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Loan Me My Money: How Texas Can Respond to the Credit Needs of Trust Beneficiaries

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NOTES & COMMENTS

LOAN ME MY MONEY: HOW TEXAS CAN RESPOND TO THE CREDIT NEEDS OF TRUST BENEFICIARIES

By Lori Campbell

ABSTRACT

"Loan me my money!" Texas trustees are hearing this plea from trust beneficiaries who need access to trust funds because of drastic declines in income produced from trust investments and the decrease in available credit. Beneficiaries, who want to preserve the trust funds for the next generation, are requesting loans to meet their temporary cash needs. These beneficiaries typically have full intentions to repay—when the good times roll.

The Texas Trust Code, however, does not provide express authority to lend trust funds to beneficiaries. Instead, trustees rely on the Code's broad, implied investment powers or stretch their discretionary distribution authority to lend funds instead of disbursing them. Using implied investment powers to lend ties the hands of trustees, likely requiring investment loan underwriting and terms. This is likely the intent of any grantor making loans to family. Using discretionary authority restricts the purpose of the loan to only those purposes authorized by the document.

This Comment explores the sources of trustee authority to lend and how each source impacts credit writing, terms, and collateral requirements for the loan. In addition, this Comment recommends a solution to the Texas legislature—adopting the lending provisions in section 816 of the Uniform Trust Code. These provisions not only expressly authorize lending to trust beneficiaries but also permit flexible underwriting standards that benefit trust beneficiaries and carry out the purpose of the trust.

Drafters have the advantage; they can clear up the ambiguity in the Texas Code with the stroke of a pen. This Comment suggests drafting options that will assist trustees in making lending decisions that carry out the grantor's intent and provide for the grantor's family long after the grantor is able.

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I. INTRODUCTION

Trust beneficiaries are not immune from the shortage of funds in this economy.[1] More than ever, trust beneficiaries are turning to their trustees for larger distributions from shrinking trust account investment portfolios. Income beneficiaries are seeing their monthly income checks shrink, creating the need for additional sources of cash. The shortage of available credit from traditional sources has also made its mark. Beneficiaries are approaching their trustees for funds that they are unable to obtain from banks who have tightened their lending standards.

Realizing the impact to future generations, trust beneficiaries may request loans of trust funds instead of distributions from principal. Taking the funds as a loan allows repayment of principal even in trusts that do not allow additions to principal. The trust also benefits from the income stream from the interest payments on the loan. In addition, by taking the funds as a loan, beneficiaries are not taxed on the

1. Keith Schiller, *Estate Planning in Tough Times*, ESTATES, GIFTS & TRUSTS JOURNAL, Sep. 10, 2009, at 1 (stating that "reversals of fortune have arisen at all financial levels, including those at great wealth who once may have felt immune from economic misfortune").

distributions. Further, beneficiaries may repay the principal and preserve the trust for the benefit of the next generation.

Despite the needs of beneficiaries, the Texas Trust Code[2] ("the Code") does not expressly authorize loans of trust funds to beneficiaries.[3] There is only one reference in the Code to lending trust property to trust beneficiaries, and it seemingly requires the trust instrument to direct the trustee to make the loan or to expressly authorize loans to beneficiaries.[4] Some commentators suggest that lending from a trust to a beneficiary is authorized as an implied investment power under the Texas Trust Code.[5] This is based on one Texas case. *Ziegler v. Southwest Film Laboratory, Inc.* states "the power of a trustee to invest necessarily carries with it the authority to lend in proper circumstances . . . ."[6] Another possible source of authority to lend lies in the discretionary powers afforded the trustee in the governing instrument. If the trustee is authorized to make an outright distribution to the beneficiary under the discretionary provisions of the trust document, arguably, the trustee may also be authorized to distribute the funds as a loan.[7]

Further, the Texas Trust Code does not provide guidance on underwriting standards, collateral, or the terms required for loans to beneficiaries. Thus, are Texas trustees required to take collateral to secure loans to beneficiaries? Are they required to charge a market rate of interest? What collection efforts are required when the beneficiary fails to repay the loan? Does the source of authority for the loan create different requirements for collateral, underwriting, and collection efforts?

This Comment will explore the possible sources of authority for Texas trustees in lending from a trust to beneficiaries. More importantly, this Comment will address how the source of lending authority impacts underwriting criteria, loan terms, and collateral requirements for loaning trust funds. Then, this Comment discusses the duty of care

2. The Texas Trust Code is not a separate code, but is located in the Texas Property Code, Title 9, Subtitle B. TEX. PROP. CODE ANN. §§ 111.001–.003, 111.005–.006, 112.001–.009, 112.011–.034, 112.036–.037, 112.039–.058, 113.001–.028, 113.030–.057, 113.059–.084, 113.086–.172, 114.001–.004, 114.006–.080, 114.082–.085, 115.002–.012, 115.015–.017, 116.001, 116.003– .004, 116.007–.171, 116.173, 116.175–117.012 (West 2007); *id.* §§ 111.0035, 111.004, 112.010, 112.035, 112.038, 112.059, 113.029, 113.058, 113.085, 114.005, 114.081, 114.086, 115.001, 115.013–.014, 116.002, 116.005–.006, 116.172, 116.174 (West Supp. 2010).

3. *See id.* §§ 113.001–.029. Trustee's powers as outlined in Chapter 113 Subchapter A do not expressly reference the authority to lend. *See id.* §§ 101.001–.002.

4. *Id.* § 113.052(b)(1).

5. RONALD R. CRESSWELL ET AL., 2 TEXAS PRACTICE GUIDE: WILLS, TRUSTS, & ESTATE PLANNING § 5:400 (2009).

6. Ziegler v. Sw. Film Lab., Inc., 351 S.W.2d 636, 641 (Tex. Civ. App.—Texarkana 1961, writ ref'd n.r.e.).

7. Beaty v. Bales, 677 S.W.2d 750, 757 (Tex. App.—San Antonio 1984, writ ref'd n.r.e.).

required by a Texas trustee in managing the loan as an asset of the trust, including the trustee's duty to collect should the beneficiary fail to repay the loan. This Comment will then contrast the Uniform Trust Code (UTC) with the Texas Trust Code, highlighting how UTC states have approached lending to trust beneficiaries. Based on this analysis, this Comment will recommend legislative changes to expressly authorize lending and guide Texas trustees in credit underwriting standards. Finally, this Comment will make recommendations for both Texas trustees and drafters in the absence of immediate legislative action.

II. Texas Trustees' Authority to Lend Trust Funds to a Beneficiary

A. *Sources of Trustee Powers, Generally*

Sources of trustee powers include the trust document, the courts, and the express and implied powers granted under state statute.[8] The Texas Trust Code acknowledges that the trust document is a primary source of trustee powers.[9] In fact, the trust document or a court order generally supersedes statutorily provided powers.[10] As stated in section 113.001, "a power given to a trustee by this subchapter does not apply to a trust to the extent that the instrument creating the trust, a subsequent court order, or another provision of this subtitle conflicts with or limits the power."[11] Texas grants, by statute, express powers to trustees in chapter 113 subchapter A of the Code.[12] The Code also provides implied powers to trustees in sections 113.002 and 113.024.[13] Under section 113.002, "a trustee may exercise any powers in addition to the powers authorized by this subchapter that are necessary or appropriate to carry out the purposes of the trust."[14] In addition, section 113.024 provides that "the powers, duties, and responsibilities under this subtitle do not exclude other implied powers, duties or responsibilities that are not inconsistent with this statute."[15] Thus, even if the trust document or court order does not provide express authority to lend trust funds to a beneficiary, the trustee may have statutory authority under the express or implied powers of the Code.

B. *The Trustee's Power to Lend to a Trust Beneficiary*

Absent specific authority in the trust document or a court order, Texas trustees must rely on state statute for authority to lend trust funds to a trust beneficiary. With the exception of section

8. § 113.001.
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.* §§ 113.001–.028; *id.* § 113.029 (West Supp. 2010).
13. §§ 113.002, .024.
14. *Id.* § 113.002.
15. *Id.* § 113.024.

113.052(b)(1), the Texas Trust Code is silent on the issue of a trustee's power to lend to beneficiaries.[16] Section 113.052(b)(1) states that "a loan is not prohibited by a trustee to a beneficiary of the trust, provided that the loan is expressly authorized or directed by the instrument or transaction establishing the trust."[17] Some commentators interpret this statute to deny Texas trustees any authority to lend trust funds to a beneficiary absent an express grant of that specific power in the trust document itself.[18] Other commentators, however, contend that the broad nature of investment powers under the Texas Trust Code provides the power to lend trust funds to beneficiaries.[19] In addition, practitioners rely on a third source of authority, the discretionary distribution provisions of the trust document. Relying on the Texas case *Beaty v. Bales*, if a distribution is justified under the discretionary language of the trust document, the trustee is authorized to distribute the funds as a loan instead of an outright distribution.[20] This position is also supported by the Restatement Third of Trusts.[21]

C. *Under Express Powers Granted in the Trust Document*

The first and primary source of trustee authority to lend to a trust beneficiary lies in the provisions of the trust document. The Texas Trust Code states that the terms of a trust document prevail over any provision of code.[22] While the Texas Trust Code provides broad general powers for Texas trustees, the express provisions of a trust document can limit or expand these powers.[23] "If the trustee's powers are unambiguously conferred by the trust instrument, neither the trustee nor the courts can add to or take away from those powers."[24] Based on this statute, the trust document can provide Texas trustees the express authority to lend to trust beneficiaries. The Code confirms this possibility by stating that a loan is not prohibited by a trustee to a

16. *See* § 113.001–.029 (containing no specific reference to a trustee's authority to lend trust funds).

17. *Id.* § 113.052(b)(1) (West 2007).

18. *See* STEVE A. AKERS ET AL., THE ANATOMY OF A WILL: PRACTICAL CONSIDERATIONS IN WILL DRAFTING 74 (2005).

19. 72 TEX. JUR. 3D *Trusts* § 114 (2010).

20. Beaty v. Bales, 677 S.W.2d 750, 757 (Tex. App.—San Antonio 1984, writ ref'd n.r.e.) (holding that an express provision in the will providing for the invasion of corpus of the estate for the benefit of beneficiaries having financial difficulties authorized disbursement of the funds as loans).

21. RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. d(6) (2009) (stating that the trustee may make a loan of trust funds to a beneficiary when the beneficiary's request falls within the reasonable discretion of the trustee).

22. TEX. PROP. CODE ANN. § 111.0035(b) (West Supp. 2010). There are certain exceptions listed in the Code where the statute prevails over trust document provisions concerning non-waivable items, but none are relevant to this Comment. *Id.* § 111.0035(b)(1)–(6).

23. Moody v. Pitts, 708 S.W.2d 930, 935 (Tex. App.—Corpus Christi 1986, no writ); CRESSWELL ET AL., *supra* note 5, § 5:395.

24. *Moody*, 708 S.W.2d at 935.

beneficiary of the trust, provided that the loan is *expressly authorized or directed by the instrument or transaction* establishing the trust.[25]

D. *Under Implied Investment Powers of the Texas Trust Code*

The broad, implied investment powers in the Code may also provide authority for a trustee to make loans to beneficiaries.[26] The Code neither expressly provides for, nor prohibits, trust loans to beneficiaries.[27] "The effect of the Code is to give the trustee broad, general powers, limited only by the trust instrument, court order, or provisions of the Code, so that trustees are not limited solely to those powers conferred in the trust instrument."[28] In fact, section 113.002 specifically states that "a trustee may exercise any powers in addition to the powers authorized by this subchapter that are necessary or appropriate to carry out the purposes of the trust."[29] Further, section 113.024 provides that "the powers, duties, and responsibilities under this subtitle do not exclude other implied powers, duties, or responsibilities that are not inconsistent with this subtitle."[30]

In fact, case law has shown that the courts have interpreted the Code's broad implied investment powers to "carry with it the authority to lend in proper circumstances and to agree to time of repayment and other terms usually incident to loans of money."[31] In *Ziegler v. Southwest Film Laboratory, Inc.*, the Texarkana Court of Civil Appeals held that the authority to make a loan from a trust was within the implied broad investment powers of the trustee.[32] Therefore, absent an express prohibition in the Code or the governing trust agreement, the implied investment powers in the Code provide sufficient authority for a Texas Trustee to make loans to beneficiaries.

E. *Under Discretionary Provisions of the Trust Document*

The trust document's discretionary provisions may provide a third possible source of trustee power to lend funds to trust beneficiaries. The discretionary distribution provisions of a trust document likely provide the authority for a Texas trustee to lend trust funds to a beneficiary for a request that would otherwise qualify for an outright distri-

25. TEX. PROP. CODE ANN. § 113.052(b)(1) (West 2007) (emphasis added).

26. Beaty v. Bales, 677 S.W.2d 750, 757 (Tex. App.—San Antonio 1984, writ ref'd n.r.e.); Ziegler v. Sw. Film Lab., Inc., 351 S.W.2d 636, 641 (Tex. Civ. App.—Texarkana 1961, writ ref'd n.r.e.); TEX. JUR., *supra* note 19.

27. § 113.052(b)(1).

28. CRESSWELL ET AL., supra note 5, § 5:395; *see also* Church & Inst'l Facilities Dev. Corp. v. First Nat'l Bank of Amarillo (*In re* Church & Institutional Facilities Dev. Corp.), 122 B.R. 958, 961 (Bankr. N.D. Tex. 1991).

29. TEX. PROP. CODE ANN. § 113.002 (West 2007).

30. TEX. PROP. CODE ANN. § 113.024 (West 2007).

31. *Beaty*, 677 S.W.2d at 757; *Ziegler*, 351 S.W.2d at 641; TEX. JUR., *supra* note 19.

32. *Ziegler*, 351 S.W.2d at 641.

bution to that beneficiary.[33] In *Beaty v. Bales*, the San Antonio Court of Appeals held that a loan to a beneficiary was authorized where the express provisions of a will provided that the corpus of the estate could be invaded for the benefit of beneficiaries having financial difficulties.[34] Admittedly, this is the only Texas case supporting this source of trustee authority to lend, but no subsequent Texas case has challenged this holding to date.[35] The Restatement Third of Trusts also supports discretionary authority to lend in instances where the request falls within the reasonable discretion of the trustee.[36] The repayment of funds, including interest, preserves trust assets for future generations. It also serves to balance the trustee's duty to both current income beneficiaries and remaindermen.[37]

III. Underwriting Required for the Loan

Once the trustee determines that it possesses the authority to lend, the next step is for the trustee to consider what underwriting standards should apply. Underwriting requirements are likely determined by the source of the trustee's authority. For example, loans authorized under express provisions of the trust document may have specific terms and underwriting criteria spelled out in the document. Loans authorized under the broad, implied investment powers granted to a trustee in the trust document or under Texas statute likely require more stringent underwriting, similar to any other investment decision for the trust.[38] Finally, loans authorized under the discretionary provisions of the trust document may require only limited underwriting because the funds qualify for immediate outright distribution to the beneficiary of the trust.

A. *Under Express Powers*

If the loan is authorized under the express powers of the trust, ideally the trust document will provide guidance on the underwriting and collateral requirements. The terms of the trust may indicate what collateral is to be taken on loans from the trust or may dispense with such collateral.[39] Many times, however, the trust document will merely list the authority to lend to a beneficiary under the Trustee

33. *Beaty*, 677 S.W.2d at 757.

34. *Id.*

35. As of January 5, 2011 when last reviewed by this Author.

36. Restatement (Third) of Trusts § 50 cmt. d(6) (2003) (stating that the trustee may make a loan of trust funds to a beneficiary when his request falls within the reasonable discretion of the trustee).

37. *See* Tex. Jur., *supra* note 19, § 78 (stating that under current Texas law a trustee is required to preserve and protect the property of the trust for the benefit of the beneficiary.)

38. 76 Am. Jur. 2d *Trusts* § 495 (2009).

39. Tex. Prop. Code Ann. § 117.008; Tex. Jur., *supra* note 19, § 66 (noting that Texas law codified the duty of impartiality in the 2004 enactment of the Uniform

Powers section of the document. This leaves the terms, underwriting standards, and collateral requirements unaddressed. In these instances, the Trustee will have to decide whether the authority for the loan arises under the discretionary provisions of the trust or under the investment powers. The source of the authority will likely drive the terms, underwriting, and collateral requirements, although no Texas court has addressed this issue.

B. *Under Implied Investment Powers of the Texas Trust Code*

As an investment of trust assets, loans to beneficiaries made under the authority of the trustee's implied broad investment powers must meet the investment criteria defined in the Prudent Investor Act.[40] Texas adopted the Uniform Prudent Investor Act into the Texas Trust Code in 2004, which governs the trustee's duties as an investor of trust funds.[41] The Prudent Investor Act requires Texas trustees to invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust.[42] In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.[43] Investment and management decisions regarding individual assets must be evaluated in the context of the entire trust portfolio and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.[44] The Act provides a list of factors to be considered by trustees in making trust fund investments:

> (1) general economic conditions;
> (2) the possible effect of inflation or deflation;
> (3) the expected tax consequences of investment decisions or strategies;
> (4) 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;
> (5) the *expected total return from income* and the appreciation of capital;
> (6) other resources of the beneficiaries;
> (7) needs for liquidity, *regularity of income*, and preservation or appreciation of capital; and
> (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.[45]

Prudent Investor Act, 78th Leg., R.S., ch. 1103, § 1, 2003 Tex. Gen. Laws 3165 (current version at TEX. PROP. CODE ANN. § 117.001–.012 (West 2007))).

40. AM. JUR., *supra* note 38.

41. Uniform Prudent Investor Act, 78th Leg., R.S., ch. 1103, § 1, 2003 Tex. Gen. Laws 3165 (current version at TEX. PROP. CODE ANN. § 117.001–.012).

42. § 117.004(a).

43. *Id.*

44. § 117.004(b).

45. § 117.004(c) (emphasis added).

These same factors would also apply in the trustee's decision process for making a loan as an investment for the trust. As such, underwriting standards for the loan should meet investment criteria including a thorough evaluation of the creditworthiness of the borrower.[46] To qualify as an investment, the loan should include adequate collateral, provide a sufficient rate of return to justify its place in the investment portfolio, and avoid creating a concentration in the portfolio.[47]

1. Collateral

Trust investments in loans must be adequately secured.[48] Such an investment without collateral is at the personal risk of the trustee.[49] A trustee generally has no authority to make *unsecured* loans of the trust corpus unless specifically authorized in the trust instrument.[50] No case law in Texas specifically addresses this requirement, but it can be inferred by case law across the country as early as 1831.[51] In 1996, the Fifth Circuit addressed this issue in *Levin v. Commissioner of Internal Revenue.* The court stated that "a trustee normally has no authority to make unsecured loans of trust corpus, unless so designated in the trust instrument, for us to hold that this would be a loan would be, in effect, to decide that the trustee committed an improper act."[52]

As a general rule, adequate collateral means the collateral of a first lien; ordinarily, a loan of trust money secured by a second lien is improper.[53] The loan to value required for a secured loan by a trustee is largely dependent on the type of collateral. For example, if the collateral is real property, courts have generally found that a trustee cannot properly lend trust funds in excess of one-half to two-thirds of the value of the collateral.[54] If it is otherwise proper for the trustee to lend trust money on a mortgage of real property, but he lends more than the proper proportion of its value, he is liable to the beneficiary for the loss of the excess.[55]

In some instances, the beneficiary's interest in the trust alone may provide adequate collateral for the loan.[56] While securing the loan in this way can have distinct advantages for both the beneficiary and the

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46. *See* AM. JUR., *supra* note 38.
47. *Id.*
48. *Id.* § 496.
49. *Id.*
50. CRESSWELL ET AL., *supra* note 5; *see also* Levin v. Comm'r., 355 F.2d 987, 990 (5th Cir. 1966).
51. *See* Gray v. Fox, 1 N.J. Eq. 259 (N.J. Ch. 1831).
52. *Levin*, 355 F.2d at 990.
53. AM. JUR., *supra* note 38, § 496; *see also* Davis v. Woods 115 S.W.2d 1043, 1051 (Ky. 1938).
54. RESTATEMENT (SECOND) OF TRUSTS § 229 cmt. a (1959).
55. *Id.* § 229 cmt. b.
56. GEORGE GLEASON BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES § 814 (2d ed. 1980).

trustee at the time the loan is made, it also poses significant risk and deserves a thorough analysis. The trustee should consider the character of the beneficiary's interest, the duration of the trust, the distribution provisions of the document, and the potential impact of market fluctuations on the assets comprising the beneficiary's interest in the trust.

The first step for the trustee is to consider whether the beneficiary's interest is a vested remainder interest or merely a contingent remainder or life interest. It is presumably imprudent for a trustee to lend on the collateral of a life interest or a contingent interest in the trust.[57] Therefore, the trustee should verify that the beneficiary has a vested remainder interest in the trust in order to use it as collateral for a loan. In determining this, the trustee should evaluate the termination provisions of the trust to consider the impact on the trust if the beneficiary does not survive until trust termination. For example, is the beneficiary's share payable to his estate or to a contingent beneficiary? If the trust proceeds are payable to the beneficiary's estate, the beneficiary's share survives, even if he does not, and would still be available to repay the trust. However, if the trust proceeds are payable to a contingent beneficiary, even though that beneficiary may have a current share in the trust, his eventual share is contingent on his survival of the trust and therefore would not qualify for a collateral interest for a loan.[58]

Next, it is important for the trustee to evaluate the duration of the loan in relation to the anticipated duration of the trust. If the expected duration of the trust is significantly longer than the term of the loan, the trustee must evaluate the effect of unproductive property on the trust for its remaining duration. This will be discussed in more detail in the interest section of this Comment.

The trustee must also consider the distribution provisions of the trust (both during the life of the trust and at termination). A loan that appears to be adequately secured by the beneficiary's remainder interest in the trust at the time the loan is made may quickly become under collateralized when substantial distributions are made to the beneficiary or other beneficiaries of the trust. This is particularly true in situations where the beneficiary is one of many who are authorized to request funds from the trust.

The market can also have the same effect. A significant market downturn can devalue the entire trust portfolio to the extent that the beneficiary's eventual share of the trust is insufficient to adequately

57. AM. JUR., *supra* note 38, § 496.

58. BOGERT ET AL., *supra* note 54; *see also In re* Pew's Estate, 16 Pa. D. & C.2d 1, 10 (Orph. 1959); CRESSWELL ET AL., *supra* note 5, § 5:70 (defining contingent beneficiary as the person who may or will benefit if the current beneficiary dies or otherwise loses rights as a beneficiary; the contingent beneficial interest is conditioned on a future occurrence which may or may not occur).

collateralize the loan. At this point the trustee would need to determine whether the trust beneficiary would be subject to a margin call. It is best if the trustee makes a decision regarding the potential consequences of a collateral shortfall to the beneficiary at the time the loan is made and documents the corrective action in the loan agreement.

While the beneficiary's residual interest in the trust may provide collateral for a loan of trust funds to the beneficiary, the complications noted above will likely lead the trustee to determine that beneficiary's interest is not sufficient collateral for the loan.

2. Ability to Repay

Underwriting standards for the loan should meet investment criteria, including a thorough evaluation of the creditworthiness of the borrower.[59] A trustee breaches its fiduciary duty to exercise reasonable skill, care, and prudence when it makes a loan to a person that the trustee knows (or should have known) lacks the ability to repay the loan in full.[60]

3. Interest Rates

To qualify as an investment, the loan must provide a sufficient rate of return to justify its place in the investment portfolio.[61] The Uniform Prudent Investor Act places on trustees the duty to invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust, including the expected total return from income and the regularity of income.[62] A trustee lending under the "prudent investor rule" must consider the productivity of the investment (loan), which would, therefore, require interest to be charged.[63] A trust is entitled to collect interest for the use of its funds.[64] In fact, Trustees do not use due care in making an investment unless they make an investigation as to the proper interest rate that should be charged.[65]

Generally, it is the duty of a trustee to use reasonable care to make the trust property productive, and therefore to keep the money of the trust estate invested.[66] The failure by a trustee to put trust funds to productive use within a reasonable period of time can render the trus-

59. *See* AM. JUR., *supra* note 38, § 496.

60. Sebastian V. Grassi, Jr., *Checklist of Trustee Duties and Common Mistakes Made by Trustee*, TAX MGMT. EST., GIFTS, & TR. J., Nov. 9, 2006, at 20–21.

61. AM. JUR., *supra* note 38, § 496.

62. RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

63. AM. JUR., *supra* note 38 (stating that it is the trustee's fiduciary duty to make investments that are income-producing and listing the asset's potential income among the facts and circumstances to be considered in determining the soundness of trust investments).

64. Slay v. Burnett Trust, 143 Tex. 621, 650, 187 S.W.2d 377, 393 (1945).

65. *See* RESTATEMENT (SECOND) OF TRUSTS § 229 cmt. b (1959).

66. CRESSWELL ET AL., *supra* note 5, § 5:391.

tee personally liable for the amount of interest that should have been earned by the trust.[67] The trustee must make reasonable efforts to obtain profit from the trust property.[68] Texas courts have consistently held that a trustee violates its fiduciary duty by failing to keep the assets of the trust producing.[69]

Further, a trustee has no power to waive delinquent interest on notes due to the trust and can be liable where the interest was collectible.[70] At least one court has held that where a trustee holds a note in trust, an agreement by him to release the obligor from a duty to pay interest is without consideration and not enforceable.[71]

Based on the trustee's duty to keep trust assets invested and to make productive use of trust funds, any loans made by the trustee under the implied investment powers of the Texas Trust Code must charge interest.[72] In fact, the prudent trustee must not only charge interest on loan of trust funds, but should require a rate of interest that is similar to returns the trust could earn by other available investment alternatives (e.g. Applicable Federal Rate, bond yields, etc.), thereby justifying the loan's place in the trust investment portfolio.

4. Special Considerations for Marital Trusts

The requirement to produce income is particularly important in a marital trust. In order to qualify the trust for the marital estate tax deduction, tax laws mandate that all income be distributed to the spouse. Under the Prudent Investor Rule, if the trust requires the income be distributed to a beneficiary, like in a marital trust, the trustee must make the trust property reasonably productive of income.[73] If property in a marital trust is not producing sufficient income, the spouse may require the trustee to make property productive. The trustee should convert property within a reasonable time, or exercise his or her power to allocate principal and income.[74] Therefore, it is particularly important for a trustee of a marital trust to ensure any loans carry a market rate of interest and remain a productive asset of the trust.

5. Concentrations

When lending under the trustee's implied investment powers, the issue of diversification must also be addressed. The Prudent Investor

67. *Id.*
68. *Id.*
69. *Id.*
70. BOGERT ET AL., *supra* note 56, § 592.
71. Wood v. Potter, 289 N.W. 131, 133 (Mich. 1939); *see also* BOGERT ET AL., *supra* note 56, § 592.
72. AM. JUR., *supra* note 38.
73. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. i (2009); Grassi, *supra* note 60, at 12.
74. TEX. JUR., *supra* note 19, § 147.

Act adopted by Texas in 2004 requires trustees to diversify, "unless the trustee reasonably determines that because of special circumstances, the purposes of the trust are better served without diversifying."[75] Therefore, when making a loan as an investment of the trust, the trustee should ensure that the loan does not create a concentration in the portfolio.

C. *Under Discretionary Provisions of the Trust Document*

Loans made to trust beneficiaries under the authority of the discretionary provisions of the trust document have a few different considerations than those made under the authority of the implied investment powers of the Texas Trust Code. The loan is still considered an asset of the trust and must be managed in compliance with the trustee duties required under the Prudent Investor Rule. The fact that the loaned funds qualify for immediate distribution to the beneficiary under the terms of the trust document, however, may provide the trustee the discretion to relax collateral requirements and underwriting standards. In addition, there are specific concerns and documentation requirements that the trustee should consider when relying on discretionary distribution authority to make loans to trust beneficiaries.

1. Collateral

Loans made under the authority of the discretionary provisions of a trust document may not require collateral other than the beneficiary's interest in the trust.[76] The rationale is that the trustee is authorized to immediately distribute the funds outright to the beneficiary because the request satisfies the requirements of a discretionary distribution. Requiring collateral in this case would be an abundance of caution—not a requirement of the prudent trustee. In *Beaty v. Bales*, loans made to the income and remainder beneficiary were presumably unsecured by anything other than the beneficiary's interest in the estate.[77] This case then supports the application of the Restatement Third of Trusts in Texas, providing for unsecured lending of trust funds under the authority of the trust's discretionary provisions.

2. Ability to Repay

The beneficiary borrower's ability to repay a loan is not a critical concern when the loan is made under a trustee's discretionary distribution authority. This is true for two reasons. First, under most trust document discretionary provisions, an analysis of the beneficiary's financial need for the distribution is required when considering any dis-

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75. TEX. PROP. CODE ANN. § 117.005 (West 2007).
76. RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. d(6) (2003).
77. Beaty v. Bales, 677 S.W.2d 750, 757 (Tex. App.—San Antonio 1984, writ ref'd n.r.e.).

tribution request.[78] The trust document likely requires documentation showing the beneficiary does not have the resources to meet the financial need on his or her own.[79] In fact, an inability to repay may likely be a requirement to satisfy the discretionary requirements for the distribution. Second, because the loan satisfies the trust document's criteria for an outright distribution of trust funds to the beneficiary, the loan can likely be converted into an outright distribution of trust funds at any time and thus, repaid.[80]

Generally the determination of whether the loan qualifies under the discretionary provisions of the document occurs at the time of the distribution. In certain circumstances, however, the trustee may need to perform a separate analysis under the discretionary provisions of the trust document at the time a loan is converted to an outright distribution to ensure that the distribution still meets the trust document's discretionary criteria. For instance, if the trust beneficiary's financial situation substantially changes and the beneficiary evidences a current ability to repay, but refuses to do so, the distribution may no longer qualify for a discretionary distribution under the document. The trustee may then have to consider other means to collect.

3. Interest Rates

Even though some commentators suggest that loans based on discretionary authority are not required to carry market interest rates, trustees should consider charging a market interest rate to ensure the assets of the trust remain productive.[81] The loan to the beneficiary becomes an asset of the trust, regardless of the authority the trustee relied upon to make it. As such, the trustee is under the same duties and obligations to make the loan as productive as any other asset in the trust portfolio.[82]

Another consideration in determining whether to charge interest rates for a beneficiary loan is the tax implications of the distribution.[83] An outright distribution of income to the beneficiary may be considered taxable income to the beneficiary, while a loan of the same funds would not be.[84] A significant factor in determining whether the distribution is a loan or a disguised distribution is whether the trustee charged interest.[85] A no-interest or market rate loan may still be a bona fide loan, but a loan without interest has at least some of the

78. BOGERT ET AL. *supra* note 56, § 678.
79. CRESSWELL ET AL., *supra* note 5, § 5:265.
80. *Id.*
81. RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. d(6) (2003) (noting that the loan may be made at a market rate of interest or at low or no interest).
82. CRESSWELL ET AL., *supra* note 5, § 5:391.
83. David B. Young, *The Pro Tanto Invalidity of Protective Trusts: Partial Self-Settlement and Beneficiary Control*, 78 MARQ. L. REV. 807, 867–68 (1995).
84. *Id.* at 867.
85. *Id.* at 868.

earmarks of a disguised distribution.[86] An interest bearing loan to a beneficiary is normally seen as an investment of trust assets, not a distribution.[87]

Because of the trustee's duty to make assets productive under the Prudent Investor Rule and the important tax implications of a disguised distribution, trustees should charge a market rate of interest on trust loans to beneficiaries made under the authority of the trust document's discretionary provisions.

IV. COLLECTION OF A LOAN GONE BAD

Trustees must protect trust property. The trustee must use reasonable care and skill to preserve the trust property and protect it from loss, damage, or other diminution in value.[88] Under this broad duty, the trustee also has a duty to enforce claims owed to the trust.[89]

A. *Duty to Collect*

When a trustee holds a loan in trust, even if the obligor is a beneficiary of that trust, the trustee has a duty to collect the loan in the event of default.[90] Further, the trustee is obligated to use the beneficiary's interest in the trust to satisfy the note if necessary.[91] This is an important consideration in deciding whether to loan trust funds to beneficiaries and, particularly, whether to require collateral. The trustee must be willing to take all necessary means to enforce the debt, even to the extent of suing the beneficiary.[92] The trustee is held to the use of ordinary judgment in collection of the loan.[93]

B. *Spendthrift Trust Considerations*

Trusts often contain spendthrift provisions, which protect the trust from claims of creditors of the trust's beneficiaries. The general rule is that most creditors of a beneficiary of a spendthrift trust may not reach the beneficiary's interest or the assets of the trust. Rather, the creditor must wait for a distribution to be made to the beneficiary, and then pursue a claim against the beneficiary individually.[94]

Texas courts regularly uphold and enforce spendthrift provisions. The courts do so out of consideration, not for the beneficiary, but for

86. *Id.*
87. *Id.*
88. Grassi, *supra* note 60, at 9.
89. *Id.* at 10.
90. BOGERT ET AL., *supra* note 56, § 592; *see* Sheridan v. Riley, 32 A.2d 93, 97 (N.J. Ch. 1943).
91. BOGERT, *supra* note 56, § 592.
92. *Id.*
93. *Id.*
94. Alan Newman, *Spendthrift and Discretionary Trusts: Alive and Well Under the Uniform Trust Code*, 40 REAL PROP. PROB. & TR. J. 567, 569 (Fall 2005).

the right of the donor creating the trust to control his gift.[95] But, even under Texas law, "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."[96] The statute lists a beneficiary's failure to repay a loan of trust funds as one of the actions that can authorize the trustee to offset against the beneficiary's interest in the trust.[97] Yet the statute recognizes that the trust document can supersede the Code. If a trust document prohibits the offset of a beneficiary's interest to satisfy a repayment for loaned trust funds or contains any broad prohibition against offsetting a beneficiary's interest, the trustee will be unable to recover from the trust.[98] The trustee should review the trust document carefully for any provisions specifically prohibiting offset before consenting to using the beneficiary's interest in the trust as collateral.

C. *Beneficiary's Personal Liability*

Generally, trust beneficiaries are personally liable for the amount of trust-loaned funds.[99] The beneficiary's interest in the trust is also subject to off-set to ensure repayment of his loan when the trust ultimately terminates.[100] This is true even if the loan was made in breach of trust.[101] A beneficiary, by his or her acceptance of the benefits of the loan, may be estopped to deny the validity of a lien.[102]

V. Compare to the Uniform Trust Code

The Texas Trust Code is hailed as one of the major foundations for the Uniform Trust Code (UTC).[103] The UTC, however, differs from the Texas Trust Code in that it contains specific authority for trustees to lend to trust beneficiaries.[104] The UTC, in its statute as well as the accompanying comments, provides not only the authority to lend to trust beneficiaries, but also the necessary guidelines to assist trustees in exercising their authority.[105] This approach benefits both the trustee and trust beneficiaries. Trustees receive the necessary guidance in

95. Burns v. Miller, Hiersche, Martens & Hayward, P.C., 948 S.W.2d 317, 321 (Tex. App.—Dallas 1997, writ denied); Tex. Jur., *supra* note 19, § 37.
96. Tex. Prop. Code Ann. § 114.031(b) (West 2007) (emphasis added).
97. *Id.* § 114.031(a)–(b).
98. *Id.* § 114.031(b).
99. Restatement (Second) of Trusts § 225 cmt. a, c (1959).
100. *Id.*
101. *Id.* § 229 cmt. a.
102. McDonald v. Republic Nat. Bank of Dallas, 404 S.W.2d 874, 878 (Tex. Civ. App.—Dallas 1966, writ ref'd n.r.e.); Tex. Jur., *supra* note 19, § 93.
103. Gerry W. Beyer, Texas Estate Planning Statutes with Commentary 621 (2009–2010 ed. 2009).
104. Unif. Trust Code § 816(18) (amended 2005), 7C U.L.A. 627 (2006).
105. *Id.* § 816 (18) cmts. (18), (19).

making the decision to loan the funds and trust beneficiaries have a clearer understanding of how a trustee will evaluate loan requests. Twenty-four states have implemented the UTC in some form. No state, however, has implemented the UTC in its entirety.[106] Yet states adopting the UTC have routinely included the provisions expressly authorizing loans to trust beneficiaries, with little, if any modifications.[107] The UTC provides a good illustration of how the Texas legislature could fill the gaps left to ambiguity in the Texas Trust Code.

A. *Expressly Authorizes Loans to Beneficiaries*

The UTC expressly provides trustees the authority to make loans of trust property to its beneficiaries.[108] Under the UTC, "a trustee may make loans out of trust property, including loans to a beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances."[109] Further, "the trustee has a lien on future distributions for repayment of those loans."[110] The trustee must consider both the fiduciary duties of the trustee and the purposes of the trust in determining what is fair and reasonable.[111]

Allowing the trustee to consider both its fiduciary duties and the purposes of the trust in determining what is fair and reasonable provides necessary flexibility in both the trustee's credit underwriting and in the trustee's discretion in whether to issue the loan. The UTC is well-written in that it provides trustees the express authority to make or deny loans to trust beneficiaries. It also provides the latitude to exercise its discretion in crafting the terms of the loan. At the same time, the UTC provides a standard—fair and reasonable—to measure against the trustee's actions.

B. *Underwriting*

The comments to the UTC acknowledge that trustees frequently make loans to a beneficiary under terms that may be less than commercially prudent, but are of great benefit to the beneficiary and, therefore, carry out the purpose of the trust.[112] Further, the UTC pro-

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106. *Id.* (noting states that have adopted UNIF. TRUST CODE § 816(18) with no substantial change: Arizona, New Hampshire, North Carolina, Ohio, Oregon, Alabama, District of Columbia, Kansas, Maine, Missouri, Nebraska, Utah, Virginia).

107. *Id.* Twenty-four states have adopted the UNIF. TRUST CODE § 816(18), all of them with little if any modifications to the lending provisions: Alabama, Arizona, Arkansas, District of Columbia, Florida, Kansas, Maine, Missouri, Michigan, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, and Wyoming. *Id.*

108. *Id.* § 816(18).

109. *Id.*

110. *Id.*

111. *Id.* § 816 (18) cmts. (18), (19).

112. *Id.*

vides options for unsecured lending to beneficiaries by stating that adequate collateral may consist of a charge against the beneficiary's interest in the trust.[113] The UTC, however, appears to be less flexible on the spendthrift clause issue, stating that the interest of a beneficiary subject to a spendthrift restraint may not be pledged as collateral for a loan.[114]

VI. Recommendation to the Texas State Legislature

The Texas legislature should adopt the lending provision of the UTC in part. This will provide express authority for Texas trustees to lend to beneficiaries and quell the debate on the existence and source of lending authority. By enacting this provision of the UTC, the legislature would provide express authority to make unsecured loans of trust funds to beneficiaries, particularly in those instances where the grantor's intent is most clear—when the trust's discretionary provisions explicitly provide for distributions of principal. Providing this authority will give beneficiaries access to principal funds without depleting the trust by allowing repayment of the funds. The trust's corpus is preserved for future generations.

Currently trustees are left on their own to interpret the broad, implied investment powers of the Texas Trust Code in determining whether they have the authority to lend trust funds. Trustees are then left to speculate what underwriting standards should be applied. Leaving the matter to interpretation leads to uncertainty and inconsistency in application. Some trust beneficiaries may be refused loans from trust funds based on the trustee's lack of confidence in its authority to lend. Trustees who decide to lend funds to trust beneficiaries have no guidelines on credit underwriting. Some trustees may lend without collateral and others may require commercial underwriting standards. The lack of guidance from the Texas Trust Code likely results in very different experiences for beneficiaries whose access to trust funds vary, not because of the grantor's intent, but because of uncertainty in the state of the law.

The Texas legislature can easily address these concerns by adopting the language in paragraph eighteen in the UTC, including the comments. The comments provide guidelines to trustees in making loans to beneficiaries with underwriting standards that are "less than prudent in a commercial sense," because doing so will benefit the beneficiary and will help carry out the purposes of the trust.[115]

Texas should retain Section 114.031(b) of the Texas Trust Code, which allows trustees to offset a beneficiary's interest in the trust

113. *Id.*
114. *Id.* (referencing § 502 of the Restatement Second of Trusts).
115. *Id.*

when the beneficiary fails to repay a loan of trust funds,[116] rather than adopting the stance of the UTC and the Restatement Second of Trusts which disallows offset in spendthrift trusts.[117] Texas's strong stance in allowing this offset, even when the trust+ contains a spendthrift provision, is necessary. Without this approach, beneficiary borrowers may be unjustly enriched by failing to repay a loan and then also receiving the full benefit of the funds at trust termination. Continuing Texas's strong stance protects the interests of other remainder beneficiaries whose shares were reduced by the one who failed to repay. It also provides greater access to trust funds for beneficiaries of spendthrift trusts who lack the outside collateral to support a loan. This statute provides trust beneficiaries the option to pledge their beneficial interest in the trust to support a loan of trust funds in lieu of other collateral.

These proposed changes to the Code will enhance the already strong Texas Trust Code. The enhancements will provide much needed guidance to Texas trustees on their authority to lend and the underwriting standards that should apply to loans of trust funds. Most importantly, these changes will provide access to trust funds for beneficiaries in great need, but who wish to preserve the trust for future generations.

VII. Recommendations for Texas Trustees

To take advantage of the broadest trustee discretion on collateral, underwriting, and terms of repayment, Texas trustees should first carefully examine the client's request and determine if the request satisfies the governing document's requirements for an outright discretionary distribution of principal to that beneficiary. If so, the Trustee should thoroughly document its decision-making process. Thorough documentation would include at a minimum:

(1) how the request meets the governing document's discretionary criteria;
(2) how making the distribution as a loan (instead of an outright distribution) will meet the best interests of both the current and remainder beneficiaries;
(3) how the terms, underwriting, and collateral requirements will best meet the interests of all beneficiaries; and
(4) what steps will be taken in the event that the beneficiary fails to repay according to the loan's terms.

The consequences for failure of timely loan repayment should also be documented in the loan agreement. Given the lack of statutory guidance on a loan from a trust, these guidelines are not fail-safe, but

116. Tex. Prop. Code Ann. § 114.031(b) (West 2007).
117. Unif. Trust Code § 816(18) cmts. (18), (19).

would show a court that the trustee acted in the best interest of all beneficiaries and made best efforts to fulfill the intent of the grantor.

When the loan request does not meet the criteria for a discretionary request and is not expressly authorized by the trust document, the trustee should review the loan request as an investment proposal. Using the guidelines established by the Uniform Prudent Investor Act, the trustee should ensure the underwriting, collateral, and trust terms meet the standards for an investment loan.

VIII. Recommendations for Drafters

Drafters have the advantage—they can clear up the ambiguity in the Texas Trust Code with the stroke of a pen. Many drafters already include the power to lend in the laundry list of trustee investment powers included in most trust documents. This approach, however, still leaves the question of whether the grantor intended to grant the authority to make a loan to trust beneficiaries, or to merely provide the authority to loan trust funds as an investment option for the trust. The best drafters are including not only the power to lend, but are also specifically stating that the power to lend extends to include lending to trust beneficiaries. These drafters also include the terms of the loan—specifying whether the loan is required to be at market terms (market rate of interest, adequate collateral margin, and penalties for non-payment)—or that the trustee has the discretion to make the loan on more favorable terms, given the beneficiary's relationship to the grantor.

Drafting the trust to precisely address the power to lend to beneficiaries will equip trustees with the knowledge of the grantor's intentions and the authority to carry out those intentions. Absent concrete authority in the Texas Trust Code, many trustees are relying on an implied investment power for the authority to lend. As discussed earlier, relying on an implied investment power likely requires the trustee to insist on commercial underwriting standards, market interest rates, sufficient collateral, and penalties for non-payment, all of which may not be consistent with the grantor's intentions. Providing the authority in the trust document, including terms and consequences of repayment will ensure the trustee makes lending decisions that carry out the grantor's wishes and provides for the family long after the grantor is gone.

IX. Conclusion

The Texas legislature has left the debate of whether Texas trustees have the power to lend to trust beneficiaries to the discretion of trustees and the drafters of Texas trusts. Trustees, absent specific authority provided by the drafter in the trust document, must decide if they actually have the authority to lend and whether this power arises under the implied investment powers granted by the Texas Trust Code or under the trustee's discretionary authority to distribute funds. The impact of that choice drastically affects the underwriting criteria, loan terms, and collateral requirements required for the loan.

Loans made under the authority of the trust document's discretionary provisions provide more latitude in terms of underwriting criteria, loan terms, and collateral, but the purpose of the loan is limited to the discretionary standard for distributions. In contrast, loans made under implied investment powers can be for almost any purpose, but the underwriting standards, loan terms, and collateral must satisfy the more strict investment requirements.

The trustee's duty to collect the loan is also impacted by the trustee's decision on the source of the power to lend. Loans made under the trustee's discretionary distribution authority may often be converted to an outright distribution, while investment loans likely require reasonable efforts to collect the loan, including foreclosing on the assets securing the loan.

Because Texas trustees are left to themselves to determine if and how the Texas Trust Code provides the authority to lend, inconsistencies are created. Some trust beneficiaries may be given no access to loans and others may be given broad access. The ambiguity in the source of lending power and the underwriting criteria for trust loans can be easily addressed by the Texas legislature by the adoption of the UTC's lending provision in Section 816, paragraph eighteen. This would provide both the express authority to lend and flexible, but measurable guidelines on how that authority should be exercised. The legislature should, however, keep the Texas Trust Code's more flexible approach to spendthrift trusts allowing a charge against a spendthrift's share should the loan become uncollectible.

In the absence of action by the state legislature, Texas trustees should carefully determine the source of lending authority for any beneficiary loan and ensure that the underwriting criteria for the loan conforms to the source of authority. Drafters of Texas trusts should specifically address the grantor's intent regarding potential loans to beneficiaries. The best drafters will include the terms of the loans, including whether the trustee has discretion to make loans on more favorable terms than commercially prudent. With the power of the pen, the drafter can provide the grantor's intent, create guidance for trustees, give beneficiaries access to a loan of trust funds, and preserve the trust for generations to come.