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Closely Held Business Interests And the Trustee's Duty to Diversify

A lot of liability traps exist for unwary trustees of trusts with concentrated holdings in closely held businesses. Here are some potential solutions

It's well settled in American jurisprudence governing trust administration that, as a general rule, the trustee's duties of due care and prudence in holding and managing trust assets include the duty to diversify investments.[1] While modern portfolio theory unequivocally embraces broad investment diversification for trusts holding an array of liquid and publicly traded marketable securities, this duty to diversify can be at great odds with the goals of family business owners who wish to use trusts to plan their estates or to maintain closely held ownership and perpetuation of the family businesses.

First let's discuss some ideas for solving, or at least mitigating, the trust law problems that can arise for a trustee seeking to oblige with family desires to maintain concentrated holdings of a family business. Then, let's review why these approaches are so necessary.

Possible Solutions

There are a variety of possible solutions, or at least risk reduction techniques, that settlors or trustees can take to counter the diversification requirement in the context of concentrated family company ownership. And often the solution turns on whether the trust is being drafted with the diversification issue at hand or whether the trustee is looking for a solution months, or even years, after the trust was formed.

With new trusts, it's critical to be specific and clear about family company ownership. Indeed, if the trust is new and in the process of being drafted, counsel can greatly help the settlor and trustee minimize the diversification problem by being as specific as possible about the settlor's purposes of the trust, desires regarding negation of the duty to diversify, acknowledgment of the lack of marketability of the family company stock, and overall vision for the company.

For example, a trust document may specifically refer to the family company, "XYZ Company, Inc.," as the company the settlor wishes to perpetuate through the trust vehicle and the capital ownership and structure of which the settlor intends to protect from undue estate taxes, divorce, third-party ownership, creditor issues or spendthrift habits of beneficiaries. The trust document may also outline the settlors desire to avoid Securities and Exchange Commission registration to promote long-term strategic incentives.

Or the settlor may wish to articulate a vision for XYZ Company, Inc.: for example, building a family dynasty company to provide family members with future employment or creating a legacy asset to promote family identity. If the exact name of the company is not known or a future sale of family company stock to the trust is contemplated, the family company stock could be defined as any interests in a closely held business or entity owned by the settlor or members of the settlor's family, or by an entity controlled by or for the benefit of the settlor or the settlor's family members, whether transferred to the trust by purchase, gift, or otherwise.

These settlor rationales and desires can provide powerful reasons for the settlor to rationally mandate negation of the duty to diversify with respect to the concentrated holding of stock in XYZ Company, Inc. The settlor could cite the fact that XYZ Company, Inc.


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stock is not marketable and is anticipated to be subject to a shareholder buy-sell agreement fashioned to promote family harmony, avoid pricing disputes, prevent third-party ownership, and encourage orderly management succession. Additionally, the settlor could provide that disposition of the concentrated holding in XYZ Company, Inc. stock to a third party is not required unless all shareholders collectively decide to sell the company stock under the shareholder agreement. The settlor may consider providing for limited "outs:" for example, the trustee's authority to dispose of family company holdings after two or three years of consecutive net operating losses, provided that the disposition can be made in accordance with outstanding shareholder agreements. It may be helpful to specifically state the settlor's desire to retain the family business and refer to the Uniform Prudent Investor Act (UPIA) or state codification of official comments permitting retention of family business assets under special circumstances.

The settlor also may consider including specific provisions permitting the primary beneficiary of the trust to approve particular investment decisions, and state that such approval would relieve the trustee of liability for state law requirements of prudence or diversification with respect to the investment. The settlor also may provide that in the event of disagreement over investments or investment decisions, the decision of a family trustee would control and relieve the independent trustee of any liability for the investment decision.

Remediation

If a trust already exists and its terms do not clearly state the trust's purpose or negation of the trustee's duty to diversify, action should be taken. Counsel for the trustee, the beneficiaries and/or the settlor may consider various options for remediation. Currently, nearly half of the states have adopted the Uniform Trust Code (UTC), so that is where we will look for relief.

• **Judicial or Administration Modification**—It may be possible to obtain a judicial or administrative modification of the trust's terms to expressly require non-diversification in some instances. The UTC permits modification of a trust's terms upon consent of all of the trust's beneficiaries (including minors and unborn remaindermen through virtual representation or guardian ad litem court appointments) without court order if the settlor consents, and with a court order if the settlor is deceased.[2]

This approach may prove difficult if there is no consensus among family beneficiaries about the proposed non-diversification. But the court in its equitable power may modify the administrative terms of a trust without total beneficiary approval if either circumstances not originally contemplated by the settlor would further the purposes of the trust, or if continuation of the trust on its existing terms would be impracticable, wasteful or would otherwise impair the trust's administration.[3]

When the original mandate to hold family company stock in a concentrated fashion without regard to diversification is unclear, a large increase in value over time and an increased dominance of family company equity ownership as a percentage of trust assets may be sufficient to persuade a court in a UTC state to specifically negate the duty to diversify.

• **Trustee Resolution**—Another potential technique to create a safe harbor for trustee liability is to have the trustees adopt a resolution or set of resolutions containing a comprehensive investment plan that will apply from that time forward.

For example, the trustees could cite the settlor's desire that the family business stay closely held, intact and owned by family members or trusts for their benefits without regard to diversification. The resolution could articulate limited conditions under which a sale of the concentrated holding of the family company ownership would be permitted. (For example, at such time as the other shareholders of the company agree collectively to sell under the terms of the governing shareholders buy-sell agreement.) Perhaps, if the settlor is still living, she could concur in the resolution and affirm that the resolution accords with her intent for the trust. Although the resolution might not create indisputable evidence of the settlor's intent in the absence of the settlor's statement, it could document the trustees' reasons for holding the stock in accordance with the settlor's purposes and intent for the trust.

• **Delegation of Authority**—Often, there are co-trustees with non-family members serving as independent trustees and family member beneficiaries serving as family trustees. Depending on the trust's terms, the independent trustee may find relief from its duty to diversify by refraining from taking part in the family trustee's unilateral decision to continue the trust's concentrated holdings in the family company ownership. For example, if the terms of the trust provide that the family trustee's decision controls in the case of disagreements concerning investments, the independent trustee could document (by trustee resolution or otherwise) its opposition to the non-diversification of family business assets and trigger relief from liability pursuant to the trust instrument.

The independent trustee also could formally delegate investment authority to the family trustee pursuant to the trust instrument or state law. For example, North Carolina law permits a trustee to delegate the performance of any function (other than those the settlor reasonably expected the trustees to perform jointly) to a co-trustee with the co-trustee's consent, and specifically provides that the performance of any function relating to investment of trust assets is not a function that a settlor reasonably expects the trustees to perform jointly.[4]

While not as specific as North Carolina law, the UTC's general authorization of co-trustee delegation reflects the position that whether, and to what extent, a function may be delegated to a co-trustee should be determined by the trust agreement and the settlor's particular reasons for appointing co-trustees.[5]

• **Release and Indemnification**—The independent trustee could seek an indemnification and hold harmless agreement from the family trustee and other trust beneficiaries to relieve the independent trustee from liability arising from the non-diversification of family company equity ownership. Though such a private agreement might not protect the independent trustee from claims of future unborn remaindermen under general contract law, an agreement by the beneficiaries relieving the trustee from liability would provide solace for the then-acting independent trustee if the current income beneficiaries will be the primary beneficiaries and family co-trustees for a long period of time.

Under the UTC, a trustee is not liable to a beneficiary for breach of a fiduciary duty for conduct consented to, approved or ratified by the beneficiary.[6] Additionally, North Carolina law allows such consent, approval or ratification by the beneficiary to be valid and binding even in the absence of consideration by the trustee.[7]

Minor, unborn, incapacitated or unascertained persons may be bound to an agreement by a person with a substantially similar interest in a dispute.

The UTC provides for virtual representation of unborn and minor beneficiaries under certain circumstances, and the persons represented will be bound by the representation to the extent permitted under state law.[8] In the absence of a conflict of interest, a person may bind their unborn or minor children if a guardian has not been appointed. Also, minor, unborn, incapacitated, or unascertained persons may be bound by a person having a substantially identical interest in a particular issue or dispute.[9] Virtual representation may be used to facilitate the consent of minor, unborn or unascertained persons with respect to modifications or terminations of trusts, or the release or affirmation of actions of the trustee.[10] But the existence of a conflict of interest and the extent of a valid and binding representation depend on the facts and circumstances surrounding a particular question or dispute.[11]

For example, consider a trust that has engaged in a grantor trust sale of closely held business interests with the settlor, who is now deceased, as part of the settlor's overall estate plan. The trust agreement contains a general authorization for the trustee to retain assets contributed to the trust by the settlor and relieves the trustee of diversification with respect to closely held businesses transferred to the trustee under the trust agreement. But otherwise the trust is silent on the trustee's duty to diversify trust investments or interests in closely held businesses purchased from the settlor. The trust agreement provides that the settlor's child is the family trustee and the primary beneficiary of the trust, and the child's issue are the secondary beneficiaries during the child's life and remainder beneficiaries at the child's death.

After the settlor's death, the independent trustee could seek a release and ratification from the beneficiaries authorizing the initial purchase of, and continued investment in, the closely held business interests held by the trust.[12] The settlor's child could consent to the investment decision on his own behalf. But there could be a conflict of interest in his representing his unborn or minor children because he is a co-trustee that authorized the transaction along with the independent trustee and is also a beneficiary with an adverse beneficial interest in the trust.[13]

Left Out on a Limb

Why are all of these possible actions so necessary to consider? Is it really so dangerous out there for trustees of trusts with closely held businesses? In short, the answer is, "Yes."

Existing law ultimately offers insufficient protection and guidance for many trustees of trusts holding family businesses as major assets. Forty-six states, including the District of Columbia, follow the UPIA.14 At the core of this act, which is modeled after the Restatement (Third) of Trusts, is a rule articulating a trustee's duty to invest and manage trust assets in the manner of a "prudent investor."

This basic rule says a trustee shall diversify the investments of the trust unless it reasonably determines that, because of special circumstances, the purposes of the trust are better served by not diversifying.[15] The trustee's concomitant duties of prudence and diversification arise upon accepting a trusteeship or receiving trust assets and apply throughout the trusteeship.[16]

Compliance with the duty to diversify seems straightforward and reasonably applied to trusts consisting primarily of cash or liquid assets. But it raises potential problems for a trustee who succeeds to a trust funded with stock in closely held businesses.

States that have adopted the UPIA seem to provide potential relief. For example, the UPIA's duty to diversify has been codified in the North Carolina Uniform Trust Code, whose Section 36C-9-903, entitled "Diversification," provides: "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstance, the purposes of the trust are better served without diversifying." Identifying circumstances when particular purposes of a trust may trump the duty to diversify, the state's Official Comment (which matches the Official Comment to Section 3 of the UPIA) specifically provides: "The wish to retain a family business is [a] situation in which the purposes of the trust sometimes override the conventional duty to diversify."[17]

The Restatement provides a similar reference to family businesses. It states: " [T]he trustee's decision to retain or dispose of certain assets may properly be influenced, even without trust terms expressly bearing on the decision, by the property's special relationship to some objective of the settlor that may be inferred from the circumstances, or by some special interest or value the property may have as a part of the trust estate . . . Examples of such property might be land used in a family farming operation, the assets or shares of a family business, or stockholdings that represent or influence control of a closely or publicly held corporation."[18]

But courts have treated the existence of "special circumstances" justifying the retention of closely held business interests as a question of fact. That means a trustee may not automatically be shielded from litigation over its determination to retain investments with a special meaning to the settlor or the trust.1[9]

Trust Provisions

Trust document language can offer some, but ultimately insufficient, relief and guidance for trustees. The UPIA provides that the duty to diversify is a default rule that may be "expanded, restricted, eliminated, or otherwise altered by the provisions of a trust" and that a trustee would not be liable to a beneficiary for investment actions taken in reasonable reliance on the terms of the trust.[20] A trustee, therefore, may rely on trust provisions that govern or direct investments in a manner inconsistent with the general rules of diversification.

But here's the rub: The determination of the trustee's liability for non-diversification hangs on whether the reliance was sufficiently "reasonable" to overcome the trustee's general duty to diversify. And it appears that the "reasonable reliance" required to avoid liability for failure to diversify must be based on specific direction in the trust agreement authorizing the retention of particular trust assets—not on a general authorization allowing or requesting the trustee to retain assets initially contributed to the trust.

A trustee *might* be entitled to rely on a general authorization to retain certain assets coupled with a provision expressly limiting the trustee's duties of prudence and diversification with respect to such assets, or by a more general investment provision specifically limiting or altering the trustee's default duties of prudence or diversification under state law. 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.[21]

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. The Restatement provides that mandatory provisions directing or restricting trust investments are legally permissible and often displace a trustee's normal duty of prudence.[22]

But the trustee may not reasonably rely on a mandatory provision when a court order directs or authorizes non-compliance. And, in some circumstances, the trustee may have a duty to request an order from a court modifying or altering the trustee's duty to comply with a mandatory provision contained in a trust agreement.

The *Restatement* provides an example where a trust agreement directs the trustee to retain a farm and operate it jointly with two of the beneficiaries: the settlor's child and the child's spouse. If the trustee acts pursuant to the trust agreement for a term of years and the farming operation is at least as successful as it was during the settlor's life, yet becomes unprofitable for two years thereafter, the trustee would not be liable for the loss incurred by the trust in the two unprofitable years absent the trustee's failure to manage the farm investment prudently. If, however, the profitability of the farming operation continues to decline and in subsequent years a pattern of losses or low yields threatens accomplishment of the trust's purpose (presumably, to provide for the trust beneficiaries), the trustee would have a duty to seek a court order permitting deviation from the trust or other modification of the mandatory direction in the trust instrument.[23]

> The trustee's duty to comply with a mandatory provision is tempered by the trustee's duty to the settlor's overall purpose for the trust.

Unfortunately, the reporter's notes commenting on the *Restatement's* farming operation example further cloud a trustee's duty to contradict a mandatory provision in a trust instrument. These notes indicate that the example portrays the trustee's duty in a more extreme situation when some trust purpose other than retention of the farming operation has been identified, such purpose is jeopardized by an irreversible pattern of unprofitability, and alternatives to the sale and disposition of the farming operation have been found wanting. Before seeking a court order authorizing abandonment of the farming operation, the trustee is required to consider other options consistent with the settlor's purpose.

For example, the trustee may be required to consider whether engaging in the operation with different management or leasing the farm to third parties would rectify the farm's unprofitability. If the land has no reasonable economic use as a farm, the trustee may be required to consider whether the total return on the trust portfolio justifies retention of the asset, such as whether losses in yields are compensated by appreciation in the land, or whether unusually high returns on other investments or the ability to invade trust corpus can effectively offset the low return generated by the farming operation.

All this suggests that the trustee's duty to comply with a mandatory provision directing the retention or continuance of a particular investment is tempered by the trustee's duty to determine the effectiveness of the investment in light of the settlor's overall purpose for the trust. Although the trustee is not permitted outright to ignore the settlor's mandate respecting the investment, particular circumstances arising after the trust's inception could create a duty for the trustee to pursue a legally permissible course of action to quash compliance with the mandatory investment provision.

The determination to seek legal modifications to the trustee's mandatory duties under the trust agreement depends on:

(1) the determination that compliance with the directed investment provision irreparably threatens the general purpose of the trust (to provide for the beneficiaries); and

(2) no circumstances exist to mitigate compliance with the mandatory investment provision otherwise in furtherance of the settlor's purpose.

The Restatement provides that when a trust's terms merely authorize action or inaction regarding a particular investment in derogation of the general duty to diversify, the provision is permissive rather than mandatory. The distinction between permissive and mandatory is profound and includes:

(1) the trustee is under no duty to comply with a merely permissive provision directing or authorizing the trustee to engage in or retain investments;

(2) the degree to which the trustee must give special consideration to specifically authorized investments, as opposed to ignoring them altogether, is unclear;

(3) the mere authorization to continue or retain certain investments neither relieves nor exculpates the trustee from the general duties to diversify or act prudently in investment matters.[24]

The Restatement's position (which the UPIA mentions and most courts follow) is that because permissive provisions regarding trust investments don't abrogate the trustee's general duties of diversification and prudence, the provisions are strictly construed against discharging the trustee's fiduciary duties with respect to investments altogether. The *Restatement* describes the effect, if any, that a specific investment authorization may have on the trustee's duty to diversify as "a difficult question of interpretation."[25] And the only guidance the *Restatement* gives for that interpretation is, "[A] relaxation in the degree of diversification may be justified under [a permissive] authorization by special opportunities for the trust or by special objectives of the settlor." Nevertheless, unlike mandatory provisions directing investments, nothing in a permissive provision appears to abrogate or otherwise modify the trustee's duty of prudence with respect to investments.

Both the *Restatement* and case law indicate that the difficulties in determining the extent to which an authorization concerning a particular investment abrogates the trustee's duties of diversification or prudence stems from a lack of precision used by the lawyer drafting the trust provisions.[26]

Expanding on the farm example, the *Restatement* adds another fact: The terms of the trust authorize the trustee to liquidate other investments to purchase additional land to expand the farming operation. The

Restatement provides that although the trustee is authorized to further concentrate the trust's investment in farming, before doing so, the trustee must determine whether it's otherwise reasonable and prudent to purchase additional farm land, even though the purchase would further aggravate the lack of diversification. Of course, such a determination would require the difficult process of interpreting the settlor's purpose for the provision.

Focusing on the lack of clarity provided by the provision used in the example, the *Restatement* notes the questions that are raised but unanswered: Does authorization to expand the farm operation reflect the settlor's belief that the child and child's spouse possess a special competence or skill in operating a farm? Or do the two beneficiaries, otherwise relatively unskilled at farming, possess a special interest or desire to operate a farm, and did the settlor intend to provide the beneficiaries with the opportunity to engage in an activity that would otherwise be unavailable to them? Will the beneficiaries operate the farm during the life of the settlor's wife, the life income beneficiary? And, thereafter, should the trust assets be available for any particular use of the beneficiaries? Moreover, when the two beneficiaries directed to participate in the farm's operation die, is the farm to be continued for the remainder beneficiaries, or does the duty to operate the farm cease and the duty to diversify arise in full?

Although the Restatement illustrates the issues of interpretation that arise from drafting general provisions directing specific investments, it does nothing to clarify what would constitute "reasonable reliance" by a trustee acting pursuant to language set forth in the trust agreement.

The guidance provided in case law is equally unclear and seems to suggest only that, unless otherwise specifically and clearly mandated by the settlor, a trustee is protected in retaining particular investments of the trust so long as the beneficiaries are compliant enough to not sue the trustee (or are bound by an indemnity or release agreement to such effect) because the primary purpose of the trust is to benefit the beneficiaries. Case law also seems to suggest that communication with the beneficiaries, whether or not the trustee ultimately decides to diversify or retain particular assets, is of primary importance to a trustee's liability for violating the prudent investor rule.

Case law supports the proposition that a trustee is obligated to comply with mandatory provisions in the trust agreement specifically directing the trustee to retain all or certain investments of a trust, and that the trustee would be liable for failure to retain such investments in the absence of impossibility, illegality or a judicially determined change of circumstances.[27] With respect to permissive provisions authorizing the retention of trust assets, cases regarding a trustee's duty to diversify provide a host of factors a trustee should consider when making a "reasonable determination" to retain or diversify trust assets primarily composed of closely held business interests. But when the terms of a trust limit a trustee's liability for investment decisions that otherwise would violate diversification or prudence, or when liability for failure to diversify is eliminated with respect to the retention of particular trust assets, then the trustee won't be liable for conduct within the standard authorized by the trust agreement.

A trustee should consider a host of factors when making a "reasonable determination" to retain or diversify trust assets.

Safe Harbors

Wood v. U.S. Bank is often cited in discussions of a trustee's liability. In it, an Ohio appellate court stated that terms of a trust specifically authorizing the trustee "[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" failed to clarify whether "advisable or proper" referred to the stock or the cash.[28]

Nevertheless, the court concluded that the trust provision merely authorized the trustee to hold its own stock as an investment. Therefore, the trustee would not be liable, under a breach of loyalty theory, for retention of its stock received from the settlor in the absence of bad faith or an abuse of discretion.

But—and here's the rub again—the court also concluded that because the trustee still has the duty to act prudently, and prudence normally requires diversification, the language authorizing retention of the stock did not affect the trustee's duty to diversify.

The *Wood* court's opinion also offers suggestions on how to draft a trust agreement that would effectively limit the trustee's duty to diversify, as opposed to merely the duty of loyalty. The court stated that rather than a general authorization to retain investments, the trust language must contain specific language directing the trustee to retain in a particular investment a larger percentage of trust assets than normally would be prudent. For example, the trust could have contained a provision specifically lessening the trustee's duty to diversify investments in general. Additionally, the clause authorizing retention of the stock could have mentioned that the trustee was relieved of the duty to diversify such stock.

Other cases also highlight the attention courts pay to the specific authorization granted in a trust instrument when determining whether a trust provision overrides or limits a trustee's general duty to diversify.

In a recent case, the U.S. Court of Appeals for the Eighth Circuit considered the effect of a trust provision stating that "any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments."[29]

The case involved a trust holding stock in a single corporation constituting 90 percent of the trust's assets at the settlor's death. Before his death, the settlor had signed an investment authorization stating that the stock was a proper investment and directing the trustee to retain it. The trust also held interests in limited partnerships that held additional stock in the corporation.

After the settlor's death, the beneficiaries removed the trustee and brought an action in federal court alleging that the trustee had breached its fiduciary duties of care and prudence by failing to liquidate the stock two weeks after the settlor's death to preserve the value of the estate and pay the estate tax due nine months later.

Applying the UPIA as enacted under North Dakota law, the Eighth Circuit affirmed the district court's grant of summary judgment in favor of the trustee, holding that the trustee had acted in reasonable reliance on the terms of the trust. Because the terms of the trust limited the trustee's liability to investment decisions not made in "good faith," the Eighth Circuit held that the trustee's potential liability for investment or retention decisions was properly limited to instances of bad faith, as well as reckless or intentional breaches of fiduciary duty. The Eighth Circuit concluded that the good faith standard was not limited to "good faith mistakes or errors of judgment," which would otherwise not shield the trustee from negligence, but rather protects "any investment made or retained by the trustee in good faith," therefore shielding the trustee from ordinary negligence in investment decisions.

When the terms of the trust authorize the trustee to retain original assets contributed to the trust in derogation of diversification requirements under state law, a trustee may be protected in its decision to retain inception assets in violation of the duty to diversify. For example, when the terms of a testamentary trust authorized the trustee to retain shares owned by the settlor at his death "if, in their discretion they shall deem it prudent and in the best interest of my estate so to do, notwithstanding the fact that the retention of such investments might, except for this express direction, be in violation of the laws of this State governing trust investments," the authorization could create a safe harbor protecting the trustee from the diversification requirements that otherwise would be deemed prudent.[30] Such a provision would grant a trustee discretionary authority to retain investments pursuant to its subjective determination of what is prudent and in the best interest of the trust, as opposed to the UPIA's objective standard of prudence.

As long as the trustee actually exercises its discretion, and the exercise is supported by the facts and circumstances of the trust, the trustee ordinarily will not be liable for a decision to retain inception assets absence an abuse of, or complete failure to exercise, its discretion.

Similarly, a Michigan appellate court found in *In the Matter of the Jervis C. Webb Trust* that when the terms of the trust grant a trustee general discretion to invest or reinvest trust assets as it deems advisable, a specific authorization to retain stock in a particular company "without regard to any rule or requirement of diversification of investments, and even if such stock does not pay dividends or pays only a small dividend," may relieve the trustee of the duty to diversify the designated stock, even if it would not be prudent to do so.[31] A trustee's retention of the designated company stock in reliance of the trust provision would be reasonable, and a beneficiary could not maintain a claim against the trustee based on breach of fiduciary duty for failure to diversify the stock. Such an authorization to retain stock in the designated company would be bolstered if the terms of the trust made it clear that the settlor intended the trustee to retain the stock so that the family could maintain control of the company and continue to have employment opportunities with the company.

Also, a trustee may be entitled to rely on an agreement entered into with the beneficiaries themselves specifically providing that the trustee would refrain from further diversifying trust assets and would retain interests held in closely held family businesses.[32] Such an agreement, however, would not protect the trustee from a failure to diversify trust assets other than the closely held family business interests covered by the agreement.

Liability Trap

Trust terms can provide additional support for retaining assets to serve the needs of beneficiaries. But, beware, case law can create a trap in these scenarios for unwary settlors and trustees.

If the terms of a trust authorize a trustee to retain trust property without regard to the portion this property bears to the entire amount of the trust "in the best interest of the trust beneficiaries,"[33] the trustee must make a factual determination to determine that non-diversification is appropriate.

Cases imposing liability on a trustee for the failure to diversify trust assets regardless of a general authorization to retain the investment usually involve factors demonstrating that the stock was directly related to the trustee or that the trustee acted with some element of bad faith. The recurring theme provided in case law is that in the absence of specific direction in the trust instrument, a trustee's "reasonable determination" depends on the actual investment plan implemented and carried out by the trustee in light of the needs of the particular beneficiaries and the particular trust portfolio involved. This requires the trustee to develop an investment strategy tailored to the factual circumstances surrounding the trust's purpose and to evaluate the income needs of the beneficiaries. A failure to communicate with the beneficiaries or exercise any discretion at all potentially subjects the trustee to liability for failure to diversify.

> A necessary step to developing an investment strategy for any trust requires the trustee to determine the trust beneficiaries' needs.

So how does the trustee determine the beneficiaries' needs?

The prudent investor standard applies to a trustee's performance in investing and managing trust assets. A necessary step to developing an investment strategy for any trust requires the trustee to determine the trust beneficiaries' needs. As an illustration, in *First Alabama Bank of Huntsville*, trust beneficiaries sued the trustee, a bank, for mismanagement of trust investments, 75 percent of which were invested in stock of the trustee bank's holding company. The settlor of the trust had been the bank's president and vice chairman, and at his death 70 percent of the trust's assets consisted of the bank's holding company stock. The bank relied on the trust instrument providing that the trustee was authorized "to change investments and to make new investments from time to time as it may seem necessary or desirable, regardless of any lack of diversification, risk, or nonproductivity." The trustee stated that, in exercising its investment discretion, it had determined that an investment plan involving moderate income and growth was appropriate and desirable for the trust. The court held that the trustee failed to invest and manage the trust assets as a prudent investor because it had failed to determine the beneficiaries' needs. Indeed, the court found, the decision to concentrate such a large amount of trust assets in undiversified stock was imprudent and not in the beneficiaries' best interests.[34]

The manner and extent of diversification also depends on the specific circumstances pertaining to the trust. When a trust is initially funded with assets concentrated in one corporation's stock, a determination to diversify assets might not be justified as a prudent course of action. For example, when a trust's main purpose is to provide for the decedent settlor and the settlor's spouse during their lives, a trustee's unilateral decision to diversify stock with a high dividend payment history into investments bearing lower income rates would be imprudent when the settlor's spouse is in deteriorating health and relies on the trust's income for support and maintenance.[35]

In contrast, when the trust terms grant the trustee sole discretion to distribute income and principal for the beneficiary's support and the trustee is expressly not required to diversify, the trustee may be relieved from liability for the decision to retain an undivided interest in family-owned property even after a general determination has been made to sell.

A D.C. appellate court held in *In re Estate of Cavin* that a trustee was not required to engage in a fire sale of property to diversify the trust's remaining investments when the property, a fractional undivided interest in real estate, was an initial asset of the trust and other trust assets had been distributed to the beneficiary.[36] When the real estate market was at a high, the trustee sought to sell the property, but offers were declined because either the other owners rejected them or the proposed sale was subject to unreasonable contingencies. After the real estate market declined, the beneficiary sued the trustee for failure to diversify.

The court determined that, when there is no market for undivided minority interests in family-owned realty, the trustee was not required to sell its undivided quarter interest at a substantially discounted price. In exercising its investment discretion, the trustee's decision to preserve the property's value and try to persuade the other owners to sell the property as a whole sufficiently justified its retention of the asset in undiversified form. Noting that the trust's other assets had been sufficient to provide for the beneficiary's support under various circumstances, including the birth of a child, the court found that before the beneficiary's needs became "acute," the trustee was under no obligation merely to diversify to partition the property and force a fire sale of the asset, contrary to the interests of the other owners of the property and the beneficiary himself.

Trust Portfolio as a Whole

Courts also have held that to justify a decision to sell or retain particular trust assets as part of an overall investment plan, the trustee must consider the other assets held by the trust.

For example, to justify a decision to invest certain assets primarily in tax-exempt bonds, a Washington appeals court in the 1986 case of *Baker Boyer Nat'l Bank v. Garver* found that the trustee could rely on an investment plan to diversify assets between tax-exempt securities and equity in real property only if the trustee considered the real property as part of the trust's investment portfolio.[37]

Similarly, a Washington appeals court found 10 years later in *In the Matter of the Estate of Cooper* that a decision to sell interests in a closely held business and reinvest the proceeds in income-producing assets, including tax-exempt bonds, must be analyzed in conjunction with other income-producing assets in the trust's portfolio. If the trust's portfolio after the purchase contains no assets geared towards capital appreciation and consists only of marketable securities or bonds heavily weighted toward current income, the failure to weigh investments based on income or capital-producing factors results in a violation of the prudent investor standard for failure to diversify.[38]

How does this "whole portfolio" approach apply in the family business context?

If a trustee holds only a small minority interest in a family business, then the decision to retain the stock may not be prudent if the purposes of the trust would be better served by investing the stock elsewhere. But a trustee's decision to retain stock constituting a minority interest in a family business may take into consideration the fact that the trust is one of several separate trusts created under a single trust agreement initially funded with a controlling interest in the settlor's family business. Language in a trust indicating the settlor's intent that the trustee retain interests in a family business to keep control within a particular family or facilitate the ability of the trust beneficiaries to participate in the business may be very relevant to a trustee's decision to retain family business interests.

Case law further suggests that in deciding whether to retain or diversify stock in a settlor's family-owned business, a trustee may consider the available market for the stock and whether the stock constitutes a controlling or minority interest.

For example, a Michigan appeals court deciding *In re Messer Trust* in 2005 found that, when a trust was funded in 1939 with stock in a company co-founded by a settlor's father and a third party, the trustee's decision to sell the stock over a five-year period nearly fifty years after the trust's inception did not constitute an abuse of the trustee's discretion.[39] When the trustee decided to sell the stock: the trust held only a small minority interest in the company; the stock represented an overly concentrated holding of the trust's assets; the trustee performed a reasonable limited valuation and determined that the only market to purchase the stock was the company itself; and the purchase price of the stock, although substantially discounted, was reasonable. Moreover, the court noted that under the terms of the trust, the restriction against sale of the family stock without the consent of a named individual had lapsed at the individual's death; thereafter, the trust only provided the settlor's non-bonding preference that the trustee retain the stock.

Another helpful example is the 2006 case of *In re Jervis C. Webb Trust* out of Michigan.[40] At issue were two trusts, one created by a father and the other by his son, that were funded with stock in a family-owned business. The beneficiaries sued the trustees for retaining the family company stock and failing to diversify trust assets. In upholding summary judgment in favor of the trustees, the court held that it must refer to the trust agreements to determine the duties and liabilities of the trustees and the intent of the settlors. The trusts gave the trustees the discretion to sell the family stock, but relieved the trustees of any liability for non-diversification or imprudence in retaining the family stock. Moreover, one of the trusts specifically provided that the settlor intended for the trustees to retain the family company stock so that the family could maintain control of the company and family members could continue to have employment opportunities with the company.

Provisions should contain language specifically mentioning the closely held company by name and specifically reference the issue of diversification.

Provisions containing language specifically mentioning the closely held company by name and specifically referencing the issue of diversification, rather than boilerplate language permitting the trustee to retain investments, is helpful to clarify the trustee's liability for retaining trust assets. An example of this is provided in a case out of Ohio in 2005, *National City Bank v. Noble*, involving a concentrated (87 percent to 25 percent) block of stock in J.M. Smucker Company.[41]

Installment Sales to Grantor Trusts

The potential for diversification issues arises not only when closely held business interests are initially contributed to the trust by the settlor, but also when the settlor transfers closely held business interests for value pursuant to an installment sale to a grantor trust. A typical grantor trust sale involves an intentionally defective grantor trust created by the settlor and funded with a gift of cash or other liquid assets; the settlor intends for the trust to purchase his closely held business interests for estate planning purposes or to provide creditor or marital protection to the trust's beneficiaries. The sale to the grantor trust is disregarded for income tax purposes, because the settlor is taxed on the trust's income and treated as the owner of the trust's assets pursuant to the grantor trust rules.[42]

The grantor trust uses the initial assets contributed to the trust to purchase stock in a closely held business of the settlor, and, if the settlor has multiple children, multiple grantor trusts may be used as part of an overall plan to acquire all of the settlor's interest in the business, with each separate trust acquiring a minority interest in the business. As part of the settlor's estate plan (for example, to centralize management of the business within the family), the trusts also may be required to enter into buy-sell agreements restricting the sale or transfer of interests to persons other than members of the settlor's family.

In these cases, trustees may be exposed to liability for decisions to invest existing trust assets in the closely held business interests, which ordinarily are subject to transfer restrictions and lack of marketability. The previously discussed cases examined a trustee's liability for the decision to retain or dispose of assets subject to transfer restrictions and marketability issues when received from the settlor, but the grantor trust sale involves the trustee's initial decision to purchase and invest in the non-marketable stock. Thereafter, if the purchased interests are held as security or subject to an escrow agreement, the trustee may be obligated to retain the assets during the term of the installment note, and the closely held business interests purchased by the trustee will continue to form a substantial majority of the trust's investments.

Although the sale to the grantor trust is typically part of the settlor's overall estate plan, the trustee may not be protected by the settlor's initial estate planning purpose if the trust agreement itself lacks authorization for the transaction or elimination of the trustee's duty to diversify. If beneficiaries of the trust sue the trustee after the settlor is deceased and the trust agreement is silent on the settlor's purpose for the trust or for the potential sale of interests to the trust, the trustee's decision to enter into the sale pursuant to its investment authority may be viewed independently of the settlor's intent and purposes for the transaction.

It is, therefore, particularly important that the trust agreement authorize the trustee's investment in the closely held business interests or limit the trustee's liability for failure to diversify trust investments by purchasing family business interests from the settlor or a member of the settlor's family.

Proceed With Extreme Caution

Clearly, trustees must take great care when handling trusts whose assets are concentrated or consist solely of a closely held business. Many factors surrounding the increasing use and sophistication of trusts (including state law relaxations on perpetual trusts, innovative uses of trusts for estate or tax planning purposes, and the expanding field of estate and trust litigation) have helped create a host of liability traps for trustees of trusts with concentrated positions in closely held businesses.

Until statutes or case law more precisely define the parameters of a trustee's liability, trustees should—before they accept the trusteeship—be prepared to investigate and determine the scope of their liability for holding concentrated positions in valued family assets in trusts specifically designed to achieve certain estate or tax planning objectives of the settlor. A non-family, independent trustee should not hesitate to make a reasonable request of the trust's settlor and current beneficiaries to provide the independent trustee with either an investment selection and retainer protocol relieving the independent trustee from decision making regarding holding closely held equity interests. Alternatively, the trustee should receive indemnity, hold harmless or other protections from the family beneficiaries who wish to hold such interests in a non-diversified manner.

Endnotes

1. *See*, for example, *Harvard College v. Amory*, 26 Mass. (9 Pick) 446 (1830).
2. Uniform Trust Code (UTC) Section 411.
3. UTC Section 412.
4. North Carolina General Statutes (N.C.G.S.) Section 36C-7-703(e).
5. UTC Section 703(e), cmt.
6. UTC Section 1009.
7. N.C.G.S. Section 36C-10-1009.
8. UTC Section 301.
9. UTC Section 303 (representation by fiduciaries and parents); UTC Section 304 (representation by person having substantially identical interest).
10. UTC Section 301, cmt; UTC Section 411 (modification or termination of trusts); UTC Section 1009 (beneficiary's consent, release, or ratification of conduct of trustee).
11. *See* UTC Section 304, cmt. (noting that presumptive remainderman may be able to bind alternative remaindermen to approval of trustee's report, but not to disputes concerning termination of trust or interpretation of remainder provision).
12. UTC Section 1009, cmt. (providing that a beneficiary's consent, release or ratification may occur before or after the approved conduct of the trustee).
13. *See* UTC Section 303 (stating that typical conflict arises where fiduciary or parent seeking to represent beneficiary is trustee or has adverse beneficial interest).
14. The states that have enacted independent prudent investor statutes are Delaware, Florida, Georgia, Kentucky, Louisiana, and New York.
15. Uniform Prudent Investor Act (UPIA) Section 3.
16. UPIA Section 4; *see also Restatement (Third) of Trusts* Section 92 . There is also a Delaware statute which provides that if the terms of a trust require a trustee to follow the direction of an adviser regarding investment decisions, then in the absence of willfull misconduct the trustee will not be liable for any loss resulting from acting in accordance with such direction. Delaware Code Annotated Section 3313(b). Moreover, the trustee would have no duty to monitor, advise, or consult with the adviser regarding investment decisions or otherwise warn or notify beneficiaries of investment decisions of the adviser that the trustee would have handled differently in its fiduciary discretion. Delaware Code Annotated Section 3313(e)..
17. N.C.G.S. Section 36C-9-903.
18. *Restatement Third* Section 92.
19. *See In re Trust Created by Inman*, 693 N.W.2d 514 (Neb. 2005) (family farm); *Wood v. U.S. Bank*, N.A., 828 N.E.2d 1072 (Ohio App. 2005) (family business).
20. UPIA Section 1.
21. *See, e.g., Restatement Third* Section 91 (comparing effect of mandatory v. permissive provisions); *Wood v. U.S. Bank, supra* note 19 (discussing language generally authorizing, rather than specifically directing, retention of assets).
22. *Restatement Third* Section 91, cmt. e.
23. *Ibid.*, illus. 5.
24. *Restatement Third*, Section 91, cmt. f.
25. *Ibid.*
26. *Ibid.*, illus. 7; *see also Wood v. U.S. Bank, supra* note 21.
27. *See Stevens v. Nat'l City Bank*, 544 N.E.2d 612 (Ohio 1989); *see also McGinley v. Bank of America*, N.A., 109 P.3d 1146 (Kan. 2005) (holding that settlor's signed statement specifically directing trustee of revocable trust to retain Enron stock comprising nearly 75 percent of trust corpus and expressly releasing trustee from liability for retaining and failing to monitor such stock was sufficient to support grant of summary judgment in favor of trustee in action for loss by beneficiaries).
28. *Wood v. U.S. Bank, supra* note 21.
29. *Nelson v. First Nat'l Bank and Trust Co.*, 543 F.3d 432 (8th Cir. 2008); *see also Ams. For the Arts v. Ruth Lilly Char. Rem. Annuity Trusts*, 855 N.E.2d 592 (Ind. App. 2006) (holding that provision stating that "any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification" was sufficiently precise to eliminate trustee's duty to diversify and exonerate trustee for failure to diversify).
30. *See In re Wedge Trust*, 2008 WL 2439904 (Mich. App. 2008).
31. *In the Matter of the Jervis C. Webb Trust*, 2006 WL 173172 (Mich. App. 2006).
32. *See Williams v. Security Nat'l Bank of Sioux City*, 293 F. Supp. 2d 958 (N.D. Iowa 2003).
33. *In re Trust Created by Inman*, 693 N.W.2d 514 (Neb. 2005).
34. *First Alabama Bank of Huntsville, N.A., v. Spragins*, 515 So.2d 962 (Ala. 1987).
35. *In re Scheidmantel*, 868 A.2d 464 (Pa. Super. Ct. 2005).
36. *In re Estate of Cavin*, 728 A.2d 92 (D.C. 1999).
37. *Baker Boyer Nat'l Bank v. Garver*, 719 P.2d 583 (Wash. App. 1986).
38. *In the Matter of the Estate of Cooper*, 913 P.2d 393 (Wash. App. 1996).
39. *In re Messer Trust*, 2005 WL 665120 (Mich. App. 2005).
40. *In the Matter of the Jervis C. Webb Trust, supra* note 31. *See also In re Trusts Created by Hormel*, 504 N.W. 2d 505 (Minn. Ct. App. 1993) (trustee's decision to not diversify was appropriate to maintain controlling interest in the family business).
41. *National City Bank v. Noble*, 2005 WL 3315034 (Ohio Ct. App. 2005).
42. *See* Internal RevenueCode Sections 671-677 (situations where grantor treated as owner of trust property and taxed on trust's income).