Question 6 – February 2019 – Selected Answer 1

(A) Did Tom violate any duties under Texas Law and are his defenses valid with regard to

(1) The $100,000 loan

Tim violated his duties under Texas law regarding the Trust and his $100,000 loan. The issues are whether a Trustee may make an interest free loan to himself under Texas law and whether the defenses of a clause in the Trust and the "prudent investor" rule are applicable.

Under Texas Law, a Trustee may no engage in any self dealing regarding the Property held under trust. This is a fidiciary duty. Furthermore, a clause that excuses and releases the Trustee from liability for any conduct, neglicent or intentional is not invalid. Thus, the Trustee may not contract away his fiduciary duty. Additionally, the prudent investor rule does not apply to breaches of fiduciary duty that arise from self-dealings.

In the present case, "Tim loaned himself $100,000 from the Trust, interest free" for six months. This is clearly a case of self-dealing and a breach of Tim's fidicuary duty as a Trustee.

Tim may not assert his "prudent investor" defense. Obvious self-dealing is a violation of Tim's basic fiduciary duties to the trust and the "prudent investor" rule is inapliccable. That defense will fail

Additionally, Tim's defense that the clause in the trust released him from any liability will also fail. A trustee may not contract away his fundamental fidicuary duties. Thus, Tim may not engage in blatant self-dealings regardless of the clause. Tim violated his fidiciary duties when he loaned himeself the $100,000 free of interest for 6 months and his defenses will fail.

(2) The commission from the $1.5 million office building sale.

Tim violated his Trustee duties under Texas law regarding the commission from the $1.5 million office building sale. The issues are whether a Trustee may materially benefit by receiving a comssion from the sale of Trust property.

Under Texas Law, a Trustee may not engage in self-dealing regarding the property held in Trust. The Trustee may not materially benefit from the sale of Trustee property.

In the present case, Tim recieved a commission from the sale of the Trust's $1.5 million office building.

While the sale may have been prudent, as a Trustee, Tim is not allowed to collect a commission for the sale of the Trust property. This is an improper form of compensation. The Trustee may be compensated under the Trust, but not through the commission of selling the Trust Property. Just like in the last question, a Trustee may not contract away his fiduciary duty not to engage in self dealing. Thus, Tim's defense that the provision relieves him of any liability will not apply and his prudent investor defense will also not apply as to the commission.

(3)The Purchase Stock from the Bank

Tim violated his Trustee duties by using the Trust funds to purchase stock for the Trust from the Bank where Tim works as a manager.

Under Texas Law, a Trustee has a fidicuary duty not to engage in any self dealing.

Purchasing stock from the Bank where Tim works as a manager clearly qualifies as self dealing. Tim used his position as the Trustee of the Bank to benefit his employer and therefore himself. This constitues a conflict of interest and a violation of his trustee's fidiciary duty.

Under Texas Law, a Trustee may not contract away his fidiciary duties to the Trust and the Trustee. Thus, the clause stating that Tim, as the Trustee, is excused and released from any intentional misconduct" is invalid.

Accordingly, Tim may not assert the clause as a valid defense.

Furthermore, Tim will not be able to assert the "prudent investor" rule as a defense as the defense does not apply to a Trustee's breach of his fidiciary duty by engaging in self-dealing. Thus, even though the "stock value increased by 50 percent", Tim's prudent investor defense will fail, as he engaged in self dealing by purchasing the stock through his own employer.

(B) What remedies, if any, does Brad have as a result of Tim's actions as Trustee?

Brad may institute an action to revoke Tim as a Trustee and may institue a suit for damages.

Under Texas law, a Trust's beneficiary may institute a suit against the Trustee to revoke the Trustee and may file a suit for damages when a Trustee violates his fiduciary duties to the detriment of the trust.

In the present case, Tim engaged in rampant self-dealings and repeatedly violated his fiduciary duties to the trust. Therefore, Brad may file a suit to remove Tim as the Trustee and replace him with another Trustee.

Furthermore, Brad may file a suit against Tim for damages regarding is willful missuse and misapprropriation of the Trust assests. This specifically includes the commission from the $1.5 million office sale as well as the interest from the $100,000 six month loan. No damages occured from the purchase of the stock.

Question 6 – February 2019 – Selected Answer 2

Part A - Violation of duties

Tim violated his duties to the trust with the loan, the commission, and the purchase of stock form the bank. His defenses will not be valid since the duty of loyalty cannot be waived. At issue are the violations of his duties as trustee and whether his defenses can apply.

Under Texas Trust Code, a Settlor creates a valid trust when there is intent to create the trust, there are ascertainable beneficaries, and there is property in the trust. A trust also requires a trustee. Fidciuary duties of good faith, loyalty, and care are attached when a person accepts a position as a trustee. To entice a trustee to serve in the position, the Settlor has the right to limit the trustee's liability to the trust in the documents that create the trust itself. However, a Settlor cannot waive the duty of loyalty to the trust. The trustee has a duty to act in the best interest of the trust and any self-dealing act makes it impossible to do so. Any act of self-dealing will be a violation of the duty of loyalty. The trustee can be liable for these acts even if the Settlor attempts to waive the duty.

Here, a valid trust was created when Sergio left a properly executed will that establish a trust for the benefit of his minor son Brad. It appointed Tim as the trustee and deposited his real estate and stock holdings in the trust for Tim to manage. Although Sergio did include a clause excusing Tim from liaility for any conduct, negligent or intentional, he could not waive the duty of loyalty. Therefore, even with the clause, if any of the violations fall under the duty of loyalty, Tim will be liable.

The $100,000 loan

Under Texas Trusts Code, a trustee cannot make a loan from the trust to themselves regardless of whether or not the trustee pays the amount back into the trust. A trustee using the funds from the trustee as apersonal loan is a breach of loyalty. The breach of loyalty occurs as soon as the loan is made.

Here, Tim took out $100,000 as a lona to himself using trust property. It does not matter that he repaid the loan within 6 months. The breach of loyalty occurred the moment Tim took the money out of the trust property. Since a Settlor cannot release for the duty of loyalty, Tim will have breached his duty and can be liable. This action in no way benefited the trust because even if it was allowed, it was done inerest free and made the trust no money and does not fall within the prudent investor rule. The $100,000 could have stayed in the trust and generated more income for the beneficary. Additionally since the clause does not apply, neither of Tims defenses will be applicable to this action.

The commission from the $1.5 million sale and commission

Under Texas Trusts Code, a trustee cannot sell property of the trust and take a commission for the sale. This is a breach of loyalty to the trust. A trustee must act in the best interests of the trust and it would be very difficult to do that if the trustee is also gaining a commission from the sale because they hae a direct interest in what the selling price should be and might adjust that price in order to create a bigger commission for themselves. Here, Tim sold a $1.5 million office building and recieved a commission from the sale. Recieving any sort of commission is a breach of loyalty even if the sale benefited the trust. A benefit to the trust cannot be used as a defense when it is also a breach of loyalty. Therefore, Tim's defenses will not be applicable in this action.

Purchase of stock from Bank

Under Texas Trusts Code, a trustee cannot make deals that could also benefit the trustee in any way. This is a breach of loyalty. Here, Tim violated this duty when he purchased stock from the bank he worked at as a manager. Therefore, he violated the duty of loyalty.

Tim's defense that it was benefical to the Trust would still not apply because even if it is benefical it is a breach of the duty of loyalty because Tim may have had other reasons not in the best interest of the trust for making the decision to purchase the stock. When a breach occurs it does not matter whether it was benefical to the trust, it is still a breach.

Had Tim made this decision to purchase stock from a bank he didn't work at, he could have applied the prudent investor rule. The prudent investor rule protects trustees from liability for financial decisions they made that were not as successful as they had hoped. Absent gross negligence, as long as the trustee used their skill and experience and did their research before making the investment, they will not be liable if the investment is not successful. However, the defense does not apply when the duty of loyalty has been breached. Therefore, none of Tim's defenses would apply to the action.

Part B- Remedies available to Brad

Under Texas Trusts Code, as the beneficary to the trust, Brad has several options available to him.

The first option would be to remove Tim from the trust as trustee. This option may not apply anymore because Brad is 18 and the trust will likely dissolve because it's purpose has been served. The trust was only to remain in effect while Brad was a minor.

The second option available is to disgorge all of Tim's profits off of selling the building, buying the stocks, and loaning $100,000 to himself interest free. Tim would have to pay back into the trust the commission of the building and what a reasonable fee would have been to loan out the money at interest for 6 months. If he recieved any economic benefit from the purchase of the stocks he woul d need to pay that back as well. Disgorgement is proper here because Texas courts do not like to see a person unjustly enriched and profitting from their wrongdoing. Here, if Tim is not disgorged he will profit from his breach of loyalty to the trust.

The third option is for Tim to reimburse all the trustee compensation he was provided while he acted as trustee. Trustee's are allowed reasonable compensation for serving as a trustee. However, since Tim did not serve without breaching his fiducary duties, allowing him to keep his compensation would be unjustment enrichment. Therefore, Tim should have to reimburse all of the compensation he was paid back into the trust and cannot collect any that he is still owed.

The last option would be for Brad as the beneficary to ratify actions that were made. Even if the actions violated a fidcuary duty, if it benefited the trust, the beneficiaries are allowed to take advantage of those actions. Here, the stock value increased by 50%. Brad would likely want to ratify this purchase because it was benefical to the trust. When stock options are purchased and they increase in value, the increase is attributed to the trust income. However, if there had been any decrease inthe stock, the loss would have been attributed to TIm and he would have had to reimburse the trust. Ben has no option to rescind or ratify the sale of the office building since it was likely sold to a bona fide purchaser for value and would have supeiror title.

Question 6 – February 2019 – Selected Answer 3

(1)

Tim violated many duties under Texas law and has no valid defenses. The issue is whether the exculpetory clause in the trust agreement is a valid defense to Tim's violations of Texas law.

Under Texas trust law, a trust is formed when title to property is validly transferred to a trustee in trust for a beneficiary. Here, the trust was properly formed by the transfer of the property via Sergio's will.

A trustee has a fiduciary duty to the trust that generally prevents the trustee from (i) taking actions that are outside the scope of the trust agreement or (ii) personally benefitting from the assets in the trust. While a trust agreement may include a clause the reduces or eliminates liability of a trustee under the trust, such exclupation is limited to negligent or grossly negligent conduct, not intentional conduct. Doing so would relieve the trustee of his duty of loyalty.

Here, the trust includes an exclupation clause that purports to immunize the trustee from intentional conduct that would violate the trustee's fiduciary duty. Because such clauses cannot exculpaty trustee's from violations arising due to intentional conduct, it will not shield Tim from liability arising from intentional conduct.

To determine whether any of Tim's conduct violated his fiduciary duty, we must first determine the purpose of the trust. Here, the purpose of the trust is to protect and preserve the value of Serfio's real estate and stock holdings.

With respect to the $100,000, interest free loan from the trust, this action assuredly violated his duty from the trust. As noted above, a trustee cannot personally benefit from trust assets or use them for his own purposes. The personal loan constitutes self-dealing. That is conduct that directly benefits himself. Tim had use of such money during the loan period which only benefitted himself. Further, the loan to himself was also entirely unsecured. This likely violated Tim's duty to "protect and preserve" as specified in the trust agreement. An unsecured loan is entirely risky.

While Tim might argue that under the prudent investor rule he is generally free to make investment decisions so long as they could benefit the trust, this argument is unavailing. Even if this loan was beneficial to the trust under the prudent investor rule, it is impermissible self dealing and self benefit.

(2) The commission from the $1.5 million dollar sale clearly violates Texas law. Here, Tim profitted from the use of trust assets. While Tim, as trustee, is afforded a salary as trustee, a trustee cannot personally benefit from trust property. The commission on the sale of the trust represent an explicit personal benefit to Tim from use of trust property.

(3) The purchase of the stock, like the commission, is an impermissible use of trust property for personal benefit. As manager, purchase of the stock by the trust accrues a benefit to Tim as manager. Thus, this is, again, a personal benefit to Tim that is impermissble and a violation of his duty as trustee. Further, the fact that the stock gained value is immaterial. This does not relieve Tim of the liability for personally benefitting from the stock as manager.

Additionally, the trust explicitly limits the purpose of the trust to the purpose of Brad. Here, all of the benefit of this transaction accrues only to Tim.

While Tim might argue that, due to the increase in value of the stock, he is protected by the prudent investor rule, this argument will not be successful. Under the prudent investor rule, trustees are given discretion with respect to investments. All investment need to be sure things or have generate rates of return. Speculative investments that do not provide high rates of return but due have the potential for large increases in principal value are allowed. However, none of these safeharbors under the prudent investor rule shield Tim from personal liability for this transaction because of the personal benefit that Tim received.

Thus, Time will be liable under all of these transactions.

(b)

Brad has numerous remedies. First, because of these violations Brad may sue to have Tim removed as trustee. As a beneficiary of the Trust, Brad has standing to sue.

A trustee may be removed for malfeasance. Here, Tim has committed malfeasance by personally benefitting from all three of these transactions. Accordingly, removal of Tim as trustee is warranted.

With respect to the $100,000 loan, Brad may sue to require Tim to pay reasonable interest during the period of the loan. Had the loan not been repaid in its entirety, Brad may have sued Tim for the balance of the loan in addition to interest. Interst will be based on the prime rate or other rate that the court deems to be reasonable.

With respect to the commision from the $1.5 million office building sale, Brad has a right to the commission Tim earned in the sale. When a trustee benefits from trust property, the benefits are considered to be held in a constructive trust for the trust. Thus, the court may order return of the commission.

With respect to the stock transaction, a beneficiary has the right to either reject or ratify the transaction. Thus, had the stock gone down in value, Brad could have rejected the transaction and pursued Tim for the value lost in the transaction. Because the value of the stock has gone up, Brad will likely ratify this transaction and receive the benefit of the appreciation of the value of the stock.