UPIA and Diversification:

Bringing Existing Trusts into Compliance with the New Law

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The Texas versions of the Uniform Prudent Investor Act and the Uniform Principal and Income Act became effective January 1, 2004. Because the two UPIAs apply to most existing trusts, trustees have been scrambling to assure that they are administering their trusts in compliance with the new laws. The purpose of this paper is to address one of the key issues where the theoretical ideas of these enlightened new statutes meet the practical realities of trust administration – the duty to diversify investments.

The trustee's duty to diversify investments permeates the Uniform Prudent Investor Act like cheap cologne at a high school dance. The duty is expressed in Section 117.005:[1]

> 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.

Prior to adoption of the two UPIAs, the Texas Trust Code did not specifically require diversification. In fact, the Code previously contained a provision which permitted trustees to retain assets which were part of the trust estate at the inception of the trust without risk of loss due to lack of diversification.[2] Even under prior law, however, Texas courts have found that trustees have a duty to diversify. *See Jewett v. Capital Nat'l Bank of Austin,* 618 S.W.2d 109, 112 (Tex. Civ. App.–Waco 1981, writ ref'd n.r.e.). In the *Jewett* case, the settlor funded the trust exclusively with Tracor stock and the trustee never varied the investments. The appellate court

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[1] Section numbers refer to sections of the Texas Trust Code (Subtitle B, Title 9, Texas Property Code) unless otherwise indicated.

[2] Former Section 113.003, repealed effective January 1, 2004.

said that the trustee was not relieved of its liability for its "negligence in failing to diversify the corpus of the trust." So, while diversification is at the front and center of trustees' attention now that the UPIAs have been adopted, it has been a factor to be considered by trustees for a while.

Nonetheless, with the advent of the Uniform Prudent Investor Act, trustees with large holdings of a single stock or other undiversified asset have been scrambling to find bases for continuing to hold the undiversified portfolio. Generally, the justification for not diversifying falls into one of two categories:

- The terms of the trust instrument override the UPIA duty to diversify; or
- There are "special circumstances" meeting the requirements of Section 117.005 which permit retaining the undiversified portfolio.

This paper will discuss the following issues surrounding diversification:

1. What constitutes diversification? In other words, how much of a particular stock or asset can a trustee hold and consider itself reasonably sure of meeting the diversification requirement?
2. What terms in the trust instrument override the UPIA duty to diversify?
3. What are "special circumstances" which might justify refraining from diversifying?
4. How long does the trustee have to diversify?
5. What are some possible back-door traps on the diversification issue?

When studying this paper, please keep in mind that, in most cases, the question of whether or not a trustee should have sold a particular investment to meet its diversification duty will be made after the investment turns sour. Thus, the trustee is in its familiar position of being second-guessed. No one is going to complain about a lack of diversification if the undiversified investment outperforms a diversified portfolio. Complaints will come when the asset in question underperforms the market. For this reason, please keep in mind that the questions of how much of the investment was too much, are there terms of the trust that override the duty to diversify and do special circumstances justify non-diversification usually will be answered by a judge or jury at an unfavorable time for the trustee, which might affect the outcome of the litigation.

1. What Constitutes Diversification?

Neither Section 117.005 of the Texas Trust Code nor the comments of the National Council of Commissioners on Uniform State Laws (NCCUSL) or the Real Estate, Probate and Trust Law Section of the State Bar of Texas say what is the greatest percentage of a trust's assets

that may be invested in one investment if the trust still is to be considered diversified for purposes of the statute. This subjectivity on the part of the statute and comments is deliberate. Here is what the NCCUSL comment to Section 117.005 says in part:

> There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: "Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries. . . . Broader diversification is usually to be preferred in trust investing" . . . .

Therefore, no one can tell a Texas trustee with authority that x% is okay, while y% is not. The facts and circumstances of each case must be taken into account. In each case, determining whether or not a Texas court would consider a trust's investment portfolio to be diversified as required by UPIA requires an examination of court decisions and commentary and, ultimately, an educated guess about what a court is likely to do in this case.

Even prior to enactment of Section 117.005, Texas courts have required trustees to diversify investments (or held trustees liable for failure to do so) in cases where trusts held large concentrations of a particular stock which declined in value or underperformed the market. *See Jewett v. Capital Nat'l Bank of Austin,* 618 S.W.2d 109 (Tex. Civ. App.–Waco 1981, writ ref'd n.r.e.); *Neuhaus v. Richards,* 846 S.W.2d 70, 74 (Tex. App.–Corpus Christi 1992), *judgment set aside without reference to merits*, 871 S.W.2d 182 (Tex. 1994). In the *Jewett* case, Tracor stock constituted 100% of the portfolio. In *Neuhaus*, it was unclear what percentage of the trust the First City stock comprised.

In other states, courts have either required trustees to diversify or held them liable for failing to diversify in cases where 40% or more of a trust's portfolio was the stock of a single company. *See, e.g., In re Williams,* 591 N.W.2d 743 (Minn. App. 1999), *affirmed in part and reversed in part and remanded,* 631 N.W.2d 398 (Minn. App. 2001) (trustee surcharged for failing to adopt plan to reduce its 39.3% holding of Borden stock). In a recent New York case, *Will of Charles G. Dumont,* 4 Misc.3d 1003(A), 791 N.Y.S.2d 868, 2004 WL 1468746 (N.Y.Sur.) (2004), the court measured the trustee's damages for failing to diversify by assuming that the trustee should have sold enough Eastman Kodak stock to bring the holding down to 5% of the trust assets. Thus, from looking at cases from other states, it is pretty clear that a trust portfolio with no single investment constituting more than 5% of the trust assets probably meets diversification requirements, where a trust portfolio with a single investment constituting 40% to 50% or more of a trust's portfolio probably does not meet diversification requirements. These are just rough parameters, however.

2. What Terms in the Trust Instrument Override the UPIA Duty to Diversify?

The Texas Trust Code in general and Section 117.005 in particular provide default rules for trusts. These statutory rules apply if the terms of the trust do not provide otherwise. Texas Trust Code Section 117.003(b) provides:

> The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

Therefore, the terms of the trust instrument may override the diversification requirements of Section 117.005 of the Code. This is critical if trusts are to achieve a settlor's objectives.

Assume that a settlor creates a trust to hold a majority interest in a closely held entity which operates the family business, or all of the family farm or ranch. One might infer from this action that the settlor intended one of the principal purposes of the trust (perhaps the ***overriding*** purpose of the trust) to be holding that key asset. Yet, unless the settlor makes this intent clear and clearly overrides the duty to diversify, the trustee of the trust is placed in a difficult position: If he or she disposes of the asset to meet the duty to diversify, he or she may frustrate the purposes of the trust and may face liability to the disgruntled family members. On the other hand, if he or she keeps the asset, he or she may face liability to beneficiaries if, after the fact, one or more beneficiaries are able to show that the trust would have performed better with a diversified portfolio.

What language could the settlor put in the trust instrument that would make clear his or her wish that the trustee does not have to dispose of part or all of a particular asset to meet the diversification duty? Obviously, now that the UPIAs are in place, it is easier for settlors and their estate planning attorneys to express this wish.[3] Unfortunately, since the UPIAs apply to existing trusts as well as new trusts, the trustee of an existing trust has to hope the settlor expressed his or her wishes about non-diversification with sufficient clarity that the trustee reasonably can rely on the trust language.

Let's say the settlor worked for Eastman Kodak Company, accumulated a large holding in that company and wanted the trustee of his trust to be free to hold the Eastman Kodak stock without diversifying. He might put this in the trust instrument:

> It is my desire and hope that said stock will be held by my trustee to be distributed to the ultimate beneficiaries under this instrument, and my trustee shall not dispose of such stock for the purpose of diversification of investment, and my trustee shall not be held liable for any diminution in the value of such stock. The foregoing provisions shall not prevent my trustee from disposing of all or part of the stock of Eastman Kodak Company in case there shall be some compelling reason other than diversification of investment for doing so.

That provision is pretty clear, and the trustee should be able to safely hold the Eastman Kodak stock without worrying about liability to the beneficiaries, right? *Wrong!* A New York

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[3] It may be harder than one thinks to intentionally override UPIA and free the trustee to hold an asset, however. See the discussion in Subsection 5 below.

trial court interpreting this language found the trustee liable for more than $20 million in damages for failing to dump the Eastman Kodak stock when it began declining in value. *Will of Charles G. Dumont*, 4 Misc.3d 1003(A), 791 N.Y.S.2d 868, 2004 WL 1468746 (N.Y.Sur.) (2004).[4] The court reasoned that the last sentence expressed the settlor's overriding intention – that the trustee should dispose of the Eastman Kodak stock if there is a "compelling reason" to do so. Thus, the court said it was not holding the trustee liable for failing to diversify, but rather for failing to get rid of the stock for the compelling reason that it was declining in value.

That was a New York surrogate's court, and perhaps it is not likely that a Texas court would follow its lead. In another case, where the settlor was less clear in expressing his wishes about diversification, an Oklahoma court found that the trustee was protected by the terms of the trust instrument in not diversifying the investments. In *Atwood v. Atwood*, 25 P.3d 936 (Oklahoma Civ. App. 2001), the trust instrument said "the trustee shall have the power . . . to retain cash or other assets . . . for so long as they may deem advisable. . . ." The trust instrument also gave the trustee the power to invest in stocks "without being limited in the selection of any investments by any statutes, rules of law, custom or usage." This was enough for the Oklahoma court, both under the prior Oklahoma investment standard and its version of the prudent investor rule, to refuse to hold the trustee liable for failing to diversify. Note that the Oklahoma instrument made no mention of the settlor's intention that a particular stock be retained, nor did it specifically mention diversification.

Many existing trusts include a "retention" clause similar to the one in the *Atwood* case. A retention clause distinguishes between the property that the settlor initially places in the trust and investments the trustee later decides to make. If the settlor put the asset in the trust, then the retention clause permits the trustee to retain it, even if it might be inappropriate for the trustee to decide on its own to invest in that asset. Some retention clauses, like the one in the *Atwood* case, do not specifically address if the trustee's power to retain an asset trumps the duty to diversify. Others specifically mention diversification. Prior to adoption of the Uniform Prudent Investor Act in 2003, the Texas Trust Code contained a default retention provision that mentioned diversification:

> A trustee may retain, without regard to diversification of investments and without liability for any depreciation or loss resulting from the retention, any property that constitutes the initial trust corpus or that is added to the trust.

Former TEX. TRUST CODE § 113.003, repealed effective January 1, 2004.

Many Texas trusts drafted before 2004 included a retention provision modeled on this former Texas statute. If a provision similar to this is in the trust instrument, the trustee *may* be protected in retaining assets that the settlor placed in the trust. Obviously, a provision which specifically mentions no liability for failing to diversify is better from the trustee's perspective than one which merely authorizes retention of assets, but a good argument can be made that any

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[4] The author believes that, at the time this is written, the *Dumont* case is on appeal.

retention provision – even one that doesn't mention diversification specifically – is the type of provision that overrides the diversification duty.[5]

In a recent case construing a retention clause, an Ohio court reached a result opposite to that reached by the Oklahoma court in *Atwood.* In *Wood v. U S. Bank, N. A.*, 160 Ohio App.3d 831, 828 N.E.2d 1072 (2005), the Ohio Court of Appeals held that a trustee was not protected from liability for failing to diversify by the retention clause in the trust instrument at issue. In *Wood*, the trust gave the trustee the power to:

> 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.

828 N.E.2d at 1074-75.[6] The corporate trustee apparently relied on this provision to retain its own stock. In fact, when it became necessary to sell securities to pay expenses, the trustee chose to sell other investments rather than its own stock, moving the percentage of the trust's investments that were in the bank's stock from 82 percent to 86 percent.

The Ohio court said that the retention provision merely authorized self-dealing, but it did not override UPIA's duty to diversify. The court said that, to abrogate the duty to diversify, the trust must "contain specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent." *Wood*, 828 N.E.2d at 1078. It held that the duty to diversify attaches to all investments, even those already in the trust, absent special circumstances[7] or explicit authorization not to diversify. The Ohio court sloughs off Oklahoma's *Atwood* case as being "flawed in many respects." *Wood*, 828 N.E.2d at 1079.

The *Wood* case may have been a "bad facts" case – the court clearly was not pleased that the corporate trustee chose to keep its own, non-diversified stock while selling other assets to pay expenses. Regardless, *Wood* stands as a clear counterpoint to *Atwood* on the issue of whether a retention clause that does not mention diversification overrides the duty to diversify.

Given the conservative nature of the Texas judiciary and Texas's geographical and

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[5] That may not be enough to avoid liability, however. In *Jewett v. Capital Nat'l Bank of Austin*, 618 S.W.2d 109 (Tex. Civ. App –Waco 1981, writ ref'd n.r.e.), the trustee was forced to a jury trial on issues of negligence and breach of fiduciary duty for failing to diversify even though the settlor contributed the non-diversified stock to the trust. The *Jewett* court did not mention former Section 113.003, and apparently the trust instrument did not include a retention clause.

[6] The court's opinion calls this wording "unfortunate" and cautions that this type of "fuzzy drafting" can create problems.

[7] See the discussion of "special circumstances" cases in Section 3 below.

philosophical proximity to Oklahoma, perhaps the *Atwood* case is a better indicator of what a Texas court would do than the *Dumont* and *Wood* cases. In any event, these cases illustrate the following:

- Each trust is different – the trust provisions are different, the settlors are different, the assets are different and the facts and circumstances surrounding the trust are different. These differences make predicting how a court will apply the law extremely difficult.

- From the trustee's perspective, a specific provision about diversification has to be better than a general one, notwithstanding the holding in the *Dumont* case. Given a choice, a trustee would prefer to have a clear expression from the settlor that a particular asset should be retained, rather than a general expression that "the trustee can do what he or she wants."

- It is difficult – perhaps impossible[8] – to include provisions in the trust instrument that will protect the trustee from liability for not diversifying in every case.[9]

If the trustee is convinced that the settlor of a trust intended for the duty to diversify to be overridden, if the terms of the trust are not clear enough on this point to give the trustee comfort, and if the beneficiaries are supportive, the trustee should consider a judicial modification of the trust to clarify that the trustee has no duty to diversify. Under Texas law in effect through December 31, 2005, the standard for modifying trusts is high, making it relatively difficult to modify a trust. However, beginning January 1, 2006, changes to Section 112.054 of the Texas Trust Code permit a trustee or beneficiary to obtain a judicial modification of the trust terms on a number of different bases. These bases under the revised statute offer the most potential benefit to a trustee facing a tough choice to diversify or not diversify:

- A court may modify a trust if, because of circumstances not known to or anticipated by the settlor, the order modifying the trust "will further the purposes of the trust." TEX. TRUST CODE § 112.054(a)(2). If it is clear to the trustee that the settlor intended the non-diversified asset to be retained, the trustee may be able to show that the settlor could not have anticipated the change in Texas law requiring diversification and that retention of the asset furthers the purposes of the

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[8] Since a trustee may go to court to seek instructions or to seek modification of a trust, the trustee of a trust with crystal-clear instructions not to diversify may nevertheless face liability if he or she "rides a stock down" for failing to seek court relief from the non-diversification provision. See the further discussion of this subject in Section 5 below.

[9] A well-drafted exculpatory clause may protect the trustee from liability, so long as the trustee's actions are not considered to have been committed in bad faith, intentionally or with reckless indifference to the beneficiaries' interest, and so long as the trustee did not profit from the action. *See* TEX. TRUST CODE §113.059(c). An exculpatory clause does not authorize the behavior it exculpates, nor does it protect the trustee from remedies other than liability for damages (removal, court-ordered actions, etc.).

trust.

- A court may modify "administrative, nondispositive" terms of a trust if the modification is "necessary or appropriate to prevent waste or avoid impairment of the trust's administration." TEX. TRUST CODE § 112.054(a)(3). This may be a more difficult sale than the first basis noted above. Is non-diversification necessary or appropriate to prevent waste or avoid impairment of trust administration?

- If all the beneficiaries agree (using virtual representation concepts to obtain approval of remote, contingent or unknown beneficiaries), then a court may modify a trust in a manner that is "not inconsistent with a material purpose of the trust." TEX. TRUST CODE § 112.054(a)(4)(B). This may be the easiest standard to meet, but it is available only if all the beneficiaries agree.

If the trustee is presented with a happy family situation now, it might be prudent to seek modification of the trust now, rather than defending a lawsuit alleging breach of the duty to diversify later, when the family situation is not so happy and the value of the asset in the trust has declined.[10]

3. What Are "Special Circumstances" Justifying Non-Diversification?

Section 117.005 requires diversification "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The NCCUSL comments to this section give two examples of circumstances which may overcome the duty to diversify:

> (A) If a tax-sensitive trust owns an undiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding.
>
> (B) The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

These are the only two examples given. It seems reasonable to the author to add a few more examples to the list (although recognize that their inclusion here does not protect the trustee from liability):

(1) The importance to the family of maintaining organized ownership and control of the family farm or ranch.

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[10] The changes to Texas Trust Code Section 112.054 noted above become effective January 1, 2006, so any action based on the changes should not be brought until that time.

(2) A trust holding vacation property which the settlor intended to be made available for use by trust beneficiaries.

(3) An irrevocable life insurance trust holding exclusively a life insurance policy on the settlor's life.

(4) Ownership of a significant block of stock in a business that is important to the community in which the settlor lived or the beneficiaries live. For example, shares of stock in the local bank which the settlor had long maintained to benefit his community, or shares of stock in the largest employer in the settlor's community.

(5) The settlor's long-term employment by the company whose stock is owned by the trust. For example, if the settlor worked for Exxon-Mobil all of his adult life and placed a large block of Exxon-Mobil stock in the trust.

Reasons (1), (2) and (3) above seem closely related to the examples included in the NCCUSL comments and, therefore, the trustee may have some safety in relying on them as "special circumstances" justifying non-diversification. Reasons (4) and (5) stretch the envelope a bit. A trustee may feel a little more uncertain about using these reasons as "special circumstances" to avoid diversification.

In all cases, an action to judicially modify the trust terms may be appropriate to provide more certainty and protection for the trustee. *See* TEX. TRUST CODE § 112.054 and the discussion under Subsection 2 above.

A corollary to Section 117.005's "special circumstances" provision is the list of circumstances that a trustee must consider in investing and managing trust assets under the general prudent investor rule found in Texas Trust Code Section 117.004. Some of these circumstances *may* offer relief to a trustee looking for a reason not to diversify. Among the circumstances the trustee is required to consider in Section 117.004(c) are:

- "the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property."

- "an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries."

These may be useful in defending a past decision not to diversify, but they are risky to rely upon, since they don't relate to diversification specifically and since the section that specifically covers diversification includes only the "special circumstances" test. Thus, the factors in Section 117.004(c) may help a trustee's "special circumstances" argument under Section 117.005, but a court may conclude that they are not an independent basis for not

diversifying.

The Nebraska Supreme Court recently found that special circumstances existed in a trust to justify non-diversification. *In re Trust Created by Inman*, 269 Neb. 376, 693 N.W.2d 514 (2005). Mr. Inman created a trust consisting primarily of his family's farm, directing that one family member receive the income from certain specific acreage, that another family member (who happened to be the trustee) receive the income from the rest of the acreage and that the land be divided among still other family members when the income beneficiaries died. The trustee decided he wanted to buy 42 acres of the trust property from the trust and used the recent Nebraska adoption of UPIA as his basis. Since this was a self-dealing transaction, he asked the court to authorize the sale. He argued that, since the trust was not diversified, he should sell some of the land to himself so that the proceeds could be invested in a diversified portfolio. The other beneficiaries opposed the sale, and the trial court refused to authorize it.

In upholding the trial court's decision not to authorize the sale, the Nebraska court did not rely on the specific language of the trust, which appears to have clearly indicated the settlor's desire that the acreage itself pass to family members. Nor did the court rely on the trust's retention provision, which specifically permitted non-diversification.[11] Rather, the court found that special circumstances existed, overriding the duty to diversify. Several family members (including, ironically, the trustee himself) testified about the sentimental nature that "the family farm" held for them. The court also cited the Nebraska equivalent of Texas Trust Code Section 117.004(c)(8) – an asset's "special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries" – as justifying the court's decision not to authorize the sale for diversification purposes. This holding helps support the idea that the circumstances to be considered in Section 117.004(c) may form an independent basis for justifying non-diversification.

The *Inman* case shows that the "special circumstances" and "special relationship" language in Texas Trust Code Sections 117.004 and 117.005 may protect the trustee from liability for retaining a family farm or ranch without diversifying, but what about stock in a publicly traded company? In *Wood v. U.S. Bank, N. A.*, 160 Ohio App. 3d 831, 828 N.E.2d 1072 (2005), the same Ohio court which said that the retention clause in the trust did not override the duty to diversify remanded the case to the trial court because the trial court's charge to the jury did not adequately address the "special circumstances" issue. The court cites Nebraska's *Inman* decision and offers this insight:

> The "special circumstances" language generally refers to holdings that are important to a family or a trust. For example, in [the *Inman* case] the Nebraska Supreme Court recently held that there was no duty to diversify when the asset in question was a piece of farmland that had a special meaning to the family. We realize that Firstar stock is not farmland. But perhaps it had a special relationship

[11] These grounds may have been overlooked because it was the trustee who wanted to sell the asset, and these grounds merely authorized the trustee to hold the asset without requiring him to do so.

> to the family or to the trust. Or perhaps it did not. Further, this was not the case of a controlling interest in a family business – which might normally be an example of special circumstances. Either way, this question was for the jury. But the trial court's instructions improperly removed that question from the jury's consideration.

Woods, 828 N.E.2d at 1079. This supports the idea that a trustee's retention of a non-controlling interest in publicly traded stock may meet the "special circumstances" standard.

4. How Long Does the Trustee Have to Diversify?

Section 117.006 anticipates that, upon becoming trustee, the trustee cannot (or, perhaps, should not) immediately bring the trust into compliance with the Prudent Investor Act. Rather, the trustee needs a little time to bring the trust into compliance. Section 117.006 provides:

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

The NCCUSL comments for this section offer further guidance:

> The question of what period of time is reasonable turns on the totality of factors affecting the asset and the trust. The 1959 Restatement took the view that "[o]rdinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year." Restatement of Trusts 2d §230, comment *b* (1959). The 1992 Restatement retreated from this rule of thumb, saying, "No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities." Restatement of Trusts 3d: Prudent Investor Rule §229, comment *b* (1992).

By its literal terms, Section 117.006 ***does not apply to the actions of a trustee that existed when the Prudent Investor Act became effective.*** Rather, it applies when a person becomes a trustee. There is no statutory provision saying how long the trustee of an existing trust has to bring that trust into compliance with the new law, which became effective January 1, 2004. Still, Section 117.006 and the comments under that section offer some guidance for existing trustees. For the same reason that Section 117.006 gives a new trustee a "reasonable time" to review assets and make and implement decisions, it is reasonable to assume that the trustee of an existing trust has a reasonable time after January 1, 2004, to do the same things.

Note that Section 117.006 anticipates three distinct actions. Trustees should document the actions they take with respect to each and be prepared to defend those actions if they are

challenged later:

(1) First, the trustee ***reviews trust assets***. Presumably this action needs to occur immediately after becoming trustee or shortly thereafter.

(2) Second, after reviewing the assets, the trustee ***makes decisions concerning the retention and disposition of assets***. Presumably the trustee decides that certain assets need to be retained and others need to be disposed of. Note that this step does not require the trustee to dispose of the asset. Rather, it requires the trustee to decide that an asset should be disposed of. It is during this phase that a trustee should consider if the terms of a trust instrument relieve him or her from the duty to diversify, if there are special circumstances justifying non-diversification or if the trust should be judicially modified to clarify the settlor's intention regarding diversification.

(3) Third, the trustee ***implements his or her decisions*** concerning the retention and disposition of assets. Factors which enter into this phase include the tax effects of the sale of the assets, the marketability of the assets, maximizing the value of the assets, etc.[12]

If the trustee has not completed the third of the above steps, he or she should be prepared to show that steps one and two have been completed and step three is under way.

5. Are There Other Diversification Traps?

The *Dumont* case, discussed in Subsection 2 above, illustrates that just because the duty of diversification is inapplicable to a trust does not mean that the trustee has no liability for failing to dispose of an undiversified asset. The duty of diversification is just one duty a trustee owes. The trustee also has duties of prudence and loyalty that could impact his or her duty to dispose of an asset. For example, it wasn't because of a duty to diversify that the *Dumont* trustee was held liable. Rather, it was a breach of its duty of prudence – it had the power to sell the undiversified stock if a "compelling reason" other than diversification presented itself, and it was imprudent for the trustee to fail to sell the stock when it declined in value.

Another duty which might enter into the mix is the duty of loyalty. Say, for example, two sisters own all of the stock of a small business. One sister dies, placing all of her stock in the closely held company in a trust and naming her sister as trustee. Even if the trust contains an express provision that the trustee does not have to sell the stock to meet its diversification duty, the trustee still may face liability to the beneficiary if she fails to sell the stock because of her own personal benefits received from the closely held business.

Finally, even if the trust terms appear iron-clad, a trustee may have a duty to get a court

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[12] See Texas Trust Code Section 117.004(c) for a list of factors which may be considered.

to grant "relief" to permit the sale of an asset if prudence dictates that the asset should be sold. Say, for example, that the settlor said in the trust instrument "the trustee shall never sell the xyz stock," and the trustee foresees that the xyz stock is likely to decline in value to the point where it becomes worthless. The trustee may have a duty to the beneficiaries to seek court permission to sell the xyz stock, even though the terms of the trust could not have been clearer.

Of course, the biggest diversification "trap" is the second-guessing nature of virtually any lawsuit brought on the diversification issue. Beneficiaries are unlikely to raise the non-diversification issue if the non-diversified investment outperforms a diversified portfolio. It is only in cases where the non-diversified investment falters that the trustee is likely to be sued. The trustee, therefore, will be having to defend his or her decision not to diversify at a time when everyone in the courtroom can see that the trust and its beneficiaries would have been better off had the trustee diversified.