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Holding Family Business Interests In Trust

Does a trustee's duty to diversify override a settlor's intent?

Diversify, diversify, diversify. That's the mantra for trust investing under the Uniform Prudent Investor Act (UPIA), which has been adopted in some way, shape or form in virtually every state. It makes sense. Having all of your eggs in one basket can be dangerous. Look at Lehman Brothers and Enron. But what if the concentrated stock position in the trust is a controlling interest in a family business, and the trust's primary purpose is to perpetuate family control? In this situation, the trust's purpose would seem to override the duty to diversify. But does it? Without proper planning, the answer is unclear. But, by following certain best practices in the establishment and management of the trust, we as advisors can help our business-owner clients and their trustees minimize the duty to diversify without prohibiting the sale of the business, if that were ever necessary or desirable.

Traditional Trust Investing

Traditionally, trust investing in the United States boiled down to generating income and preserving principal. In the seminal 1830 case, *Harvard College v. Amory,*[1] the Massachusetts Supreme Judicial Court set forth what would become known as the "prudent man-prudent person" standard for trust investing. According to the court, a trustee "is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."[2]

Although this seems like a flexible standard, subsequent courts and state legal list statutes (that is, statutes that describe which investments are permissible for a trust and which aren't) interpreted the prudent man-prudent person rule narrowly to require a trustee to preserve principal or face potential surcharge. Courts analyzed the performance of each investment in the trust separately. So, even though overall trust assets increased in value, a trustee could still be surcharged if an individual asset lost value. The prudent man-prudent person standard required a trustee to invest cautiously and avoid "speculative assets." As the stock market began its spectacular rise, first in the 1960s and then again in the 1980s, many trusts didn't participate in the upside, because they were invested primarily in bonds. In the 1990s this began to change, with trust law belatedly adopting modern portfolio theory, which had already been the standard for institutional investors for at least two decades.

Modern Portfolio Theory

According to modern portfolio theory, which deals with the relationship between investment risk and investment return, there are two types of risk: good and bad. Good risk is known interchangeably as "market risk" or "systematic risk." This relates to those risks applicable to all companies. For example, the recent financial recession would be considered market or systematic risk. This type of risk can't be diversified away. Bad risk, also known as "firm-specific risk" or "unsystematic risk," however, can and should be diversified away. This includes risks associated with a particular company or industry. Think

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of AIG, Bear Stearns and Lehman Brothers from the recent financial downturn. If you had all of your money in any of these particular stocks, you would now be broke or close to it. If, on the other hand, you had all of your assets in an S&P 500 index fund, you would have dealt with the market or systematic risk that occurred because of the 2008 downturn, but you would still have the vast majority of your assets. A basic premise of modern portfolio theory is that investors need to have a compelling reason for not maintaining a diversified portfolio, since firm-specific or unsystematic risk can be avoided through diversification.

UPIA

The law of trust investing has gone through a massive transformation over the past two decades, beginning with the publication of the *Restatement of the Law (Third) of Trusts: Prudent Investor Rule* (the *Restatement (Third))* in 1992, whose revised standards of trust investing based on modern portfolio theory were incorporated into the provisions of the UPIA in 1994. In general, the UPIA provides that a trustee shall invest and manage (including ongoing monitoring) 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. A trustee's investment and management decisions regarding individual assets must be evaluated not in isolation (as was the case under prior law), but in the context of the trust portfolio as a whole and as part of an overall investment strategy with risk and return objectives reasonably suited to the trust.

According to UPIA Section 3, a trustee is required to diversify the investments of the trust unless the trustee determines that, because of "special circumstances," the trust's purposes are better served without diversifying. The diversification requirement applies not only to trust assets purchased by the trustee, but also to assets received by the trustee from the settlor. Special circumstances include the wish to retain a family business. In that situation, according to the UPIA, the purposes of the trust sometimes override the conventional duty to diversify.

It's important to note that UPIA Section 1(b) provides that the prudent investor rule is a default rule that may be expanded, restricted, eliminated or otherwise altered by the provisions of the trust. And, according to Section 1(b), a trustee isn't liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the trust's provisions.

The grantor's wish to retain a family business is a special circumstance that can sometimes override the duty to diversify.

A simple reading of the UPIA alone should provide great comfort to both the settlor and trustee of a trust holding a concentrated position in a family business. The grantor's wish to retain a family business is a special circumstance that can sometimes override the duty to diversify. If the settlor is concerned about the uncertainty associated with the word "sometimes," he needn't be, since the prudent investor rule is merely a default rule, which can be overridden by a specific waiver of the duty to diversify in the trust instrument. If only it were that simple. The *Restatement (Third)*, case law and the Uniform Trust Code (UTC) create uncertainty that would never be apparent from the provisions of the UPIA. It's only by looking at this broader context that we come to understand that the law regarding diversification is in a continuing state of flux, and results can differ dramatically from state to state and from judge to judge.

The *Restatement*

When seeking to interpret the UPIA, the best place to start is the *Restatement (Third)*. Think of it as the

legislative history. Although the *Restatement (Third)*, like the UPIA, provides that the terms of the trust can override the diversification requirement, it does so by categorizing such provisions as "mandatory" or "permissive." Mandatory provisions should be respected. Permissive provisions, like precatory language, aren't binding on the trustee.[3]

A mandatory provision requires the trustee not to sell a specific concentrated position. Unless violative of some public policy, the *Restatement (Third)* provides that mandatory provisions are legally permissible and are ordinarily binding on the trustee in managing trust assets, often displacing the typical duty of prudence. A court may, however, direct noncompliance with a mandatory provision when, as a result of circumstances not known or anticipated by the settlor, technically referred to as "changed circumstances," compliance would defeat or substantially impair the accomplishment of the trust's purposes. According to the *Restatement (Third)*, under these circumstances, the trustee may have a duty to apply to a court for permission to deviate from the trust's terms.

Under the *Restatement (Third)*, when the trust's terms merely authorize, but don't mandate, a particular investment, the provision is permissive rather than mandatory. A trustee isn't under a duty to make or retain investments that are made merely permissive by the trust instrument. The fact that an investment is permitted doesn't relieve the trustee of the fundamental duty to act with prudence. A trustee must still exercise care, skill and caution in making decisions to retain the investment. In addition, mere authorization regarding retention of an investment or type of investment doesn't exculpate the trustee from liability for failure to diversify.

The extent to which a specific investment authorization may affect the typical duty to diversify a trust portfolio can be a difficult question of interpretation. Because permissive provisions don't abrogate a trustee's duty to act prudently, and because diversification is fundamental to risk management, trust provisions should be strictly construed against dispensing with the diversification requirement altogether. Nevertheless, the *Restatement (Third)* provides that a settlor's special objectives may relax the degree of diversification required by a trustee. In this way, the *Restatement (Third)* appears to be consistent with the exception to diversification for "special circumstances" in the UPIA. But, in both cases, the relaxation of the diversification rules is qualified, and, therefore, a trustee may not rely on those rules with any certainty.

Case Law

In interpreting the duty to diversify under the UPIA, the courts, at first blush, appear to be all over the map. But, upon careful reflection, we can discern four distinct themes. The first three themes depend on the language in the trust regarding diversification. First, the cases seem to be least favorable to trustees when the trust instrument is silent on diversification, with no specific language overriding the UPIA diversification requirement, particularly if the trust is funded with a non-controlling interest in a public company. Second, outside of New York (and to a lesser extent, Ohio), most trustees have had good luck with "retention clauses," even those that fall into the "permissive" category (particularly specific permissive retention clauses). Third, results for trustees have been mixed when a trust didn't include a retention clause, but did include exculpatory language relieving the trustee from certain breaches of trust. The fourth theme relates not to trust language, but rather to the special circumstances associated with family business interests being held in trust when the trust is silent on retention and the duty to diversify, and there's no exculpation clause. Trustees have generally been successful in situations in which the special circumstances exception to diversification has applied.

Trust Silent

There's little justification for a trustee who fails to diversify out of a concentrated stock position in a publicly traded stock when the settlor's family doesn't control the company, and the trust instrument is silent regarding diversification. In the absence of specific trust language or special circumstances, UPIA Section 3 provides that a trustee "shall" diversify the assets of the trust. This includes both assets received from the settlor, sometimes referred to as "inception assets," and those subsequently acquired by the trustee.

Since New York is both the strictest state regarding diversification and has had the greatest number of diversification cases, we'll begin there. The first case, *In re Janes*[4] (which was under the former prudent person standard prior to the UPIA) involved two trusts funded at the settlor's death exclusively with shares of Kodak (which filed for Chapter 11 bankruptcy this past January,

illustrating the concept of firm-specific or unsystematic risk). At the time of the decedent's death, the stock was valued at $135 per share. The trusts were silent regarding the retention of the stock. By 1978, Kodak stock was at $40 per share. The trusts were terminated in 1980, and the trustee filed a final judicial accounting. The beneficiaries requested that the trustee be surcharged for failure to diversify out of the Kodak stock. The New York Court of Appeals agreed and surcharged the bank trustee $4 million, holding that, based on the facts and circumstances, the trustee should have divested the Kodak stock no later than Aug. 9, 1973, shortly after the decedent's death.

In re Rowe[5] was a case similar to *Janes* (also decided on the former prudent person standard), involving a New York testamentary trust funded in 1989 with 30,000 shares of IBM. Although some of the beneficiaries expressed concern to the bank trustee regarding the investment strategy, and the trust was silent regarding retention, the trustee held on to most of the IBM stock for more than five years while the value of IBM stock declined from $117 per share in 1989 to $74 per share in 1994. Needless to say, the trustee was surcharged and forced to pay $630,000, because the judge found that the IBM stock should have been sold by January 1990, shortly after the decedent's death.

Bottom line: A trustee of a trust funded with a non-controlling concentrated position in a publicly traded stock has no justification for failure to diversify, if the family doesn't control the company and there's neither retention language nor exculpatory language.

Retention Clauses

According to the *Restatement (Third)* Section 228, retention clauses come in two forms: (1) mandatory, and (2) permissive. A mandatory clause is typically binding on a trustee, although such clauses are extremely dangerous because the trustee can only sell the concentrated position under a mandatory provision by petitioning the court, asserting that because of changed circumstances, the stock should be sold. By that point, it may be too late and the stock could be worthless. So, business owners should avoid strict mandatory provisions.

Permissive provisions come in two types: specific and general, which can include a broadening of trustee investment discretion. In a specific permissive clause, the grantor specifies a certain security or type of security that's to be retained. Usually, such a clause relates to the particular asset or assets that funded the trust. In a general retention clause, the grantor doesn't mention any specific asset or assets, but instead permits the trustee to retain any assets received from the grantor.

Mandatory retention provisions. As discussed above, because of their inflexible nature, mandatory retention provisions aren't typically used. One case involving a mandatory retention provision is *In re Pulitzer's Estate*,[6] a New York case from the early 1930s. The case involved a trust established under the will of Joseph Pulitzer, creator of the Pulitzer Prize. The will included language prohibiting the trustees, under any circumstances, from selling "any stock of Press Publishing Company, publisher of 'The World' newspaper."[7] The trustees were Pulitzer's three sons. They petitioned the court to waive the mandatory sale provision, arguing that the company had operated at a loss for five years and that if the company weren't sold, it might become worthless. The court applied the doctrine of "changed circumstances," reading into the will an implied power to sell. In reaching its holding, the court said that it would be guided by the policy of protection of the trust funds rather than blind obedience by the trustee to the language used by the testator.

Permissive retention provisions. The New York Surrogate's Court decision in *In re Charles G. Dumont*[8] should serve as a cautionary tale for any trustee who feels shielded from liability because of a specific permissive retention clause. *Dumont* involved a trust created under a will that was funded with Kodak stock. The will included a specific permissive provision stating that it was the testator's "desire and hope that ... neither my Executors or my said Trustee shall dispose of such stock for the purpose of diversification of investment and neither they nor it shall be liable for any diminution in the value of such stock."[9] The will went on to provide, however, that the "foregoing provisions shall not prevent my said Executors or my said 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."[10]

Although the language in the will provided for specific retention of the Kodak stock by the trustee and included an exculpation clause relieving the trustee from liability for failure to diversify, the New York Surrogate's Court awarded $21 million in damages to

the beneficiaries. The court found that although the language in the will clearly waived the duty to diversify, it didn't waive the trustee's duty to prudently manage the concentrated stock position.

The appellate court subsequently overturned the *Dumont* judgment based on a technicality, but it should be noted that the appellate court didn't disagree with the lower court's decision that a waiver of the duty to diversify doesn't relieve the trustee from managing the concentration prudently and, therefore, diversifying. Since the specific retention provisions in the will were permissive, rather than mandatory, they didn't relieve the trustee from the fundamental duty to act with prudence. The takeaway from *Dumont* is that trustees relying on specific permissible retention clauses should never become complacent. Without a mandatory provision to rely on, the trustee may find himself at the whim of a judge, particularly if that judge happens to be in New York. Having said that, courts outside of New York would typically find in favor of a trustee if faced with facts similar to those in Dumont and almost certainly in the case of a trust funded with a family business, the purpose of which was to perpetuate family control.

A good example of a case outside of New York featuring a specific permissive provision involving a family business is the Michigan Court of Appeals decision in In the Matter of the Jervis C. Webb Trust.[11] *Webb* involved two trusts funded with concentrated positions in the Jervis B. Webb Company, a closely held family business. One of the beneficiaries of both trusts, a direct descendant of the founder and the former general counsel of the company, sued the trustees for failure to diversify the assets of the two trusts and invest in stocks that paid higher dividends.

The company was the quintessential family business. Founded in 1919, it had grown significantly over the years, but remained closely held, and its leadership had passed among generations of the Webb family. In addition, almost all of the company's stock was held by family members or their trusts.

Both trust agreements included language specifically allowing the trustees to retain the stock of the company and relieving the trustees of the duty to diversify. One of the trusts also made it clear that the settlor intended that the trustees retain the company stock so that the family could maintain control of the company and continue to have employment opportunities within it. The trial court determined that both trusts relieved the trustees of any duty to diversify. The Michigan Court of Appeals agreed. The facts of *Webb* provide an excellent example of a trust funded to retain control of a family business. Although specific permissive language was included in each trust, and the duty to diversify was waived, the trustees weren't bound by a mandatory provision, but could sell if the trust circumstances changed—for example, if a sale were necessary because of changed economic circumstances.

What about general permissive retention clauses? A relatively recent case involving a general retention clause is *Wood v. U.S. Bank, N.A.*,[12] which involved a testamentary trust funded almost exclusively with the bank trustee's own stock. It's important to note that the retention clause didn't name any particular stock to be retained or waive the duty to diversify. The retention language permitted the trustee "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 a class of investments a trustee may be permitted by law."[13] In ruling against the trustee, the court held that, even if the trust document allowed the trustee to retain assets that wouldn't typically be suitable, the trustee's duty to diversify remained, unless there were "special circumstances." The court went on to note that the provisions of the Ohio Prudent Investor Act were default provisions and, therefore, could be overridden by specific trust language. According to the court, "a trustee's duty to diversify may be expanded, eliminated, or otherwise altered by the terms of the trust."[14] But, the court continued that "this is only true if the instrument creating the trust clearly indicates an intention to abrogate the common-law, now statutory, duty to diversify."[15]

The court in *Wood* made some other interesting points that are helpful in drafting proper retention language. It mentioned that the trust said nothing about diversification and that the retention language smacked of boilerplate. The court stated 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."[16]

A second case involving a general retention clause that was favorable to the trustee is *Americans for the Arts*

v. Ruth Lilly Charitable Remainder Annuity Trust.[17] This case involved two charitable remainder trusts funded exclusively with $286 million in Eli Lilly & Company stock. Both trusts contained the same retention language allowing the trustee:

> to retain indefinitely any property received by the trustee … and 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.[18]

The court had no issue with the language, holding that the general retention language combined with the clause explicitly lessening the trustee's duty to diversify were sufficient to except the bank trustee from "the default duty to diversify trust assets."[19]

Can we reconcile the holdings in *Wood* and *Lilly*? The trust in *Lilly* specifically waived the duty of the trustee to diversify, but the trust in *Wood* didn't. Is this enough to hang your hat on as a trustee? Although other courts have reached the same result, without the addition of a specific retention provision and, perhaps, exculpatory language, there are no guarantees of success. Even then, in a state like New York, if the trust is funded with a non-controlling interest in a public company, even these additions may not be sufficient to protect the trustee from liability for the failure to diversify.

Exculpation Clauses

Although exculpation (or exculpatory) clauses come in many shapes and sizes, in their purest form they don't act as a waiver of the duty to diversify, but, rather, relieve the trustee from liability for failure to exercise the fiduciary duties of care, diligence and prudence. The trustee is typically relieved of liability for breach of trust unless he's acting in bad faith or there's gross negligence. This standard is a dramatic reduction in the typical fiduciary standard, which is the highest standard of law. A number of states, including California and New York, prohibit certain types of exculpation clauses as against public policy. New York Estates, Powers and Trusts Law Section 11-1.7 provides that a provision in a will or testamentary trust relieving a trustee from liability for "failure to exercise reasonable care, diligence and prudence is contrary to public policy." In states where there's no statutory prohibition against exculpation clauses, most courts don't find that exculpation clauses are against public policy. But that doesn't mean courts will respect them.

In re Trusteeship of Williams[20] involved a testamentary trust funded almost exclusively with the decedent's closely held stock. Although the business was sold to a public company (Borden), the Borden stock represented 98 percent of trust assets in 1980. Even though the three trustees (two individuals and a bank trustee) eventually began to diversify, by 1990, the Borden stock still represented 40 percent of trust assets. During this time, Borden stock was on the decline. One of the three trustees wanted to continue diversifying, but the other two (including the bank trustee) voted to continue to hold the Borden stock until it recovered some of its value. It didn't. The value of the stock dropped from $36 to $14 per share by 1995. The beneficiaries sought to surcharge the bank trustee. The bank argued that it was protected from liability by an exculpation clause. The clause provided that no trustee "shall be liable for any loss by reason of any mistake or errors in judgment made by him in good faith in the execution of the trust."[21]

> A trustee relying exclusively on an exculpation clause does so at his own peril.

The appellate court in Minnesota didn't agree and remanded the case for further findings. According to the court, although exculpatory clauses aren't necessarily against public policy in Minnesota, the clause in question wasn't sufficient to protect the trustee from losses due to negligence. The court stated that exculpation clauses should be strictly construed against the trustee. Regarding the specific clause, the court ruled that it only protected the trustee against "mere errors of judgment,"[22] not negligence. The court found that if the settlor had wanted to relieve the trustee of liability for negligence, the trust would have said so. On remand, the trial court held that the trustee had, in fact, been negligent in failing

to diversify the Borden stock and surcharged the bank trustee $4 million. This case stands for the proposition that if exculpation clauses on their own (without any additional retention language or waiver of the duty to diversify in the trust instrument) are going to be effective, they should be tailored to particular circumstances (and not boilerplate) and include a waiver of negligence. Even then, a trustee relying exclusively on an exculpation clause does so at his own peril.

Special Circumstances

As already discussed, UPIA Section 3 provides that 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." According to the comment to UPIA Section 3, circumstances can overcome the duty to diversify. The comment provides two examples. First, "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." The second example involves the wish to retain a family business "in which the purposes of the trust sometimes override the conventional duty to diversify."

In addition, the *Restatement (Third)* states that a settlor's special objectives may relax the degree of diversification required of the trustee. In this way, the UPIA and *Restatement (Third)* seem consistent.

The problem with the special circumstances exception is that there's not much case law directly on point in the context of family businesses, particularly under circumstances in which there's no retention clause or exculpatory language. The New York appellate case *In re Hyde*[23] falls into this category. *Hyde* involved contested accountings for three trusts funded with large concentrations of Finch Pruyn common stock. Finch Pruyn was a closely held family business engaged in manufacturing. Each trust granted the trustees absolute discretion in managing trust assets, but contained no directions, specific or general, regarding the disposition of the Finch Pruyn stock, and neither trust waived the duty to diversify.

The issue in question was whether the trustees' management of the trusts comported with the prudent investor rule, which became effective in New York on Jan. 1, 1995, and, specifically, whether the trustees failed to adequately diversify the investment portfolios of the trusts. Because of an ownership structure involving voting and non-voting stock, the trustees, after meeting with investment bankers, determined that a fair price for the trust's stock couldn't be obtained. Finch Pruyn also wouldn't redeem the trusts' shares, except at a heavily discounted value. In finding in favor of the trustees, the court referenced special circumstances, including the fact that a sale would result in large capital gains and the gridlock engendered by the company's capital structure, noting that it "may have been intended by Finch Pruyn's founders in order to sustain Finch Pruyn as a family business."[24] It's important to note, however, that special circumstances weren't the only reason the court found in favor of the trustees. The court also looked at the fact that after the trustees made a great effort, they could find no buyers. The fact that it was impossible to sell the stock appeared from the decision to be just as important as the special circumstances that the trust held an interest in a family business.

UTC

No discussion of holding family business interests in trust is complete without an understanding of the role the UTC plays in the more than 20 states that have adopted it. The UTC is the first national attempt to codify the law of trusts. The UTC was drafted in cooperation with the authors of the *Restatement (Third)*.

The UTC is made up primarily of default provisions that the settlor can override. But, the UTC also includes certain mandatory provisions that the settlor can't override. One of these provisions is set forth in UTC Section 404, which "requires that a trust and its terms be for the benefit of the beneficiaries." Yale Law School Professor John Langbein, who's perhaps the most respected (although at times controversial) academic regarding the law of trusts, believes that the UTC's benefit-the-beneficiaries rule may, in most circumstances, require a trustee to diversify trust investments. If, in fact, the rule mandates a trustee to diversify trust investments regardless of the settlor's intent, as expressed in the trust instrument, where does this leave trusts funded with family business interests in states that have adopted the UTC? Although Langbein says that retaining family business stock in some circumstances benefits

the beneficiaries, this isn't always the case. According to Langbein:

> the benefit-the beneficiaries rule requires that a prudent trustee who is directed by the trust terms to retain a troubled family enterprise should investigate whether doing so would be sufficiently inimical to the interests of the beneficiaries of the trust that the trustee should petition the court for instruction.[25]

Otherwise, says Langbein, a trustee could potentially be found liable for failure to diversify. Although Langbein's position may sound extreme, it's not that different from the *Restatement (Third)'s* position—in the case of a mandatory provision, when there have been significant changed circumstances, a trustee may have a duty to a apply to a court to deviate from the trust's terms.

In *National City Bank v. Noble*,[26] the plaintiffs argued that the trustee should have diversified out of J.M, Smucker, a public company controlled by the Smucker family. Although the case was decided a little more than a year before Ohio adopted the UTC, the plaintiffs used the benefit-the-beneficiaries argument to assert that the trustees should have diversified. Specifically, they claimed "that when the Trust Agreement is read as a whole, it is evident that Welker Smucker's primary concern was to create a trust to benefit his heirs and not merely to retain Smucker stock."[27]

Noble involved a trust established in 1965 by Welker Smucker, son of the founder of the J.M. Smucker Company, for the benefit of his two children. The trust was funded primarily with Smucker stock. The trust included a specific permissive provision whereby the trustees were "expressly empowered to retain as an investment, without liability for depreciation in value, any and all securities issued by The J.M. Smucker Company, however, and whenever acquired, irrespective of the portion of the trust properly invested therein."[28] The trust also specifically waived the duty to diversify and included an exculpation clause.

Some of the beneficiaries sued the trustees for failure to diversify, because the stock had lost 52 percent of its value. However, the court disagreed. According to the court, the settlor was crystal clear in his desire to have the trustees retain the Smucker stock, without liability for any decline in value. The court found that the special circumstances exception to the duty to diversify applied, since Smucker, although public, was a family business controlled by the Smucker family.

This sounds like a definitive rebuttal of the benefit-the-beneficiaries argument in the context of family business interests held in trust. Or does it? The court went on to state that, although the trust had lost some value in the 1990s, "it is unquestionable that the value of the trust increased since inception—providing both for the retention of Smucker stock and for the benefit of the beneficiaries."[29] Would the result have been different if the value of the Smucker stock in trust was less at the time of the suit than when the trust was funded in 1965? Unfortunately, that wasn't discussed, leaving us with less certainty than we would have hoped. It's interesting to note that although the 1990s may not have been great for Smucker stock, for the 10 years from 2000 to 2010, the stock's value increased 309 percent, while the S&P 500 lost 15 percent.

The more specific a permissive retention clause is, the better the chances are that courts will respect it.

Best Practices

How can we as advisors sort through this sometimes conflicting body of law to advise clients who want to fund trusts that hold concentrated positions in closely held family businesses to perpetuate family control, without being forced to diversify and without having to use mandatory retention language that could be a problem if it were ever necessary or desirable to sell the stock quickly? There are best practices that, when combined, can increase a trustee's comfort level regarding holding family business stock without a mandatory provision requiring retention. They include:

1. **Retention clause.** A specific permissive retention

clause is typically the best approach. A mandatory clause, even one that includes certain objective standards for sale, is too risky if a quick sale were ever necessary and, therefore, should be avoided. The specific permissive clause should reference the reason for permitting a trustee to retain the specifically named stock (for example, to perpetuate family control of the business), along with both an authorization to retain and a waiver of the duty to diversify, both specifically referencing the stock to be retained. The more specific and less like boilerplate a specific permissive retention clause is, the better the chances are that courts will respect it.

2. Exculpation clause. An exculpation clause on its own may not be enough to protect a trustee from the failure to diversify. However, an exculpation clause drafted to relieve a trustee from loss in value of a specific security that also includes a waiver of negligence may add incremental protection when combined with a specific retention clause.

3. Special circumstances. Relying on the special circumstances exception in UPIA Section 3 for retaining a family business should be of help in most states. Having said that, expressly referring to the special circumstance of retaining family control of a family business in a specific permissive clause that permits retention of the specific stock; waives the duty to diversify the specific stock; and provides exculpation regarding the specific stock, should provide greater protection for the trustee.

4. Delegation. Under the UPIA, trustees can delegate their fiduciary duties to invest trust assets. If done properly, and if the trustee continues to monitor, delegation typically relieves the trustee from liability for trust investments. There's no certainty, however, that diversification, which is central to the UPIA, can be waived through delegation, since the duty to monitor might be interpreted to include the duty to diversify. Having said that, delegating investment responsibility regarding the family business interests held in trust to a family member co-trustee may provide some relief to the independent co-trustee.

5. Impossibility of sale. Another way to deal with the diversification issue is to take the decision out of the trustee's hands. This isn't done through the use of a mandatory retention provision, but rather through rigid transfer restrictions in a buy-sell agreement that all shareholders, including the trust, are party to, which make it virtually impossible for the trustee to sell without the approval of all of the other shareholders. A second approach is to recapitalize the company between voting and non-voting stock and only fund the trust with the non-voting shares. This, combined with the buy-sell, can make it virtually impossible for the trustee to sell the shares. Presumably, these restrictions would need to be in place before the stock was transferred to the trust. It's doubtful that restrictive agreements entered into by the trustee post-transfer would have any effect on the duty to diversify.

6. Beneficiary communication and consent. Just as studies have shown that doctors with good bedside manners are sued less often than doctors without them, good relations between the trustee and the beneficiaries go a long way toward reducing a trustee's liability exposure. Good relations are based on good communication, which should be regular and comprehensive. In addition, communication is a two-way street and requires not only that the trustee communicate with the beneficiaries, but also that he listen to their concerns. Sometimes trustees have beneficiaries sign retention letters. Such letters have proved of little value in court for a variety of reasons, including the lack of sophistication of the beneficiaries, the question of whether such letters are legally binding, the continuing duty of the trustee to inform the beneficiaries regarding developments in connection with the stock and the fact that retention letters typically bind only the beneficiaries who sign them. Therefore, such retention letters can prove more trouble than they're worth.

7. Decline in value. Taking the best practices referenced in points 1 through 6 above and using them in combination goes a long way to protect a trustee from failure to diversify. But, overcoming the duty to diversify with respect to family business interests held in trust isn't the whole story. There are also practical issues. What if the stock is declining in value or the stock in trust is in an industry that, because of technology, may not exist in a decade? It would be the rare settlor who would want the entire value of his business to disappear to preserve family ownership. That's why we recommend specific permissive provisions rather than mandatory ones that require a trustee to petition a court for permission to sell the stock because of changed circumstances. By the time a court approves, it may be too late. Even under a specific permissive provision, it may be very difficult for

a trustee to determine when the family business should be sold. Remember the *Noble* case, in which the stock lost 54 percent of its value in the 1990s, but gained over 300 percent between 2000 and 2010. If the stock had been sold in the 1990s, the trust would never have participated in the tremendous upside. Knowing if and when to sell is the most difficult issue for a trustee holding a family business in trust. It requires an active trustee who works closely with the company's officers and board of directors, as well as communicates with trust beneficiaries. At the same time, he must verify the company's outlook through independent appraisals and discussions with industry experts. Even then, there are no guarantees that a trustee will make the right decision. But, with proper trust language and proper trust oversight, a trustee of a trust holding family business interests should in most cases, under current law, be protected from liability.

8. Directed trust. There may be circumstances in which either the settlor or a trustee doesn't feel comfortable following the advice given in points 1 through 7 above and wants an alternative approach. That approach exists in the form of a directed trust. A number of states have enacted directed trust statutes protecting a trustee from liability for failure to diversify. Under these statutes, the duties of the trustee are unbundled and, typically, with respect to the trustee's investment duties, the trustee is subject to the control of a third party, known as a "trust advisor" or "investment advisor." Through the use of a directed trust, the trust agreement can provide that the investment advisor must make all investment decisions relating to the family business, which may eliminate the trustee's liability for investment decisions, including the decision to retain the family business in the trust.[30]

9. Decanting. Using a directed trust probably isn't necessary in most circumstances of a trust funded with family business interests. But, given the fact that the law in this area is evolving, it would be prudent to include a decanting provision in every trust funded with interests in a family held business, which would permit the trustee, in case a particular state's law became unfavorable, to decant the trust's assets to a new directed trust in a state with a favorable statute. When decanting, it's crucial that both the trust's situs and governing law be changed to a new state.

Although some settlors will go the directed trust route from the beginning, most should feel comfortable following the best practices outlined in this article, using their home state's law, while including decanting language in the trust instrument to provide flexibility if their home state's law should become unfavorable in the future.

Endnotes

1. *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830).
2. *Ibid.*
3. *Restatement of the Law (Third) of Trusts: Prudent Investor Rule* Section 228 (1992).
4. *In re Janes*, 90 N.Y.2d 41 (1997).
5. *In re Rowe*, 274 A.D.2d 87(N.Y. App. Div. 2000).
6. *In re Pulitzer's Estate*, 249 N.Y.S. 87 (Surr. Ct. 1931).
7. *Ibid.*
8. *In re Charles G. Dumont*, 791 N.Y.S.2d 868 (Surr. Ct. 2004).
9. *Ibid.*
10. *Ibid.*
11. *In the Matter of the Jervis C. Webb Trust*, 2006 Mich. App. LEXIS 209.
12. *Wood v. U.S. Bank*, N.A., 828 N.E.2d 1072 (Ohio Ct. App. 2005).
13. *Ibid.*
14. *Ibid.*
15. *Ibid.*
16. *Ibid.*
17. *Americans for the Arts v. Ruth Lilly Charitable Remainder Annuity Trust*, 855 N.E.2d 592 (Ind. Ct. App. 2006).
18. *Ibid.*
19. *Ibid.*
20. *In re Trusteeship of Williams*, 591 N.W.2d 743 (Minn. Ct. App. 1999).
21. *Ibid.*
22. *Ibid.*
23. *In Re Hyde*, 845 N.Y.S.2d 833 (App. Div. 2007).
24. *Ibid.*
25. John Langbein, "Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments," *Boston University Law Review*, 375, 395 (2010).
26. *National City Bank v. Noble*, No. 85696, 2005 WL 3315034 (Ohio Ct. App. Dec. 8, 2005).
27. *Ibid.*
28. *Ibid.*
29. *Ibid.*
30. A full discussion of directed trusts is beyond the scope of this article. For those seeking more information, three recent articles from *Trusts & Estates* on this topic are (1) Al W. King, III and Pierce H. McDowell, III, "Delegated vs. Directed Trusts," *Trusts & Estates* (July 2006) at p. 26; (2) David A. Diamond and Todd A. Flubacher, "The Trustee's Role in Directed Trusts," *Trusts & Estates* (December 2010) at p. 24; and (3) Joseph F. McDonald, III, "Emerging Directed Trust Company Model," *Trusts & Estates* (February 2012) at p. 49.