

Question 11 – February 2014 – Selected Answer 1

1. a. Yes, failing to prepare an accounting for the trust violates Tom's duties as a trustee. The issue is if a trustee violates duties when he does not make an accounting statement of the trust to the trust beneficiary. When a trustee gets the property of the trust into his possession, it is mandatory that the trustee put together a statement of accounting showing all the assets of the trust. This should be done within 90 days of receiving the trust property. After that, a trustee should put together a new statement of accounting every 12 months after the initial accounting to show what is in the trust and what has come out and what has gone back in. A trust beneficiary has the right to demand a statement of accounting from the trustee at any time and the trustee will have to show the statement of accounting to the beneficiary of the trust. Here, Tom violated his duties when he stated that there were no accounting records. Tom did not put any together, which is something he is supposed to do as a trustee. Furthermore, when the trust beneficiary (Miguel) asked for an accounting statement right away and was not given one then Tom violated his duties as trustee again. Tom should have at least given Miguel the last updated accounting statement that he had. Tom is not under the duty to make a new accounting statement every month like Miguel demanded, but he is obligated to at least have made an accounting statement and to have accounting statements from every 12 months that the trust has been in existence. Tom did violate in failing to prepare the accounting statement.

b. Yes, purchasing a luxury vehicle for himself is a violation of Tom's duties as a trustee. The issue is if a trustee violates a duty when they purchase a luxury vehicle for themselves. A trustee is not allowed to partake in any type of self-dealing. A trustee is only allowed to be reasonably compensated for being a trustee and buying a luxury vehicle is not a way that you can be compensated. Also, a trustee may pay reasonable costs of maintaining the trust out of the trust, but buying a luxury car to help maintain the trust is not something that is allowed. Here, Tom bought a luxury vehicle for himself and claimed that this was okay because he used the luxury car for mainly conducting trust business. This is considered self-dealing because there is nothing reasonable dealing with the trust that Tom would do with a luxury vehicle. Tom does not really need a luxury vehicle to conduct trust business and therefore he just uses the car for himself and has partaken in self-dealing, which is a breach of duty to not self-deal with the trust funds. Tom definitely violated his duties as a trustee when he bought himself a luxury car since he was self-dealing.

c. Yes, Tom violated his duties as trustee when he loaned himself \$250,000 from the trust. The issue is whether a trustee has violated their duties as trustee when they loan themselves money from the trust, but later pay the trust back. When a trustee loans themselves money, they are self-dealing from the trust. This is not allowed and is a breach of duty as a trustee. Even if a trustee pays the money back with interest, it does not matter; the trustee has still participated in self-dealing and will be violating their duties as trustee. Here, Tom loaned himself \$250,000 from the trust money. He did pay back the money to the trust and did not add any interest to the trust. However, adding interest would not have mattered anyway. Either way it does not matter because as soon as Tom loaned himself money from the trust he has breached a duty since he was self-dealing and this is not allowed under your duties as a trustee. Tom violated his duties as trustee when he loaned himself the \$250,000 from the trust.

d. Tom will not be violating his duties as trustee if he invested the trust money in the alternative fuels business under the prudent investor rule or if he had an investment plan. The issue is whether Tom breached his duties when he invested trust money into an alternative fuels business. A trustee is under the duty to diversify the trust and to invest the money in the trust under the prudent investor rule. The prudent investor rule states that a trustee has to prove that they invested the money how any prudent investor would invest the money. Tom will need to show evidence that he did his research on the area of alternative fuels business and that it appeared to be a good option when entering into it and will need to show that a prudent investor would have also invested into this field. The court cannot decide that the investment was not prudent just because the trust has not made any income from the investment. As long as the investment was prudent then Tom can say that his investment was sound and for the benefit of the trust and so he has not breached his duty as a trustee to invest and diversify in the trust. However, if it is found that Tom only invested in the business because his two former

business partners were the ones who started the business and Tom was getting some sort of kick back for investing in the business then again this would be self-dealing and Tom would be violating his duties as trustee. Here, the evidence does not show that and so Tom probably did not violate his duties as long as his investment was shown to be what a prudent investor would do.

2. Miguel has several different remedies against Tom. The issue is what remedies does Miguel have for Tom's actions as a trustee. First, Miguel can petition the court to have Tom removed as the trustee on the trust. A court can remove a trustee for breaching duties that they have to the trust. Here, there is much evidence to show that Tom has breached several areas of the trust. Miguel especially has great evidence that Tom has been self-dealing, which is not allowed. The judge will most likely terminate Tom as the trustee and either appoint someone else as trustee or will see if the trust agreement has another trustee noted and then that person would become the trustee. Second, Miguel can recover the money that Tom spent on the luxury vehicle since Tom was self-dealing from the trust. Miguel could request instead that he gets the vehicle if he wants the vehicle. Most likely though, the judge will make Tom pay back the \$90,000 to the trust that he took to buy the vehicle. Miguel can also recover interest that he should have received from the loan that Tom took out. It should be determined how much interest Tom should have paid by looking at the interest that a normal bank would have charged had they loaned Tom \$250,000 dollars. Miguel can recover this amount if the judge chooses to let him. Miguel could not recover anything with the investment trust money because there has been no loss to the trust at this point in time and it is not clear if Tom breached his duty here.

3. No, Miguel did not waive his claims of breach. The issue is if Miguel waived his claims of breach when he did not file his legal claims against the trustee no later than six months from the date of the breach. A trustee cannot waive his rights to pursue a legal claim against a trustee who has breached their duties to the trust. Duties of a trustee cannot be waived in general because this would be against public policy. If this were to happen then trustees would have this type of clause put in the trust so they can be sure they will not get in trouble for breaching duties against the trust. Miguel was not even aware of the clause in the trust so this would be unconscionable to enforce. Under these facts, Miguel would not be able to waive the breach and Tom cannot state that he waived the breaches.

Question 11 – February 2014 – Selected Answer 2

1. A trustee has fiduciary duties to the trust beneficiaries. This duty requires the trustee to subordinate his interest to those of the beneficiaries. However, this duty can be modified by the settlor (the creator). Although the settlor cannot waive the trustee's liability for intentional acts, liability for ordinary negligence may be waived. Further, a settlor may not limit the statute of limitation in which a beneficiary can bring a claim against the trustee. Under Texas law, the statute of limitations does not even begin to run on an action against the trustee until after the trustee repudiates the trust. Therefore, the limitation in the trust for bringing a claim within 6 months from the date of the breach is ineffective.

a. Accounting: Although a trustee has an obligation to provide an accounting to primary beneficiaries, this is only required upon the demand of a beneficiary. Further, even with a demand, an accounting must only be provided on a yearly basis. Here, Tom did not have to provide an accounting until Miguel, as the beneficiary, demanded one. Although Miguel demanded an accounting after meeting with Tom, he unreasonably demanded that Tom produce the accounting within 24 hours. This is unreasonable. Thus, Tom is also not liable for failing to comply with the 24-hour demand. However, Tom will have a duty to provide an accounting to Miguel based on his demand. He just did not have to provide it within 24 hours.

b. Luxury Vehicle: Buying the luxury car with trust assets is likely a violation of Tom's fiduciary duty as trustee. Although Tom claims that car is use for "mainly" conducting trust business, this appears to be self-dealing and an improper use of the trust funds for the trustee's benefit. The trust at issue was created by Sandi for the benefit of her son, Miguel. Thus, Tom's buying a luxury vehicle probably did not fit within this purpose. Further, even if a vehicle was required, a luxury vehicle was not. Therefore, Tom will be liable for violating his duty as trustee when he purchased a luxury vehicle for his own use. Further, although a trustee is entitled to reasonable compensation, a luxury vehicle is not likely applicable as reasonable compensation (depending on the nature of the trust), and further, Tom does not appear to be claiming that the vehicle is compensation.

c. \$250,000 Loan: Although the money was paid back to the trust, Tom will be liable for breaching his duty as trustee by loaning himself money from the trust. When analyzing self-dealing or an interested transaction by the trustee, the concern is primarily that the transaction will affect the trustee's judgment. Thus, things like using trust property as collateral or loaning himself money from the trust are prohibited. Therefore, since a trustee cannot loan himself money from the trust and even if not loss is suffered, Tom is liable to Miguel for violating his duty as trustee. This would even be true if Tom had charged himself interest on the loan.

d. Alternative Fuels Business: Similar to a loan to himself, a trustee cannot use trust funds for self-serving purposes, including investing in a relative's business. A trustee has a duty to invest the trust funds as a reasonably prudent investor. The Uniform Prudent Investment Act (UPIA) governs the investment of trust funds. Under the UPIA, a trustee must invest under the modern portfolio theory which looks at an investment portfolio as a whole rather than at each individual investment. Further, reasonableness is determined at the time of the investment and not in hindsight. A trustee may also invest in the "legal list" of statutorily approved investments that are considered safe without court approval. Otherwise, court approval is typically required. Here, investing trust money in the alternative fuels business was probably improper. Not only does this appear to be a risky investment that a reasonably prudent investor would not make, but it is also to Tom's former business partners. Similar to a relative, an investment with a former business partner may compromise Tom's ability to use judgment in determining what is best for the trust. In addition, it is irrelevant that the investment has not made or lost any money as this does not necessarily determine if an investment was proper or not.

2. Remedies: Given the violations discussed above, Miguel may have a few different remedies for Tom's violations of his duties as trustee. The beneficiary can get back any trust property that has not passed to a bona fide purchaser. If the property cannot be recovered, the trustee is liable for damages resulting from the improper use of the trust funds. In addition, a constructive trust may be used to disgorge an unjust enrichment based on wrongful conduct, such as a breach of a fiduciary duty. Furthermore, a trustee may be removed for breach of his fiduciary duties to the beneficiaries. Applicable here, it is likely that Miguel can first either get an injunction against Tom for an accounting or have Tom removed as trustee for failing to provide and act in accordance with his duties as trustee. Further, with regard to the luxury vehicle, Miguel may likely recover either the cost of the vehicle from Tom or have it sold and then Tom would be liable for any loss to the trust. With regard to the loan that was repaid, although it does not appear that the trust suffered a loss, Tom may be liable for any interest on the loan or any loss in interest that might have been made if properly invested. Finally, the \$100,000 of trust money that has been invested in the alternative fuels business can likely be recovered from the business or a constructive trust can be implemented. Further, any of these violations may form the basis for removing Tom as the trustee and for denying or procuring a reimbursement for any compensation paid to Tom as trustee. As discussed above, a trustee is entitled to reasonable compensation. However, if the trustee violates his duties to the trust, compensation may be denied and past compensation may even be recovered from the trustee, if applicable. Therefore, Miguel has several remedies available for any breaches by Tom.

3. Waiver: Miguel has not waived any claims of breach, and as discussed above the limitation in the express trust language is likely ineffective. As discussed above, the provision in the trust language limiting the statute of limitations for bringing a claim against the trustee is likely ineffective. A beneficiary's claim against the trustee does not even begin to run until the trustee repudiates the trust. Further, a settlor cannot limit the statute of limitations to bring a claim, although a settlor can limit liability for ordinary negligence. On the other hand, Miguel may choose to waive any breaches of the trust discussed above in order to retain any benefit. For example, if Miguel likes the investment in the alternative fuels business, he may waive the breach and ratify the investment in order to maintain the investment.

Question 11 – February 2014 – Selected Answer 3

1. Tom did a variety of actions that violated his rights to the trust, primarily through self-dealing. In determining an action of self-dealing there is generally a no inquiry approach taken by the courts and the concern will be the award of damages. Self-dealing is not determined by whether the action was

done by the trustee in good faith or what the outcome was for the trust.

Failure to prepare accounting

Tom will not be liable for the trust for failure to prepare an accounting up until Miguel made such a request. The issue is whether a trustee is liable for failure to provide accounting reports without a demand. A trustee should make an accounting of the trust within the first twelve months and then make periodic accountings every twelve months. However, such requirement is done by demand. Here, Miguel had not been in touch with Tom for many years and there was no indication that he had made a requirement for an accounting. However, once Miguel demanded an account he did have the requirement of providing an account but not within the time frame that Miguel provided. The fact that Miguel felt there was some improper conduct could raise the need for an immediate accounting on the trust accounts but it is unlikely that it would require accounts made every months. Therefore, Tom will not be liable for failure to make accountings prior to Miguel's request but he will be liable for failure to administer one after his request.

Purchase of a luxury vehicle

Tom will be liable for the purchase of a vehicle with the trust's assets. The trustee cannot use the trust assets for his personal purpose. The trustee is allowed to get reasonable compensation. The purchase of a vehicle for \$90,000 is not reasonable compensation for a trust with minimal assets and minimal work. Such improper use will amount as self-dealings. Here, Tom purchased a vehicle for himself using the trust funds. He purchased it in the name of himself as trustee; however the vehicle was not used to conduct trust business. In fact, he clearly stated that there had not been much going on. In light of the facts, the court will find this to be self-dealing and he will be sued for the damages based on the purchase of the vehicle.

Loaning himself \$250,000

Tom will be liable for the loan he made to himself. The issue is whether he can still be held liable even though he paid the loan back. As noted, self-dealing by the trustee is not evaluated based on good faith or the outcome of the trust. Although, the trust did not lose money based on the loan it still does not preclude the fact that Tom engaged in self-dealing. The court will apply the no inquiry standard and will sue him for damages based on the improper loan. The trustee can make a permissible loan to the beneficiary but not a loan to himself or to his business associates or friends.

Investing Trust Money in Alternative Fuels

Tom's loan to his former business partners for the investing in alternative deals will be found to be self-dealing because it is a loan to his friends or former business associates with trust assets and it is not a valid investment decision under the Uniform Prudent Investor Standard. The trustee is precluded from making loans to friends or associates. Such loans are considered self-dealing by the trustee. Here, Tom made a loan to his former business partners. Although, Tom could make the argument that he loaned the money because he thought it would be a good business decision for the trust it will likely to be found self-dealing since it was a new company started by his former business partners. Moreover, the investment will fail under the Uniform Prudent Investor Standard. The Uniform Prudent Standard looks at the entire investment portfolio, encourages diversification, and assesses the prudence of the decision at the time of the investment. Here, there were no other investments made in the trust with the exception of a very large \$100,000 investment in this new business with no prior showings of returns. Additionally, there was no diversification, since the investment amount was not shared among various securities. Finally, it is not prudent for a trustee to invest such a large amount in a new business with no returns. Therefore, the investment will be considered self-dealing because of the improper loan and investment decision and Tom will be liable for damages. Miguel will have the choice to either ratify the transaction or sue on the damages.

2. All of the instances of self-dealing will afford Miguel the opportunity to sue for damages based on the no inquiry standard and remove any compensation and also remove Tom as the trustee. The issue is what are the rights and remedies for a beneficiary when there has been misconduct and self-dealing by the trustee. When a trustee has been held liable for self-dealing, the beneficiary can ratify the transaction, sue for damages, remove any compensation due to the trustee and remove the trustee. The

court will apply a no inquiry and focus on the amount of damages. Here, Tom has a number of incidences related to self-dealing. Miguel can sue him on the various incidents of self-dealing; remove any compensation that he is receiving under the trust and can remove him from his position as trustee.

3. Miguel did not waive his claim for breach. The issue is whether the clause in the instrument will preclude Miguel from suing Tom as the trustee for self-dealing. A settlor cannot waive liability from a trustee for gross negligence, intentional misconduct and self-dealing. The clause providing a six month window for suit will not be valid in precluding a claim for self-dealing. Here, Tom engaged in acts that were self-dealing and fraudulent and were not in the best interests of the trust. Such liability cannot be waived by the settlor. Miguel as the beneficiary can sue Tom for self-dealing and will be able to remove compensation and remove him as trustee. The court can decide to either wind up the trusts or can appoint another trustee. The trust will not fail because of the removal of Tom. Therefore, Miguel did not waive his claim under the breach.