

# ADMINISTERING TRUSTS IN RECESSIONS: TRUST LOANS TO BENEFICIARIES

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**April 21, 2020**

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# Areas of Discussion

- Today, we will discuss the following:
- Authority to Make Loans;
- Duties of Loyalty and Confidentiality;
- Duty of Impartiality;
- Duty to Properly Manage Trust Assets;
- Due Diligence Considerations;
- Loans as Distributions;
- Tax Implications;
- Claims Against Trustees; and
- Options To Limit Risk.

# Authority To Make Loans: The Trust

- Trustee should first review trust and its terms.
- If the trust prohibits a loan, absent some other action, the trustee should not make the loan.
- In this circumstance, there are other options.
- If the trust allows a loan under certain conditions, the trustee must follow the conditions.
- If the trust is silent, a trustee should conduct due diligence and follow internal procedures for making a distribution to a beneficiary and should document it.

# Authority To Make Loans: Statutes

- Some states, based on Model Code, have express statutes allowing loans to beneficiaries, but Texas does not.
- A trustee has the general power to do anything that is necessary or appropriate to carry out the purpose of the trust. Sec. 113.002.
- A trustee has the power to reinvest trust assets in property of any character. Sec. 113.006.
- “[A] trustee may invest in any kind of property or type of investment consistent with the standards of this chapter.” Sec. 117.004.
- “The powers, duties, and responsibilities under this subtitle do not exclude other implied powers, duties, or responsibilities that are not inconsistent with this subtitle.” Sec. 113.024.

# Authority To Make Loans: Common Law

- “Apart from statutorily authorized powers, a trustee can exercise only those powers expressly granted by the settlor or those necessarily implied in the trust instrument and neither the trustee nor the courts can add to or take from these powers but must permit them to stand as written, subject only to the construction intended by the settlor.”
- The power of a trustee to invest necessarily carries with it the authority to lend in proper circumstances and to agree to the time of repayment and other terms usually incident to loans of money.

# Authority To Make Loans: Other Issues

- Under the Texas Trust Code, unless a trust expressly allows such, a trustee cannot make a loan of trust funds to an affiliate, which is defined as a relative of the trustee.
- Therefore, where the trustee and the beneficiary are related, the trustee cannot make a loan to the beneficiary unless the trust document expressly allows such a loan.
- Co-Trustee approval.

# Duty of Loyalty

- A trustee owes a trust beneficiary an unwavering duty of good faith, loyalty, and fidelity over the trust's affairs.
- As a general proposition, a trustee should not administer the trust to benefit anyone but the beneficiaries.
- Where there are multiple beneficiaries, the trustee owes each of them a duty of loyalty.

# Conflict's Of Interest

- Making a loan to a beneficiary may be a conflict of interest.
- For example, if the beneficiary has an outstanding loan to the trustee, and the trustee wants to make a loan to the beneficiary from the trust so that the beneficiary can use those funds to pay off the loan to the trustee.
- A trustee, in its individual capacity, may make a loan to the beneficiary and then secure the loan with trust assets; if there is a default, the trustee will have to collect against the trust.
- A trustee should attempt to avoid conflicts of interest.
- Otherwise, the trustee should hire counsel to assist to limit risk and obtain appropriate consent from all relevant parties.

# Duty To Disclose

- A trustee also has a duty to disclose all material facts known to it that might affect the beneficiaries' rights.
- In *Shannon v. Frost Nat'l Bank*, a court of appeals found that there was a fact issue on whether a trustee breached duties by failing to inform a beneficiary that she was entitled to distributions of trust assets instead of loans from the trustee, individually, to the trust. 533 S.W.2d 389 (Tex. Civ. App.—San Antonio 1975, writ ref'd n.r.e.).
- The Restatement provides: “In matters that can be expected to affect the trust beneficiaries generally, such as decisions establishing or altering investment policy, impartiality may call for trustees to communicate—if they do so at all—with both the trust’s current beneficiary (or beneficiaries) and its primary future-interest beneficiaries.”

# Duty of Confidentiality

- The Restatement provides: “The trustee is under a duty to the beneficiary not to disclose to a third person information which he has acquired as trustee where he should know that the effect of such disclosure would be detrimental to the interest of the beneficiary.”
- But: “This duty of confidentiality ordinarily does not apply to the disclosure of trust information to beneficiaries or their authorized representatives... [T]he trustee has a duty to act with sensitivity and, insofar as practical, with due regard for considerations of relevancy and sound administration, and for the personal concerns and privacy of the trust beneficiaries.”
- May have to disclose a loan, but maybe not the purpose of same.

# Duty of Impartiality

- Texas Jurisprudence states: A trustee must act for all the beneficiaries; he or she may not properly act for only some of them. The trustee owes the same fiduciary duty to all to protect their respective interests, without partiality or favor to some at the expense of others.”
- A trustee should weigh whether loaning money from the trust to one beneficiary is fair to other beneficiaries or classes of beneficiaries.
- Potentially, a loan to a beneficiary (as opposed to an outright distribution) may be a method to be fair to other beneficiaries.

# Duty to Properly Manage Assets

- “A trustee’s fundamental duties include the use of the skill and prudence which an ordinary, capable, and careful person will use in the conduct of his own affairs as well as loyalty to the trust’s beneficiaries.”
- But, trustees who hold themselves out as having special expertise in the area of finance and investments must use this expertise in managing their trusts.
- “A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.”

# Duty to Diversify

- Trustee has a general duty to diversify assets.
- The Act does not require diversification in all circumstances.
- Rather, “A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.”

# Due Diligence

- A reasonable lender should do certain due diligence in making a loan to minimize the lender's risk.
- A lender should ensure that a borrower can repay the loan by viewing relevant documents: financial statements, W-2s, tax returns.
- A lender should attempt to have security and review documents concerning same.
- Guaranty agreements.
- Interest rates.
- Ongoing diligence after loan consummated.

# Loans As Distributions

- Because a loan to a beneficiary is inherently different from a loan to a third party, a trustee should consider whether the loan is more akin to a distribution.
- The Restatement provides: “If the trustee is reluctant for some reason to make the requested distribution, and particularly if the trustee’s concern is one of impartiality, the trustee has discretion to make a loan or advance to the beneficiary. The loan need not qualify as a prudent investment... It is a form of discretionary benefit, and may be made at a market rate of interest or at low or no interest; and funds may be advanced with recourse only against the beneficiary’s interest, without personal liability.”

# Loans As Distributions

- Some statutes expressly state that trustees can make loans to beneficiaries on less than commercially reasonable terms, but not in Texas.
- Further, a trustee may treat a defaulted loan as a distribution if the trust language so allows.
- Tax implications of a loan as a distribution.

# Documentation of Loan

- The trustee should take care to properly document the loan transaction.
- Maintain due diligence file and ongoing efforts.
- Note.
- Security Agreement.
- Deed of Trust.
- Documents should cover interest rate, payment terms, remedies, dispute resolution procedures.
- Contractually extend statute of limitations for default.

# Trusts Securing Loans

- A beneficiary may request that the trust agree to guarantee or secure a loan from a third party.
- A trustee should first review the trust document.
- There is also a specific statute that addresses encumbering trust assets: “A trustee may ... encumber all or any part of the assets of the trust as is advisable in the judgment of the trustee for the advantageous administration of the trust.” Sec. 113.015.
- A lender will likely want to make sure that the trustee has the authority to encumber trust assets.
- When a trustee wants to enter into a transaction to secure a loan for a beneficiary, it may want to provide a certification of trust.

# Trust Claims Against Beneficiaries

- If a trustee makes a loan to a beneficiary, the trustee should be prepared to collect on the loan if the beneficiary defaults, which may mean suing the beneficiary.
- Can a trustee sue a beneficiary?
- Texas Property Code Section 114.031 provides: “A beneficiary is liable for loss to the trust if the beneficiary has: ... (3) failed to repay an advance or loan of trust funds...”

# Trust Claims Against Beneficiaries

- The Texas Property Code also has a provision that allows a trustee to offset any distributions to the beneficiary due to a loss: “Unless the terms of the trust provide otherwise, the trustee is authorized to offset a liability of the beneficiary to the trust estate against the beneficiary’s interest in the trust estate, regardless of a spendthrift provision in the trust.” Sec. 114.031(b).
- If a trustee has a claim against the beneficiary, the trustee can payoff that debt by offsetting distributions otherwise due to the beneficiary from the trust.
- True even if spendthrift trust.
- Likely true even if limitations has expired.

# Trustee Liability

- Trustee has a duty to properly manage trust assets.
- If a beneficiary defaults, trustee may have a duty to pursue claims.
- The Texas Trust Code provides: “A trustee may compromise, contest, arbitrate, or settle claims of or against the trust estate or the trustee.” Sec. 113.019.
- A trustee is authorized, but not required, to pursue litigation against a debtor.

# Trustee Liability

- A trustee does not always need to pursue every potential claim.
- In determining whether to sue a party, a trustee should weigh the likelihood of success, the amount of damages, the ability of defendant to pay, and the expense of the suit.
- A trustee does not need to pursue collection efforts if the beneficiary cannot repay the loan: “A trustee may abandon property the trustee considers burdensome or worthless.” Sec.113.020.

# Trustee Liability

- Texas Estate's Code provides: "If there is a reasonable prospect of collecting the claims or recovering the property of an estate, the personal representative of the estate shall use ordinary diligence to: (1) collect all claims and debts due the estate; and (2) recover possession of all property to which the estate has claim or title." Sec. 351.151.
- If the representative fails to do so, it can be liable for the loss.
- Where there is clear liability and a defendant has the ability to pay a judgment, a trustee should generally pursue claims that would result in a benefit to the trust.
- *Ward v. Stanford*, 443 S.W.3d 334, 346 (Tex. App.—Dallas 2014, pet. denied).

# Trustee Liability

- Trustee should know the limitations period and act accordingly.
- Trustee should know the relevant law that applies to the loan transaction.
- Advice of counsel is a defense.

# Methods to Limit Risk

- Settlor can execute specific trust language that allows loans.
- Settlor can execute general exculpatory clause.
- Settlor statement on special circumstances.
- Structuring asset to limit risk.
- Directed trusts.
- Decanting.
- Settlor consent and release in revocable trusts.
- Beneficiary consent and release in irrevocable trusts.

# Methods to Limit Risk

- Beneficiary written directives.
- Trustee resolution.
- Beneficiary ratification document.
- Judicial modification of trust.
- Judicial approval.
- Disclosure of facts to start limitations.

# Conclusion

- Trustees find themselves in very difficult positions when their beneficiaries request loans from a trust.
- Of course, every situation is different and there are few black and white rules.
- A loan can set the trustee up for potential liability: to the debtor beneficiary and other beneficiaries.
- In addition to traditional fiduciary duties, the trustee may open itself up for lender liability claims as well.

# Conclusion

- In the end, the trustee should consider the impact that such a loan will have on trust assets, investment strategy, the beneficiary, other beneficiaries, and tax implications.
- The trustee and/or beneficiary should obtain financial and legal advice before completing a loan agreement and before any demand for repayment is made.

# Conclusion

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