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*Synopsis*

*The Texas Trust Code requires trustees to invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, a trustee must exercise reasonable care, skill and caution. A trustee can best fulfill this responsibility by developing an investment policy for the trust and prudently evaluating trust investments.*

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**I. Special Issues with Trust Assets**

**A. Real Estate**

Generally, trustees should inspect any real property held in the trust shortly after beginning their duties. For property located far away, they may consider hiring an agent to make the inspection. However, if the property is valuable enough to justify the travel expense, the inspection may be made personally. Such inspections can expose the following potential problems: environmental or other hazards that may open the trust estate to liability; use of the property by unauthorized persons; lack of compliance by the tenants with lease requirements; maintenance needs; potential zoning changes; and possible changes in the area around the property which may affect the value and use of the property in the future.

You should confirm that there is current and appropriate casualty and liability insurance for all real estate owned by the trust. You should read each policy in its entirety and discuss it with the trust's insurance agent. Care should be taken to insure that each policy's coverage will be effective and adequate. Pay special attention to exclusions (such as vacant dwellings) that may apply.

You should read each lease on each piece of real property owned by the trust. Make note of applicable notice provisions regarding the lease termination date and any notices that may need to be given or received. The books should be reviewed to confirm that the tenant is paying the proper amount (particularly in a net lease, where taxes or other expenses that are to be borne by the tenant may change). With respect to leases that are nearing their expiration, you should evaluate whether the lease is on market terms, and should begin taking steps to re-sign the tenant or to attempt to lease the property before it becomes vacant. Any improved real estate which is not leased should be carefully reviewed. Appropriate steps should be taken to protect the property from vandalism or other damage, to lease the property, if possible, or to dispose of the property, if appropriate.

You should review property tax appraisals from each taxing authority to insure that values are not overstated. Take the necessary steps to reduce overstated values to appropriate levels. For agricultural property, overstated values may effect roll-back taxes, if and when the property is sold and its use is

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changed. Also verify that the property taxes on the property are current, and that any appropriate exemptions available to the trust estate are being utilized.

Take steps to evaluate and minimize any potential environmental risks associated with holding real estate. Your objective is to identify and minimize current environmental exposure, and enact procedures to prevent future problems. Identifying environmental exposure can be difficult, but at a minimum, a special inquiry should be made if you know or suspect that gas tanks are or have been located underground, dangerous material (e.g., pesticides, motor oil, defoliant, etc.) have been sprayed on the property, or an industrial use has been made of the property. Potential protective environmental actions include carefully selecting the tenants and managers responsible for maintaining property (including the financial ability of those persons to rectify any environmental problems created by them), performing environmental audits, and carefully drafting property management and lease agreements to deal with environmental issues. With regard to property that the person who created the trust (or another party) desires to add to the trust, or which may be purchased by the trustee at a later date, you should perform due diligence *before* accepting or purchasing the property, to insure that you are not taking on environmental liabilities and thus exposing the remainder of the trust estate to liability. In some cases, taking these steps creates a defense preventing the imposition of liability on the trustee or the trust estate, even if environmental contamination is later found to exist.

### **B. Mineral Interests**

You should carefully review all division orders to insure they properly reflect the trust's ownership, and that the trust is receiving the royalties and other payments to which it is entitled. Also be sure that the operators, lessees and other parties who may be making payments as a result of the mineral interests (as well as the appropriate taxing authorities) have the trust's proper address.

### **C. Business Interests**

The Code expressly permits trustees to invest in, continue, or participate in the operation of any business or other investment enterprise. The presence of business interests in trust estates, however, present significant risks and issues for trustees. If your trust holds a business interest, you must specifically identify what is held -- the restrictions, voting rights, management rights and other characteristics. Further, you should determine whether it is marketable.

Immediately request and review all buy-sell agreements, voting agreements, business continuation agreements and other shareholder agreements to which the trust is a party or which impose restrictions on, or give rights to, the business interests held by the trust. Make notations of the substantive provisions of the documents. Give notice of your current address to the other parties in the manner specified in those documents, to insure that you receive the notices required to be given to the trustee. In addition, it may be advisable to have these agreements reviewed by counsel to determine whether they are still appropriate to the current circumstances of the trust and if not, whether they may be renegotiated. In connection with reviewing these agreements, you should also review any insurance on owners or other key employees which is designed to fund payments under those agreements, and should verify that any required insurance is in place, is owned by the proper entity, and is payable to the proper beneficiary.

If your trust holds a controlling interest in a closely-held business, you must immediately determine whether it should be continued, liquidated or sold. In making this determination, consider whether the trust instrument authorizes you to continue a business; whether holding it would allow the trust to be adequately diversified; whether sufficient funds are on hand to operate the business; whether there is a market (or if one may be created) for selling the interest; whether the expected returns of the business are sufficient to offset the risks; and whether competent people are running the business, or can be hired to do so at an acceptable cost. Remember that a business which generated a nice income for its founder may not be of sufficient size to provide a reasonable return to the trust estate if an outside person must be hired to run it.

If you decide to continue the business (either indefinitely or for winding down), its current structure should be evaluated and changed if necessary. Different business entities include sole proprietorships,

general partnerships, limited partnerships, limited liability companies, and corporations (including S corporations, assuming the trust can qualify as an S corporation shareholder under the Internal Revenue Code). In deciding which entity should be used, consider the costs associated with changing the current structure, the value of limiting the exposure of other trust assets to the business risks, providing the fiduciary appropriate control of the business, minimizing negative income tax consequences, and limiting adverse effects to beneficiaries upon termination of the trust.

If the trust acquires stock in a corporation that will be treated as an S corporation for federal tax purposes, you must determine whether it is an eligible shareholder. The Internal Revenue Code restricts ownership of stock in S corporations to certain qualifying trusts. Even these trusts must have their beneficiaries make a special election to remain eligible. This election must be filed within 75 days of the date the trust acquires the stock. If the trust does not qualify as an S corporation shareholder, you must promptly decide whether to dispose of the stock (by sale or distribution) allowing the corporation to continue as an S corporation, or to hold the stock, thereby terminating the S status. Determine whether the shareholders signed an agreement which may impose liability on a shareholder for terminating the corporation's S election. You must be careful to act from proper motives if you are selling or distributing stock to preserve the S election, especially, if you are also a shareholder in the business. Any benefits to you personally from retaining S corporation treatment, if not in the best interest of the trust, may subject your action to second-guessing by the beneficiaries and the courts.

#### **D. Review Cash Accounts**

Upon becoming trustee, determine whether all cash in bank accounts is within the insured limits in an FDIC insured institution. If not, evaluate the strength of the financial institution and take appropriate steps to protect the cash by moving it if necessary. Trustees who fail to maintain all cash funds in interest-bearing accounts may be later questioned by the beneficiaries. If you ever hold any operating funds in non-interest bearing accounts, keep records explaining this action (i.e., monthly fees or other charges would exceed any possible interest earned). Daily "sweeping" of cash in brokerage accounts may be arranged, so that as cash is earned or deposited, it is swept into an interest-bearing account. To the extent cash is not needed for the regular trust operations, carefully evaluate alternatives to cash, such as short-term debt instruments, certificates of deposit, T-bills, and other investment alternatives with high liquidity, minimal volatility, and rates superior to those obtained in bank accounts or money markets.

#### **E. Stocks and Bonds**

Evaluate individual issues of stocks, bonds and mutual funds held by the trust estate to determine whether they should be retained as investments. Give immediate attention to issues known to be "troubled" to determine whether it is prudent to retain them while implementing the investment policy, or whether prompt sale is required. Remember, the Code allows you to obtain investment advice. Further, you open yourself up to criticism from trust beneficiaries for failing to consult with an investment professional, if the trust's investment performance is poor.

#### **F. Life Insurance Policies**

You should confirm that any company providing life insurance benefits is sound financially. There are four major rating agencies for life insurance companies: A.M. Best Co.; Standard & Poors; Moody's; and Weiss Research. You are advised to maintain policies with reasonably high ratings by at least three of the rating firms. Before purchasing new policies, consider the cost of the insurance as compared to the cost of similar policies from similarly rated carriers. Ask the agent to help you evaluate issues such as mortality assumptions, company costs, dividend paying history, investment portfolio mix, and the impact of the "load" (the commissions payable) on the expected performance of the policy. Determine whether there are comparable policies available with lower charges.

Consider whether life insurance is an appropriate asset to hold in the trust. If insurance comprises the entire trust estate (such as with a traditional irrevocable life insurance trust), you could conceivably be questioned about your failure to diversify the trust estate, unless the trust instrument expressly authorizes this form of investment. Life insurance policies, over time, may or may not perform as strongly as a more

traditional well-diversified portfolio, especially if the insured substantially outlives expected mortality. Nonetheless, life insurance may be an entirely appropriate investment to own, given the purposes of the trust. In fact, the grantor of a trust frequently intends the trust be solely for the purpose of owning such policies, and does not intend, at least until the death benefit proceeds are paid, for the trustee to create a diversified trust estate. If an existing policy is transferred to the trust as its only asset, retention of the original policy in the trust estate may be protected by the Code because it was an original trust investment. Even if the policy *is* an original trust investment, however, you are making an investment decision separate and apart from the original contribution to the trust estate when you use future contributions to the trust estate to pay additional premiums on that policy.

### **G. Promissory Notes**

Review all promissory notes due and owing to the trust estate. Determine the balance due and whether payments are current or in default. Also, review all security agreements or deeds of trust securing the payments under the note. If the note is in default, take steps to get the maker to bring it current. The trust should take action on a note in default before its collection is barred by the applicable statute of limitations. If the note is secured by real estate, environmental risks should be evaluated before you foreclose on the property.

## **II. Developing An Investment Policy**

You should evaluate the entire trust corpus to determine how its investments are allocated. As discussed in more detail below, develop an investment policy for the trust. Next, map out a plan to shift current trust assets so your investment strategy may be ultimately fully implemented.

### **A. Setting the Investment Policy**

Investment policies are like blueprints that orchestrate all investment decisions. They are invaluable tools for implementing, monitoring and evaluating trust investments. Deviation from such a plan may open a trustee to liability, if he *also* fails to document his rationale for deviation. Charges of negligence are more likely to arise where no clearly articulated investment policy exists at all. Absent the existence of a policy, investment decisions are frequently made on an *ad hoc* basis, without adequate thought given to the investment in the context of the trust's overall financial plan. Since poor investment policies, and the failure to comply with good ones, may be held against trustees, your policy must be prudently developed and meticulously followed. Be certain to consult with investment advisors or study investment philosophies and trends before developing this policy.

When developing the investment policy, communicate with the beneficiaries regarding their current and future distribution needs. Such projections will necessarily impact your decisions as to the appropriate types and amounts of assets you will need to meet your obligations. Current income verses future growth must be adjusted appropriately. Also consider the beneficiaries' (including remainder beneficiaries) risk tolerance. You should consult with investment advisors and/or study investment philosophies and trends before developing this policy.

A key component of investment philosophy is the target long-term rate of return. This rate is usually defined as a percentage above the rate of inflation, as determined by the Consumer Price Index. This target should be achievable and reasonable considering historical returns of well-diversified portfolios. Many trustees use 3% to 5% above inflation as their target for long-term investment return. The rate you select, however, should not be so high as to encourage speculative investment. In short-term trusts, the target rate is frequently adjusted somewhat downward. In setting a performance goal, look at historical long-term performance of various classes of assets. Most investors are cautious about setting goals that reflect the 1980's or late 1990's rates of return, which probably will not be realistic in the future. Your investment policy should also expressly note when certain goals may not be achievable. For example, most plans indicate that the goal may not be met during extended periods of high inflation.

Although investment philosophies differ, recent research suggests that long-term performance of a portfolio may be more dependent upon the asset allocation (i.e., how the portfolio is invested in different

classes of assets), than upon the performance of the individual assets within the portfolio. In other words, long-term performance is influenced more by the fund's equities to fixed-income investments ratio, than by the specific issues of stock purchased. When prudent, asset classes might include cash, fixed-income (including taxable and non-taxable bonds), securities, domestic equities (large companies), foreign equities, small- or mid-capitalized equities, real estate, oil and gas interests, and business or venture capital investments. All classes should be evaluated to determine if they are appropriate and prudent for the trust estate to hold. Among the asset classes selected, determine the percentage of the estate to devote to each, based on the trust's investment time-frame, the beneficiaries' risk tolerance, and the trust's overall performance goals. Permissible variations between percentages to be devoted to each asset class may be specified (i.e., domestic large company equities shall comprise 15% of the trust estate, plus or minus 5%). This allows you the flexibility to adjust percentages when market conditions dictate it, without changing the basic investment policy.

Your investment policy should establish guidelines for investing in the various asset classes. Asset classes include cash, fixed-income (including taxable and non-taxable bonds), securities, domestic equities (large companies), foreign equities, small- or mid-capitalized equities, real estate, oil and gas interests, and business or venture capital investments. You may require that all bonds meet the minimum quality requirements set by the ratings agencies, or you may set a maximum maturity period for their purchase. Similar criteria should be developed for other asset classes. Further, it is advisable to specifically limit the percentage of the trust estate which may be invested in any one security or industry. Although you may deviate from this guideline in extraordinary circumstances, you should carefully document your reasons for doing so. If the beneficiaries insist on such a variation, get their signatures on a document stating they are aware of the risks, and nonetheless wish that the investment be made.

You should compare the performance of the trust estate with your goals on a regular basis. Benchmarks should be used to determine whether investments are performing well within their class. For example, if the equity portion of the portfolio is performing substantially below the S&P 500, the trust portfolio (and the equity manager, if any) should be reviewed, but not necessarily changed (a value-oriented equity manager may under-perform the market in some time frames and outperform it in others). If funds are invested with a money manager or a fund that is performing at levels significantly below other funds or money managers with similar philosophies and goals, the fund or money manager should be reevaluated.

### **III. Implementing the Investment Policy**

#### **A. Investment Consultants, Advisors and Managers**

The cost of hiring investment consultants, advisors, or money managers may be an unnecessary expense for a trustee of a small trust with limited assets to invest, or for a trustee with significant investment expertise. For trusts with substantial assets, however, unless you are willing to spend significant amounts of time overseeing the investments and gaining the expertise necessary to analyze them, the requirement of prudence may necessitate hiring someone to assist with devising and implementing the investment policy.

Should you choose to hire an advisor, pay careful attention to costs. So-called "wrap" accounts and similar arrangements that layer several types of investment fees may generate fees of 3% or higher on the investment assets. Carefully consider whether the anticipated return from using such an arrangement would be great enough to offset the expense when compared to the alternatives.

Above and beyond the cost considerations, if you seek professional advice, take steps to insure you make a prudent selection. Obtain several referrals. Interview multiple candidates to insure selection of an advisor who understands the parameters of the trust and shares your investment philosophy. Review his or her performance data with an eye not only on returns, but also on volatility. High overall returns coupled with frequent short periods of poor performance will be particularly unattractive to you since the final trust distributions or tax bill may come due during a low cycle. Look at how the advisor is compensated. Some advisors make commissions for products sold, while others have fees based on hourly rates or on a percentage of assets under management. Although either type *may* provide quality investment advice,

beware of individuals and entities offering "financial and investment services" who in fact are merely selling a particular product.

The Code expressly allows trustees to "employ attorneys, accountants, agents, and brokers reasonably necessary in the administration of the trust estate." Nonetheless, trustees may not delegate authority to third persons to carry out duties which require the *exercise of discretion*. **You are under a duty not to delegate to others the administration of the trust or the performance of acts in the administration of the trust that you ought to personally perform.** Accordingly, while obtaining advice from professionals is certainly proper, after giving it due consideration, **you** must ultimately make the decisions. Do not assume that because you hired a professional you may blindly follow their advice.

In circumstances where the exercise of discretion is not an issue, it may be proper for a trustee to delegate. Some authorities suggest that trustees have a duty to personally perform all trust responsibilities except for those a prudent person would delegate to others. Keep in mind, however, that no Texas court has ever found a trustee so unqualified as to expressly require the delegation of investment responsibilities. Accordingly, until the Code is clarified, or case law expressly allowing delegation develops, you should oversee investments in a way that will not be perceived an abdication of your responsibilities as trustee.

Trustees should not give brokers or investment advisors power over the trust account authorizing them to unilaterally purchase investments. If the agent handles a mutual fund or investment partnership which is a prudent investment and in which the trust may purchase shares, it is probably permissible to purchase such shares, even though the money manager may purchase other investments within the fund or partnership. Although no case law supports this proposition, if you exercised discretion in selecting the fund or partnership, a strong argument supporting such an action may be made.

#### **B. Mutual Fund Investments**

One method of obtaining professional investment management at a reasonable cost is through purchasing shares of mutual funds. It may not be cost-effective for trusts with investment portfolios less than \$250,000 (or \$500,000, for some money managers) to utilize an individual money manager. Because mutual funds are managed by professional money managers, purchasers of their shares gain the benefit of that expertise. Additionally, utilizing mutual funds fulfills one of the primary components of prudent investing -- diversification. Trust estates which are too small to cost effectively diversify on their own (i.e., those with insufficient funds to buy the number of stocks and other investments necessary to comprise a well-diversified portfolio) can nonetheless acquire a well-diversified portfolio by holding shares in a mutual fund or funds.

Mutual funds with costs and 12b-1 expenses in excess of similar mutual funds must out-perform those funds in an amount sufficient to overcome those higher costs and expenses. Prior to purchase, carefully compare high-expense funds with similar low cost ones. Funds with front-end loads (a sales charge) or back-end redemption costs must significantly out-perform other funds to be considered. Carefully review the impact those costs will have on long-term performance before purchasing a "load" fund versus a "no-load" fund. In general, brokers (at least those at full service firms) can only purchase funds with loads. Therefore, you may need to do independent research if you use a full service broker for the other investment purchases of the trust. You may decide to invest directly with the fund to provide the trust estate access to no-load funds.

Another alternative (with the benefit of providing a consolidated statement reflecting all the mutual funds held by the trust) is purchasing no-load funds through a discount broker who will purchase such shares for a set dollar fee (and will purchase shares in certain families of funds for no fee). Since discount brokers do not provide investment advice, fund selection would require additional independent research on your part. Some advisors who regularly research mutual funds will make recommendations of suitable funds, monitor those selected and recommend changes as appropriate, for a fee based upon a percentage of invested funds.

In selecting mutual funds, evaluate their long-term performance and volatility. Aggressive funds which stay fully invested at all times may perform very well over the long-term, but have greater fluctuations and correspondingly greater downside risk over the short-term. These funds may be appropriate for trusts with a twenty-year time horizon, but not for those only expected to last for a short period of time, since you might be required to sell during a down period in the market. Several publications provide "report cards" or evaluations of mutual funds at least once yearly, including *Forbes Magazine* (which gives each fund a grade in both bull markets and bear markets), *The Individual Investor's Guide to No-Load Mutual Funds* by The American Association of Individual Investors, *Money Magazine*, and other investment and business journals. Many investment newsletters likewise monitor and evaluate mutual funds (and stocks and bonds) on a frequent basis.

Although mutual funds are diversified in terms of holding numerous individual securities, they typically are not invested in all asset classes. Accordingly, you may invest in multiple mutual funds in order to participate in all classes you desire. For example, the trust could be diversified among the following types of funds: (1) small cap; (2) funds specializing in mature, but growth oriented, companies; (3) funds specializing in foreign equities; (4) funds specializing in income-oriented equities, such as utilities, oil and gas companies and other high yield companies; and (5) funds specializing in fixed-income investments (or possibly several funds that specialize in fixed-income securities, with different maturity ranges). Likewise, you may decide to utilize funds managed by individuals holding different philosophies.

Even if you plan to purchase individual securities for the trust, you may consider using mutual funds for some of the asset classes. For example, even if you are comfortable with your ability to invest in domestic securities prudently, you may want to use mutual funds if investment in foreign equities is desired.

#### **C. Index Funds Solution**

You may consider purchasing so-called "index" funds. These funds track major stock exchanges or public listings of publicly traded stock such as the S&P 500, the Wilshire 4500 (or Wilshire 5000), the Value Line Composite, the Shearson/Lehman Broad Bond Index, etc. This approach insures that you will not "under perform" those indexes by more than the expenses of the fund in question. Several families of mutual funds (including no-load families of funds with low expense ratios) offers index funds. Again, you must be sure to allocate the trust estate appropriately between the various fund types.

#### **D. Regular Review of Portfolio and Performance**

Periodically, you should review the trust's portfolio and its performance. National bank trust departments are required by federal regulation to review all investments at least once a year. You would be wise to follow the same guidelines, and at a minimum, document an interim review during the trust and estate administration process. Such reviews help trustees spot small problems before they develop into major ones and provide opportunities to readjust the portfolio to keep it in line with the investment policy. If a particular asset class has experienced significant appreciation relative to the other classes, you can use the periodic review as an opportunity to sell some of the investments within that asset class, bringing the portfolio's percentages in the various asset classes back within the investment policy parameters. Your investment policy itself should articulate how frequently the portfolio review and reallocation among assets will occur. Under-performing investments or money managers should also be reviewed and changed, if appropriate.