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# Asset Concentrations And The Duty To Diversify

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# Introduction

- Trustee has an ever growing and difficult job: financial markets are becoming more global.
- Settlors or beneficiaries may want a trustee to retain concentrations of assets, especially oil and gas or real estate.
- Regulator and internal pressure may exist to diversify concentrations.
- What is a trustee to do? Resign? Not resign but incur greater risk of liability?

# Areas Of Discussion

- History of the duty to diversify;
- Statutory and common-law requirements;
- Retention/Waiver Provisions;
- Risk avoidance options; and
- Potential ramifications.

# History

- Trust origins
- Prudent man standard
- Prudent investor standard

# What is Diversification?

- A portfolio strategy designed to reduce exposure to risk by combining a variety of investments, such as stocks, bonds, and real estate, which are unlikely to all move in the same direction. The goal of diversification is to reduce the risk in a portfolio.
- No black and white standard in Texas (or elsewhere).
- Non-legal experts may be required to determine reasonableness of diversification efforts.
- If within zone of reason, trustee should not be second-guessed by courts.

# Common Law

- A trustee owes a duty of good faith, fair dealing, loyalty and fidelity over the affairs of the trust and its corpus.
- “A trustee is under a duty to the beneficiary except as otherwise provided by the terms of the trust, to distribute the risk of loss by a reasonable diversification of investments, unless under the circumstances it is prudent not to do so.”

# Statutory Duty

- Texas Trust Code section 113.051 provides: “The trustee shall administer the trust in good faith according to its terms and this subtitle. In the absence of any contrary terms in the trust instrument or contrary provisions of his subtitle, in administering the trust the trustee shall perform all the duties imposed on trustees by the common law.” Tex. Prop. Code § 113.051.
- So, the statute expressly instructs us to look to the common law regarding a trustee’s duties.

# Statutory Duty

- The Texas Trust Code historically did not expressly require any diversification of trust assets.
- Rather, the Code expressly stated that a trustee had no duty to diversify any assets originally conveyed to the trust by the settlor. *See* former Tex. Prop. Code Ann § 113.003 (repealed effective January 1, 2004).
- Today, subject to Chapter 117, a trustee may manage trust property and invest and reinvest in property of any character on the conditions and for the lengths of time as the trustee considers proper. Tex. Prop. Code Ann. § 113.006.

# Statutory Duty

- The Texas Legislature (along with 48 other states) adopted the Uniform Prudent Investor Act that became effective January 1, 2004.
- It provides that a trustee who invests and manages trust assets owes a duty to the beneficiaries to comply with the prudent investor rule. Tex. Prop. Code Ann. § 117.003(a).

# Statutory Duty

- A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
- Decisions should be made in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

# Statutory Duty

- Among circumstances that a trustee shall consider in investing and managing trust assets are:
- (1) general economic conditions;
- (2) the possible effect of inflation or deflation;
- (3) the expected tax consequences of investment decisions or strategies;
- (4) 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;

# Statutory Duty

- (5) the expected total return from income and the appreciation of capital;
- (6) other resources of the beneficiaries;
- (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

# Statutory Duty

- A trustee may invest in any kind of property or type of investment (absent other direction from trust).
- A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.
- Standard for professional trustees will be a higher one than for non-expert trustees.

# Statutory Duty

- Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this chapter.

# Every Trust Is Different

- A trustee must review the trust and beneficiary to determine whether diversification is appropriate.
- In one case, a trustee was held grossly negligent for diversifying assets. *In re Sky Trust*, 868 A.2d 464 (Pa. Super. 2005). The beneficiary had a need for income, and the trustee diversified the assets (the trustee's own stock) into more equity based investments and lengthening the investment time horizon. *Id*.
- The court of appeals affirmed the gross negligence finding: "diversification cannot become a goal in and of itself. Rather, diversification is a tool that can provide the means to effectuate a settlor's goals of a trust, if used properly and prudently with due regard to the specific facts and circumstances that exist in a particular case." *Id*. The trustee's hypothetical strategy did not satisfy its fiduciary duty. *Id.*

# Special Circumstances

- If the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying, it need not do so.
- What are special circumstances?
- Tax implications, family businesses, closely-held businesses, personal property, farm or ranch property, maintaining residential or vacation property, life insurance policies, stock in a company where the settlor had long-term employment or other special relationship, commercial real property, special purpose trusts, and assets that are difficult to sell.

# Special Circumstances

- Courts have found special circumstances with farm/ranch assets.
- *Inman Trust* (Nebraska 2005): Court ruled that a trustee could not diversify a farm held in trust by selling a portion of it due to the relationship of the beneficiaries to the farm.
- *Shriners Hospitals* (Wyoming 2016):charitable beneficiary sued a trustee to terminate the trust and distribute the assets and also sued the trustee for not diversifying the trust's ownership of a large ranch. Lower court and appellate court agreed that the trustee did not breach duty to diversify due to settlor's intent to maintain ranch.

# Special Circumstances

- A trustee prefers to follow the settlor's intentions to support special circumstances that have been expressed, but those intentions can also be implied.
- For example, *In the Estate of Maxedon*, a settlor created a trust and placed a farm as its main asset. 946 P.2d 104 (Kan. App. 1997). After the trustee filed an accounting, a beneficiary objected to the trustee's failure to diversify. The court of appeals held: "While the trust document did not expressly prohibit the trustee from selling the land, the trustee could properly have considered the fact that the subject land was placed into the trust by the settlor and comprised a majority of the corpus of the trust, thus indicating the settlor's intent that land remain the primary asset of the trust." *Id*. at 109.

# Special Circumstances

- Oil and Gas: No real precedent.
- In the *Maxedon* case, the court held that evidence of oil and gas investments supported diversification: “Male testified that the fact the farmland was spread out over three counties and consisted of tillable land as well as pasture, plus the fact there was oil and gas production on some of the property, showed the trust was in fact diversified.”

# Special Circumstances

- Trustee can properly maintain a concentration in a real estate/energy asset where there are “special circumstances.”
- To do so, the trustee should actively document all of the following: the decision to not diversify; the facts and circumstances that justify the decision, the settlor’s intent regarding same; communications informing the beneficiaries of the decision and the impact that it may have on the trust’s portfolio; the beneficiary’s knowledge, acceptance, and agreement in that decision; and regular re-evaluations of the decision.

# Retention/Waiver Clause

- Generally, a trust document's terms govern, and a trustee and court should follow them.
- The Texas Trust Code expressly provides that the prudent investor rule may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. Tex. Prop. Code Ann. § 117.003(b).
- "A trustee is not liable to a beneficiary to the extent that the trustee acted *in reasonable reliance* on the provisions of the trust." *Id*.

# Mandatory vs. Permissive Clauses

- "In determining the reasonableness of a trustee's adherence to provisions directing or authorizing retention of certain investments, the Restatement and courts have focused on distinctions between mandatory and discretionary provisions on both the trustee's duty and the assets to which the duty applies."
- Distinction between mandatory and permissive clause.
- "The 'reasonable reliance' requirement may be satisfied when a specific abrogation of the duty to diversify is made with respect to a particular investment, or when a mandatory provision directs the trustee to engage in or retain certain investments."
- Mandatory clause would require trustee to seek court intervention to modify trust – is there a duty to do so?

# Mandatory vs. Permissive Clauses

- "The fact that an investment is permitted does not relieve the trustee of the fundamental duty to act with prudence."
- Some jurisdictions hold that a trustee still has an overarching duty of prudence, and the trustee can be held liable for not being prudent in failing to decide to overrule the trust's nonspecific retention clause and sell the asset.
- Most jurisdictions are favorable to enforcing permissive clauses and that if a trust allows a trustee to exercise his discretion in a manner that might otherwise be inconsistent with the prudent investor rule, then the trustee's performance under that power does not give rise to a claim for breach of fiduciary duty.
- Factors that detract from enforcement? General language and self-interested transactions.

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# Mandatory vs. Permissive Clauses

- There is not a particular form of a clause that will apply to all circumstances, but the important aspects are to:
- 1) specifically mention the asset and state the trustee may retain it;
- 2) disclaim any duty to diversify or other trustee duties of prudence or care with regard to the asset;
- 3) acknowledge that there is a risk of a loss of value and still allow the trustee to retain the asset; and
- 4) provide a standard or factors that give the trustee guidance in making a decision to diversify.

# Retention/Waiver Clause

- A Texas commentator has stated that if a trust allows a trustee to retain assets or abrogates any duty to diversify, then a trustee may reasonably rely on that term of the trust.
- There are only a few cases in Texas that discuss a retention clause:
- *Jewett v. Capital Nat. Bank of Austin*, 618 S.W.2d 109, 112 (Tex. Civ. App.—Waco 1981, writ ref'd n.r.e.).
- *Neuhaus v. Richards*, 846 S.W.2d 70, 74 (Tex. App.—Corpus Christi 1992), judgment set aside without reference to merits to effect settlement agreement, 871 S.W.2d 182 (Tex. 1994).

# Retention/Waiver Clause

- More recent Texas Supreme Court precedent would tend to support the enforcement of a retention/waiver clause:
- *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835 (Tex. 2004).
- *Texas Commerce Bank v. Grizzle*, 96 S.W.3d 240, 249 (Tex. 2002).

# Exculpatory Clause

- An express term of a trust relieving a trustee of the duty to diversify may be considered an exculpatory clause.
- A trust may not limit a trustee's duty to act in good faith and in accordance with the purposes of the trust. Tex. Prop. Code Ann. § 111.0035(b)(4)(B).
- Further, any term relieving a trustee of liability for a breach of trust committed in bad faith, intentionally, or with reckless indifference or for any profit derived by the trustee from the breach will not be enforceable. Tex. Prop. Code Ann. § 114.007(a).

# Exculpatory Clause

- There is a theoretical difference between a retention clause and an exculpation clause.
- A retention clause may set the standard for a trustee's duty.
- A trustee may have an affirmative duty to retain an asset or may have the ability to retain an asset, which means that a trustee does not breach a duty by retaining an asset.
- An exculpation clause forgives a trustee for a breach.
- Accordingly, there is an argument that the statutory limitations on exculpation clauses may not apply to a retention clause.

# Methods for Limiting Liability Risk

- 1) Retention/Waiver Clause;
- 2) Exculpatory Clause;
- 3) Statements on Special Circumstances;
- 4) Other Related Documents That Limit Right To Diversify;
- 5) Directed Trust Provisions;
- 6) Decanting of Trust;
- 7) Settlor's Consent and Release;
- 8) Beneficiaries' Consent and Release;

# Methods for Limiting Liability Risk

- 9) Beneficiaries' Retention Agreement;
- 10) Beneficiaries' Written Directives;
- 11) Trustee Resolution;
- 12) Beneficiary Ratification;
- 13) Judicial Modification;
- 14) Judicial Approval of Investment Plan; and
- 15) Statute of Limitations/Disclosure.

# Ramifications For Breaching Duty

- There are many potential ramifications for a trustee breaching a duty.
- Claim for damages by beneficiaries.
- Removal. Texas Property Code Section 113.082 provides that a trustee may be removed if the trustee materially violated a term of the trust or attempted to do so and that resulted in a material financial loss to the trust or the court finds other cause for removal.

# Ramifications For Breaching Duty

- A court may compel a trustee to perform its duties and, specifically, may order a trustee to account. Tex. Prop. Code § 114.008.
- Court may reduce or deny a trustee compensation for breaches of duty. *Id*.; § 114.061.
- A plaintiff only needs to prove a breach (and not causation or damages) when she seeks to forfeit some portion of trustee compensation. *Longaker v. Evans*, 32 S.W.3d 725, 733 n.2 (Tex. App.—San Antonio 2000, pet. withdrawn).

# Ramifications For Breaching Duty

- Attorney's Fees. Texas Property Code Section 114.064 provides: "In any proceeding under this code the court may make such award of costs and reasonable and necessary attorney's fees as may seem equitable and just."
- Co-Trustees. Trustees have potential liability for co-trustee's actions if the trustee does not act with reasonable care. *See* Tex. Prop. Code § 114.006.
- Trustee should exercise reasonable care to prevent a co-trustee from committing a serious breach of trust and compel a co-trustee to redress same.

# Duty To Disclose

- Full disclosure is very important on all material decisions.
- The Texas Supreme Court has stated that "trustees and executors have a fiduciary duty of full disclosure of all material facts known to them that might affect [the beneficiaries'] rights." *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996). *See also Valdez v. Hollenbeck*, 465 S.W.3d 217 (Tex. 2015).
- The Restatement (Third) of Trusts, Section 82(1) provides that a trustee has a duty to keep beneficiaries reasonably informed of about significant developments concerning the trust and its administration, particularly material information needed by beneficiaries for the protection of their interests.

# Conclusion

- Many believe that a trustee has an absolute duty to diversify that cannot be altered.
- That is not true: 1) special circumstances; 2) retention/waiver clause; 3) exculpation clause.
- Many methods to protect a trustee and limit liability risk for not diversifying.
- Diversification may be a simple answer, but it may also be a violation of a trustee's more basic duties.