of family businesses survive to the second generation, and another half of family businesses fail to make it to the third generation.[25] Many business owners place their businesses in trust to ensure that the family member running the business, a committee, or some other designated preferred decision-maker can retain voting control and keep the business alive. Sometimes, these business owners even ensure that shareholder agreements or other restrictions within the corporate governance documents are in place to maintain the ownership within the family. Unfortunately, no written document can change people or family dynamics, and so the trustee of a trust comprised of privately held company stock often gets caught in the crossfire of the food fight at the dinner table.

A. Cain And Abel: A Problem Of Biblical Proportions

Unfortunately, placing one child in charge of the business often results in litigation due to conflicts of personality or the inability of the party in charge to resist the corruption of power. The concept of conflicts of interest and trustee hostility is discussed in-depth in the accompanying panel presentation. As far as pure abuse of

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[24] *Puhl v. U.S. Bank, N.A.*, 34 N.E.3d 530 (Ohio App. 2015).
[25] *The Facts of Family Business*, FORBES, July 31, 2013.

power goes, the unpublished case of *Scherer v. JP Morgan Chase & Co*[26] demonstrates how things can go sorely wrong when a family member becomes obsessed with his own advancement at the expense of the rest of his family, other shareholders and the business itself.

In *Scherer*, Roger became "chief executive in charge of day-to-day operations" of the family wholesale magazine business. JPMorgan was trustee of the three trusts for Roger, his sister and his mother/grandmother that owned the stock of the family business. Roger's relationship with the bank deteriorated consistently over a decade or so while he was running the business and refused to provide financial information to JPMorgan in its capacity as trustee. The bank sued shortly into that decade and settled with Roger in an agreement that required him to disclose the information the bank felt it needed to do its job as trustee. After another 7 years or so, JPMorgan could not deal with Roger anymore and the bank indicated it was going to prepare a final accounting and resign. Roger's response was to file first to remove the bank as trustee.

During the pendency of the litigation, Roger repeatedly failed to comply with discovery requests. Apparently, he had good reasons to obscure the financial information, as the court found that he engaged in transactions outside the usual course of business and diverted millions of dollars that should have gone to the trusts. Roger "knowingly impeded [the bank's] ability to perform the very functions that [he] alleges [the bank] failed to fulfill despite its diligent efforts to do so."

The court awarded damages against Roger of approximately six million dollars, which Roger appealed. That did not work out well for Roger, as the court affirmed the lower court ruling and required Roger's counsel to show cause as to why he should not be sanctioned for filing the appeal.

But the case did not end there. Scherer continued his litigation march, proving that when it comes to family businesses held in trust, having a truly independent trustee that is on the ball can make a big difference in protecting beneficiaries who are not participants in the business activities. As demonstrated in the companion case *Scherer v. Wiles*,[27] where the troublesome party has a power to control the vote on the trust's shares, an engaged and impartial trustee can make a difference.

This subsequent opinion filled in more of the details on the family saga. Scherer and Talbott were running the family magazine distribution business after their father died. JPMorgan became frustrated with the lack of information and proposed election of more cooperative directors for the trust-owned companies. Scherer and Talbott refused, using their veto power as trust advisors to block the change.

Scherer entered one of the companies into a merger that failed and resulted in a quick demise of that entity. After that, Scherer again refused to provide the trustee with information. At that point, the bank had had enough and filed a declaratory judgment action to compel Scherer to provide the information it needed to prepare a final accounting so it could cease to serve as trustee and a successor could be appointed.

Grateful for the diligence shown by the bank, the beneficiaries counterclaimed, asserting breach of fiduciary duty, breach of trust, defamation, fraudulent concealment, and tortious interference, among other items. In the end, the court approved the bank's final accounting over the objections of the beneficiaries, dismissed the claims of the beneficiaries against the bank, and found Scherer liable to the trust for $6.2 million.

Family strife is not limited to situations where a sibling is controlling the family business. Fathers and uncles also overreach, as demonstrated by *Rollins v. Rollins*.[28] This case originated in 2010 when four of the nine beneficiaries of the trusts set up by Wayne Rollins sued their father, Gary, and their uncle, Randall, individually and as trustees, along with a third party as trustee. The 2016 case arose when the Georgia Supreme Court vacated the appellate court ruling in *Rollins IV* and remanded with instruction.

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[26] 508 Fed.Appx. 429 (6th Cir. 2012).
[27] 2015 WL 4512393 (S.D.Ohio 2015).
[28] 338 Ga.App. 308 (Ga.App. 2016).

The trusts at issue were structured to terminate and be distributed to each beneficiary when he or she attained age 45. Most of what the trusts owned were interests in family entities created by the settlor, of which Gary and Randall were the managers and also partners. The principal family entity was the RIF partnership. Two years after the settlor's death, Gary and Randall amended the partnership agreement to allow non-pro rata distributions by redemption of a partner's capital account. And as an aside, the amendment also gave exclusive management and distribution authority to Gary and Randall.

A few years later, Gary and Randall amended the partnership agreement again, but this time to amend the distribution scheme so the partners would receive redemption distributions only if they were eligible based upon a formula established by Gary and Randall that included a personal code of conduct. For obvious reasons, the beneficiaries were not happy about the amendments. They argued that distributions were not made to them, but were made to Randall's children. In addition, they argued that the amendment placed Gary and Randall in a conflict position where they could favor themselves and others over the suing beneficiaries by deviating from the original pro rata distribution requirement of the partnership agreement. The trustees argued that they had the authority to amend and did so with expert legal advice, but the court did not agree that just because you have power, you can and should use it.

> *[A]lthough there can be no debate that Gary as trustee had the power to agree to an amendment of the RIF partnership on behalf of the S-Trusts, this does not foreclose the requirement under general trust law that Gary, in his role as trustee, had to do so in good faith and consistent with the trust's terms and purposes.*

In addition to executing the disputed amendments, Gary and Randall also created new entities that they controlled and funded those entities with trust assets. These steps "caused formerly marketable assets to be invested in illiquid family entities and altered the power structure of RIF such that the beneficiaries lost the right, granted in the original amendment, to vote their own interests once they turned 45." The case was remanded for further fact determinations, specifically as they related to the motives for Gary and Randall's actions and consideration of whether those actions were in good faith or not.

In *Scherer*, the settlor had created a check on power by appointing the corporate co-fiduciary. That co-fiduciary did its job, but enforcement to protect the trust required litigation. Perhaps more could have been done in the drafting to avoid having the case end in such protracted litigation, although it seems that Scherer was litigious and likely would have sued upon any challenge to his power. In a situation where an independent fiduciary will be reliant upon the individual co-fiduciary for information about a privately held company, however, expressly requiring the individual fiduciary to provide certain information on a regular basis to the independent trustee might shorten the life of the court action. Depriving the non-compliant trustee of voting rights during periods of noncompliance in excess of a certain time period might also help encourage cooperation. Imposing a limitation for willful noncompliance could be problematic because it requires a subjective determination. Objective criteria, while less flexible, are more likely to avoid litigation.

The issues proposed by the *Rollins* case may be harder to address. Did Wayne Rollins intend to allow his sons to alter the terms of the distributions to Wayne's grandchildren? If so, he could easily have permitted the trustees to form additional entities, "even if those entities would reduce the beneficiaries' access to liquidity." Wayne Rollins also could have made the distributions discretionary rather than requiring distribution at a set age. Putting a trustee in a situation where he may want control but is not given any control could be setting that trustee up to fail by the inability to resist breaching his fiduciary duty.

B. It's Your Business, But Stay Out Of It

The case of *Yost v. Yost*,[29] presents an interesting issue in the family business context. In *Yost*, the settlor funded a trust with stock in his company, DSI. He named as trustees his wife, two children, and two individuals

[29] 713 S.E.2d 758 (N.C.App. 2011).

chosen from among officers or directors of DSI. There were some elaborate rules in the trust regarding terms for trustees and voting to fill vacancies, including the direction that the desired number of trustees was nine.

As might be anticipated with nine trustees where the structure functions more like a board of directors than a trustee, a dispute arose around vacancies, voting and the composition of the trustees. The corporation itself moved to intervene as a plaintiff, seeking resolution of the trustee issue and amendment of the trust.

Even the court recognized the unusual nature of the intervention, stating, "This presents the unusual situation of trust property suing the trustees." Because DSI was not named as a beneficiary of the trust, the court held that DSI lacked standing to participate in the matter, leaving DSI to sit on the sidelines and await its fate.

C. Face It, Girls, I'm Older And I Have More Insurance

Trustees who are also directors of a company of which stock is owned by the trust may find themselves surprised if they try to call on their D&O insurance with respect to transactions with company stock. *Langdale Co. v. National Union Fire Ins. Co.*,[30] was the follow-on to the case filed by the beneficiaries of the trust against their trustees. Those beneficiaries had sued Johnny and Harley Langdale for "embark[ing] on a scheme" to consolidate their control over the The Langdale Company ("Langdale Co.") by redeeming trust-owned stock at "an absurdly low price." Apparently, Johnny and Harley provided false information about the trust termination date and negative tax consequences to induce the beneficiaries into agreeing to redemptions at a value lower than the true value of the stock.

The sequence of events to effectuate the redemption of the trust's stock showed a fair amount of creativity. First, Johnny resigned as trustee, remaining a corporate officer and director of Langdale Co. The next day, Johnny signed a redemption agreement for 20% of the trust's stock on behalf of the company. Harley signed the agreement as trustee. The same day, Harley executed an option agreement that allowed him to purchase the trust's remaining 80% of Langdale Co. shares. About 6 months later, Harley assigned his option agreement rights to Langdale Co., which purchased the shares. Johnny and Harley had also signed a shareholder agreement that bound the trust to its detriment. The allegations reflect that the redemption of the stock in the aggregate may have been at as much as $120 million below fair value.

Langdale Co. indemnified Johnny for his legal fees and costs. When Langdale Co. sought defense costs from its D&O insurer, however, National Union denied coverage on the basis of an exclusion that applied to any claim arising out of or based upon acts that were perpetrated in any capacity other than as a director or officer of the company. Johnny made the argument that he was not a trustee when the redemption agreement was signed, so he could not have been acting in that capacity. Affirming the lower court's grant of summary judgment in favor of National Union, the court stated "To the extent that Johnny and Harley Langdale were allegedly acting as directors and officers, that misconduct was so inextricably intertwined with their alleged misconduct as trustees that the duty to advance defense costs was not triggered."

In addition to the other risks noted above regarding abuse of power, putting a trustee in charge of a company and a trust that owns stock of the company for the benefit of other people may create a gap in insurance. If the test truly is intertwining of actions as trustees and corporate directors/officers, then many family business situations could have an issue when they try to collect on their insurance. One of the solutions may be analyzing the exclusions of the D&O insurance to determine whether modifications are possible.

IV. Conflicted Trustees

Perhaps the most important aspect of an estate plan is choice of trustee. The most detailed, accurate, skillful and clever provisions ever written will not make a good estate plan if the person or entity chosen to

[30] 609 Fed.Appx.578 (11th Cir. 2015).

oversee the operation of the trust is not prepared, capable or willing to do the job according to the rules of the trust and the fiduciary duties set forth under the law.

The personality of the trustee also is an important consideration, and trustee selection should not be a surprise to the beneficiaries. If the beneficiary and the chosen trustee do not get along or cannot at least maintain a civil working relationship, creating that partnership is asking for a trip to the courtroom, particularly if the beneficiary and trustee have competing interests. The word "partnership" has been used intentionally. Although it is the settlor's choice to mandate distributions as he sees fit (within the legal parameters noted in this portfolio), ignoring the fact that the trustee and beneficiary have an intertwined relationship that functions best when the parties work together is to turn a blind eye to practical realities.

Self-dealing is one of the most common trustee conflict issues. Although a transaction or dealing that violates the duty of loyalty to the beneficiary may be invalidated regardless of gain or loss to the trustee,[31] this prohibition is not absolute. In certain circumstances, the settlor of a trust may expressly or impliedly waive the duty of loyalty required of a trustee or even approve a self-dealing transaction of a trustee.[32]

Under Illinois law, for example, a trustee has a duty to serve the interests of the beneficiaries with complete loyalty and is prohibited from dealing with trust property for his own interest.[33] The settlor can waive the duty of undivided loyalty expressly, but may also waive it by implication if the settlor knowingly places a trustee in a position that might conflict with the interests of a beneficiary.[34] A waiver of the duty of loyalty, however, does not excuse the trustee from acting in good faith and exercising reasonable care in managing investments, and does not eliminate the trustee's duty to remain impartial.[35]

An express waiver of any duty is preferable to an implied waiver, and the court cases addressing conflict bear this out. Where a complete or partial exception from the duty of loyalty for self-dealing is intended, the trust instrument specifically should state that the trustee is permitted to engage in self-dealing transactions. For example, in *Texas Commerce Bank v. Grizzle*,[36] the court found that an exculpatory clause in the trust instrument relieved a corporate trustee from liability for self-dealing. The beneficiary alleged that the trustee had misapplied or mishandled trust funds and had failed to reinvest substantial sums of trust monies in a timely manner.[37] Although certain self-dealing transactions were expressly prohibited by the controlling state trust code, the court noted the code also provided that where the terms of a trust conflict with the code, the terms of the trust control.[38] Here, because the type of self-dealing engaged in by the trustee was not the type expressly specified and prohibited in the code, it was permissible that the trust instrument exonerated the trustee from liability for mishandling funds.[39]

As a general rule, a trustee should not place itself in a position where its interests conflict with the interests of the trust. Just as there is an exception for self-dealing, however, many jurisdictions permit a settlor to expressly or impliedly approve a trustee's conflict of interest position.

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31 BOGERT & BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543 (2d rev. ed. 1978).

32 *See e.g. In re Abdella*, 102 A.D.2d 921 (N.Y. App. Div. 1984); RESTATEMENT (THIRD) OF TRUSTS § 170, cmt. f ("the trustee can properly purchase trust property for himself with the approval of the court"); SCOTT & FRATCHER, THE LAW OF TRUSTS § 170.15 (4th ed. 1987) ("The settlor can waive the application of the rule of undivided loyalty").

33 *In re Halas*, 568 N.E.2d 170, 178 (Ill. App. Ct. 1991).

34 *Dick v. Peoples Mid-Illinois Corp*., *609 N.E.2d 997* (Ill. App. Ct. 1993).

35 *See Giagnorio v. Emmet C. Torkelson Trust*, 686 N.E.2d 42, 47-49 (Ill. App. Ct. 1997); *Mucci v. Stobbs*, 666 N.E.2d 50 (Ill. App. Ct. 1996) ("No Trustee has unrestricted authority. The requirements of loyalty and fair dealing and good faith are at the core of every trust instrument, whether specifically stated or not").

36 96 S.W.3d 240 (Tex. 2002).

37 *See id*. at 246.

38 *See id*. at 248.

39 *See id*. at 250-51. Texas updated its statutes in 2005 to provide that a breach of trust committed in bad faith, intentionally or with reckless indifference to the interest of a beneficiary may not be waived even by the express terms of a trust instrument. Tex.Prop.Code.Ann. § 114.007.

In the Illinois case *Childs v. National Bank of Austin*,[40] an individual served as chairman of the board of the trustee bank, was a member of the bank's trust committee and was also chairman of the board of a corporation for which the trust owned stock. The court found that the individual's management role in the corporation and simultaneous administrative role at the bank created a clear conflict of interest.

After ascertaining the intent of the settlor by reviewing the trust instrument and extrinsic evidence, however, the court concluded that the settlor intended the conflict between the interests of the trustee and the interests of the company. The court recognized that under the exception to the general rule, where the conflict is contemplated, created and expressly sanctioned by the trust instrument, the conflict may be permissible. This exception is triggered when a trust clearly shows the settlor's intent to allow such a conflict.

Sometimes settlors recognize the conflict, but if they are not clear in creating their checks and balances, the feared result of the conflict may surface. The unpublished case of *Mennen v. Wilmington Trust Co.*[41] is a good example of why conflicted trustees, particularly siblings with conflicts, present special problems. The court's own words best summarize the problem.

> *[B]ecause most of the trustee's personal fortune was out-of-reach in his own trust, the trustee turned to his brother's trust as a piggy bank he readily opened to fund a few private companies in which the trustee had invested his time and on which he had staked a claim that he was uniquely skilled at selecting and advising small fledgling companies that he could turn into the "next big thing." Certain that fortune and acclaim were around the bend, the trustee eschewed the interests of the beneficiaries in favor of subsidizing his self-aggrandized standing as a financier.*

In this case, the settlor created an irrevocable trust for each of his four children, funding each trust with a substantial number of shares in The Mennen Company. The initial trustees were Lowell Wallace, a friend of the settlor, and Wilmington Trust Company. When Wallace resigned, settlor appointed his son Jeff as successor individual trustee with Wilmington Trust for the trust for Jeff's brother, John. Jeff had been very emotionally and financially supportive of John during John's divorce and struggles with alcoholism. The settlor had reason to believe and did believe that Jeff would continue to take care of John.

Things seemed to function well until The Mennen Company was sold to Colgate-Palmolive in 1992. Somewhere around that time, Jeff ceased being Chairman and working for the company. He started a consulting business for family-owned businesses. That's where the story turns.

By May 2000, the value of John's trust exceeded $100 million. John lived on a farm, never having completed college and working what he described as "blue collar" jobs. John relied on the trust to provide about a million dollars each year for his support. John trusted Jeff due to the past history and was not a sophisticated person. As long as the checks continued to come, he assumed things were fine.

But they were not. Jeff, unable to control his own trust, started investing John's trust funds in businesses for which Jeff was a consultant, and typically also a board member and investor. As each of these companies headed toward bankruptcy, Jeff pumped more of John's trust into each of the businesses to try to keep them alive for Jeff's big win that never came.

Despite the fact that John's other siblings sued to get away from Jeff's trusteeship and warned John not to trust Jeff, John continued to believe Jeff's promises that things were going well. So, where was the corporate trustee? Well, the corporate trustee had determined that directed trust language in the trust, although limited to certain duties, applied to investments in private companies. That meant that Jeff was investing the trust funds without the check and balance system that the settlor had put in place by appointing a corporate fiduciary. As the court noted, "Unfortunately, Jeff's skill at identifying successful investments proved inversely related to his own

40 658 F.2d 487 (7th Cir. 1981).

41 2015 WL 1914599 (Court of Chancery of Delaware, April 24, 2015).

certainty in his abilities." Jeff generously loaned money to John's trust to enable it to continue paying John his needed cash flow.

John's children eventually figured out what was happening and convinced John to file suit to protect his share of the family fortune. By the time the lawsuit was filed, John's trust was shown as being worth $50 million on account statements, but $48 million of that related to debt instruments for two of Jeff's failed/failing businesses. Ultimately, Wilmington Trust, after the court found Wilmington had misinterpreted the directed trust language, settled for an undisclosed amount. Jeff was removed as trustee and the court awarded damages against him of approximately $97 million.

It is not completely clear from the opinion whether the corporate trustee's misinterpretation of the directed trust was blatantly wrong or due to language subject to multiple interpretations. In any event, this case reflects the importance of establishing clear rules for conflicted trustees and a sound system of checks and balances.

A. Hostility Between the Trustee and the Beneficiaries

Conflicts of interest are not the only way in which a trustee can be conflicted. Often, there is hostility between a trustee and one or more beneficiaries that creates an entirely different type of conflict. Most courts will look at this hostility and will analyze whether it is actually or potentially (depending on the state) impairing the administration of the trust. In the end, the decision to remove a trustee usually turns on the behavior of the trustee. Are the beneficiaries just angry, or is the trustee actually neglecting or breaching its duties?

In *Estate of Gilmaker*,[42] the beneficiary alleged that the corporate trustee maintained money in an account separate from his trust, refused to provide a semi-annual accounting, and refused to consult with him pursuant to the trust instrument. The beneficiary claimed that the hostility between the trustee and himself prevented the consultation the beneficiary felt was essential to the proper administration of the trust. Looking at the facts and circumstances surrounding the trust administration, the court found that the hostility between the trustee and beneficiary was constant and intense, that there were disagreements over almost everything relating to the administration, and that at one point the trustee told the beneficiary not to come to the bank anymore. In its holding to remove and replace the trustee, the court noted that the hostility impaired the administration of the trust.

In the Illinois case *Wylie v. Bushnell*,[43] the son of the testator asked the court to remove the trustee on the grounds of incompetence, unfairness, and mismanagement of the estate. The beneficiaries alleged a long list of items the trustee failed to do, including the filing of reports and inventorying of funds. The plaintiff stated that these failures created such ill feelings between the trustee and the beneficiaries that the trustee should be removed. In a well-reasoned decision, the Illinois Supreme court referenced several former Illinois decisions, highlighted that the removal of a trustee is a remedy that ought to be used "sparingly," and noted that there must be such misconduct as to show the trust property is in jeopardy.[44] The court found for the trustee, holding that the trust property was not in danger and the conduct of the trustee did not rise to the level of improper administration.

A New York appellate court, however, affirmed the removal of a trustee even though the trust was flourishing under his direction.[45] The trustee was removed due to the hostility that existed between himself and his sister (a beneficiary) and mother (a beneficiary and co-trustee). The trial court determined that the trustee refused to speak to his sister, destroyed rent checks, and abandoned estate property in an effort to avoid delivering the property to his mother. The court held that the trustee failed in his duty of loyalty and his removal was warranted because his hostility was detrimental to the interests of the beneficiary.

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[42] 371 P.2d 321, 322 (Cal. 1962).
[43] 115 N.E. 618, 620 (Ill. 1917).
[44] *Id.* at 627.
[45] *Matter of Duell*, 258 A.D.2d 382 (N.Y. App. Div. 1999).

As the case of *Wilbourn v. Wilbourn*[46] reflects, the courts will distinguish between ordinary disagreements and displeasure with a trustee and actual hostility that rises to the level where it impairs the administration and purposes of a trust.

Richard II had been very successful and had accumulated a substantial estate, primarily shares in Citizens National Bank. He became chairman of the bank board and brought his son, Richard III, onto the board. Apparently, he was aware of his son's potential character flaws, and had Richard III execute a memorandum of agreement that Richard III would resign if his father thought his participation was no longer in the family's best interests and that when his father died, Richard III would nominate another family member to take Richard II's place on the board.

On the death of Richard II, all of the bank shares were left in trust for the benefit of decedent's wife and Richard III's mother, Deanna. Richard III and Deanna were named as co-trustees. In the trust instrument, Richard II expressed his intent regarding the retention of the bank stock and required unanimous consent of all beneficiaries to sell the stock. The trust instrument also provided for removal of a co-trustee by unanimous action of Richard II's children and Deanna "if and only if a Co-Trustee shall become incompetent, unable to serve or grossly mismanaged the trust."

For two years following Richard II's death, Deanna and Richard III were able to agree on how to vote the bank stock in the election of the board. In March 2007, however, they were unable to resolve their differences, so the bank stock was not voted and the Wilbourn family voice was not heard. That was the beginning of the end.

Richard III began interfering with the bank's operations and alienating employees. His relationship with the bank CEO deteriorated and the CEO ultimately approached Deanna for help. Deanna, along with her other children, Elizabeth and Garnett, spoke to Richard III about his behavior and Richard III apologized and improved his behavior...for a few months.

Deanna again met with her son and questioned whether he was acting in the best interests of the family. She told him to either cooperate with the CEO or resign from the board. During this time, Richard III had been trying to convince his other siblings to transfer the bank shares to a new trust controlled by Richard and his friend and non-family member. Also during this time, Richard was secretly recording his conversations with his mother, apparently trying to set up a case for her incapacity. Once Deanna discovered the recordings, things got worse. A few days later, the bank holding company board voted to remove Richard III from the board of which he had been chairman. Thereafter, Richard III intentionally refused to agree with his mother on voting of the bank shares to create a situation where he and another shareholder group would have enough shares to vote him back onto the board.

This led to Deanna, Elizabeth and Garnett removing Richard III as trustee. Litigation ensued. Quoting from the Restatement (3d) of Trusts (section 37 comment e(1) (2003)), the court noted "a serious breakdown in communications between beneficiaries and a trustee that justify removal, particularly if the trustee is responsible for the breakdown or it appears to be incurable. Serious friction between co-trustees may also warrant removal of one or both of them." Upholding the lower court's finding that Richard III's removal as trustee was proper, the court found that Richard III had "violated his duty of loyalty by choosing his interest over the interests of his beneficiaries."

It was important to the court that Richard III was the source of the hostility with his co-trustee and with the beneficiaries. In the end, however, the test was whether the hostility rose to a level where it defeated the purposes of the trust.

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[46] 106 So.3d 360 (Court of Appeals of Mississippi 2012).

B. Protecting the Trustee So It Can Do Its Job

Trustees in conflict positions are best protected when their standard of care is clearly defined. Although the law generally protects a trustee's exercise of discretion absent an abuse of that discretion,[47] the settlor's intent should be paired with a clause that exculpates the trustee for decisions made in good faith absent willful wrongdoing or gross negligence.[48]

A fiduciary in doubt regarding whether an anticipated action will be in breach of his duty of loyalty may seek the advice of the court.[49] A court of equity generally has the authority to advise and instruct a trustee regarding its powers and duties, however, there are limits on a court's authority.[50] Specifically, the court's authority is limited to giving instructions where the trustees have reasonable doubt about their duties.[51] While it is well-established that a trustee may seek guidance from the courts where proper administration of a trust is uncertain,[52] a trustee also must be careful about running to court without good reason or clear authority to do so in the trust instrument.[53]

A court may authorize a self-dealing transaction by a trustee where there was full disclosure of the nature of the transaction and where the transaction was in the best interests of the trust.[54] In *Wachovia Bank & Trust Co. v. Johnston*,[55] the court granted the trustee authority to sell a commercial building held in the trust to itself. Some of the beneficiaries raised objections, even though the trustee made a full disclosure of all facts and presented evidence that the property held by the trust was diminishing in value, was in need of extensive repair in excess of what the trust could afford, and had no other interested buyers.

In determining whether the purchase was permissible, the court noted the strict rule that a trustee cannot be both vendor and vendee. The court acknowledged, however, that there are rare and justifiable exceptions when the court, employing its inherent equitable powers, may authorize a purchase of trust property by the trustee. Such authorization is permissible where: (1) the trustee has made complete disclosure of all of the facts, (2) the sale would materially promote the best interests of the trust and its beneficiaries, and (3) there are no other purchasers willing to pay the same or greater price offered by the trustee.[56] Emphasizing that the primary consideration is the

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[47] *See* RST (3d) of Trusts § 87 (1992). ("When a trustee has discretion with respect to the exercise of a power, its exercise is subject to supervision by a court only to prevent abuse of discretion."). *See, e.g., Rock Springs Land and Timber, Inc. v. Lore*, 75 P.3d 614 (Wyo. 2003). ("To the extent to which the trustee has discretion, the court will not control his exercise of it as long as he does not exceed the limits of the discretion conferred upon him, citing SCOTT & FRATCHER, THE LAW OF TRUSTS § 187 [2d ed. (1956) at 1374]); *U.S. v. O'Shaugnessy*, 517 N.W.2d 574, 577 (Minn. 1994); *Hopkins v. Cleveland Trust Co.*, 127 N.E.2d 385, 390 (Ohio 1955).

[48] For an in-depth discussion of trustee duties and liability risks, *see* Richard M. Horwood and Lauren J. Wolven, 857 T.M., *Managing Litigation Risks of Fiduciaries*.

[49] BOGERT & BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543(V); *see generally*, *Hungerford & Terry, Inc. v. Geschwindt*, 94 A.2d 540 (N.J. Super. Ct. Ch. Div. 1953), *aff'd* 99 A.2d 666 (N.J. 1953).

[50] *See Rock Springs Land and Timber, Inc. v. Lore*, 75 P.3d 614, 623 (Wyo. 2003).

[51] *Id*. at 623.

[52] *See* RESTATEMENT (SECOND) OF TRUSTS § 259. *See also, Warner v. Mettler*, 103 N.E. 259 (Ill. 1913); *Waterman v. Alden*, 32 N.E. 972 (Ill. 1893); *Griggs v. Veghte*, 19 A.867 (N.J. Ch. 1890).

[53] *See Warner*, 103 N.E. at 260-61 ("As the trustee is not expected to incur the least risk, if the equities are not clear he should decline to act without the sanction of the court, and he will then be allowed his costs and expenses, but if he appeals to the court without reason he will be answerable in costs."); *Griggs*, 19 A. at 867-68 ("This right does not, however, extend to the solution of propositions which do not present themselves as requiring any action by the trustee; or where the events which must control the rights of parties and the duties of the trustee have not transpired and are yet uncertain; or which should properly be submitted to some other tribunal; or which are so clear as to admit of no question. The court should be called on to decide and direct, not to counsel and advise.").

[54] *See* BOGERT & BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543.

[55] 153 S.E.2d 449 (N.C. 1967).

[56] *Id.* at 454-55; *citing* BOGERT & BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 146 (4th ed. 1967) ("If the settlor or a trustee or beneficiary can prove to the court that such a situation exists, the court has power to allow the trustee to deviate from the administrative provisions laid down by the settlor, to ignore them, and to employ other methods in carrying out the trust").

need to preserve the trust estate, the court remanded the case for a determination of whether there were other prospective purchasers of the property.

In seeking court instruction when there is reasonable doubt as to what action the trustee should take,[57] the trustee may insulate itself from liability by applying for instructions from the court prior to taking action.[58] If a trustee finds itself in a position of conflict with the trust, he should either resign, take action to immediately remove the conflict, or inform the beneficiaries of the conflict and request court approval of his conduct.[59] In situations where a conflict arises, courts have held that it is not only the trustee's right, but rather the trustee's duty to seek court advice.[60]

In short, where the trustee has placed himself in a position where his personal interests might conflict with those of the beneficiaries, there is a presumption created that the trustee violated its duty of loyalty.[61] Therefore, the settlor needs to give careful consideration to duty of loyalty issues when selecting a trustee. If the trustee is an officer or director of a closely held business, stock of which business is owned by the trust, the settlor should either expressly approve the conflict or choose another trustee. Should there be any possible circumstance under which a trustee may want or need to purchase an asset from the trust, such as under a shareholder agreement, the trust instrument also should contain provisions addressing that self-dealing issue.

V. <u>**This Land Is My Land**</u>

Trustees have become more aware of the risks associated with real property in a trust portfolio in the last few decades, perhaps as a result of the numerous court cases addressing trustee breaches with respect to management of real property. As the cases below demonstrate, seeking expertise to assist in management of the real estate is an important tool for fiduciary risk management. Trust law generally permits the trustee to hire expert assistance where needed and within reason, and many trust instruments expressly authorize retention of professional assistance. When it comes to real estate, therefore, knowing one's limits is half of the trustee's battle.

A. There's An Albatross Around My Trustee's Neck

A trustee has a general duty to protect trust property against damage or destruction.[62] This duty usually is interpreted to require active management of trust property and making expenditures as needed to keep trust property in good repair. Preserving and protecting requires the trustee to employ due diligence to discover the location of the trust property and to take control of the trust property in a reasonable period of time.[63] This duty to preserve and protect also includes timely payment of assessments that are, or may become, liens upon the trust property to avoid loss of the property or unnecessary expense to clear the property of liens.[64] The duty to protect and preserve also has been widely held to include payment of any mortgages outstanding on real property.

Where trust assets consist of real property, a trustee may be forced to determine whether he should use trust assets to repair or preserve, or even whether he has sufficient assets to do so. Frequently referenced authorities on trustee duties state that the trustee has the privilege and duty to make those repairs to the trust

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[57] *First Nat'l Bank v. Christopher*, 624 S.W.2d 474, 481 (Mo. Ct. App. 1981).
[58] BOGERT & BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543.
[59] *Fulton Nat'l Bank v. Tate*, 363 F.2d 562, 572 (5th Cir. 1966).
[60] BOGERT & BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543(V); *see also Hungerford & Terry, Inc. v. Geschwindt*, 94 A.2d 540 (N.J. Super. Ct. Ch. Div. 1953), *aff'd* 99 A.2d 666 (N.J. 1953).
[61] *Ledbetter v. First State Bank & Trust Co*., 85 F.3d 1537, 1540 (11th Cir. 1996); *citing Fulton Nat'l Bank*, 363 F.2d at 571.
[62] *See* Restatement (Second) of Trusts §176 cmt. b (1959) ("It is the duty of the trustee to use reasonable care to protect the trust property from loss or damage."); GEORGE GLEASON BOGERT t, THE LAW OF TRUSTS AND TRUSTEES §582 rev. 2d ed. (1980).
[63] *See DiMarco v. Michigan Conference of Teamsters Welfare Fund*, 861 F.Supp. 599, 614 (E.D. Mich. 1994), citing GEORGE GLEASON BOGERT t, THE LAW OF TRUSTS AND TRUSTEES §583 rev. 2d ed. (1980).
[64] See GEORGE GLEASON BOGERT t, THE LAW OF TRUSTS AND TRUSTEES §602 rev. 2d ed. (1980).

property as a "reasonably prudent man would make in order to accomplish the objectives of the trust."[65] As one might expect, these duties are easier to define in a sentence than they are to exercise in real life.

In *Matter of Trust of Rosati*,[66] there was a testamentary trust established for the benefit of the settlor's wife that owned one-half interest in each of two parcels of real estate when the bank assumed the role of trustee. Three years later, the trustee traded property interests with the settlor's brother in order to give the trust a 100% interest in one parcel of real estate. Problems arose because that parcel contained two residential properties that were in need of repair. Several months after acquiring the 100% interest, the trustee's agent inspected the homes and found one to be dilapidated. The trustee received a condemnation letter for this home and advised the beneficiary that no funds should be invested in the property. There was a potential buyer for the property offering $10,000 less than the value of the appraisal when the property was acquired, but he later backed out of the deal and the condemned home was ultimately demolished. Adding insult to injury, the trustee failed to pay a water bill for the other residence on the property and neglected to have the water shut off, resulting in the pipes freezing and bursting.

The court found that the trustee failed to care for the property during its first three years as trustee; more specifically, the trustee failed to make minimal repairs, to ascertain whether the property should have been fixed or sold, and to list the property for sale until six months after one of the homes was condemned. The trustee was found to have breached its duty to protect and preserve the trust property.

Time and again the cases involving real estate in trusts reflect that the trustee acted slowly in ascertaining a plan for the property. The trustee in *Rosati* took a correct first step in having the property inspected. Had the trustee then developed a game plan for maintenance, repair or sale of the property after the inspection, it likely would have been in a better risk management position even if its plan was not perfect.

B. Honey, I Shrunk The Real Estate

Liability for a breach of the duty to protect and preserve trust property varies depending on the behavior of the trustee and the damage to the value of the trust property. In particular, courts look to see whether the trustee was negligent or somehow in direct violation of the obligations set forth in the trust agreement and under the law.

The Supreme Court of Iowa upheld a jury award of compensatory and punitive damages in *Hamilton v. Mercantile Bank of Cedar Rapids*.[67] The court's holding was based on the trustee's repeated willful and wanton breaches of the duty to protect and preserve trust property. Among its many errors, the trustee failed to collect revenue, pay taxes, insure against loss and preserve the value of the property through routine maintenance and repair. The trustee also failed to notify the beneficiary of material changes in the trust property during the same time period the trustee increased its trustee fees significantly.

Maintaining the property to prevent loss of value is not the trustee's only duty. If a trustee holds property and does not have the appropriate information to manage or sell the property in a reasonable manner consistent with the market, then the trustee generally should bring in the resources it needs to perform its job. *Wells Fargo Bank Wyoming v. Hodder*[68] demonstrates the care a trustee must undertake when selling real estate. A trustee who is not expert in the type of real estate owned by the trust or about the state of the market where the real estate is located should do its due diligence. Due diligence in this context involves ensuring that the trustee positions the property well to sell at a good price (e.g. marketing and proper list price) and that the trustee is not accepting a low offer due to lack of information about the true value of the property.

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[65] *Id. See also Corpus Christi Bank & Trust v. Roberts*, 587 S.W.2d 173 (Tex.App. 1979) (holding trustee liable for decrease in value of trust properties for failure to make repairs where trust instrument authorized trustee to make all necessary repairs to existing improvements on trust properties.

[66] 441 N.W.2d 30 (Mich.Ct.App. 1989).

[67] 621 N.W.2d 401 (Iowa 2001).

[68] 144 P.3d 401 (Wyo. 2006).

The trust at issue in *Hodder* held several parcels of real estate. The trustee sold five parcels to Quality Stores, which Quality stores then developed for its own use. The development of the property by Quality Stores led to a drainage issue on adjoining property sold by the trust to another buyer and also on 6.7 acres of undeveloped adjoining property owned by the trust. In addition, there was a fuel spill on trust property leased to Mini-Mart that was not adequately addressed by the trustee.

The appeal revisited a dispute over an exculpatory clause in the trust agreement caused by poorly drafted trust amendments. The court ultimately held that the intent of the settlor was that the trustee be free from liability for actions taken in good faith. The question then turned on what good faith means in the trust context and, therefore, by what standard the trustee's actions should be judged. Looking to the Restatement (Second) of Contracts, § 205, cmt. a, the court found that the following Restatement definition is applicable in the context of trust agreements:

> *Faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness.*

The court looked at the trustee's actions in this context and determined that the trustee failed to obtain a current appraisal of the lots sold to Quality Stores, which appraisal was required in its policy manual. The trustee further failed to market or promote the property, to obtain approval for the sale from its trust oversight committee, or to employ real estate experts to assist with the sale. These failures were not "good faith" because the trustee "as a matter of law did not act faithfully to the agreed purpose of the trust or the justified expectations of the beneficiaries."

Issues involving remediation of the fuel spill and overpayment of a property "consultant" also were decided against the trustee. The trial court had held that to allow recovery of attorney's fees by the trustee "would permit an invasion of the Trust corpus for an unwarranted purpose, where the litigation has conferred no benefit on the Trust." Adding insult to injury, the court also upheld the lower court's determination that the bank was not entitled to withhold trust funds to cover costs associated with the litigation.

Hodder is a clear reflection in the real estate context of the rule that good intentions are not sufficient when it comes to trust investments; the courts expect more. Although only one of issues in *Hodder*, the fuel spill remediation issue also demonstrates a common problem with trust portfolios that contain real estate -- environmental issue that pre-date the trustee's involvement with the property.

C. Toxic to the Trust Relationship

Environmental contamination can be particularly problematic because often a trustee may not know about the hazard when it assumes the role of trustee. Remediation of the contamination tends to be particularly expensive, which also creates issues because it can be difficult to explain to beneficiaries why other trust assets must be spent to fix a problem that cannot necessarily be seen easily.

In the unpublished opinion *Martin v. Ward*,[69] the trustee found itself in trouble when unexpected contamination caught the trustee between a rock and a hard place. The bulk of the trust at issue consisted of two parcels of real property in downtown Seattle. The beneficiaries agreed with the trustee, First Union Bank of California, that the bank would wind up the trust by selling both properties and distributing the proceeds. While it was marketing the Third Avenue property, the bank learned that there was contaminated soil under the building's ground floor, likely as the result of a long-term prior dry cleaner tenant.

The bank was unable to find the insurance records for the relevant period, which was about 20 years prior to the discovery of the contamination. The bank received trustee fees for these efforts in searching for the

[69] 132 Wash.App. 1025, 2006 WL 1029998 (Wash.App.Div.1 2006).

insurance information, even though the bank had been trustee at the time and even though the efforts were to no avail. The bank recommended hiring an outside investigator at the trust's expense for $25,000, but the beneficiaries declined to pay. The bank continued its in-house investigation.

The bank obtained a 1.6 million cash offer for the property, subject to payment of unlimited remediation from the sale proceeds. The beneficiaries declined to consent, which consent was required by the trust instrument. The building was subsequently damaged by an earthquake and required repairs. One of the beneficiaries then sued the beneficiaries withholding consent to try to force the sale to the buyer noted above.

The court appointed a referee, who was able to negotiate a sale for $1.1 million with no liability for remediation. The holdout beneficiaries then sued the bank trustee for advocating the first sale with unlimited liability, for failing to locate the insurance information, and for failing to seek an adjustment to the real estate taxes due to the contamination and dilapidation of the building.

The trust agreement contained an exculpatory clause that relieved the bank of liability "for discretionary decisions unless they constitute gross negligence, willful default, or bad faith." The court found that advocating the sale was fine because the bank followed the trust and did not sell without consent. Failing to maintain the building was also an acceptable exercise of discretion regarding proper use of trust assets. The failure to maintain adequate insurance records, however, raised a question of gross negligence, and the failure to appeal the real estate taxes (which would have resulted in lower trustee fees in this case) raised a question of bad faith. The court reversed and remanded as to these two claims that fell outside the exculpatory clause.

Lack of cooperation by the beneficiaries does not seem to be unusual when it relates to contaminated real property. As in the *Scherer* case discussed above in the context of family businesses, having an independent trustee who is diligent about its duties can protect other beneficiaries from the family bully. When Joel attempted to withdraw his half of a trust estate that owned two parcels of adjacent property, trustee National City Bank refused.[70] In its good judgment, the trustee was not willing to trust Joel that he would "deal with" the outstanding issues and demands for remediation made by the U.S. Environmental Protection Agency and the U.S. Army Corps of Engineers. National City held firm on its position that it had an obligation to preserve and restore the trust property for the benefit of both beneficiaries (Joel's sister was the beneficiary of the other half).

When Joel brought suit to have the trust terminated as to his half and seeking damages, the trial court not only found that National City's conduct was authorized, but stated that National City's behavior "can further only be characterized as reasonable and prudent." Fully affirming the lower court decision, the Court of Appeals of Ohio further supported National City's decision, finding "[National City] really had no choice but to hire an environmental expert and to retain capable legal counsel to attempt to avoid the huge fines and penalties which could have been assessed by the [EPA]…." Of course, standing up to a beneficiary often leads to litigation, so the problem remains that a trustee who is doing everything right may still be facing the specter of litigation.

Avoiding litigation completely in every circumstance is not possible. Sometimes beneficiaries are just litigious and other times there are items that are not contemplated in a trust agreement – because not every scenario is capable of contemplation. If a trust is likely to have real estate in its portfolio, expressly authorizing the trustee to seek court instruction in the event of environmental issues or natural disasters could reduce the trustee's hesitation to request guidance.

D. Blame Your Mother…Nature

Just as environmental contamination can show up as a surprise in the trust portfolio, mother nature also can wreak unexpected havoc. Trustees who own real property need to make sure they have explored appropriate insurance options to protect and preserve the trust property (and that they keep good records regarding the insurance), or they may find themselves in the eye of the storm. That is literally the case for Regions Bank, in its

[70] *Claffey v. Natl. City Bank*, Slip Copy, 2011 WL 4477315 (Ohio Ct.App. 2011).

capacity as trustee of the J.F.B. Lowrey Trust.[71] The primary asset of the Lowrey Trust was 20,000 acres of timberland in Alabama. When Hurricane Ivan made landfall in 2004, the eye of the storm passed over much of the timberland. Most of the standing timber owned by the Lowrey Trust was destroyed or suffered severe wind damage.

The beneficiaries sued the trustee, asserting that the trustee should have purchased casualty-loss insurance on the timber, should have sold most of the timberland before the hurricane in order to diversify, should have cut the timber more quickly, or should have employed some combination of insurance, sale and harvesting. One of the main problems with the beneficiaries' last two arguments is the prior litigation they had engaged in with the trustee, which resulted in a court-ordered timber plan that the beneficiaries had approved. The trustee had followed the advice of the retained forestry experts and had periodically updated the plan as required by the prior court order. That order also specifically allowed the trustee to retain the timberland even though such action "might violate principles of investment diversification".

When defining the standard for determining whether Regions Bank had breached its duty to diversity, the court acknowledged that the duty cannot be applied in a manner that does not consider the particular circumstances of a trust.

> *It is undisputed that the Lowrey Trust assets were not diversified across investment classes. It is also undisputed that [Regions] inherited these assets from the former trustee. Thus, the [beneficiaries'] burden is to prove that [Regions'] decision not to sell the Lowrey Trust timberland prior to Hurricane Ivan constituted a breach of fiduciary standards in effect at that time based on what was known at that time.*

In addition to presenting evidence regarding the prior court order, the trustee was able to demonstrate that selling the timberland would have resulted in a significant capital gains tax due to low basis and that it had followed the plans of the professional forestry experts. The trustee had records that allowed it to show that the timberland had an internal rate of return of 11%, even after adjusting for the losses caused by the hurricane. The trustee testified that it had explored casualty insurance and that cost was too expensive in relation to the small risk of loss for the timberland. In fact, the evidence presented demonstrated that no hurricane of the intensity of Hurricane Ivan had crossed through the timberland area prior to 2004. Although the trustee did not have records of these inquiries, the conclusion was consistent with the standard practice of timberland owners not to insure the timber.

Furthermore, the trustee took steps to mitigate the damages to the trust by having the damaged timber salvaged. The methods employed by the bank realized financial recovery on more than 80% of the damaged timber, which was substantially higher than the norm. In the end, judgment was entered in favor of the trustee and the beneficiaries who sued were charged with the costs of the litigation.

Regions Bank reflects the importance for a trustee of documenting its decisions and taking the proper steps to bring in expertise in managing specialized property. In this case, it seems that the bank could have kept better records on its exploration of insurance, which is a good lesson. Its general due diligence in actively managing the property consistent with a written plan developed by experts and in mitigating losses to the trust, however, placed it in a position to defend the propriety of its actions.

E. Past The Point Of No Return

As demonstrated in the *Puhl* and *Wood* cases with respect to diversification, it is also important for a trustee to analyze its powers with respect to real estate. In particular, a trustee should identify where those powers start and where they end. The trustee in *Claffey* continued with environmental remediation despite the fact that one of its trust beneficiaries had executed his power to withdraw his trust. Although such withdrawal put the trust into winding-up mode, the court held it was proper for the trustee to delay termination of the trust until after remediation.

[71] *Regions Bank v. Lowrey*, 101 So.3d 210 (Ala. 2012).

Typically, however, a trustee's powers are narrowed during the winding-up period. In *T.W. Nickerson, Inc. v. Fleet Nat. Bank*,[72] the trustee was sued along with the beneficiaries after property was not sold to Clark pursuant to an unsigned purchase agreement and under other rights arising from a lease. In addition, the lease renewal was put on hold when the settlor's wife died and the trustee determined that trust termination was triggered by her death.

Clark argued that the trustee had a duty to complete renewal of the lease and sale of the property. The trustee took the position that its job was to terminate the trust and distribute the property to the beneficiaries. The court agreed with the trustee. Citing to *Scott on Trusts*, the court stated, "Once a trust is terminated, and absent a specific grant of authority in the trust, the trustee has the power and obligation only to preserve the trust property while winding up the trust and delivering any trust property to the beneficiary." With specific evidence that the trustee had notified the beneficiaries about the right of first refusal that they then ignored, and with no evidence to show that the trustee acted without good faith, the court found that the trustee had neither breached its fiduciary duties nor the covenant of good faith and fair dealing.

VI. <u>You Want Me To Do What?</u>

A. Blurred Lines and Gray Areas

In this new era where most states have a statute that permits dividing traditional fiduciary duties among multiple parties, the issues noted above become even more complex. So-called "directed trusts" frequently allocate the investment responsibility (along with duty to diversify, some of the duty of loyalty, and portions other trustee duties) to a party separate from the trustee. As trustees become more litigation-conscious, assets that are commonly desired to be held in trust, such as closely held company stock, investment real estate, or other "hot potato" items, are ones that many corporate fiduciaries prefer not to hold without direction.

If prepared and administered properly, a directed trust can insulate the trustee from decisions that it does not wish to make, or that the grantor wishes to bestow upon a different decision maker. The difficulty, of course, is that the devil is in the details.

B. Good Fences Make Good Neighbors

Of the more than 40 states that have some sort of directed trust statute, each has its own permissible bifurcations. While approximately half of the states with directed trust statutes follow the UTC, even some of those have added their own flair. What that means is that a trustee needs to make sure that what has been carved out of its duties and granted to another fiduciary is within the permissible bounds of the governing law.

Directed trusts should be structured to completely segregate the portion of traditional trustee duty desired by the grantor to the directing fiduciary. A properly crafted directed trust does not look like a delegation; rather, it is a complete set of bylaws dictating who has what powers. The trustee should be required to follow the directions of the directing fiduciary, and phrases such as "may direct" should be avoided because a permissive direction power likely will leave some monitoring responsibility, and therefore liability, with the trustee.

Once the trustee determines that it is in the safety zone of a properly prepared trust, it needs to turn its attention to administration. As noted with loans, but also relevant to real estate, closely held businesses, and other issues previously discussed in these materials, it is important for a trustee to consider when it needs to get approval from a fellow fiduciary before it takes action.

Trustees under directed trusts will want to have a clear set of processes and procedures in place to ensure proper interaction with the directing fiduciary. Ideally, the trustee will also have a right under the trust instrument to demand information that the trustee needs to fulfill its own duties (such as filing tax returns). Methods of

[72] 924 N.E.2d 696 (Mass. 2010).

communication between the trustee and directing fiduciary should be established early on, and perhaps one or more form letters can be created for the directing party to quickly and easily be able to document its directions to the trustee.