

# SERVING AS TRUSTEE UNDER THE NEW TRUST LAWS AND ATTORNEY FIDUCIARY DUTIES IN TEXAS

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# **SERVING AS TRUSTEE UNDER THE NEW TRUST LAWS AND ATTORNEY FIDUCIARY DUTIES IN TEXAS**

## **I. INTRODUCTION.**

The Texas Trust Code, originally enacted as the Texas Trust Act in 1943 and now incorporated as Subtitle B (Chapters 111-117) of Title 9 of the Property Code, has undergone several changes and amendments over the years. Perhaps the most significant changes in the last twenty years occurred in the last two legislative sessions -- the 78<sup>th</sup> legislative session in 2003 and the 79<sup>th</sup> legislative session in 2005. In 2003, the legislature passed a modified version of the Uniform Prudent Investor Act and the Uniform Principal and Income Act, often referred to as the UPIA twins. Those amendments to the Trust Code became effective January 1, 2004 as will be discussed later in this outline, represent a significant shift in the standards for investing trust property and the manner in which trustees make distributions and account for them.

The 2003 legislative changes also addressed recent court decisions that seemed to loosen the reins on the extent to which trustees could be absolved from liability under trust instruments and sought to tighten those reins by limiting the scope of exculpatory clauses. In the 2005 legislative session, law makers primarily sought to codify some common law trustee duties to better define them and establish certain minimum standards by establishing some mandatory provisions for all trusts. Most of these changes become effective on January 1, 2006, though some were effective on September 1, 2005. In this outline, the Texas Trust Code after the 2005 amendments are effective will be simply referred to as the "Trust Code," except as otherwise stated.

### **A. Mandatory Provisions Superseding Trust Terms.**

Perhaps the most significant feature of these changes that requires all trustees to take immediate note, is the fact that many of these provisions are mandatory provisions that cannot be modified by the terms of the trust. In fact, many of these codified changes or clarifications of trust law override existing language in a trust, no matter how old the trust instrument, and may change the way in which a trust is administered, even though the express terms of the trust have not changed. A list of these mandatory provisions is provided in new § 111.0035 of the Trust Code, which every trustee should immediately consult.

The following is a paraphrased version of the list of duties the terms of the trust may not limit:

**1. Prohibition of Illegal Purposes and Criminal or Tortious Acts.** The requirement that a trust not be created for any illegal purpose and that it not require the trustee to commit a criminal or tortious act or an act that is contrary to public policy.

**2. Corporate Trustee Self-Dealing.** The duties and liabilities of and restrictions placed on corporate trustees for certain self-dealing transactions under § 113.052 or § 113.053. This includes the lending of funds to a trustee or affiliated persons and entities, but does not include loans to a beneficiary when authorized by the trust or deposits with a corporate trustee. Also prohibited as self-dealing by a trustee is the direct or indirect buying or selling of trust property from or to the trustee or affiliated entities or persons, although exceptions are provided for (a) court-authorized sales of its own stock, (b) retention of its own stock and the exercise of pro rata purchases, (c) purchasing fractional shares to round out to a full share, (d) completing a settlor's executory contracts, (e) sales of securities complying with the prudent investor rule, (f) certain conduct of a custodian or a trustee of a retirement plan or account, (g) exercising investments discretion with respect to securities of a registered open-end or closed-end management investment company or an investment trust (provided the investment is not prohibited by the trust instrument).

**3. Limited Exculpation of Trustees.** Exculpation of a trustee from liability that exceeds the limits of § 114.007 (discussed more fully below).

**4. Preserve Statute of Limitations.** Period of limitation for commencing a judicial proceeding regarding a trust.

**5. Account to and Inform Beneficiaries.** A trustee's duty to (a) provide an accounting when demanded from a current beneficiary or first-tier remainder beneficiary, (b) to act in good faith in accordance with the purposes of the trust, and (c) comply with the duty to keep reasonably informed trust beneficiaries twenty-five years of age or older with respect to the administration of the trust and any material facts necessary for the beneficiary to protect his interests.

**6. Court Authority.** The power of a court to exercise jurisdiction or to take any of the following actions: (a) modify or terminate a trust or other action under § 112.054, (b) remove a trustee, (c) exercise jurisdiction under § 115.001, (d) require, dispense with, modify or terminate a trustee's bond, or (e) adjust or deny a trustee's compensation if the trustee commits a breach of trust.

The purpose of this outline is to highlight some of the more significant changes passed in the last two legislatures that will impact trustee duties and powers. This outline is not intended as an exhaustive analysis of the many trustee duties and powers owed by trustees under Texas trust law, though it may touch on some unaffected duties and powers. Rather, this outline intends to aid serving trustees or those who are considering serving as trustees to consider how these trust law changes might affect the performance of their duties and extent of their powers.

Most of the 2005 amendments are based largely on similar provisions of the Uniform Trust Code ("*UTC*") and do little more than codify existing common law. This connection to the UTC may now provide some additional guidance to legal advisors and the courts that might search for more clarity in the extensive comments that accompany the UTC, particularly with respect to those provisions of the Texas Trust Code that are now closely aligned with the UTC.

**B. Identifying the Powers and Duties of the Trustee and Responding to Trust Code Changes.**

A Trustee's powers and duties when administering trusts in Texas are generally derived from three sources. First and foremost, a trustee is to follow the terms of the trust instrument. Second, to the extent the trust instrument is silent, and in some cases now, to the extent the trust instrument is contrary to mandatory trust code provisions, trust administration is governed by the Texas Trust Code. Third, Texas common law rules establishing trustee duties and defining the extent of Trustee powers should be consulted.

These recent amendments to the Trust Code have significantly changed the landscape for trust administration in Texas. In light of these changes, trustees would be well advised to take the following steps before performing any administrative duties. First, a trustee should carefully review the trust instrument to be sure the trustee fully understands the purpose and intent of the trust he or she is administering and identify any provisions of the trust that have now been altered by mandatory provisions added to the Trust Code. Second, a Trustee should carefully review the trust's policies for distribution to trust beneficiaries to assure that they are consistent with the purpose of the trust, and are not contrary to any dictates of the new Trust Code changes, including the manner in which principal and income are allocated with respect to distributions and disbursements. Third, the trustee must immediately review the investment provisions of the trust to determine whether the trust is under a prudent man or prudent investor rule and make any necessary adjustments to the investment portfolio, which should include an initial and periodic review of the portfolio design. Fourth, each trustee, particularly those who are individual trustees, should consider whether they have the expertise necessary to administer the trust in accordance with its terms as it may be modified by these new Trust Code changes. Depending on his situation, the trustee might consider delegating some duties to professionals with the necessary expertise to the extent permitted by the trust instrument or trust law, and to the extent it cannot be so delegated, the trustee might consider resigning and seeking replacement by a qualified professional trustee or trust company.

**C. The Interrelationship of Powers, Duties and Liabilities of Trustees.**

When discussing the administration of trusts, it is helpful to understand the relationship that a trustee's powers, duties and liabilities have to each other so as not to confuse them. Since the trustee is the legal title owner of property held by a trust and the beneficiaries are the equitable owners of that property, there are certain powers that trustees are deemed to have as the legal owner of trust property, though the trust instrument can grant specific additional powers, can make them conditional, and can limit them. Generally, except to the extent that a trust instrument provides otherwise, a trustee is deemed to have the powers necessary to carry out the purposes of the trust. Still, powers held by a trustee are necessarily limited by the duties that trustee owes to the beneficiaries, the equitable owners of the trust property, and it is the Trustee's breach of that duty that gives rise to his liability to beneficiaries. This interrelationship was well stated by Austin W. Scott in his treatise, SCOTT ON TRUSTS, which states:

When we say that the trustee has power to do certain things, what is meant is that he is not under a duty to the beneficiary not to do them. Hence, the scope of his powers depends on the scope of his duties. When we speak of the liabilities of a trustee, we are dealing with the consequences of a breach of duty. The trustee does not incur a liability unless he has been guilty of a violation of a duty. Hence, the scope of his duties determines the question of his liability. 2A SCOTT ON TRUSTS § 163A, at 249 (1988).

#### **D. Determining the Extent of Discretion.**

When discussing trustee powers and duties and advising trustees in the proper exercise of their discretion, the first source of guidance is the trust instrument itself. Unfortunately, legal advisors often find the trust instrument lacking in clear direction. The nature of the exercise of any trustee power and adherence to related duties necessarily involves some discretion on the part of the trustee. On discretion, Austin W. Scott states:

The trustee may be given discretion whether to exercise a power or not to exercise it; and where he is directed to exercise a power, the time and manner of its exercise may be left to his discretion. The discretionary power may relate to the business administration of the trust, or it may relate to the distribution of income or principal. 3 SCOTT ON TRUSTS § 187, at 14 (1988).

In this regard, trustees should be aware that although most trust instruments grant the trustees “*absolute discretion*” or the authority to act in their “*sole judgment*,” the meaning of these words should not be taken literally. In trust administration, all discretion exercised by a trustee is subject to standards derived from the trust, the Trust Code or common law and must at least be consistent with the purpose of the Trust. The court will look closely at the trust instrument and, to the extent necessary, the Trust Code and common law to set the standard by which a trustee’s duties will be measured. Inasmuch as these new Trust Code changes have altered the standard of care in some cases, trustees should carefully reassess the standards under which they have been administering the trust to be sure that they are taking into account any change in those standards and the extent of their discretion.

When reviewing a trustee’s exercise of discretion, the court does not seek to control the trustee’s exercise of discretion or to substitute its own judgment for the trustee’s judgment. Rather, the court looks to determine whether or not the trustee committed an abuse of discretion. This essentially hinges on whether or not the court considers the trustee to have acted outside the bounds of reasonable judgment. *See id.*

## **II. FIDUCIARY DUTIES OWED BY TRUSTEES.**

A trustee of a trust is clearly a fiduciary owing several duties to a trust beneficiary. A number of the more commonly recognized duties are discussed below and an attempt is made to identify those duties most affected by the recent trust law changes. One of the important objectives in the Trust Code amendments identifying certain provisions that cannot be overridden by the trust instrument was to assure that there are indeed fiduciary duties owed to trustees so that extensive or over zealous drafting to relieve fiduciary duties and limit liability does not obviate the trust itself. According to the RESTATEMENT (SECOND) OF TRUSTS § 25, “[n]o trust is created unless the settlor manifests an intention to impose enforceable duties.” Section 113.059 and other mandatory provisions of the Texas Trust Code reflect the legislature’s intent that a trust will indeed exist by requiring certain minimum fiduciary duties. In order to secure these minimum protections and preserve the trust, it was necessary to limit the extent to which fiduciaries can be exculpated from liability in the trust instrument. This was carefully addressed in the last two legislative sessions addressing the *Grizzle* decision by the Texas Supreme Court and will be discussed more fully below.

In the absence of provisions in the trust instrument or the Texas Trust Code modifying the common law duties owed by trustees, § 113.051 of the Trust Code expressly provides that all of the common law duties of trustees are incorporated in the Code. This provision on a trustee’s general duty requires that a trustee “...administer the trust in good faith according to its terms and [the Trust Code].” The words “*good faith*” were added in 2005 emphasizing the trustee’s duty at common law to adhere to a good faith standard. Below is a summary of some of the more commonly recognized duties owed by fiduciaries. Since some of these duties have been significantly impacted by the recent trust law changes, an attempt is made to identify those duties that should be reviewed by trustees to determine whether their duties have been altered by these new laws.

### **A. The Duty to Administer the Trust According to Its Terms.**

The initial task undertaken by all trustees should be to review carefully and thoroughly all of the terms of the trust instrument to identify its purposes and the duties imposed on the trustee. The trustee should identify all general and any specific duties or responsibilities imposed on the trustee and study the nature of the trust assets and the trust beneficiaries. After such a review, best practice would suggest that the trustee prepare a summary outlining his or her duties which should include:

- 1) distribution provisions, including withdrawal rights and powers of appointment, and the nature of discretionary distributions;
- 2) investment limitations, if any;
- 3) accounting requirements;
- 4) tax planning objectives;

- 5) required notices;
- 6) trustee resignation, succession, removal and delegation provisions and provisions for resolving an impasse.

The trustee will be bound by a duty to follow the strict terms of the trust, though it is common that interpretive provisions allow the trustee a certain degree of latitude for interpreting the meaning of ambiguous provisions. In cases where the trust is ambiguous on important disputed issues, the trustee may be well advised to seek a court order authorizing the interpretation believed to be appropriate by the trustee.

In light of the mandatory nature of certain new trust code amendments, it is important for trustees of existing trusts to review the trust provisions in light of the new amendments to the Trust Code. As discussed more fully below, significant changes to the investment standards and allocation of principal and income rules will necessitate a trustee's reassessment of the standards, duties and administrative procedures the trustee will follow when administering those terms.

Fortunately, new § 112.009 of the Trust Code allows new trustees an opportunity to accept the trust contingently subject to full review by the trustee. This may enable a trustee to allow a trust to be continued for a reasonable period but avoid liability in the event the trustee determines that the trustee does not possess the expertise necessary to manage the trust under its terms and in light of the trust assets and circumstances surrounding the trust. Existing trustees will remain liable for any claims that arise prior to discharge of the prior trustee during the transition to a new trustee. A successor trustee is only liable for the breaches of the predecessor trustee, however, if the successor trustee knows of the breach and does not take appropriate and timely action with regard to it. *See* TEX. TRUST CODE § 114.002.

**1. Judicial Modification of Trusts.** One helpful change in the Trust Code amendments is the somewhat relaxed requirements for judicial modification of trust instruments. Under Trust Code § 112.054, the reasons for modifying or terminating an irrevocable trust by court action were expanded making it easier to modify or terminate a trust when appropriate. Previously, the applicant for modification or termination would have to show either: (a) that the purposes of the trust have been fulfilled or become impossible or illegal to fulfill or (b) because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the purposes of the trust. The second of these standards has now been expanded to allow modification or termination of a trust upon a showing that:

- a) The modification or termination will further the purposes of the trust. TEX. TRUST CODE § 112.054(a)(2).
- b) Administrative, non-dispositive provisions should be modified because it is necessary or appropriate to prevent waste or avoid impairment of the trust's administration. [Interestingly, this standard does not require an inquiry into the settlor's knowledge or intent.] TEX. TRUST CODE § 112.054(a)(3).

- c) The modification or termination is necessary to achieve the settlor's tax objectives, so long as the action is not contrary to the settlor's intentions. TEX. TRUST CODE § 112.054(a)(4).
- d) If all beneficiaries agree, a trust can be terminated if the "...continuance of the trust is not necessary to achieve any material purpose of the trust..."; and the trust may be modified so long as "the order is not inconsistent with a material purpose of the trust..." Special rules apply for determining whether minor, incapacitated, unborn or unascertained beneficiaries are deemed to have consented. TEX. TRUST CODE § 112.052(a)(5), (d).
- e) Section 112.054(c) also allows the court to direct that its order for modification under this provision has retroactive affect, although it is not clear whether retroactive application will be honored under the Federal Tax Code. According to the National Conference of Commissioners on uniform state laws to Uniform Trust Code § 416 (the source of this Texas Trust Code provision):

Whether such a modification made by the court under this section will be recognized under Federal tax law is a matter of Federal law. Absent specific statutory or regulatory authority, binding recognition is normally given only to modifications made prior to the taxing event, for example, the death of the testator or settlor in the case of the Federal estate tax. *See* Rev. Rul. 73-142, 1973-1C.B.405. The list of the specific modifications authorized by the Internal Revenue Code or Service includes (1) the revision of split-interest trusts to qualify for the charitable deduction, (2) modification for a trust for a non-citizen spouse to become eligible as a qualified domestic trust, and (3) the splitting of a trust to better utilize the exemption from generation-skipping tax.

These somewhat more relaxed thresholds for achieving a modification or termination of the trust can be a helpful tool to trustees facing difficult administrative issues as a result of changes in the law that change the meaning of the trust and seem to place it in conflict with the initial trust purpose and its historical administration.

**2. Limits on Exculpatory Clauses.** In the recent Texas Supreme Court decision rendered in the *Texas Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240 (Tex. 2002), the court addressed the extent to which a settlor may relieve a trustee of duties otherwise owed under the Texas Trust Code or common law at the time. The court held that § 113.059 of the Trust Code (prior to amendment in 2003) gave the settlor broad latitude to relieve a trustee from a duty, liability or restriction imposed by the Code. An exception was made in the prior statute only for certain self-dealing transactions by corporate trustees. Thus, in the absence of other trust-imposed limitations, the court concluded that the Trust Code allows a settlor to relieve the corporate trustee from liability for self-dealing so long as it does not exceed the special limited protection against corporate trustee self-dealing in §§ 113.052 and 113.053 of the Trust Code.

The Texas Supreme Court refused to agree with the Court of Appeals that there should be a public policy protection against such broad limitations on liability. Instead, the Court found that the legislature's adoption of the Trust Code in its present form reflected the public policy, and the Court invited the legislature to make further changes if it wished to further limit the extent to which a trustee could be exculpated from liability.

In response to this decision, the Texas legislature adopted a new § 113.059 to the Trust Code effective September 1, 2003 to specifically address the *Grizzle* decision and provide limits on the extent to which a settlor could exculpate in a trust instrument. This statute was further clarified in the 2005 legislative session, by repealing it and moving it to § 114.007 of the Trust Code. This new statute now provides:

- a) A settlor may not relieve the trustee of liability for:
  - (1) a breach of trust committed:
    - A) in bad faith;
    - B) intentionally, or
    - C) with reckless indifference to the interest of the beneficiary; or
  - (2) any profits derived by the trustee from a breach of trust.
- b) A provision in a trust instrument relieving the trustee of liability of a breach of trust is ineffective to the extent that the provision is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor.
- c) This section applies only to a term of a trust that may otherwise relieve a trustee from liability for a breach of trust. Except as provided in § 111.0035, this section does not prohibit the settlor, by the terms of the trust, from expressly:
  - (1) relieving the trustee from a duty or restriction imposed by this subtitle or by common law; or
  - (2) directing or permitting the trustee to do or not to do an action that would otherwise violate a duty or restriction imposed by this subtitle or by common law.

This provision more or less codifies parts of § 222 of the RESTATEMENT (SECOND) OF TRUSTS, which Texas Courts had previously applied as part of the common law. *See InterFirst Bank*

*Dallas v. Risser*, 739 S.W.2d 882 (Tex. App. -- Texarkana 1987, no writ), *rev'd on other grounds*. It's reliance on the provisions of § 111.0035 of the Trust Code tie-in the other mandatory protections and minimum duties accomplished by the 2005 amendments.

Consequently, some exculpatory clauses that have been incorporated into trusts that went beyond the pre-*Grizzle* common law as applied in Texas, or after *Grizzle* sought to expand the exculpatory clause, may not, actually limit liability as written. To the extent that an exculpatory clause exceeds the statutory limitations of § 113.059, it will likely be carved back to fit within the statute. Trustees relying on exculpatory clauses should carefully review them to be sure that they are not assuming lesser duties or relying on lower risk of liability than will be applied by a court under this amended Code provision.

## **B. Duty to Account and Maintain Accurate Books and Records.**

The common law requirement that the trustee produce a written statement of accounts covering all transactions of the trust upon demand by a beneficiary has been modified by the Trust Code, which outlines how and to whom accountings must be given in the event the trust does not specifically provide more. There is also a common law duty for trustees to keep accurate books and records for review by beneficiaries and to provide a full and accurate accounting.

**1. Duty to Account.** Trust Code § 113.151(a) allows the trustee ninety days to comply with a beneficiary's demand for accounting and may be allowed a longer period if ordered by the court. Accountings cannot be required more frequently than every twelve months unless ordered by the court. If necessary, an interested person may compel a non-compliant trustee to provide a written account if the Court finds that the nature of his interest in the trust, his claim against the trust, or the affect of trust administration on the interested person is sufficient to require an accounting by the trustee. TEX. TRUST CODE § 113.151(b). Interestingly, an interested person for this purpose would include any beneficiary of the trust, even contingent and remainder beneficiaries. *See* TEX. TRUST CODE § 111.004(7). Although new Trust Code § 111.0035 permits the settlor to restrict the disclosure of information to any beneficiary under 25 years of age, this provision does not appear to apply to demands for accounting under § 113.151. Under § 111.0035(5)(A), however, the settlor may restrict certain beneficiaries from the right to demand an accounting if they are not entitled or permitted to receive distributions from the trust or would not receive a distribution from the trust if it was then terminated. Thus, first tier beneficiaries cannot be prevented from exercising their demand for an accounting under the Trust Code. Although this provision does restrict some non-first tier beneficiaries from their right to an accounting, it does assure that at least first tier beneficiaries have the right to an accounting and can hold the trustee accountable.

Once demanded, the required contents of an accounting are listed in Texas Trust Code § 113.152, which remains unchanged after the recent Trust Code amendments. Under this statute, the written statement of accounts must show:

- a) All trust property that has come to the trustee's knowledge or into the Trustee's possession and that has not been previously listed or inventoried as property of the trust;
- b) A complete account of receipts, disbursements, and other transactions regarding the trust property for the period covered by the account, including their source and nature, with receipts of principal and income shown separately;
- c) A listing of all property being administered with an adequate description of each asset;
- d) The cash balance on hand and the name and location of the depository where the balance is kept; and
- e) All known liabilities owed by the trust.

TEX. TRUST CODE § 113.152.

**2. Duty to Keep Records.** A necessary extension of the right to demand an accounting is the common law duty to keep accurate books and records of account so that they can be compiled into a written accounting when demanded. *See Hollenbeck v. Hanna*, 802 S.W.2d 412, 414 (Tex. App. -- San Antonio 1991, no writ) (finding that a settlor could not totally eliminate a trustee's duty to provide an accounting as it would oust the court of its inherent, equitable, constitutional or statutory jurisdiction and override a legislative act and be void as against public policy). A trustee is required to keep full, accurate and orderly records concerning the status of the trust estate and of all acts performed thereunder. *Shannon v. Frost Nat'l Bank*, 533 S.W. 2d 389 (Tex. App. -- San Antonio, 1975, writ ref'd. n.r.e.).

In the case of *Corpus Christi Bank & Trust v. Roberts*, the Appeals Court summarized this duty as follows:

‘One of the primary duties of the trustee is to keep full, accurate and orderly records concerning the status of the trust Estate and all acts performed thereunder... A trustee is charged with the duty of maintaining an accurate account of all of the transactions relating to the trust property. He is chargeable with all assets coming into his hands, the disposition for which he can not account...’

*Roberts*, 587 S.W. 2d 173 (Tex. Civ. App. -- Corpus Christi 1979), reformed in part on other grounds and affirmed in part, 597 S.W.2d 752 (Tex. 1980).

Obviously, a trustee should keep full and accurate records of all trust administration activities necessary to provide such a complete accounting, and should retain those records at least until a full accounting is made and the applicable statute of limitations for that accounting has run.

**3. Statute of Limitations.** Texas does not have a specific statute of limitations for breaches of fiduciary duty under its Trust Code, but does provide a four year limitations period under the Texas Civil Practices and Remedies Code, § 16.004 commencing after the date the cause of action accrues. *See also* TEX. CIV. PRAC. & REM. CODE § 16.051 (providing a four year limitations period on other non-specified actions). It is important to note that this four year statute of limitations does not begin to run until all of the facts are discovered giving rise to the claim. That is, the statute does not begin to run until the claimant knows or should have known of the breach. *See Taub v. Houston Pipeline Co.* 755 S.W.3d 606, 618 (Tex. App. - Texarkana 2002, pet. denied); *see also In re: Estate of Fawcett*, 55 S.W. 3d 214, 218 (Tex. App. - Eastland 2001, pet. denied). Section 111.0035(b)(4) of the Texas Trust Code prohibits a settlor from shortening the limitations period for actions involving a trust.

Consequently, it might be best practice for the trustee to give an accounting or make a full disclosure of all material facts even if waived by the settlor in the trust instrument in order to assure that the statute of limitations has begun to run. If there is a provision waiving the duty of full disclosure or limiting a beneficiary's right to an accounting, there may also be provisions extending the general duty of confidentiality beyond third persons to certain more remote beneficiaries, such as contingent remaindermen. If this is the case, the trustee may be in a particularly uncomfortable position of leaving the statute of limitations open for a longer period of time in order to comply with the requirement of confidentiality.

**C. Duty to Keep Beneficiaries Reasonably Informed.**

It has long been held under Texas common law that a trustee owes a duty of full disclosure of all material facts known to the trustee that might affect the beneficiary's rights. *See Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996); *Montgomery v. Kennedy*, 669 S.W.2d 309, 313 (Tex. 1984). Now, the Texas Trust Code codifies that rule in § 113.060, which sets the following standard for informing beneficiaries:

The trustee shall keep the beneficiaries of the trust reasonably informed concerning:

- 1) The administration of the trust; and
- 2) The material facts necessary for the beneficiary to protect the beneficiaries' interests.

This new Code section is one of the mandatory provisions dictated under § 111.0035, however, it does allow a settlor to waive the trustee's obligation for a full disclosure to the same beneficiaries for whom the trust can waive a demand for accounting, but only to the extent the beneficiaries have not attained the age of 25 years. In other words, notwithstanding the terms of a trust instrument, a trustee must make full disclosure to all beneficiaries over the age of 25 years who are either current beneficiaries entitled to a distribution or first tier remaindermen. *See* TEX. TRUST CODE § 111.0035(5)(C).

It is important to note that this duty of full disclosure is not contingent upon any request from the beneficiary for information. It is a proactive duty that requires the trustee to determine what material information that a trust beneficiary should know and to make full and timely disclosure of that material information. The allowance for settlors to waive these disclosure rules for certain beneficiaries as described above must be clearly stated in the trust instrument, otherwise the disclosure obligation to all beneficiaries would apply.

**1. What Should be Disclosed.** Certainly, except to the extent properly waived by the settlor in the trust, a trustee should provide each beneficiary with a copy of the trust. In his outline on *Risk Management for Trustees*, Erwin Davenport recites several provisions of the Guide for ACTEC Fellows Serving as Trustees. He suggests that the best practice of trustees with regard to disclosure would include periodic written communications being sent to beneficiaries informing them of the status of the trust, important developments, investment performance and other relevant information. Mr. Davenport suggests some of the following topics be covered in a summary of beneficiaries' rights that should be given to each beneficiary:

- a) Standards for distribution of income and principal, whether mandatory or discretionary;
- b) An explanation of any guidance or restrictions provided in the instrument as to the investment policy the trustee must follow, or whether the trustee has broad discretion in making investments;
- c) The frequency of accountings and whether or not court approval will be required;
- d) Special tax planning objectives of the trust;
- e) Provisions for mandatory partial or terminating distributions from the trust, at specific ages, or otherwise;
- f) Successor trustee provisions, including provisions for removal of the trustee and whether beneficiaries or others have the removal power;
- g) Inter vivos and testamentary powers of appointment and rights of withdrawal;
- h) Trustee compensation; and
- i) Identification of trust counsel with an explanation that he or she represents the trustee and not the beneficiaries.

Erwin Davenport, *Risk Management for Trustees*, 29<sup>th</sup> Annual Advanced Estate Planning and Probate Course, Chapter 22, at 4 (June 8-10, 2005).

A best practice with respect to disclosures to beneficiaries might also include annual or other periodic reports, a receipt for which is to be signed by each beneficiary and, if appropriate, a release by beneficiaries of any claims with respect to matters disclosed in the accounting. It should be noted, however, that a requirement of a release by a beneficiary in order for them to receive distributions they would otherwise be entitled to receive may not bar future claims by the beneficiary. Although the Trust Code does not provide a specific procedure for approval of final accountings and discharge of a trustee like the discharge of a dependent administrator under the Probate Code, if a beneficiary refuses to sign an otherwise enforceable release, the trustee may seek approval of a final account and a judicial discharge under the declaratory judgment provisions if done during the permissible wind-up period under § 112.052 of the Trust Code. *See Kimball v. Baker*, 285 S.W.2d 425 (Tex. Civ. App. -- Eastland 1955, no writ).

**2. Duty to Give Notice.** Trustees also have a duty to give notices to trust beneficiaries, co-trustees and successor trustees to the extent it is required in the trust instrument. One common duty to give notice arises with respect to the rights of beneficiaries to make withdrawals of trust contributions or to exercise powers of appointment. This is not only a duty under the trust instrument providing for the giving of notices, but also may be critical in the context of a “*Crummey Trust*” that is designed to qualify contributions to the trust as present interest gifts by giving beneficiaries a thirty day or longer time to withdraw any such contributions. The failure to give proper and timely notice of *Crummey* withdrawal powers can lead to liability for potential tax losses.

**3. Drafting Waivers of the Duty to Inform.** It is presumed that any exculpatory clause exceeding the new limits provided by amendments to the Trust Code in § 111.0035, including provisions that seek to waive the trustee’s duty to provide any information, would be carved back to the limit provided now by the new Trust Code amendments. This view is certainly subject to review by the courts who may, in fact, find such excessive provisions wholly unenforceable rather than carving them back to the maximum amount of prevented disclosure under the new statute. When drafting new trusts, it is probably best to draft up to but not exceed the provisions relieving the trustee from the duty to inform.

#### **D. Duty of Loyalty.**

“Perhaps the most fundamental duty of a trustee is that he must display throughout the administration of the trust complete loyalty to the interest of the beneficiary and must exclude all selfish interests and all consideration of the interests of third persons.” GEORGE BOGERT, TRUSTS AND TRUSTEES § 543 (2d ed. Rev. 1992). This duty of loyalty arises from the fiduciary relationship itself making it “the duty of the trustee to administer the trust solely in the interest of the beneficiaries.” A. SCOTT and W. FRATCHER, THE LAW OF TRUSTS, § 170 (4<sup>th</sup> ed. 1988). Commentators and jurists have identified the duty of loyalty as inherent and inviolate thereby prohibiting a trustee from taking a position in which his personal interests or the interests of a third party becomes adverse the interest of the beneficiary. *See* RESTATEMENT (SECOND) OF TRUSTS, 2d § 170. The duty of loyalty is codified as to investment and asset management specifically in Trust Code § 117.007 (added to the Trust Code effective January 1, 2004), that provides “[a] trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.” There is also a statutory prohibition of all self-dealing with respect to lending

and buying or selling property except as expressly permitted in §§ 113.052 and 113.053 of the Trust Code. These prohibitions can be overridden in the trust instrument, except as limited by the mandatory provisions of § 111.0035 and the exculpation limitations of § 114.007 of the Trust Code.

It is the breach of duty of loyalty through self-dealing by the trustee that has received the most considerable attention by the courts. This prohibited act occurs when there is an obvious conflict between the individual interest of the trustee and the interest of the trust and its beneficiary in a transaction involving trust property. Essentially, there is a presumption that this conflict between the personal interests of the trustee and the interest of the trust prevents him from exercising independent and disinterested judgment on behalf of the trust. Consequently, the courts have routinely found that selling or leasing trust property or lending trust funds to the trustee and similar transactions benefiting the trustee are prohibited.

The prohibition against self-dealing is rooted in the presumption of the existence of fraud that is inaccessible to the eyes of the court. *See Nabours v. McCord*, 80 S.W. 595 (Tex. 1904); *see also McDonald v. Follett*, 180 S.W.2d 334 (Tex. 1944). There exists a certain presumption of fraud in self-dealing transactions because the very nature of the self-dealing transaction is such that the trustee deals on both sides of the bargain and this inside nature of the transaction makes it potentially inaccessible to beneficiaries and the courts to determine its fairness.

Self-dealing transactions involving trust property should be distinguished, however, from actions of a trustee in the ordinary administration of the trust that might favor the trustee who is also a beneficiary. Although instances favoring a trustee as beneficiary may involve breaches of duty, such as the duty of impartiality or the duty of loyalty generally, it will not necessarily involve of a conflict of interest that gives rise to the type of self-dealing claim that is based in fraud.

Notwithstanding this prohibition against self-dealing at common law, some self-dealing can be permitted by a settlor in drawing his trust instrument. This is severely limited, however, by the new minimum requirements of the mandatory provisions of § 111.0035 of the Trust Code. These provisions override any excessively permissive provision allowing a trustee to profit by his self-dealing. Section 114.007 provides that a trust provision relieving the trustee of liability for breach of trust is unenforceable to the extent that it allows any profit derived by the trustee from a breach of trust and in any event when a breach of trust is committed (a) in bad faith, (b) intentionally, or (c) with reckless indifference to the interest of a beneficiary. This provision also prohibits the exculpation of corporate trustees from self-dealing transactions that involve lending or buying or selling trust properties, though it apparently permits individual trustees to do so if waived under the trust agreement. Still, although it may be possible to relieve a trustee from certain liability regarding certain self-dealing transactions that do not violate the mandatory provisions outlined above, such conduct by a trustee still must meet the requirement that it be fair to the beneficiaries and be done in good faith and consistent with the purposes of the trust. *See TEX TRUST CODE §§ 114.007, § 111.0035.*

Although the duty to segregate trust property from a trustee's own property is really a separate duty, it stems from the same duty of loyalty discussed above. Though this is seldom a

problem for corporate trustees, a significant number of fiduciary cases have arisen from a failure of individual trustees to keep trust property separate from their own property and properly account for the administration of trust property. The RESTATEMENT (SECOND) OF TRUSTS § 179, provides that a trustee has the duty to keep trust property separate from other property and to properly designate it as property of the trust. It further states that a trustee must keep the property of separate trusts separate from each other. Thus, simple inattention to detail in the titling of accounts and of real and personal property, or incidental commingling of funds can lead to liability for the trustee that might have easily been avoided.

#### **E. Duty of Impartiality.**

The RESTATEMENT (SECOND) OF TRUSTS § 183 provides: “When there are two or more beneficiaries of the trust, the trustee is under a duty to deal impartially with them.” More specifically, a trustee must show impartiality in balancing the interests of life beneficiaries and remaindermen and in balancing the interests of members of the same class. This duty of impartiality can be significantly modified by the trust terms which may subject beneficiaries to different treatment.

This duty of impartiality should become of paramount concern whenever a trustee is exercising discretion, particularly with respect to investment decisions, allocation of principal and income decisions, and distribution decisions. Whenever a trustee takes discretionary action that might be construed as partial to one beneficiary or another, the trustee would be well advised to carefully document the reasons and possibly disclose it to the other beneficiaries when the act is taken. When in doubt, it is probably best for the trustee not to be partial to any beneficiary, unless the trustee can show that it is fair to all beneficiaries.

A common situation in which the impartiality of a trustee may be challenged is when income and remainder beneficiaries are not the same. In that situation, a distribution in favor of the income beneficiaries can reduce the value of the trust and the ultimate benefit to the remainder beneficiaries. On the other hand, refraining to make a distribution to income beneficiaries favors remainder beneficiaries. Other challenges can occur when there are multiple beneficiaries eligible for the same distributions, such as in a spray or sprinkle trust. In such cases, the greater the definition provided by a settlor wishing to waive this duty for the trustee, the better.

Some assistance is provided to trustees by the addition of new § 113.027 to the Trust Code, which permits non-pro rata distributions and divisions of trust property as a default provision. Although many well drafted trusts already allow for non-pro rata distributions and divisions, this statute makes it the rule when a trust is silent on this issue. When this default rule applies, a trustee should be able to make non-pro rata distributions among beneficiaries and make divisions of property to allow distributions of whole interests of equivalent value (rather than undivided interests in real property, for example). Of course, the requirement of good faith dealing and fair play will always apply when determining the fairness of the non-pro rata distribution or division of property.

With respect to discretionary distributions in particular, the trustee must initially determine and should consistently apply the distribution standards outlined in the trust, to the extent that they are clear. Common distributions standards provided in trusts include health, support, maintenance, education, welfare, comfort, best interest of a beneficiary and others. A truly discretionary trust, on the other hand does not provide any standards for distribution, but simply gives the trustee discretion to make distributions to certain identified beneficiaries. Often, the trust instrument will provide additional factors that the trustee should consider in exercising this discretion to make distributions, but even if no further direction is made, the following might be considered by a trustee in exercising that discretion:

- 1) Other sources of income available to a beneficiary, including other trusts from which the beneficiary may actually be receiving distributions already;
- 2) Other assets available to a beneficiary and whether those assets generate income sufficient to provide for the beneficiary;
- 3) Other income generated by the beneficiary;
- 4) The accustomed standard of living of the beneficiary; and
- 5) Special health problems that can affect a beneficiary's earnings or access to other income or assets, and whether or not there is insurance to assist the beneficiary with those problems.

As discussed earlier in this outline, sole and absolute discretion granted to a trustee is little help in waiving this duty of impartiality, but it bears repeating that the standard for review of discretion by a court would be whether or not it was an abuse of discretion that is completely outside the bounds of reasonable conduct.

#### **F. Duty to Enforce Claims and Defend Actions for the Trust.**

The RESTATEMENT (SECOND) OF TRUSTS § 177 provides that the trustee is under a duty to the beneficiary to take reasonable steps to realize on claims that he holds in trust. This duty is somewhat an extension of the duty to take control of property and to the extent a claim might be lost due to the trustee's inaction or delay in acting, he may be subject to surcharge for any resulting loss. *See Bogert*, at § 592; *see also Scott* at § 177. Although the Texas Trust Code does not specifically impose a duty on the trustee to prosecute claims for the trust, Texas Trust Code § 113.019 gives the trustee the power to "...compromise, contest, arbitrate or settle claims of or against the trust estate or the trustee." This is supported by Texas case law as is illustrated in *Cogdell v. Fort Worth Nat'l Bank*, 544 S.W.2d 825 (Tex. Civ. App. -- Eastland 1976 writ ref'd n.r.e.). In that case the Court found that the trustee has the authority to compromise and settle claims involving the trust and may apply to the Court for instruction if he is in doubt about whether or not to compromise. As a result, a beneficiary who did not agree with the settlement was bound by it and left with the prospect of pursuing an action against the trustee for breach of his duty in seeking to settle.

This duty to pursue claims for the trust was modified in one respect by the new Trust Code amendments. Section 113.028 of the Trust Code now permits trust beneficiaries to bar a trustee's prosecution or assertion of a claim for damages against a party who is not a beneficiary of the trust. The scope of this provision is limited to claims for damages against a person who is not a beneficiary of the trust (which may include former non-beneficiary trustees) and only applies if each beneficiary of the trust provides written notice to the trustee. Although the final legislation signed into law does not specify that it applies only to new litigation after the effective date, legislative history suggests that it is not intended to apply to pending litigation. *See* Glen M. Karish, *2005 Legislative Update*, STATE BAR OF TEXAS NEWSLETTER, Sept. 2005, at 120 ¶ 2.5.

A trustee's duties upon defense of the trust from claims against the trust would seem to run similar to that for enforcing claims and the trustee would seemingly be able to pursue court instruction to the extent it is unclear whether the claim should be compromised. Since new Trust Code § 113.028 does not apply to defensive claims, a trustee might nevertheless receive sufficient comfort in taking an action if it is agreed by all current beneficiaries.

Agreements limiting liability may be possible under the rather broad provisions of § 114.032 of the Trust Code authorizing and making enforceable most agreements between trustees and beneficiaries. This provision makes final and binding those agreements relating to a trustee's duty, power, responsibility, restriction or liability if it is a written agreement and meets the requirements of that section. Interestingly, this section might also bind minor beneficiaries under certain circumstances. Similarly, § 114.005 authorizes releases of a trustee to relieve him of liability except with respect to corporate trustees committing self-dealing under §§ 113.052 or 113.053 of the Trust Code.

#### **G. Duties Relating to Multiple Trustees.**

At common law “[w]here there are several trustees it is the duty of each of them, unless it is otherwise provided by the terms of the trust, to participate in any administration of the trust.” RESTATEMENT OF TRUSTS (SECOND) § 184. This gives little guidance when there are multiple trustees and even less guidance when they are unable to reach a unanimous decision. Under this common law rule, there also existed a duty not to delegate to third persons or to other co-trustees an act that the trustee, himself, could perform. *See id.* Although the Trust Code prior to recent amendments attempted to address the non-unanimous voting problem and absolve dissenting co-trustees from liability for decisions by the other trustees, more extensive guidance and clarity was needed in this area. *See* TEX. TRUST CODE §§ 113.085, 114.006 (2002) (providing rules prior to new amendments). Consequently, these provisions of the Texas Trust Code have been amended to permit delegation among trustees and clarify how co-trustees may act without a unanimous consent.

Section 113.085 now provides that if a unanimous decision cannot be reached, a majority of co-trustees can act and those remaining co-trustees may act when there is a vacancy. The amendments further provide that each trustee is to perform all trustee functions unless (1) the Trustee is unavailable to perform the function for certain enumerated reasons, or (2) the trustee has delegated the performance of the function to another trustee. This authorization for delegation of functions must either be permitted by the terms of the trust or applicable law and must be communicated to all other co-trustees, together with a filing of the delegation in the records of the trust. Section § 113.085(e) authorizes delegation among co-trustees unless the settlor specifically directs that a function be performed jointly, and a delegation is deemed to be revocable unless the co-trustee's delegation is made irrevocable.

**1. New Co-Trustee Delegation Rules.** Section 114.006 allows a co-trustee to avoid liability when he does not join in the actions of the other co-trustees unless he does not exercise reasonable care to (1) prevent a serious breach of trust; and (2) compel a co-trustee to redress a serious breach of trust. A dissenting co-trustee will also not be held liable for any actions in which he joins if he notifies any co-trustee of his dissent at or before the time the action is taken. Similarly, a co-trustee may be excused from liability incurred by other co-trustees from which he dissented, provided the dissenting co-trustee exercises reasonable care to prevent the commission of a serious breach of trust and to compel the other co-trustee to redress a serious breach of trust. The net affect of these multiple trustee provisions is that the rule against delegation of duties by trustees is now reversed, and a trustee may delegate duties and be relieved from liability for the wrongful acts of the other co-trustee, so long as the delegating co-trustees meets his or her duties under the liability provisions of § 114.006(b). This new authorization for delegation of trustee duties will be explored in more detail in connection with the delegation of duties with respect to the investment of trust property.

**2. Successor Trustees.** The Trust Code provision discussing liability of successor trustees for their predecessor's misdeeds was unchanged by the recent Trust Code amendments. Texas Trust Code § 114.002 still permits a successor trustee to avoid liability for a predecessor's breach of trust unless he knows or should know of a situation constituting breach of trust committed by the predecessor, and the successor trustee improperly permitted it to continue, failed to take a reasonable effort to compel the trustee to deliver the trust property or failed to make a reasonable effort to compel a redress of the breach. This is very similar to the newly expanded and clarified co-trustee liability rules of § 114.006.

An interesting and helpful amendment to the Trust Code allows a new trustee to engage in certain conduct without actually accepting the trust and avoid the incurring of liability with respect to the trust after acting on this provisional basis. Actions a prospective trustee could take without actually "*accepting*" the trust include (1) acting to preserve the trust property if, within a reasonable time after acting, the person gives notice of the rejection to the settlor or all beneficiaries then entitled to receive distributions (in the event the settlor is deceased or incapacitated), and (2) inspecting or investigating trust property for any purpose including determining the potential for liability of the trust under environmental or other law. Thus, successor trustees may now begin to take these minimal actions without being deemed to accept the trust and assume the liability of the trust.

**3. Trust Protector Liability.** Section 114.003 recognizes the practice of providing a “*trust protector*” to whom certain powers are given to direct trustees to take certain actions. The provision specifically authorizes a trust to give a trust protector the power to direct the modification or termination of the trust and a trustee must follow that direction unless it is manifestly contrary to the terms of the trust or the trustee knows the direction would constitute a serious breach of a fiduciary duty owed by the trust protector. This provision also clarifies that such a trust protector is presumed to be a fiduciary and acting in good faith with regard to the purposes of the trust and the interests of the beneficiaries, and the trust protector is to be held liable for any breach of his fiduciary duties. *See* TEX. TRUST CODE § 114.003.

#### **H. Duty to Prudently Invest Trust Assets.**

Perhaps the most significant change brought about in the 78<sup>th</sup> legislature in 2003, was the adoption of a modified version of the Uniform Prudent Investor Act of 1994, which was made effective on January 1, 2004. Prior to this effective date, Texas courts and Texas statutes have long applied the prudent person rule as a standard for investing trust funds. Now, Texas aligns itself with approximately forty-two other states that have adopted the prudent investor standard. A companion uniform act, the Uniform Principal and Income Act of 1997, was also adopted by the Texas legislature and similarly made effective January 1, 2004. This statute coordinates the allocation of principal and income with the new rules for investment that might change how an income beneficiary is treated. The prudent investor standards are also extensively addressed in the RESTATEMENT (THIRD) OF TRUSTS.

The changes made by these new acts, though welcome in many respects, have changed the standards for investing and, therefore some of the fiduciary duties by which trustees will be measured. It is important that individuals serving as trustees, in particular, have these changes communicated to them and an opportunity to understand them. This is not only to help guard against their inadvertent breach of a fiduciary duty by failing to meet the new standards, but also to afford them the opportunity to seek professional investment assistance which might be necessary in some cases and is now permissible and perhaps encouraged under the new law. Attached as Appendix 1 to this outline is a sample memorandum to trustees informing them of the standards and duties of the prudent investor rule and suggesting some ways to meet those standards and limit liability in the exercise of those duties.

The addition to the Trust Code of § 117.001 *et seq.* provides the Texas version of the Uniform Prudent Investor Act. This replaces the prudent person rule with the prudent investor rule. The former prudent person rule at common law was codified in Texas Trust Code § 113.056, which stated in part, “. . . a trustee shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income from, as well as the probable increase in value and the safety of, their capital.” This more traditional prudent man rule was updated some years ago to consider the larger portfolio when assessing the trustee's performance, rather than a consideration as to the prudence of a single investment.

It is critical for trustees and their advisors to understand that there was no phase-in of the prudent investor rule, which is a default rule that now applies to all trusts, whether new or existing, as of its effective date of January 1, 2004. Although this rule can be overridden by terms of the trust instrument, the new statute makes it harder to override this new rule with special trust provisions and even states that provisions specifically intending to apply the prudent man rule may in fact invoke the prudent investor rule. Interestingly, new § 117.012 of the Trust Code specifically provides that most language intended to invoke the prudent man rule is automatically converted to invoke the prudent investor rule. Consequently, trustees must note that it is very unlikely that a trust originally drawn with a prudent man rule in mind will not actually be automatically converted on the effective date to a prudent investor standard for trust investments. Language that is now converted to the prudent investor rule is identified in § 117.012, that reads as follows:

The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes an investment or strategy permitted under this chapter: “investments permissible by law for investment of trust funds,” “legal investments,” “authorized investments,” “using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of 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 their capital,” “prudent man rule,” “prudent trustee rule,” “prudent person rule,” and “prudent investor rule.

New Trust Code § 117.004 provides most of the prudent investor standards, which generally include the following features:

- (1) prudence is applied to the total portfolio rather than individual investments;
- (2) a fiduciary's central consideration should be the risk and return of investments in the portfolio;
- (3) restrictions on certain types of investments have been removed; and
- (4) the requirement of diversification has been added.

Texas has now entered the age of the modern portfolio theory with respect to its trust management requirements and replaced capital preservation and income generation priorities with total return considerations.

The following highlights some particular changes that individual trustees (as well as corporate trustees) should note:

**1. No Default Provision for Retention of Assets.** This former presumption that investments originally contributed by the settlor may be retained is now replaced by the duty to

diversity investments. This duty may be waived by the trust terms, but it should be very clear and specific as to what may be retained and that there be no duty to diversify. The protection for retaining assets already owned by the trust has been removed from the statute. Former § 113.003 of the Trust Code provided, “[a] trustee may retain, without regard to diversification of investments and without liability for any depreciation or loss resulting from retention, any property that constitutes the initial trust corpus or that is added to the trust.” Similarly, some forgiveness for retention without diversifying was provided under former § 113.056 (b) and (c) of the Trust Code which stated:

(b) Within the limitations of subsection (a) of this section [the prudent man rule], a trustee may acquire and retain every kind of property and every kind of investment that persons of ordinary prudence, discretion, and intelligence acquire or retain for their own account.

(c) Within the limitation of subsection (a) of this section [the prudent man rule], a trustee may indefinitely retain property acquired under this section without regard to its suitability for original purchase.

Since many older trusts relied on these provisions for the ability to retain family-owned businesses, ranch and farm land, collectibles and life insurance, the absence of language allowing retention can now cause serious upheaval in the historical management of trust property. This is particularly true in light of the duty to diversity (discussed below). Hopefully any lacking language to retain property the family would like to keep in trust can be corrected by trust modification (if the purpose of the trust to retain is clear enough), or by agreement of all trust beneficiaries.

**2. Duty to Diversify.** There is now an affirmative duty to diversify the assets of the trust (for long term investments). The diversification requirement can cause problems for certain trusts, particularly those where there is a high concentration of one asset, such as family businesses, farms or ranches, other closely held business interests, and life insurance trusts. If there are not provisions avoiding the diversification requirement of the new Act, the trustee may need to seek judicial modification or find some way to diversify. TEXAS TRUST CODE ANN. § 117.005 (Vernon 2003).

**3. Requirement to Plan and Monitor Portfolio.** The trustee must initially assess the portfolio and make and implement decisions concerning the retention and disposition of assets. *Id.* at § 117.006. The trustee must also more actively and periodically assess the portfolio mix and determine what changes need to be made from time to time, and may need to seek professional assistance to the extent the trustee does not consider himself competent to do so. *Id.* at § 117.004.

**4. Possible Duty to Delegate.** A trustee may now delegate his investment authority if he meets a certain criteria specially added in the Texas version of the uniform act, by which he may then avoid liability. *Id.* at § 117.011. This authority to delegate is not only new, but it may also even rise to the level of a duty to delegate if a trustee is not capable to exercise all of his

investment and other duties under the prudent investor rule. When and how a trustee may delegate is discussed more fully in Appendix 1 to this outline.

**5. Speculative Investments Allowed.** The general rule that a trustee cannot engage in speculative or risky investments was reversed by the new prudent investor rule that allows all types of investments. *Id.* at § 117.004(e); and see former Trust Code § 113.056. Although a trustee may now engage in speculative investments, they only constitute a part of the overall portfolio consideration of risk and return factors and the trustee must still meet the general rule of prudence. See TEX. TRUST CODE § 117.004(b).

### **I. Duties With Respect to the Allocation of Principal and Income.**

The New Principal and Income Act replaces various provisions previously governing the allocation of principal and income and other accounting provisions under the Trust Code. The new Principal and Income Act appears in § 116.001 *et seq.* of the Trust Code. It became necessary to make these principal and income allocation changes in part because the new focus on investing for growth and total return under the new prudent investor rules could create a problem for protecting income beneficiaries.

**1. Income Beneficiaries.** The focus of Chapter 116 allocation rules is on balancing the rights of income beneficiaries to income and remainder beneficiaries to principal at the end of the income term of the trust. “*Income beneficiaries*” are defined as those to whom net income is payable. TEX. TRUST CODE § 116.002(5). “*Net income*” is defined as total receipts allocated to income during an accounting period, less disbursements made from income during the period. TEX. TRUST CODE § 116.002(8). An “*income interest*” is the right of an income beneficiary to receive net income, whether mandatory or discretionary. TEX. TRUST CODE § 116.002(6). The allocation rules that apply to determine the allocation of receipts to net income for the benefit of these income beneficiaries are contained in §§ 116.051-116.206 of the Trust Code.

**2. Remainder Beneficiaries.** The interest in trust principal that follows an income interest is that of the Remainder Beneficiary, which is defined in § 116.002(11). It is this remainder interest and its preservation and growth in competition with the income interest of current income beneficiaries that fuels much of the need for trustee fairness in investing for and allocating receipts. It is also this conflict of interests that can adjust the income and principal allocation under § 116.005 which will be more fully discussed below.

**3. Power to Adjust Between Principal and Income.** The new principal and income act empowers the trustee to adjust principal and income to provide a more fair result, but is only available in limited circumstances. This power to adjust, however, has a downside. The trustee may expect to hear from whichever of the income or principal beneficiaries was more negatively affected by the adjustment, and he may scrutinize the trustee's decision in search of an abuse of discretion. It also appears that the decision to exercise the power to adjust, when it is available, must be made annually, rather than setting a standard adjustment to apply perpetually. Understandably, a trustee could begin to feel that he is damned if he does and damned if he doesn't with respect to adjustments. In order for a trustee to exercise the power to adjust, Trust Code§ 116.005(a) requires the following:

- (a) The trustee must invest and manage the trust assets as a prudent investor (that is, he must be subject to the prudent investor rule),
- (b) The terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income (that is, there must be an income beneficiary), and
- (c) the trustee must determine that he cannot meet his duty to impartially administer the trust based on what is fair and reasonable to all beneficiaries (subject to clear contrary intention in the trust itself) unless he makes an adjustment. *See* TEX. TRUST CODE § 116.004.

When deciding whether and to what extent a trustee should exercise the power to adjust, § 116.005 of the Code requires that the following factors be considered:

- (a) the nature, purpose, and expected duration of the trust;
- (b) the intent of the settlor;
- (c) the identity and circumstances of the beneficiaries;
- (d) the needs for liquidity, regularity of income, and preservation and appreciation of capital;
- (e) the assets held in the trust; the extent to which they consist of financial assets, interests and closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;
- (f) the net amount allocated to income under the other sections of Chapter 116 and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;
- (g) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;
- (h) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and
- (i) the anticipated tax consequences of an adjustment.

Once the trustee has decided to make an adjustment, the trustee will need to determine the extent of the adjustment and how distributions in accordance with the adjustment will be paid. In this regard, the trustee will need to carefully follow its other trustee duties, particularly the duty of impartiality. Although a trustee may determine that an adjustment is necessary in one year, it should not be presumed that it would thereafter also be necessary in subsequent years or to the same extent. Consequently, in order to meet the trustee's duty with respect to adjustments, they should be considered separately each year and the decision to adjust and the extent of adjustment should be documented in accordance with the standards of § 116.006 listed above.

Fortunately, the Trust Code does provide some protection from liability for trustees who adjust. First, there is a presumption of fairness and reasonableness to all beneficiaries. 116.004(d). Trustee's decision to exercise or decision not exercise a discretionary power to

adjust is subject to the abuse of discretion standard of review, so a court cannot change the trustee's decision without finding an abuse of discretion. A trustee's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power. TEX. TRUST CODE § 116.006(a). If a court determines that a trustee has abused its discretion, the court may place the income and remainder beneficiaries back in the position they would have occupied if the discretion had not been abused by distributing an additional amount to income beneficiaries or withholding future distributions from them. If this method of restoring income and remainder beneficiaries to their previous positions is not possible, the court may also order the trustee to pay an appropriate amount from the trustee's own funds to one or more of the beneficiaries, the trust or both. TEX. TRUST CODE § 116.006(c).

**4. Advisory Opinion.** For those situations where the trustee is convinced he will be second guessed by a disgruntled beneficiary, he might avail himself of § 116.006 which permits the trustee to seek an advisory opinion from the court about an adjustment decision he is considering. This proceeding is only permitted if there are reasonable grounds to believe that a beneficiary will object in the absence of an advisory opinion. Trustees will have to pay the costs of the proceedings, but they may be reimbursed at the discretion of the court.

**5. Automatic Allocation Rules.** The new principal and income act also replaces former §§ 113.101-113.111 regarding the allocation of receipts and disbursements between principal and income on various assets. The new rules make several changes and address several new investment types. It has been said that these new allocation rules generally favor principal. Notable differences relate to (a) oil, gas and mineral income, (b) timber, (c) retirement plans and IRAs, (d) distributions from entities, and (e) accounting for an incorporated business.

Trustees with income beneficiaries, in particular, should review the new principal and income allocation and accounting rules to determine how it might affect the allocation of income. They should then, of course, determine whether any adjustments might be necessary and whether circumstances qualify for adjustments. As with periodic review of the investment portfolio, trustees will also have to review their income and principal allocation formulas to be sure they are always accurate and updated.

Generally, the new environment created by adopting the principal and income act and the prudent investor act is one that should cause all trustees to quickly assess whether or not they have the competence to perform the tasks they will be required to perform, immediately determine whether adjustments, if any, may be necessary in their investments or allocations with respect to the trust, promptly execute any adjustments, and periodically review them. In all, this may be an era more favorable to the professionals who advise and with whom trustees consult, than it is for the trustees.

### **III. OTHER TRUST CODE CHANGES TRUSTEES SHOULD NOTE.**

In addition to the significant Trust Code changes affecting various trustee duties outlined in Section II above, several other Trust Code changes were made in the last legislature that

trustees should note. Some of these changes are particularly helpful to legal advisors of trustees and estate planners who should be aware of how these changes may affect drafting choices. Some of the more notable changes are discussed briefly below. All of these changes are effective January 1, 2005, unless otherwise noted.

**A. Division and Combination of Trusts.**

Section 112.057 of the Trust Code has been expanded to allow for the division or combination of trusts for any reason, provided the rights of beneficiaries are not impaired and it does not adversely affect the achievement of trust purposes.

**B. Pet Trusts.**

Section 112.037 has been added to the Trust Code providing a means for a settlor to provide care and support for companion animals who survived the settlor. These pet trusts are limited to providing for the care of existing animals and do not extend to the offspring of those animals born after the settlor's death. This statute attempts to fill in some of the gaps that might otherwise cause the trust to fail. For example, the statute allows anyone interested in the welfare of the surviving pet to ask the court to appoint someone to enforce the trust if the trust does not specifically provide a means for enforcing the trust. There is a fail-safe provision allowing a Court to determine that the trust property exceeds that which is necessary for the trust's intended use and may order its distribution. The statute also provides a means for determining the remaindermen of the pet trust if the settlor fails to name them. Interestingly, although pet trusts would also be subject to the rule against perpetuities, animals cannot be used as measuring lives.

**C. Distributions to Minor and Incapacitated Beneficiaries.**

Section 113.021 of the Trust Code now provides a helpful default provision for trusts that do not specifically provide an array of options for making distributions to or for the benefit of a beneficiary. Although the prior statute allowed for distribution to a uniform transfers for minors account in the case of minor beneficiaries, there was not a provision for continued maintenance of funds distributed for the benefit of an otherwise incapacitated beneficiary. This amendment permits a trustee to manage a distribution as a separate fund within the trust for the incapacitated or minor beneficiary, however, the beneficiary has a continuing right to withdraw the distribution. Since an incapacitated beneficiary probably does not have the capacity to withdraw the funds, presumably a guardian could do so. It would seem that the purpose of the provision would be to avoid the need for a guardianship and allow the trustee to continue to manage the funds for the incapacitated beneficiary's benefit indefinitely.

**D. Definition Change for Settlers.**

Trust Code Section 111.004 modified the definition of "*settlor*" to address the situation where there are multiple settlors and provide that one who contributes property to a trust is a settlor only in proportion to the property contributed by that person.

**E. Codified Remedies for Breach of Trust.**

A definition for “*breach of trust*” was also added as a necessary corollary to new § 114.008 of the Trust Code which lists the remedies for breach of trust. A breach of trust is defined in sub-section (25) as “a violation by a trustee of a duty the trustee owes to a beneficiary.” The list of remedies provided in new Code § 114.008 are not new as they were all probably already available under Texas common law. The list is helpful, however, as a reference for remedies when the trustee duties outlined above and others have been breached. Section 114.008 lists the following remedies a Court may impose in that instance:

- (1) Compel the trustee to perform the trustee’s duty or duties;
- (2) Enjoin the trustee from committing a breach of trust;
- (3) Compel the trustee to redress a breach of trust, including compelling the trustee to pay money or to restore property;
- (4) Order a trustee to account;
- (5) Appoint a receiver to take possession of the trust property and administer the trust;
- (6) Suspend the trustee;
- (7) Remove the trustee as provided under § 113.082;
- (8) Reduce or deny compensation to the trustee;
- (9) Void an act of the trustee, impose a lien or constructive trust on trust property, or trace trust property of which the trustee wrongfully disposed and recover the property or the proceeds from the property [provided that one who assists a trustee in good faith is protected from liability as if the trustee had properly exercised the applicable powers under sub-section (b)]; or
- (10) Order any other appropriate relief.

TEX. TRUST CODE § 114.008.

**F. Scope of Court Intervention in Trust Administration.**

Section 115.001 of the Trust Code was amended to clarify that a Court may intervene in the administration of a trust to the extent that the court’s jurisdiction is invoked by an interested person or is otherwise provided by law. The statute does clarify, however, that a trust is not subject to continuing judicial supervision unless the court orders such supervision. It might be appropriate to also note here that the question raised by amendments in 2003 as to whether the statutory probate court still had jurisdiction over testamentary trusts, has been resolved by adding that language back to Probate Code § 5(e). This provision again clarifies that statutory probate

courts and district courts have concurrent jurisdiction over charitable, inter vivos and testamentary trusts.

**G. Necessary Parties to Trust Litigation.**

Previously, § 115.011 made any person designated by name in the instrument creating the trust a necessary party to an action involving the trust. This often included as necessary parties many who had little or no interest in the trust. Newly amended § 115.001 now provides that beneficiaries designated by name in the instrument and the trustee actually then serving are the only necessary parties.

**H. Expanded Time for Giving Notice to Attorney General In Charitable Trust Litigation.**

Previously, litigation involving a charitable trust required notice be given to the Attorney General within thirty days of filing and at least ten days prior to a hearing. The ten day minimum requirement has now been expanded to twenty-five days to provide more reasonable notice and preparation time for the Attorney General. This amendment to § 123.003 of the Texas Property Code also makes it clear that no notice of an uncontested probate proceeding is required.

**I. Court May Override Waiver of Bond.**

Changes to § 113.058 of the Trust Code provides that a court is not prohibited from ordering a trustee to post a bond in an appropriate case even though the trust instrument waives the bond.

**J. Trustee's Powers Include the Granting of Options.**

Under new Trust Code § 113.003, a trustee is empowered to grant an option involving a sale, lease or other disposition of trust property even if the option is exercisable beyond the trust term and may similarly acquire and exercise an option that is exercisable beyond the duration of the trust. Like any other trustee powers, this one is permitted subject to any contrary provisions of the trust instrument.

**K. Spendthrift Trust Provisions Protect Beneficiary Trustees With an Ascertainable Standard of Distribution.**

Recently, the American Law Institute published its RESTATEMENT (THIRD) OF TRUSTS, comments and examples under § 60 of which questioned whether spendthrift trust provisions protected trustees who are also beneficiaries of a trust from his or her creditors, even if the trustee's discretion to make distributions is limited to an ascertainable standard such as health, education, maintenance and support. The Restatement considers beneficiaries with powers to make distributions to themselves or direct it to others similar to settlors to whom the spendthrift trust provisions do not ordinarily apply. In order to assure that spendthrift protection remains intact, notwithstanding frequent reliance on the Restatement of Trusts by Texas courts, § 112.035 now clarifies that spendthrift protection can extend to trustees who are also beneficiaries even

though the beneficiary has a presently exercisable power to distribute property to himself. This protection is limited, however, to cases where the beneficiary's power is limited by an ascertainable standard, is subject to consent of an adverse party, or is a non-general power of appointment. It also clarifies that testamentary powers of appointment and annual exclusion withdrawal rights are not sufficient to undermine spendthrift trust protection for beneficiaries holding those powers.

**L. Management Trusts Can Be Created Without First Creating a Guardianship.**

Management Trusts under § 867 of the Guardianship Code can now be established by court order upon initial application for a management trust without first establishing a guardianship trust as under prior law. These amendments to § 867 and related provisions of the Guardianship Code, not only make the creation of a management trust on the determination of incapacity without a guardianship possible, but also clarify that management trusts are available for any incapacitated ward, not just minors. Such management trusts can become a sound alternative to costly guardianships in some cases. It is also now possible under these amendments to have an individual appointed as management trustee, provided the ward's assets to be subject to the trust do not exceed \$50,000 and no professional corporate trustee will accept the trust.

**M. Effect of Divorce on Living Trust Beneficiaries.**

New Probate Code §§ 471-473, now provide that provisions of a revocable lifetime trust in favor of a former spouse that was executed prior to a divorce will be revoked by treating the former spouse as having died immediately before the dissolution of the marriage for purposes of that trust instrument. This makes the effect of divorce on living trusts on par with the effect of divorce on wills under § 69 of the Probate Code and as named beneficiaries under life insurance policies. Still at risk, however, are former spouses named as retirement plan or IRA beneficiaries. This statute, as the others disfavoring former spouses after divorce, can be overridden in an instrument that specifically intends to provide for the former spouse if executed after the divorce. Section 473(b) also obligates the former spouse to return any property of the other spouse he or she was not entitled to receive after the divorce.

**N. Special Considerations for Attorneys Serving as Trustees.**

Because of their professional experience with legal matters and trustworthiness, lawyers are often asked by family members and clients to serve as trustee of their trusts. Attorneys should remember that they already are acting in a fiduciary capacity in their attorney-client relationship, which has its own fiduciary liability issues that will be discussed more fully below. For any attorney who has accepted or is considering a trustee appointment for a client, there are several ethical concerns to be considered.

**1. Selection of Trustee.** A lawyer's mere appointment to serve as trustee of a trust has its own conflicts of interest concerns, particularly if the attorney drafts the trust or participates in the discussion on selecting trustees. Because an attorney has a fiduciary duty to act solely in the best interest of the client, there may be an inherent conflict of interest in his serving in a role to

administer the trust according to its terms that may be against a beneficiary/client's wishes or worse, contrary to their best interests.

Under Texas Disciplinary Rules of Professional Conduct, Rule 1.06(b)(2), a lawyer shall not represent a person if the representation of that person reasonably appears to be or becomes adversely limited by the lawyer's or law firm's own interests. Although there may be an exception if the client consents with full disclosure, this is only available if the lawyer reasonably believes the representation will not be materially affected. TEX. DISCIPLINARY R. PROF'L CONDUCT 106(c). Comment 5 to this Rule provides further "the lawyer's own interests should not be permitted to have adverse affect on representation of a client, even where paragraph (b)(2) is not violated." "If the probity of a lawyer's own conduct in a transaction is in question, it may be difficult for the lawyer to give a client detached advice." *Id.* If it may be presumed that a beneficiary's interest is generally to receive funds from a trust, and a trustee's duty is to withhold or invest those funds in accordance with the trust terms and to pay trust expenses (including the trustee fee), there would seem to be a real conflict, particularly if there are other beneficiaries whose interests differ from the client beneficiary.

Thus, if a lawyer is to consider serving as a trustee notwithstanding these ethical problems, it would certainly be best for the client to be advised on the selection of the trustee and the drafting of the trust by an independent other lawyer and that the client consent in writing after full disclosure. It is imperative that the attorney point out all alternatives to himself as trustee in the selection process and avoid allowing his self-interest to interfere with his independent professional judgment in recommending the best choice for fiduciaries. Failing to do so might constitute self-dealing unless it is expressly authorized by the trust.

**2. Trusts Benefiting the Attorney as Trustee.** There is also a prohibition in Rule 1.08 against a lawyer preparing an instrument giving the lawyer or person related to the lawyer any substantial gifts from a client, including a testamentary gift, except where the client is related to the donee. TEX. DISCIPLINARY R. PROF'L CONDUCT 108(b). A lawyer should also be cautious about any trustee power or liability limiting provisions that might give him an advantage over his client. Rule 1.08(g) though targeting malpractice and not a breach of fiduciary duties, prohibits a lawyer from making an agreement prospectively limiting the lawyer's liability toward a client unless permitted by law and the client is independently represented or waives such representation after being advised in writing to be independently represented. Obviously, any exculpatory clauses drafted by the lawyer who is to serve as trustee, could run afoul of this rule.

**3. Trustee Compensation.** Trustee compensation might also be problematic for attorneys whose clients benefit from a trust, particularly if the attorney is also being compensated for his legal representation. There is certainly a duty to prudently hire legal advisors, and the attorney might have a conflict in selecting himself or his law firm to provide legal representation to himself as trustee. Under Rule 1.04, the reasonableness of attorney's fees might well include fees granted to a trustee for his trustee services under the trust, so that the combined fee for legal representation and trustee services may not exceed a reasonable fee.

**4. Other Trustee Duties.** There are, of course, all the other concerns that any trustee who is also a beneficiary might face with respect to duty of loyalty and impartiality to the other

beneficiaries of the trust. Because the attorney-client relationship is considered by courts as a highly fiduciary relationship, coupling it with the high fiduciary responsibility owed by trustees, only makes a more potent cocktail for liability. A discussion of the fiduciary duties an attorney owes in the attorney-client relationship is summarized below.

#### **IV. FIDUCIARY DUTIES OWED BY ATTORNEYS TO CLIENTS.**

Texas Courts have found fiduciary relationships to exist in two ways. First, a fiduciary relationship may be found to exist as a **matter of law**. Second, fiduciary relationships may arise because of prior personal relationships and dealings, together with surrounding circumstances sufficient to create a fiduciary relationship as a **question of fact** (sometimes referred to as “*confidential relationships*”). Aside from the clear fiduciary duties owed by the trustee as outlined above, this section focuses on the fiduciary duties owed to the client by attorneys.

##### **A. Fiduciary Relationships as a Matter of Law.**

Fiduciary relationships the courts have found and statutes have declared as a matter of law, include the following (which is not exhaustive):

- (1) Trustees;
- (2) Executors, administrators, guardians and receivers;
- (3) Attorneys in an attorney-client relationship (these have been referred to as “*highly fiduciary*” relationships);
- (4) Partners;
- (5) Directors of corporations;
- (6) ERISA fiduciaries;
- (7) Spouses (usually as to community property);
- (8) Agents in a principal-agent relationship, including real estate agents, brokers, escrow agents, trusted employees, and attorneys-in-fact under a power of attorney.

An agent or attorney-in-fact under a power of attorney clearly stands in a fiduciary relationship to his principal as a matter of law. TEX. PROB. CODE ANN. § 489B(a) (Vernon 2003); *Southland Lloyd's Ins. Co. v. Tomerlain*, 919 S.W.2d 822 (Tex. App.—Texarkana 1996, writ denied.); *State v. Durham*, 860 S.W.2d 63 (Tex. 1993); *Sassen v. Tanglegrove Townhouse Condo. Ass'n*, 877 S.W.2d 489 (Tex. App.—Texarkana 1994, writ denied.). As a fiduciary, the agent owes his principal a high duty of good faith, fair dealing, honest performance and strict accountability. *Sassen*, 877 S.W.2d at 492.

## **B. Confidential Fiduciary Relationships as a Question of Fact.**

If one seeks to establish a fiduciary relationship as a question of fact, it will have to be proven at trial and determined by the trier of fact. To make this determination, one should examine the entire relationship between the parties, not just the end results. There must be evidence of some preexisting relationship or prior course of dealing between the parties, separate and apart from the relationship at issue. An informal or confidential fiduciary relationship arises from a moral, social, domestic or merely personal relationship where one person trusts and relies upon another. *Crim Truck and Tractor v. Navistar Int'l. Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992), *rev'd on other grounds*. See *Richter v. Waggoner*, 90 S.W.3d 890, 896 (Tex. App.—San Antonio 2002, no pet.). The factors usually applied by the Court seem to include the following:

- 1. A Voluntary Undertaking by the Purported Fiduciary.** See *Heutt v. State*, 970 S.W.2d 119 (Tex. App.—Dallas 1998, no pet.), see also *Kapur v. Goldstein*, No. 01-02-00023-CV, 2003 WL 1848559 (Tex. App.—Houston [1st Dist.] Apr. 10, 2003, no pet.) (mem. opinion) (not designated for publication).
- 2. The Purported Fiduciary Assumed a Position of Confidence or Influence.** See *Texas Bank and Trust Co. v. Moore*, 595 S.W.2d 502, 507-508 (Tex. 1980).
- 3. The Beneficiary of the Fiduciary Relationship Has a Reasonable Basis to Believe That the Purported Fiduciary Would Act Primarily in the Beneficiary's Best Interest.** See *Texas Bank and Trust Co.*, 595 S.W.2d at 507-508; *R. R. Street and Co., Inc. v. Pilgrim Enters., Inc.*, 81 S.W.3d 276, 305 (Tex. App.—Houston [1st Dist.] 2001, no pet.).
- 4. When Seeking to Establish a Fiduciary Relationship in a Business Context, the Plaintiff Must Also Show That the Fiduciary Relationship Existed Before and Apart From the Agreement or Transaction in Question.** See *Swanson v. Schlumberger Tech. Corp.*, 959 S.W.2d 171, 176 (Tex. 1997); *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667 (Tex. 1998).

Such confidential relationships, once established by the trier of fact, will generally impose the same fiduciary duties on the fiduciary as though it was a fiduciary as a matter of law, though the scope of the authority may differ greatly.

## **C. Background on Attorney's Fiduciary Duties.**

Over one hundred years ago, the highest Texas court held that attorneys owe their clients fiduciary duties as a matter of law. *Cooper v. Lee*, 12 S.W. 483, 486 (1889). More recent rulings are quick to find that same fiduciary relationship and to apply a strict code of conduct. See, e.g., *Archer v. Griffith*, 390 S.W.2d 735 (Tex. 1964); *Burrow v. Arce*, 997 S.W.2d 229 (Tex. 1999). Additionally, courts exercise a duty to protect the integrity of attorney-client relationships

as a matter of public interest. *Burrow*, 997 S.W.2d at 244 (asserting that offense to the public sense of justice is a factor in determining remedies in case of fiduciary breach by lawyers).

In Texas, the behavior of attorneys is also governed by the Texas Disciplinary Rules of Professional Conduct (the “Rules”) located in the State Bar Rules. The Rules, however, specifically except from adding any substantive legal duty or defining standards for civil liability. See TEX. DISCIPLINARY R. PROF’L CONDUCT preamble ¶ 15, *reprinted* in TEX. GOV’T CODE ANN. tit. 2, subtit. G app. A (Vernon Supp. 2003) (TEX. STATE BAR R. ART. X, § 9). As such, the Rules provide the broad framework for attorney-client relationships and state minimum standards for conduct. TEX. DISCIPLINARY R. PROF’L CONDUCT preamble ¶ 7. Should an attorney violate any of the Rules, he will be subject to disciplinary action. *Id.* Rules 1.01 through 1.15 supply especially concise lists of specific duties an attorney must perform in the attorney-client relationship. The Rules never describe an attorney as a fiduciary *per se*, but the list of duties in the Rules parallel those imposed on fiduciaries under common law and can serve as a reference tool for self-assessment and guidance in attorney-client relationships.

**D. Elements of An Attorney’s Fiduciary Duties.**

The fiduciary duty owed a client by the attorney is broad reaching and includes:

- (1) loyalty;
- (2) good faith;
- (3) integrity in all matters;
- (4) fair, honest dealing;
- (5) avoidance of conflicting positions; and
- (6) disclosure of all material information potentially prejudicial to the client.

See *Hartford Cas. Ins. v. Walker County Agency, Inc.*, 808 S.W.2d 681, 688 (Tex. App.—Corpus Christi 1991, no writ) (*citing Douglas v. Aztec Petroleum Corp.*, 695 S.W.2d 312, 318 (Tex. App.—Tyler 1985, no writ)).

Although many Texas and Fifth Circuit courts have relied specifically on attorney-client fiduciary duty cases for precedent, fiduciary duty cases from trust law or agency law can be applied as well to define the attorney’s fiduciary duties in appropriate situations. See *Snyder v. Cowell*, 2003 WL 1849145 (Tex. App.—El Paso 2003, no pet.) (trustee’s duty to beneficiary); *Pinnacle Data Servs., Inc. v. Gillen*, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet) (directors’ duty to shareholders); *Kinzbach Tool Co. v. Corbett-Wallace*, 160 S.W.2d 509 (Tex. 1942) (employee’s duty to employer); *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1936) (partner’s duty). In short, courts will look closely at an attorney’s actions and attempt to construe those actions as within the fiduciary definition if it is appropriate to do so.

The duty of care standard found in negligence law is applied to legal malpractice cases and should be distinguished from those cases sounding in breach of fiduciary duties. Legal malpractice arises when an attorney does not exercise the degree of care or skill required as measured against a reasonable and customary standard. *Deutsch v. Hoover, Bax and Slovacek*, 97

S.W.3d 179, 189 (Tex. App.—Houston [14th Dist.] 2002, no pet.); *Gofney v. Rabson*, 56 S.W.3d 186 (Tex. App.—Houston [14th Dist.] 2001, pet. denied). Fiduciary duties are breached, however, when an attorney improperly benefits from his relationship with the client by self-dealing or possessing an unrevealed conflict of interest or mismanaging client funds. The benefit acquired is improper because, as a fiduciary, an attorney is required to put the client's interests ahead of his own. *Gibson v. Ellis*, 126 S.W. 3d 324, 330 (Tex. App.—Dallas 2004, no pet. h.); *Kimleco Petroleum v. Morrison & Shelton*, 91 S.W.3d 921, 923 (Tex. App.—Fort Worth 2002, pet. denied).

**E. Duties Owed by Attorneys are Highly Fiduciary.**

Many cases choose slightly different words in an effort to define the contours of the attorney's fiduciary duties. Whatever words are used, the foundation for these duties is the **trust** instilled by the client in the attorney and the confidential nature of their relationship. See *Kinzbach*, 160 S.W.2d at 512. In many ways, the duties owed by attorneys to clients surpass mere legality and instead are bounded by moral obligation. *Restatement of the Law (Third), The Law Governing Lawyers* puts it this way:

A lawyer is a fiduciary, that is, a person to whom another person's affairs are entrusted in circumstances that often make it difficult or undesirable for that other person to supervise closely the performance of the fiduciary. Assurances of the lawyer's competence, diligence, and loyalty are therefore vital...A lawyer's work is sometimes complex and technical, often is performed in the client's absence, and often cannot properly be evaluated simply by observing the results. Special safeguards are therefore necessary.

*Restatement § 16, cmt. b.*

Cases demonstrate the special safeguards courts have applied in Texas. First and foremost is the recognition that the attorney-client relationship as fiduciary as a matter of law. See *Cooper*, 12 S.W. at 489. Other safeguards include imposing an especially high order of fiduciary duties, shifting evidentiary burdens to the fiduciary defendant, and even imposing standards of behavior upon lawyers that would be generally constitutionally protected (such as free speech).

Attorneys also have a fiduciary duty to the justice system as a whole. This duty sometimes even trumps an attorney's constitutional right of generally protected political speech. *Comm'n for Lawyer Discipline v. Benton*, 980 S.W.2d 425 (Tex. 1998). In *Benton*, an attorney wrote a post-verdict letter to jury members attacking their integrity and berating their decision against his client. The attorney was charged with a disciplinary rule violation even though the trial court essentially agreed with the attorney and granted a motion for new trial. When the Texas Supreme Court ruled on the case, it held that the letter was a form of protected speech, but that the disciplinary rule limiting an attorney's speech is constitutional because protecting the jury system is preeminent. *Id.* at 433. *Benton* relied in part on *Gentile v. State Bar of Nevada* in

noting that in their role of officers of the court, attorneys accept a fiduciary responsibility to the justice system and are “an intimate and trusted and essential part of the machinery of justice.” *Gentile*, 501 U.S. 1030, 1071 (1991). The Texas court also pointed to the heightened capacity of fiduciaries to harm those persons dependent on them. *Benton*, 980 S.W.2d at 430. A client’s dependency arises from the trust given the attorney. In return, the attorney’s fiduciary duties far exceed those required by the contractual relation between them.

**F. Presumption of Unfairness and Burden of Proof.**

The Texas Supreme Court has adopted the English view of presumed unfairness in contracts between attorneys and clients. *Archer v. Griffith*, 390 S.W.2d 735 (Tex. 1964) (*relying on POMEROY, EQUITY JURISPRUDENCE*, 5th ed. 1941, s 960d). In *Archer*, the court cancelled a deed given by a client as payment for legal services in part because of the presumed unfairness of the contingency contract between she and her attorney. *Archer*, 390 S.W.2d at 738. The court further noted that the attorney bears the burden to show the contract’s fairness and the level of scrutiny afforded such transactions is the same as between a trustee and the trust for which he is responsible. *Id.* at 739. Fee contracts and other agreements must be as clear as possible because of their presumed unfairness and also because of the knowledge gap between attorneys and clients. Asset transfers as payment for services are extremely circumspect.

**G. Attorney-Client Relationship Must Exist.**

The attorney-client relationship must exist in order for the fiduciary duties to attach. *Yaklin v. Glusing, Sharpe & Krueger*, 875 S.W.2d 380, 383 (Tex. App.—Corpus Christi 1994, no writ). Courts will endeavor initially, then, to determine whether the relationship between the parties rises to the level of attorney-client. The relationship can begin immediately upon consultation with a prospective client, particularly when the client is less sophisticated and establishes reliance that the attorney would act on her behalf. *Nolan v. Foreman*, 665 F.2d 738, 739 n.3 (5th Cir. 1982) (applying Texas law); *SMWNPF Holdings, Inc. v. Devore*, 165 F.3d 360 (5th Cir. 1999). In *Nolan*, the attorney met with the defendant Rick Nolan and Nolan’s father. The three discussed the cases against Nolan and later, the attorney’s fee. *Nolan*, 665 F.2d at 739 n.3. The Fifth Circuit found that the fiduciary relationship began at the moment the three began discussing Nolan’s legal problems because the attorney did so with an eye towards representing Nolan. *Id.*

So, under Texas law, fiduciary duties attach to preliminary consultations. *Id.* (*relying on Braun v. Valley Ear, Nose, and Throat Specialists*, 611 S.W.2d 470 (Tex. Civ. App.—Corpus Christi 1980, no writ). The attorney-client relationship can be established in a preliminary consultation because although the relationship is contractual, the contract may be either express or implied. *Sutton v. Estate of McCormick*, 47 S.W.3d 179, 182 (Tex. App.—Corpus Christi 2001, no pet). The level of sophistication of the client is relevant because more sophisticated clients may not be entitled to rely on the creation of fiduciary duties until the signing of a fee agreement. *See Tanox, Inc. v. Akin, Gump, Strauss, Hauer & Feld, L.L.P.*, 105 S.W.3d 244 (Tex. App.—Houston [1st Dist.] 2003, pet. denied). However, the duty to retain confidences obtained during initial consultations or upon a promise of confidentiality even to a non-client will be enforced. *In re Skiles*, 2003 WL 1389060 (Tex. App.—Beaumont 2003, no pet.); *Nat'l*

*Med. Enters., Inc. v. Godbey*, 924 S.W.2d 123 (Tex. 1996). If the evidence does not conclusively establish an attorney-client relationship, then a question of fact for the jury arises. *Sutton*, 47 S.W.3d at 182. An objective standard of what the parties said and did is used to determine the existence of the attorney-client relationship, not their subjective states of mind. *SMWNPF Holdings*, 165 F.3d at 365. Nonetheless, it is best to err on the side of caution and presume that a fiduciary duty attaches upon the first contact with a potential client.

#### **H. The Scope of the Attorney-Client Relationship.**

Attorneys should be particularly careful when representing an agent on behalf of a principal because an attorney-client relationship, and therefore the attendant fiduciary duties, can be imputed to the principal for whom the agent acts. *Lydick v. Rachal*, No. 05-00-01908-CV, 2002 WL 31193440 (Tex. App.—Dallas 2002, no pet.) (not designated for publication). In *Lydick*, an agent son with power of attorney sought the assistance of lawyer Rachal to establish a trust for the agent's principal Lydick. When the father later sued both his son as agent and the attorney Lydick, the jury found that Lydick and Rachal were attorney and client. Even though it was unpublished, *Lydick* is not an aberration. *In re McCall* was a mandamus action whereby the court found an attorney-client relationship between a principal and a law firm as a basis for requiring production of the firm's invoices after an agent had consulted the firm. No. 08-02-00071-CV, 2002 WL 1341104 (Tex. App.—El Paso 2002, no pet.) (not designated for publication).

Although it is generally accepted that an attorney for an executor does not represent the beneficiaries, an attorney-client relationship with the beneficiaries can be found if the attorney undertakes actions for the beneficiaries directly, e.g., selling land on their behalf. *Querner v. Rindfuss*, 966 S.W.2d 661 (Tex. App.—San Antonio 1998, pet. denied); *Vinson & Elkins v. Moran*, 946 S.W.2d 381 (Tex. App.—Houston [14th Dist.] 1997). With each and every transaction, an attorney should consider the possibility of additional imputed clients falling into a fiduciary relationship.

The scope of an attorney's fiduciary duties to any given client is not without boundaries, however. The subject matter of representation can limit the reach of an attorney's fiduciary duties. For instance, in *Stephenson v. LeBoeuf*, an attorney representing a client in her divorce was found not to have a fiduciary duty to his client for an unrelated escrow account. 16 S.W.3d 829 (Tex. App.—Houston [14th Dist.] 2000, pet. denied). Still, a wise course of action is to make the scope of representation clear in the engagement letter and then not exceed the stated scope.

#### **I. Damages and Remedies.**

Remedies available in breaches of fiduciary cases are both legal and equitable. Actual damages must be established with reasonable certainty. *Dyll v. Adams*, 167 F.3d 945, 946-947 (5th Cir. 1999). Chapter 41 of the Texas Civil Practice and Remedies Code requires more than nominal actual damages for an exemplary damage award. TEX. CIV. PRAC. & REM. CODE ANN. § 41.004(a) (Vernon 2003).

**1. Fee Forfeiture.** Many different equitable remedies can be fashioned in a breach of fiduciary duty case. One of the most common for lawyers is fee forfeiture. Once a plaintiff shows a fiduciary duty breach, fee forfeiture is enforceable as a matter of law. *Russell v. Truitt*, 554 S.W.2d 948, 952 (Tex. Civ. App.—Fort Worth 1977, writ ref'd n.r.e.). The amount of fee forfeiture is a matter for the court, not the jury and will be evaluated by applying factors similar to those used for punitive damage awards. *Burrow v. Arce*, 997 S.W.2d 229, 243 (Tex. 1999). As an equitable remedy, however, fee forfeiture must be specifically pleaded in the trial court. *Shands v. Texas State Bank*, 121 S.W.3d 75, 78 (Tex. App.—San Antonio 2003, pet. denied). The plaintiff need not show actual damages to support fee forfeiture. *Burrow*, 997 S.W.2d at 240.

Fee forfeiture is also available in the context of contingency fees. Attorneys have a fiduciary duty to completely explain their contingency fees and a breach of the contingency fee contract is a fiduciary duty breach. *Lopez v. Munoz, Hockema & Reed, LLP*, 22 S.W.3d 857, 864 (Tex. 2000) (dissent by Gonzales, J.). Even if the contingency fee contract bestows fees for little or no work, in no event should an attorney accept it. Accepting a fee under these circumstances is a breach of fiduciary duty. *Id.* The attorney's fiduciary duty to his client overrides the contractual benefits.

**2. Rescission.** Rescission is the flip side of fee forfeiture in that a client can move to have his contract with the attorney canceled. If the attorney benefited through self-dealing or failed to disclose all information to the client, rescission can be used to nullify the contractual relationship between the parties. In *Pope v. Darcy*, for instance, the court rescinded the contract between an attorney and an estate after the attorney attempted to purchase part of the beneficiary's interest. 667 S.W.2d 270 (Tex. App.—Houston [14th Dist.] 1984, writ ref'd. n.r.e.). Rescission will require the plaintiff client to return any consideration received. *Id.* As noted previously, however, the burden will lie with the attorney to prove the fairness of the contract. *Archer*, 390 S.W.2d at 738.

**3. Disgorgement.** Disgorgement requires the attorney to account for and return to the client any gains made in the breach of the attorney's fiduciary duty. The client may make an election of remedies to restore the asset as it was before the breach of duty plus interest or receive the asset as invested with all profits. *Slay v. Burnett Trust*, 187 S.W.2d 377 at 393 (Tex. 1945). Generally speaking, the attorney must disgorge all benefits flowing from the breach of duty. *Id.*

**4. Constructive Trust.** The court can impose a constructive trust upon a finding of breach of fiduciary duty. A constructive trust is imposed when legal title is held by the breaching attorney-fiduciary and the court then imposes an equitable duty to convey the property to the plaintiff. In other words, if an attorney gains title to an asset in breach of his fiduciary duty, the court could impose a constructive trust to return the property or any proceeds or exchanges to the plaintiff.

**5. Accounting.** The client can ask for an accounting by his attorney for fees or assets. The Texas Rules of Civil Procedure provide the court with broad authority to

order an accounting or audit. TEX. R. CIV. P. 172. Rule 172 allows the court to appoint an auditor whenever it appears “necessary for the purpose of justice”.

**6. Injunctive Relief.** Clients may also seek injunctive relief. A court will issue an injunction, upon a showing of danger of future damage. In the context of attorney-client fiduciary relationships, if the breach of fiduciary duty is ongoing, injunctive relief may be indicated.

**7. Exemplary Damages.** Exemplary damages are not common, but can be had under extraordinary circumstances in breach of attorney-client fiduciary duty cases. In one case, the Texas Supreme Court let stand a trial court’s fiduciary breach damages that included mental anguish and punitive damages as well as a re-division of marital property. *Vickery & Richards v. Vickery*, 999 S.W.2d 342 (Tex. 1999). Under the incredible facts of this case, two attorneys acted together to defraud the wife of one of them into a divorce and property division. The plaintiff chose the much larger portion of the martial estate as her remedy.

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