

FIDUCIARY DUTIES WITHIN FIDUCIARY DUTIES

**TRUST OWNING STOCK
IN A CLOSELY-HELD CORPORATION**

PRESENTED AND WRITTEN BY:

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FIDUCIARIES WITHIN FIDUCIARIES

Trust Owning Stock in a Closely-Held Corporation

I. INTRODUCTION

Ownership by a trust (or estate or guardianship) of an interest in a closely-held corporation, whether originally contributed by the settlor or purchased by the trustee, presents significant risks and issues for the trustee. If the interest constitutes a substantial part of the trust assets, the trustee must consider the consequences of concentrating substantial assets in a single investment. In addition, if trustee holds a controlling interest and is also an officer or director of the corporation, he serves in multiple roles that present special areas of concern. Similar issues arise with respect to a trust, or executor, or guardian owning other types of business entities, such as partnerships and limited liability companies. This paper is specifically limited to an analysis of issues related only to trusts owning closely-held corporations, but most of the concepts discussed herein also should apply to other types of entities.

II. TRUSTEE HOLDING CORPORATE STOCK - DUTY TO DIVERSIFY

There are three main sources of rules governing trustees: the terms of the trust instrument, the Texas Trust Code and Texas common law.

A. Texas Trust Code Provisions

Texas has adopted the Texas Trust Code. *See* TEX. PROP. CODE ANN. § 101.001 *et seq* (Vernon 2007) (hereafter the “TEX. TRUST CODE”). The Texas Trust Code applies to all trusts governed by Texas law unless the trust indicates a clear intent to provide otherwise. Therefore, unless the terms of a trust validly provide otherwise, the provisions of the Texas Trust Code govern:

- 1) The duties and powers of a trustee;
- 2) Relations among trustees; and
- 3) The rights and interests of a beneficiary.

See TEX. TRUST CODE § 111.0035(a).

1. Uniform Prudent Investor Act

Effective January 1, 2004, Texas adopted the Uniform Prudent Investor Act (“UPIA”), which is contained in Chapter 117 of the Texas Trust Code.

Section 117.003 of the Texas Trust Code provides that a trustee owes a duty to the beneficiaries of the trust to comply with the “prudent investor rule.” The prudent investor rule is a default rule, which may be expanded, restricted, eliminated or otherwise altered by the provisions of a trust.

Under the prudent investor rule, a trustee must 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, the trustee shall exercise reasonable care, skill and caution. TEX. TRUST CODE § 117.004(a). A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. TEX. TRUST CODE § 117.004(b).

In making investment and management decisions, a trustee should consider the following circumstances:

- General economic conditions;
- The possible effect of inflation or deflation;
- The expected tax consequences of investment decisions or strategy;
- The role that each investment plays within the overall trust portfolio;
- The expected total return from income and the appreciation of capital;
- Other resources of the beneficiary;
- Needs for liquidity, income and preservation or appreciation of capital; and
- An assets special relationship for special value, if any, to the trust or a beneficiary.

TEX. TRUST CODE § 117.004(c). A trustee may invest in any kind of property or type of investment consistent with the standard of the UPIA. TEX. TRUST CODE § 117.004(e). Section 113.008 of the Texas Trust Code authorizes a trustee to invest in, continue, or participate in the operation of any business or other investment enterprise in any form.

a. Diversification is Mandatory Absent “Special Circumstances”

Section 117.005 of the Texas Trust Code mandates that a trustee diversify the investments. No guidance is provided regarding what constitutes proper

diversification. The Comments to the Uniform Prudent Investor Act state:

There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: “Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries. . . . Broader diversification is usually to be preferred in trust investing,” and pooled investment vehicles “make thorough diversification practical for most trustees.” [Citing] Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments e-h, at 77 (1992).

“Special Circumstances” may override the duty to diversify. If the trustee “reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying,” then the trustee is not required to diversify. TEX. TRUST CODE § 117.005. The Comments to the Uniform Prudent Investor Act suggest that an example of such a “special circumstance” that might overcome the duty to diversify is the “wish to retain a family business.”

b. Authority to Automatically Retain Initial Assets Repealed

Current Section 117.006 of the Trust Code requires a trustee “within a reasonable time after accepting a trusteeship or receiving trust assets,” to “review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements and other circumstances of the trust, and with the requirements of [the UPIA].”

Former Section 113.003 of the Texas Trust Code, which allowed a trustee to retain property constituting initial trust corpus without regard to diversification, was repealed effective January 1, 2004. Former Section 113.003 provided: “A trustee may retain, without regard to diversification of investments and without liability for any depreciation or loss resulting from the retention, any property that constitutes the initial trust corpus or that is added to the trust.” Thus, under former Section 113.003, a trustee was under no duty to diversify assets which were contributed to the trust at its creation.

However, even in situations where former Section 113.003 may apply (e.g., claims relating to pre-2004), stock that was an initial asset of the trust might lose its protected status if it was altered, changed form, or was exchanged for other stock. See *Neuhaus v. Richards*, 846 S.W.2d 70, 73 (Tex. App.—Corpus Christi 1993, vacated pursuant to settlement by *Richards v. Neuhaus*, 871 S.W.2d 182, Tex. 1994) (First City Bank stock was not an “initial asset” of the trust for purposes of 113.003 even though it was acquired by the trust in a merger in exchange for McAllen State Bank stock, which was an initial trust asset.) In a footnote, citing out of state authority, the court indicated that a trustee’s ability to retain stock in a corporation that was initially owned by the trust and that is later merged into or with another corporation depends on whether the new stock is “substantially equivalent to the old stock, considering among other things the similarity of the sphere of activity, products manufactured, and the capital structure of the old and new corporations.” *Id.* at 79.

2. Duty of Loyalty

Section 117.007 of the Texas Trust Code provides that a “trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.”

3. Duty of Impartiality

“If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.” TEX. TRUST CODE §117.008.

4. Delegation of Investment and Management Functions

Under prior law, a trustee was permitted to delegate investment and management functions, but the trustee remained primarily responsible for the activities of the trust. Current Section 117.011 permits the trustee to avoid liability for the actions of the trustee’s agent if such duties are properly delegated pursuant to statutory requirements.

B. Texas Common Law

The powers and duties of a trustee are also governed by common law to the extent the trust instrument does not validly provide otherwise, and the common law is not inconsistent with the provisions of the Texas Trust Code. See TEX. TRUST CODE §111.005.

A trustee owes a fiduciary duty to preserve and protect the assets of the trust. RESTATEMENT (SECOND) OF TRUSTS §176 (“RESTATEMENT”); BOGERT §582; SCOTT ON TRUSTS §176 (“SCOTT”); *Bandy v. First State Bank*, 835 S.W.2d 609, 623 (Tex. 1992); *Byrd v. Woodruff*, 891 S.W.2d 689, 706 (Tex. App. – Dallas 1994, writ denied); *Bruce v. Republic Nat’l Bank & Trust Co.*, 74 S.W.2d 461 (Tex. Civ. App. – El Paso 1934), *aff’d*, 105 S.W.2d 882 (Tex. 1937).

A trustee is under a duty to distribute the risk of loss by reasonable diversification unless the trust excuses him of that duty. *Jewett v. Capital Nat’l Bank of Austin*, 618 S.W.2d 109 (Tex.App.–Waco 1981, writ ref’d n.r.e.)

C. Trust Provisions

1. Trust Terms Prevail

The terms of a trust, as set forth in the governing instrument, generally govern. It is well settled in Texas that the first principle of trust construction is to honor the intent of the settlor. To determine the intent of the settlor, a court looks primarily to the text of the written instrument establishing the trust. *Nowlin v. First National Bank*, 908 S.W.2d 283, 286 (Tex. App. – Houston 1995). This principle has been recognized by Section 111.0035(b) of the Texas Trust Code:

The terms of a trust prevail over any provision of this subtitle, except that the terms of a trust may not limit:

- (1) the requirements imposed under Section 112.031;
- (2) the applicability of Section 114.007 to the exculpation term of a trust;
- (3) the periods of limitation for commencing a judicial proceeding regarding a trust;
- (4) a trustee’s duty:
 - (A) with regard to an irrevocable trust, to respond to a demand for accounting made under Section 113.151 if the demand is from a beneficiary who, at the time of the demand:
 - (i) is entitled or permitted to

receive
distributions
from the trust;
or

- (ii) would receive a distribution from the trust if the trust terminated at the time of the demand;
- (B) To act in good faith and in accordance with the purposes of the trust; and
- (5) The power of a court, in the interest of justice, to take action or exercise jurisdiction, including the power to:
 - (A) Modify or terminate a trust or take other action under Section 112.054;
 - (B) Remove a trustee under Section 113.082;
 - (C) Exercise jurisdiction under Section 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.

See also TEX. TRUST CODE §111.002 (If the terms of this subtitle and the terms of a trust conflict, *the terms of the trust control....*); TEX. TRUST CODE §113.001 (A power given to a trustee does not apply to a trust to the extent that the instrument creating the trust ... conflicts with or limits the power.”); TEX. TRUST CODE §113.051 (The trustee shall administer the trust according to its terms and this subtitle. *In the absence of any contrary terms in the trust instrument* or contrary provisions of this subtitle, in administering the trust, the trustee shall perform all of the duties imposed on trustees by the common law.”); TEX. TRUST CODE §113.059(a) (“[A] Settlor by provision in an instrument creating, modifying, amending, or revoking *the trust may relieve the trustee from a duty, liability, or restriction imposed by this subtitle.*”); *Beaty v. Bales*, 677 S.W.2d 750, 754 (App. Tex. – San Antonio 1984) (“... the trustee’s powers are conferred by the instrument and neither the court nor the trustee can add or take away such power.

The trust is entitled to that construction which the maker intended.”); *Stewart v. Selder*, 473 S.W.2d 3 (Tex. 1971) (a court interprets a trust in order to determine the settlor’s intent); *Bleiden v. Greenspan*, 742 S.W.2d 93, 96 (Tex. Ct. App. – Beaumont 1987) (citations omitted), *rev’d on other grounds*, 751 S.W.2d 858 (1988) (“[I]t is well settled and elementary that the supreme goal of construing a trust instrument or a testamentary instrument, is to determine the intent of the testator-trustor-settlor.”).

If the terms of the trust are ambiguous, then the court must resolve the ambiguity by looking to extrinsic evidence, including the facts and circumstances surrounding the formation of the trust instrument, the actions of the settlor and the trustee since the formation of the trust, and expressions of the settlor’s intent. *Id.* (uncontraverted affidavit of trustor is “only meaning that can be used if the court finds that the trust language is ambiguous”); *Jochec v. Clayburne*, 863 S.W.2d 516, 520 (Tex. App. – Austin 1993, den.) (ambiguity resolved by looking to parol evidence of settlor’s intent); RESTATEMENT §4, Comment a; SCOTT §164.1. And if the terms of the trust are unambiguous but extrinsic evidence reveals that they fail to express the intent of the Settlor in forming the Trust, then the Trust must be reformed in order to express the Settlor’s true intent. *E.g., Brinker v. Wobaco Trust*, 610 S.W.2d 160 (App. Tex. – Texarkana 1980) (parol evidence of settlor’s unilateral mistake requires reformation).

2. Trust Terms May Override Duty to Diversify

The UPIA provisions, including the duty to diversify, are default rules and may be altered or abrogated by the settlor. TEX. TRUST CODE §117.003(b). A settlor may relieve the trustee of certain duties, restrictions, and liabilities imposed by statute. TEX. TRUST CODE §113.059. *Jewett v. Capital Nat. Bank of Austin*, 618 S.W.2d 109 (Tex. App. – Waco 1981, writ ref’d n.r.e.); RESTATEMENT §228.

3. Required Language to Override Duty to Diversify

Due to the fundamental duty to diversify trust investments under the UPIA, if a settlor wants the trustee to hold corporate stock as the sole or primary asset of the trust, the trust terms should expressly direct, or at least authorize, the trustee to retain the specific stock and explicitly relieve the trustee of the duty to diversify the trust’s investments. No Texas cases have considered what constitutes sufficient language to override the

trustee’s duty to diversify, but several cases in other states have addressed the issue.

In *Warmack v. Crawford*, 195 S.W.2d 919, 925 (Mo. Ct. App. 1946), which involved the stock of International Shoe Company, the trust provided that “the trustees, without accountability for loss, may retain as investments of the trust estate, any and all real estate, or bonds, stocks, loans, and other securities received in trust hereunder.” *Id.* at 925. The settlor had worked for International Shoe for many years and, at his death, the stock constituted over 90% of the assets of his estate, which passed to a testamentary trust. The Court held that the language was sufficient to grant the trustees the discretion to retain the stock if they determined that to be prudent:

By inserting the foregoing clause in the will, the testator must have intended to grant to his trustees a free discretion with reference to the retention of securities, unhampered by any arbitrary rules of trust management which would ordinarily be applicable if the will were silent as to such matter. The language of the clause quoted is not narrow. It does not, as respondent contends, limit the discretion of the trustees to a retention only if the ordinary requirement of diversification is complied with. If that had been the testator’s intention, it would have been simple for him to have said so. The language is general, not limited. It gives discretion to retain “any and all,” and not such as might be left after the application of the rule of diversification. These are words of broad discretion, and, when considered in connection with the facts and circumstances shown in evidence, including the fact that at the time the will was drawn practically all of the testator’s savings were invested in the stocks in question, must be construed as relieving the trustees of the duty to diversify, if, in their discretion, exercised in good faith, the securities in question are otherwise proper.

The court relied on the general rule stated in the Restatement of the Law of Trusts, Section. 228(f), which provides that the terms of the trust may dispense with the

requirement of diversification, either by a mandatory direction to the trustee to invest the whole or a specified part of the trust property in a particular security or type of security, or by permission to the trustee so to do. In the case of a mandatory direction the trustee is not liable for making investments in accordance therewith (except as provided by §§165–167). Where the trustee is given permission, he is not liable for making investments in accordance therewith unless he abuses that discretion (see §187) or fails to act with prudence (see §227).

The court held that the trustees were not required to sell and dispose of any portion of the stock of the International Shoe Company unless it appeared to them that said stock was not a prudent investment, having primary consideration for the preservation of the estate and the appropriate income to be derived. In determining this matter, the question of diversification need not be ignored, but it is not a controlling factor. “The whole thing rests within the sound discretion of the trustees. They alone can exercise it. They cannot shift the duty to the Court. The Court can interfere only where there is an abuse of that discretion.” *Id.* at 925.

In *Baldus v. Bank of California*, 530 P.2d 1350 (Wash. Ct. App. 1975), the court listed three factors to consider in determining whether the trust instrument negated the duty of diversification:

- (1) whether the settlor has directed, recommended, or merely authorized the retention of the investments;
- (2) whether an authorization to retain is applicable generally to property included in the trust at the time of its creation, or is applicable to specific securities or types of securities; or
- (3) the character of the trust property and the purposes of the trust.

Id. at 1355. In *Baldus*, the beneficiary of the trust sued the trustee for failing to diversify the trust’s holdings in the stock of the National Lead Company, which originally constituted over 99% of the value of trust assets when contributed by the settlor. The settlor had

been a long time employee of the Company. The trust instrument specifically authorized the trustee to retain the stock of the National Lead Company and provided that “there shall be no criticism or complaint of trustee’s action in retaining said stock should it deem it advisable.” *Id.* at 1352. Moreover, the settlor gave the trustee “absolute management and control of the trust estate.” *Id.* at 1356. The court held that the trustee had discretion to retain or sell the stock, and in the absence of any abuse of discretion on the part of the trustee for failure to diversify, there was no basis for imposing liability on the trustee. *Id.* at 1356-57.

In *First National Bank of Boston v. Truesdale Hospital*, 192 N.E. 150, 153 (Mass. 1934), a trustee was allowed to retain shares of stock of F.W. Woolworth Company based on the testator’s expressed intent:

Furthermore, the intent of the testator was that the shares of the corporation in which he had made his fortune might be retained by the trustee, so that the corpus of the trust might consist wholly of such shares. The stock, the will declared, was to “become a permanent trust fund * * * and be * * * divided up” among the trusts for the different beneficiaries. It was stock, not money, that was to be “put aside and invested” for Truesdale Hospital. It may be that the word “invested” implies a right to change investments, though that becomes unimportant in view of the power to do so under G. L. (Ter. Ed.) c. 203, § 19, which the will does not negative. Nevertheless the trust fund was to consist primarily of common stock of F. W. Woolworth Company to the value of \$500,000. Unless there should be reason to fear for the safety of the investment, the trustee under this will had the right to retain the trust fund in the form in which it was received.

First National Bank of Boston v. Truesdale Hospital, 192 N.E. at 153.

In *Americans for the Arts v. Ruth Lilly Charitable Remainder Annuity Trusts*, 855 N.E.2d 592, 603 (Ind. Ct. App. 2006), a general “retention clause” permitting the trustee to retain initial investments,

combined with exculpatory language providing that so long as the trustee acted in good faith, any investment it retained is proper even if there was a resulting lack of diversification, was found sufficient to override the duty to diversify under the provisions of the Uniform Prudent Investor Act.

However, in *Wood v. U.S. Bank*, 828 N.E.2d 1072, 1078-79 (Ohio App. 2005), applying the UPIA, the Ohio Court of Appeals held that the general retention provision in the trust did not affect the trustee's duty to diversify:

The retention clause merely served to circumvent the rule of undivided loyalty. The trust did not say anything about diversification. And the retention language smacked of the standard boilerplate that was intended merely to circumvent the rule of undivided loyalty—no more, no less. There were significant tax consequences that precluded John from diversifying by selling the Firststar stock during his lifetime, but that hurdle was removed upon his death. Had John wanted to eliminate Firststar's duty to diversify, he could simply have said so. He could have mentioned that duty in the retention clause. Or he could have included another clause specifically lessening the duty to diversify. But he did not. We hold that the language of a trust does not alter a trustee's duty to diversify unless the instrument creating the trust clearly indicates an intention to do so.

(It should be noted, however, that unlike in the other cases noted above, the majority of the stock in *Wood* was held in the corporate trustee's stock rather than a family corporation.) See Also RESTATEMENT (3d) §229, Comment d: "A general authorization in an applicable statute or in the terms of the trust to retain investments received as a part of a trust estate does not ordinarily abrogate the trustee's duty with respect to diversification or the trustee's general duty to act with prudence in investment matters." But see *Nat'l City Bank v. Noble*, 2005 WL 3315034 (Ohio App.) (trustee not required to diversify Smucker Company stock under general retention clause "based on the clear intent of Welker Smucker").

D. "Special Circumstances" May Override Duty to Diversify

If the language of the trust is not sufficient alone to override the duty to diversify, "special circumstances" may excuse diversification under Texas Trust Code Section 117.005. This provision has received no attention in Texas and little elsewhere. It was discussed somewhat in *Wood v. U.S. Bank*, 828 N.E.2d 1072, 1078-79 (Ohio App. 2005). The Ohio Court of Appeals stated that the term "special circumstances" generally refers to a holding that is important to a family or trust. *Wood*, 828 N.E.2d at 1079. The court cites *Brackett v. Tremaine*, where the Nebraska Supreme Court held that there was no duty to diversify when the asset in question was a piece of farmland that had special meaning to the family. *Wood*, 828 N.E.2d at 1079. The court recognized that stock could have special relationship to the family, which could be a special circumstance relieving the trustee of the duty to diversify. *Id.* The court stated that a controlling interest in a family business might be another example of a "special circumstance" that would override the duty to diversify. *Id.* at 1079.

It can be strongly argued that a company founded, developed and successfully operated by the settlor, and contributed to the trust by the settlor, would have special meaning and a special relationship to the family, which would permit the trustee to retain it as the sole or primary asset.

E. Beneficiaries May Excuse Performance of Duty to Diversify

If there is any question whether the trust instrument permits the trustee to retain a holding, the trust beneficiaries may excuse performance by the trustee of the duty to diversify in writing. TEX. TRUST CODE §114.005, 114.032. A beneficiary also may, by his consent, acquiescence or ratification, be estopped to complain of a trustee's failure to diversify if the beneficiary had full knowledge of all material facts. *Burnett v. First Nat'l Bank of Waco*, 536 S.W.2d 600 (Tex. Civ. App.—Eastland, writ ref'd n.r.e.); RESTATEMENT §216 & Illustrations 1-3:

(1) A is trustee of \$100,000 for B. By the terms of the trust A is directed to invest only in bonds. B requests A to invest in shares of stock and A does so. The shares fall in value. B cannot hold A liable for breach of trust

(2) The facts are as stated in Illustration 1, except that A suggested the investment in shares of stock and B consented to it. B cannot hold A liable for breach of trust.

(3) A is trustee of Blackacre for B. By the terms of the trust A is forbidden to sell Blackacre. With the consent of B, A sells Blackacre. B cannot hold A liable for breach of trust.

III. TRUSTEE AS OFFICER/DIRECTOR OF TRUST-CONTROLLED CORPORATION

When a trust owns all or a controlling interest in a corporation, it is not uncommon for the individual serving as trustee to also be an officer, director, employee and/or shareholder of the trust-owned corporation, and possibly other related entities. Although these multiple roles create areas of potential conflict and confusion, each role is legally separate and has its own unique set of duties and standards. The rules applicable to trustees differ significantly from those applicable to corporate officers and directors, and the differences are crucial to the types of claims that may be made, who can make them, and the required proof.

A. Fiduciary Duties of a Trustee

1. Highest Legal Duties

Fiduciary duties are the highest duties known to the law. *Nathan v Hudson*, 376 S.W.2d 856, 860-61 (Tex.App.–Dallas 1964, writ ref'd n.r.e.). Texas Courts hold trustees to a “very high and very strict standard of conduct which equity demands.” *Slay v. Burnett's Trust*, 187 S.W.2d 377, 387-88 (Tex. 1945). A trustee consents to have his conduct “measured by the standards of the finer loyalties exacted by courts of equity. That is a sound rule and should not be whittled down by exceptions. *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (Tex. 1938). See also *Geeslin v. McElhenney*, 788 S.W.2d 683, 685 (Tex.App.–Austin 1990, no writ); BOGERT §544. Probably the most famous, and eloquent, description of a “fiduciary” was made by Justice Cardozo in the case of *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545-46 (1928):

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an

honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. ... Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

2. Categories of Duties

Texas Trust Code Section 113.051 provides that the trustee shall “administer the trust according to its terms and [The Texas Trust Code]. In the absence of any contrary terms of the trust instrument or contrary provisions of [The Texas Trust Code], in administering the trust the trustee shall perform all of the duties imposed on the trustees by the common law.” Case law has categorized fiduciary duties in various ways, but generally, they fall into the following four main categories:

a. Duty of Loyalty

The duty of loyalty is the hallmark of a fiduciary relationship. The trustee must at all times place the interests of the beneficiary above his own. *Slay v. Burnett Trust*, 187 S.W.2d 377 (Tex. 1945). The trustee is not permitted to “place himself in a position where it would be for his own benefit to violate his duty to the beneficiaries.” SCOTT § 170; RESTATEMENT § 170.

The duty of loyalty includes the duty not to “self-deal.” A trustee who benefits personally from utilizing or dealing with trust property is considered to be “self-dealing.” Any self-dealing by a fiduciary will give rise to a “presumption of unfairness,” and the burden of proving the fairness of the transaction is placed on the fiduciary. *Texas Bank and Trust Co. v. Moore*, 595 S.W.2d 502 (Tex. 1980); *Pace v. McEwen*, 574 S.W.2d 792 (Tex. Civ. App.–San Antonio 1978, writ ref'd n.r.e.); *Jochec v. Clayburne*, 863 S.W.2d 516 (Tex. App.–Austin 1993, writ denied).

Texas Trust Code Section 117.007 expressly provides that a trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Section 117.008 expressly requires a trustee to act impartially in investing and managing trust assets if the trust has two or more beneficiaries, taking into account any differing interests of the beneficiaries. See also SCOTT § 183; RESTATEMENT § 183.

b. Duty of Competence

The Trustee has an affirmative duty to administer the trust. TEX. TRUST CODE §§113.006, 113.051. The fundamental duties of a trustee include the use of the skill and prudence which an ordinary, capable and careful person would use in the conduct of his own affairs. *Interfirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 888 (Tex. App.—Texarkana 1987, no writ). The duty of competence encompasses many “sub-duties,” some of which are described below.

(1) Duty to Comply With Prudent Investor Rule

As discussed above, effective January 1, 2004, the Texas Trust Code adopted the “prudent investor” rule. Texas Trust Code Section 117.003 provides that a trustee owes a duty to the beneficiaries of the trust to comply with the prudent investment rule, unless altered by the provisions of the trust. The standard of care for the prudent investor is stated in Trust Code Section 117.004 and requires a trustee 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, the trustee shall exercise reasonable care, skill, and caution. A trustee’s investment decisions regarding individual assets must be evaluated in the context of the trust portfolio as a whole and as part of an overall strategy having risk and return objectives reasonably suited to the trust. See Section II.A.1. *infra*.

(2) Duty Not to Delegate

The trustee is generally obligated to personally administer the trust and cannot delegate to others acts that the trustee should personally perform. See SCOTT § 171; RESTATEMENT § 171. There are exceptions to this rule. A trustee may employ attorneys, accountants, agents, including investment agents, and brokers reasonable necessary in the administration of the trust estate. TEX. TRUST CODE § 113.018. A trustee also may delegate investment decisions under certain circumstances. TEX. TRUST CODE §117.001.

(3) Duty to Keep and Render Accounts

A trustee is under a duty to the beneficiaries of a trust to keep full accounts of the trust estate that are clear and accurate. SCOTT § 172; RESTATEMENT § 172. A beneficiary may demand a written statement of accounts covering the trust's transactions. TEX. TRUST CODE §113.151.

(4) Duties at Inception of Trusteeship

Within a reasonable time after receiving trust assets, a trustee shall review the trust assets and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements and other circumstances of the trust, and the Texas Trust Code. TEX. TRUST CODE §117.006.

(5) Duty to Exercise Reasonable Care and Skill

For matters other than investments, "a trustee is under a duty in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property." See SCOTT §174; RESTATEMENT §174.

(6) Duty to Take and Retain Control of Trust Property

The trustee is under a duty to take all reasonable steps to obtain and control the trust property. See Scott § 175; RESTATEMENT §175.

(7) Duty to Preserve Trust Property

A trustee must use the same care and skill that a person of ordinary prudence would use to preserve trust property. SCOTT §176; RESTATEMENT §176.

(8) Duty to Enforce Claims

A trustee is under a duty to take reasonable actions to collect claims that are due to the trust estate. See SCOTT §177; RESTATEMENT §177.

(9) Duty to Defend

The trustee is under a duty to do what is reasonable, under the circumstances, to defend actions by third parties against the trust estate. See SCOTT §178; Restatement § 178.

(10) Duty Not to Co-Mingle Trust Funds

The trustee has a duty to keep trust property separate from other property, and to properly designate it as trust property. Not only is it the trustee's duty to keep the trust property separate from the trustee's own property, but also to keep that property separate from other trusts the trustee may administer. *See* SCOTT §179; RESTATEMENT §179. Joint investments may be proper, but each trust's interest must be kept separate.

(11) Duty With Respect to Bank Deposits

Although a trustee may deposit funds in a bank, he is under a duty to use reasonable care in selecting the bank and to properly designate the deposit as a trust deposit. He may not subject the deposit to unreasonable restrictions on withdrawal or leave the property in non-interest bearing accounts for unduly long periods of time. *See* SCOTT §180; RESTATEMENT §180. *See also* Section 113.007 of the Texas Trust Code, which authorizes the trustee to deposit trust funds that are "being held pending investment, distribution, or the payment of debts in a bank that is subject to supervision by state or federal authorities."

(12) Duty With Respect to Co-Trustees

Unless the trust provides otherwise, all trustees are under a duty to participate in the trust administration. Therefore, a trustee cannot properly delegate the acts required of the trustee to co-trustees. It is also the duty of a trustee to use reasonable care to prevent other trustees from committing a breach of trust. *See* SCOTT §184; RESTATEMENT §184.

c. Duty of Full Disclosure

A fiduciary has an affirmative duty to make a full and accurate disclosure of all material facts necessary for the beneficiaries to protect their interests. *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996); *Montgomery v. Kennedy*, 669 S.W.2d 309 (Tex. 1984); *Kinszbach Tool Co. Inc. v. Corbett-Wallace Corp.*, 160 S.W.2d 509 (Tex. 1942). The rationale for this rule is described in SCOTT § 173:

The trustee is under a duty to the beneficiaries to give them on their request at reasonable times complete and accurate information as to the administration of the trust. The beneficiaries are entitled to know what

the trust property is and how the trustee has dealt with it. They are entitled to examine the trust property and the accounts and vouchers and other documents relating to the trust and its administration. Where a trustee is created for several beneficiaries, each of them is entitled to information as to the trust. Where the trust is created in favor of successive beneficiaries, a beneficiary who has a future interest under the trust, as well as a beneficiary who is presently entitled to receive income, is entitled to such information, whether his interest is vested or contingent.

A trustee has a fiduciary duty, upon demand by the beneficiary, to furnish the beneficiaries with a formal trust accounting; to inform a beneficiary of the nature and amount of the trust property, the trustee's management actions, and the intent of the trustee regarding the future administration of the trust estate; and to allow the beneficiary to inspect the books and records of the trust. *Shannon v. First National Bank*, 533 S.W.2d 389 (Tex. Civ. App. 1976, writ ref'd, n.r.e.); SCOTT §173; and RESTATEMENT §173. The fiduciary duty of full disclosure operates before and after litigation has been filed and is in addition to any obligations of disclosure imposed by the "discovery" provisions of the Texas Rules of Civil Procedure. *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996); *In re Peterson*, 2004 WL 88872 (Tex. App. – Amarillo) (not designated for publication).

d. Duty to Reasonably Exercise Discretion

A trustee must exercise a discretionary power - "reasonably." *See Sassen v. Tanglegrove Townhouse Condo. Assoc.*, 877 S.W.2d 489 (Tex. App.-Texarkana 1994, writ denied). Effective January 1, 2004, Texas enacted the Uniform Principal and Income Act. Former Trust Code Sections 113.101 through 113.111 have been repealed. The Uniform Principal and Income Act is contained in Chapter 116 of the Texas Trust Code. In exercising a discretionary power of administration regarding a matter covered by the Uniform Principal and Income Act, "a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this

chapter is presumed to be fair and reasonable to all of the beneficiaries. TEX. TRUST CODE §116.004(b).

(1) Power to Adjust Between Principal and Income.

Trust Code Section 116.005 authorizes a trustee to adjust between principal and income if the trustee is in compliance with the prudent investor rule, the trust provides for distributions to a beneficiary by reference to the trust's "income" and the trustee cannot otherwise administer the trust impartially, based on what is fair and reasonable to all of the beneficiaries. The power to adjust specifically includes the power to allocate all or part of a capital gain to trust income. This section lists nine factors that a trustee may consider in deciding whether or how to exercise the power to adjust and prohibits a trustee from making an adjustment under certain circumstances.

Trust Code Section 116.006 provides that a court may not question a trustee's exercise or non-exercise of the power to adjust unless the court determines that the decision was an abuse of the trustee's discretion. If a court determines that a trustee has abused its discretion, the court may place the income and remainder beneficiaries in the positions that they would have occupied if the discretion had not been abused. TEX. TRUST CODE §116.006(c). If the trustee reasonably believes that one or more beneficiaries will object to the exercise of a discretionary power, the trustee may petition the court to determine whether the proposed discretionary act will result in an abuse of the trustee's discretion. TEX. TRUST CODE §116.006(d). In such a suit, the trustee is directed to advance from the trust principal all costs incident to the judicial determination, including attorney's fees of the trustee, any beneficiary who is a party and any guardian ad litem. At the conclusion of the proceeding, however, the court may award costs and attorney's fees as the court deems to be "equitable and just" as provided in Trust Code Section 114.064, including awarding costs against the trust, a beneficiary and/or the trustee in its individual capacity if the court determines that the trustee's exercise of the discretionary power would have resulted in an abuse of discretion or that the trustee did not have reasonable grounds for believing that a beneficiary would object.

The remaining sections of the Uniform Principal and Income Act generally provide for allocation of specific receipts and disbursements between income and principal. For a detailed discussion of these provisions, see SCOTT § 170; KARISCH, TEXAS TRUST LAW

CHANGES (2003); COX, UPIA TWINS, 2004 Annual Advanced Estate Planning and Probate Course; BURDETTE, ENFORCING BENEFICIARIES' RIGHTS, 2010 Annual Advanced Estate Planning and Probate Course.

(2) There is no "Absolute" Discretion.

Regardless of the language used in a trust instrument, a trustee's exercise of discretion in the performance of his duties is always subject to review by Texas courts under an "abuse of discretion" standard. *Corpus Christi Bank and Trust v. Roberts*, 597 S.W.2d 752, 754 (Tex. 1980).

(3) Petitioning Court for Instructions.

A trustee may seek court clarification of ambiguous terms in the trust instrument or of issues relating to discretionary decisions (other than the trustee's power to adjust between principal and income, judicial control over which is now provided in Section 116.006). An action may be filed under the Declaratory Judgment Act, TEX. CIV. PRAC. & REM CODE §§37.001 et seq. An action also may be filed under Trust Code Section 115.001(a) to:

- construe a trust instrument;
- determine the law applicable to a trust instrument;
- appoint or remove a trustee;
- determine the powers, responsibilities, duties and liability of a trustee;
- ascertain an officary;
- make determinations of fact effecting the administration, distribution, or duration of a trust;
- determine a question arising in the administration or distribution of a trust;
- relieve a trustee from any or all of the duties, limitations, and restrictions otherwise existing under the terms of the trust instrument or of this subtitle;
- require an accounting by a trustee; review trustee fees, and settle interim or final accounts; and
- surcharge a trustee.

For a comprehensive discussion of fiduciary duties, see J. MOORE, *LITIGATION INVOLVING FIDUCIARIES: TRIAL*

HANDBOOK 2009, 33rd Annual Advanced Estate Planning and Probate Course.

B. Fiduciary Duties of an Officer/Director

Under Texas law, there are essentially three fiduciary duties owed by corporate directors/officers: the duty of care, the duty of loyalty, and the duty of obedience. *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (interpreting Texas Law); *Loy v. Harter*, 128 S.W.3d 397, 407 (Tex.App.-Texarkana 2004); *In re Jones*, 445 B.R. 677, 714 (N.D. Tex. 2011).

1. Duty of Care - The Business Judgment Rule

A director is required to handle his duties with the care “an ordinary prudent man would use under similar circumstances” *McCollum v. Dollar*, 213 S.W. 259, 261 (Tex. Comm’n App. 1919, holding approved). Generally, a director fulfills his obligation to act with care if his actions comport with the “business judgment rule.” Under Texas law, corporate directors owe three broad fiduciary duties to the corporation: obedience, loyalty, and due care. *See Gearhart*, 741 F.2d at 719. However, for over a hundred years -since 1889- Texas courts have refused to impose liability upon a non-interested corporate director who breached a fiduciary duty unless the challenged action is ultra vires or is tainted by fraud. *Id.* at 721 (citing *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846 (1889); *Robinson v. Bradley*, 141 S.W.2d 425 (Tex. Civ. App. - Dallas 1940, no writ); *Bounds v. Stephenson*, 187 S.W. 1031 (Tex. Civ. App. - Dallas 1916, writ ref’d); *Caffall v. Bandera Tel. Co.*, 136 S.W. 105 (Tex. Civ. App. 1911); *Farwell v. Babcock*, 65 S.W. 509 (Tex. Civ. App. 1901)). As the Texas Supreme Court stated:

[I]f the acts or things are or may be that which the majority of the company have a right to do, or if they have been done irregularly, negligently, or imprudently, or are within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved, these would not constitute such a breach of duty, however unwise or inexpedient such acts might be, as would authorize interference by the courts at the suit of a shareholder.

The business judgment rule “precludes judicial interferences with the business judgment of directors absent a showing of fraud or an ultra vires act.” *Gearhart*, 741 F.2d at 724 n. 9. This rule prevents claims against management for “alleged unwise, inexpedient, negligent or imprudent decisions or conduct.” *Cleaver v. Cleaver*, 935 S.W.2d 491, 496 (Tex.App.-Tyler 1996). *See also Langston v. Eagle Pub. Co.*, 719 S.W.2d 612, 616 (Tex.App.-Waco 1986, writ ref’d n.r.e.). Essentially, a breach of the duty of care requires proof of gross negligence. *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846, 849 (Tex. 1889).

2. Duty of Loyalty

A director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation. *Gearhart*, 741 F.2d at 719; *See also Pinnacle Data Servs. v. Gillen*, 104 S.W.3d 188, 198-99 (Tex. App. - Texarkana 2003, no pet.) The duty of loyalty is described as requiring an extreme measure of candor, unselfishness, and good faith on the part of the officer or director. *Id.* at 199. Courts have traditionally held that contracts between a corporation and its officer are voidable for unfairness and fraud. *See, e.g., Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963). These transactions are generally referred to as “interested director transactions.” *See Gearhart*, 741 F.2d at 719-720. Section 21.418 of the Texas Business Organizations Code provides a safe harbor for what may be considered an “interested director transaction.” Generally, an interested director transaction will not be voidable if: (1) a majority of disinterested directors approve the proposed transaction in good faith with knowledge of all material facts; (2) a majority of shareholders approve the proposed transaction in good faith with knowledge of all material facts; or (3) the transaction is fair to the corporation and the shareholders or board of directors ratify the transactions. TEX. BUS. ORGS. CODE §21.418. Officers or directors usurp a corporate opportunity if they “misappropriate[d] a business opportunity that properly belonged to the corporation.” *Loy v. Harter*, 128 S.W.3d 397, 408 (Tex.App.-Texarkana 2004, pet. denied); *Landon v. S&H Mktg. Group*, 82 S.W.3d 666, 681 (Tex.App.-Eastland 2002, no pet.). An opportunity properly belongs to the corporation if the corporation has a “legitimate interest or expectancy in and the financial resources to take advantage of” a particular business opportunity. *Holloway*, 368 S.W.2d at 576-578; *Landon*, 82 S.W.3d at 681.

3. Duty of Obedience

The duty of obedience requires a director to avoid committing ultra vires acts, i.e., acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation. *Id.* at 719. A director is not personally liable for an ultra vires act, negligent or not, unless the action is also illegal. *Id.* Even if the act is illegal, to impose liability on a disinterested director for ultra vires acts, a plaintiff must plead and prove that the director knew of or took part in it. *FDIC v. Benson*, 867 F. Supp. 512, 522 (S.D. Tex. 1994); *see also RTC v. Norris*, 830 F. Supp. 351, 355 (S.D. Tex. 1993). Barring an illegal act in which the director took part or had knowledge of, the business judgment rule will protect him or her from personal liability.

C. **Actions Between Trustee and Corporation - Self-Dealing**

“Self-dealing” by a trustee involves a transaction where the trustee uses trust property for his personal benefit. Transactions between a trustee and a corporation of which he is an officer, director, or shareholder may constitute self-dealing, as the trustee is using trust assets to benefit himself in his dual capacities.

Common examples include a trustee buying or selling trust property to himself, making a side-profit or fee in a transaction involving trust property or taking advantage of an opportunity that presents itself as a direct or indirect result of the fiduciary relationship. *Slay v. Burnett Trusts*, 187 S.W.2d 377 (Tex. 1945); *Texas Bank and Trust Co. v. Moore*, 595 S.W.2d 502 (Tex. 1980); and RESTATEMENT §170. To prove a prima facie case of self-dealing by a trustee, a beneficiary plaintiff must plead and prove that “(1) the defendant owed the plaintiff a duty of loyalty as trustee; and (2) the defendant breached the duty of loyalty by engaging in self-dealing.” 14 C.O.A. 411.

In Texas, there are two kinds of self-dealing: statutory self-dealing and common law self-dealing.

1. Statutory Self-Dealing

The Trust Code expressly prohibits a trustee from making loans or sales to himself or related parties. Texas Trust Code Section 113.052(a) prohibits a trustee from lending trust funds to:

- (a) the trustee or an affiliate,

- (b) a director, officer, or employee of the trustee or an affiliate;
- (c) a relative of the trustee; or
- (d) the trustee’s employer, employee, partner, or other business associate.

Texas Trust Code Section 113.053(a) prohibits a trustee from directly or indirectly buying or selling trust property from or to:

- (a) the trustee or an affiliate;
- (b) a director, officer, or employee of the trustee or an affiliate;
- (c) a relative of the trustee, or
- (d) the trustee’s employer, employee, partner, or other business associate.

“Affiliate” means a person directly or indirectly controlling, controlled by, or under common control with another person, including a person with whom a trustee has an express or implied agreement regarding the direct or indirect purchases of trust investments by each from the other, except a broker or stock exchange. TEX. TRUST CODE §111.004(1). “Relative” means a spouse or, whether by blood or adoption, an ancestor, descendant, brother, sister, or spouse of any of them. TEX. TRUST CODE §111.004(13). Trust Code Section 113.054 places limitations on a trustee’s ability to sell property of one trust to another trust when he is the trustee of both trusts. Finally, Section 113.055 prohibits a corporate trustee from purchasing its own securities.

Statutory self-dealing imposes strict liability. Once it has been established that there is statutory self-dealing, the “no-further inquiry” rule comes into play. The fact that the trustee operated under good faith and fairness does not save the trustee from liability if the trustee has engaged in statutory self-dealing. *Interfirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 898 (Tex.App– Texarkana 1987, writ).

2. Common Law Self-Dealing

Common law self dealing occurs when a trustee takes any discretionary action as trustee which directly or indirectly benefits the trustee (or the trustee’s family or affiliates) to the detriment of the beneficiaries. The

burden of proof shifts to the fiduciary to show that the transaction is fair to the beneficiaries of the trust. *Archer v. Griffith*, 390 S.W.3d 735 (Tex. 1964). In establishing the fairness of the transaction, courts will look at factors such as whether the trustee made full and fair disclosure, whether the consideration is adequate, or whether the trustee has benefitted or profited from the transaction at the expense of the beneficiary. *Miller v. Miller*, 700 S.W.2d 941, 946 (Tex. App.—Dallas 1985, writ ref'd n.r.e.). The most important of these factors is whether the trustee made a full and fair disclosure because the trustee has a duty, without demand, to disclose all relevant information relating to any transaction in which the trustee has a personal interest. *Id.* Unlike statutory self-dealing where the trustee is strictly liable, under a common law self-dealing case, the Plaintiff must prove not only the breach of loyalty, but also loss to the trust and a causal connection between the breach and the loss.

When a trustee owns a small amount of stock for the trust, a vote for himself individually and as officer/director is not apt to be the cause of his election as officer or obtaining his salary. The vote of the other stockholders brings about that result. Only when the trustee holds a large percentage of the stock in his capacity as trustee would the vote of the trustee for himself be significant. Bogert § 543. Where trustees are officers of a corporation and continue to be after appointment as trustees, there is no breach of trust in receiving salaries and there is no duty to disclose this relation to the beneficiaries in an accounting. *In re McLaughlin's Estate*, 274 P.2d 868. *See Nat'l City Bank v. Noble*, 2005 WL 3315034 at 7 (Ohio App.) (service as both a trustee and a director does not per se, create a conflict sufficient to establish a breach of a fiduciary duty); *Guerra v. Guerra*, 2011 WL 3715051 (Tex. App. — San Antonio)(not designated for publication), discussed *infra* (service as both executor and officer and director does not per se create a conflict of interest and a breach of fiduciary duty; executor must use his power as executor for his personal interest at the expense of the estate in order to breach his fiduciary duty).

D. Actions as Trustee are Legally Separate from Actions as Officer/Director

If the same individual serves as trustee of a trust holding corporate stock and as an officer/director of that corporation, it is critical to determine the capacity in which he has acted in connection with any claim. Due to the higher legal standard applicable to trustees as compared to officers and directors, a beneficiary would prefer to assert claims against the person as trustee.

1. Texas Law - Actions Totally Separate

Under Texas law, if the trustee is also an officer or director in his individual capacity, the trust beneficiaries cannot sue him as trustee for actions taken as a director or officer. The law recognizes that actions by an individual in one capacity are treated as if they were the actions of another separate individual. As one court explained:

A person who sues or is sued in his official or representative capacity is, in contemplation of law, regarded as a person distinct from the same person in his individual capacity and is a stranger to his rights or liabilities as an individual. It is equally true that a person in his individual capacity is a stranger to his rights and liabilities as a fiduciary or in a representative capacity.

Elizondo v. Texas Natural Resource Conservation Commission, 974 S.W.2d 928, 931 (Tex. App. — Austin 1998, no pet.), and cases cited therein. *See also McGinnis v. McGinnis*, 267 S.W.2d 432, 435 (Tex.Civ.App.—San Antonio 1954, no writ). As another court stated: “The law is clear that there is a legally significant difference between a person in his individual capacity and the very same person in his representative capacity.” *In Re: Estate of Spivey*, 2000 WL 4397 (Tex.App.—Texarkana) (not designated for publication). This distinction was explained by a New York court as follows:

[T]he mere fact that a person occupies the position of an estate fiduciary does not result in coloring his entire life and action to the exclusion of all his other rights and interests. He still eats breakfast, performs his daily tasks, and retires for the night as an individual and these private activities are as immune from the prying eyes of the beneficiaries of the estate of which he is a fiduciary as if they had been performed by an entirely different person. As a matter of legal fact, he is not subject to scrutiny as a fiduciary except to those matters which are performed strictly in the management of the estate, and any knowledge or information he may possess or acquire in his extra fiduciary

relations are as privileged as
are his breakfast menu or his
nocturnal habits.

In re Ebbets' Estate, 267 N.Y.S. 268, 267-68 (N.Y. Surrogate's Court, Kings County 1933). Commenting further on this dual personality, the New York court stated: "It has been repeatedly held that persons suing or being sued in their official or representative capacity are, in contemplation of law, distinct persons, and strangers to any right or liability as an individual." *Id.* at 267.

Current Texas law draws a clear line between the actions of a trustee of a trust and the actions of an officer or director of a corporation owned all or in part by the trust, even where the same person "wears both hats." *Adam v. Harris*, 564 S.W.2d 152 (Tex. Civ. App. – Houston [14th Dist.] 1978, writ ref'd n.r.e.). A claim against a trustee for self-dealing or other breach of fiduciary duty can only be brought against a trustee acting in his trustee capacity. Transactions between the corporation whose stock is held by the trust and the trustee not acting in his trustee capacity do not constitute self-dealing or breaches of fiduciary duties by the trustee and cannot form the basis for a claim by a trust beneficiary against the trustee. *Adam v. Harris*, 564 S.W.2d 152. Thus, the actions of a director or officer will not be subject to the higher fiduciary duties owed by a trustee to the trust beneficiaries.

In *Adam*, the court held that an alleged self-dealing transaction between a director of a corporation, who was also the trustee of a trust owning a controlling interest in the corporation, and a related entity did not constitute a breach of fiduciary duty by the trustee or self-dealing with trust property. Robert Adam was the trustee of a testamentary trust that owned a controlling interest in a trucking corporation. Adam also was a director of the corporation. The corporation purchased truck insurance from Adam Gordon Insurance Agency, an agency owned by Adam's brothers. The trust beneficiaries sued Adam as trustee for self-dealing under the Texas Trust Act, which prohibited a trustee from buying property from a related party. The beneficiaries argued that the transaction between the corporation, of which Adam was a director and was the owner as trustee, with the insurance company owned by Adam's brothers constituted prohibited self-dealing by Adam as trustee. They sought to recover any profits made from the insurance transactions. The Houston Court of Appeals disagreed with the beneficiaries, stating as follows:

The flaw in this argument, however, is that whatever breach of fiduciary duty Robert Adam committed was in his capacity as director of the truckline corporation and not in his capacity as trustee. Robert Adam did not self-deal with the trust property, the shares in the corporation, but rather with the corporation's property, the monies used to purchase the insurance for the trucks. Section twelve of the Texas Trust Act directs that a "trustee shall not buy nor sell . . . any property owned by or belonging to the trust estate ... from or to ... a relative" Here, no property either entered or left the trust res; the trustee neither bought nor sold trust property. Under these circumstances we hold that no cause of action for self-dealing lies against anyone on the basis of the beneficiary-trustee relationship.

Id. See also *Cleaver v. Cleaver*, 935 S.W.2d 491 (Tex. App. – Tyler 1996) (Trust beneficiary's spouse [in divorce action] claimed trustee, who owned minority interest in corporation as trustee and controlling interest in his individual capacity, breached his fiduciary duty as trustee by allegedly suppressing dividends. In dicta, the court found no evidence that the trustee received any personal benefit arising out of his service as trustee, but the court also discussed the fairness of the transactions to all of the shareholders, thereby blurring the lines between the separate capacities.) See also *Guerra v. Guerra*, 2011 WL 3715051 (Tex. App. – San Antonio)(not designated for publication), discussed *infra*.

2. Non-Texas Cases - Actions Separate Only Where Trustee Not Holding a Controlling Interest

In some non-Texas cases, courts have drawn a clear distinction between the actions of an individual as trustee and his actions as a director or officer only where the trustee owned less than a majority of the corporate stock and thus was unable to control corporate affairs. *In re Ebbets' Estate*, 267 N.Y.S. 268, 270 (Surrogate's Court 1933). In *Ebbets*, the issue was whether the executors, in connection with their accounting of the estate, could be required to produce the books and records of the corporations of which the estate owned 50% of the stock and the executors also served as directors (but did not constitute a majority of directors).

The court held that the executors' did not have to provide any corporate information because the estate did not own a controlling interest and the executors did not constitute a majority of the board of directors. The accounting was to cover only matters relating to the executors' administration of the estate, including their management of the estate assets. Here, the executors had no duty to run the corporation. The executors' duty was to hold the stock, vote the stock, and receive any property or dividends that might be paid. "The management of [the corporation's] affairs was entirely different and separate from any duties the [executors] were called upon to perform as executors and trustees." *Id.* at 266. Further, "at no time was the estate in a position to exercise control over the corporations, since at no time did it own a majority of their stock or possess voting control." The executors were always "minority representatives [on the board] and were therefore unable to conduct the affairs of the corporations as an adjunct to those of the estate." *Id.* at 270.

However, if an estate holds a controlling interest in the corporation, the executor may be required to disclose corporate information in an estate accounting. *In re Sylvester's Estate*, 172 N.Y.S.2d 57 (S. Ct. 1958) ("[t]here can be no question that where an estate fiduciary is a controlling stockholder in a corporation by reason of holding such stock in a fiduciary capacity, he can be compelled to disclose details of a corporate activity."); *Taylor v. Errion*, 44 A.2d 356 (NJ 1945) (trustee holding majority of stock and who actively managed the corporation, breached his fiduciary duties as trustee when he utilized his control of the board of directors to make an unjustified increase in his salary as a corporate officer and was subject to removal as trustee); *Brown v McLanahan*, 148 F.2d 703 (4th Cir. 1945) (trustees breached fiduciary duties owed to beneficiaries where they misused their voting powers for their own benefit or for the benefit of corporations in which they were interested personally).

In a recent Texas case, the San Antonio Court of Appeals appeared to consider the estate's lack of control of the corporation as significant to a breach of fiduciary duty claim against the Executor. In *Guerra v. Guerra*, *supra*, Armengol was the executor of his father's estate. The estate owned 37% of Laredo Hardware Company. The remaining stock was owned by his wife, two sons, and two sisters. Armengol also was an officer and director of the Company. The company had an option to purchase the decedent's shares, but elected not to do so. The executor distributed the estate's shares to the

beneficiaries pursuant to the Will. Maria, his sister, sued Armengol for breach of fiduciary duty as executor and for breach of fiduciary duty as an officer and director of the Company for not liquidating the company, and sought personal damages. In addition, Maria asserted a claim for shareholder oppression.

The Court held that Armengol did not breach his fiduciary duty as an executor, despite the alleged conflict of interest that he had as executor and as an officer, director and employee of the Company. The Court stated:

However, merely being in a position that may create a conflict is not alone a breach of his fiduciary duty. *Id.* For there to be a conflict of interest and a breach of fiduciary duty, an executor must use his power as executor for his personal interest at the expense of the estate. *Lesikar v. Rappeport*, 33 S.W.2d 282, 297 (Tex. App. – Texarkana 2000, pet. denied)(citing *Slay*, 187 S.W.2d at 388).

The Court also held that the executor had no duty to liquidate the corporation in order to preserve the assets of the estate:

Laredo Hardware was not an estate assets. Rather, the estate owned company stock, which represented only a thirty-seven percent, non-controlling interest in the company. Maria implies Armengol was required to engage in a course of conduct which would result in liquidation. Maria cites no authority that Armengol had a duty to take affirmative steps to liquidate Laredo Hardware. There is no evidence that Armengol, as the executor of his father's estate, had the authority or power to liquidate Laredo Hardware. Armengol had a duty to use reasonable care to preserve estate assets. *Lawyers Sur. Corp. V. Snell*, 617 S.W.2d 750, 752 (Tex. Civ. App. – Houston [14th Dist.] 1981, no writ); *Humane Soc'y*, 531 S.W.2d at 580; *Frost Nat'l Bank of San Antonio v. Kayton*, 526 S.W.2d 654 (Tex. Civ. App. – San Antonio 1975,

writ ref'd n.r.e). He did not have a duty to persuade shareholders in a corporation to liquidate the company.

Guerra, 2011 WL 3715051 (Aug. 24, 2011).

The books and records of a corporation in which a trustee owns a minority interest may be relevant, and therefore discoverable, in a breach of fiduciary duty suit by a trust beneficiary against the trustee. However, production would be required only as to such records within the trustee's possession, custody or control. *In Re Rogers*, 200 S.W.3d 318, 322 (Tex.App.—Dallas 2006, orig. proceeding); *In Re Vance*, 2010 WL 3037578 (Tex. App. 2010, no pet.) (not designated for publication); *In re Kuntz*, 124 S.W.3d 179, 183-84 (Tex.2003) (employee sued in his individual capacity did not have "possession, custody, or control" of documents within his corporate employer's possession; thus, he could not be compelled to produce those documents in response to discovery); and *American Maplan Corporation v. Heilmayr*, 203 F.R.D. 499 (D.Kan.2001) (president of corporation sued in his individual capacity could not be compelled to produce documents belonging to corporation because it was a separate legal entity and not a party to the suit).

- a. What is a "Controlling Interest"?
- (1) The Trustee owns a minority interest as trustee, but owns a majority interest individually.

It can be argued that the Trustee does not hold a controlling interest as trustee because he holds a controlling interest in his individual capacity without the trust's shares. *See In re Sylvester's Estate*, 172 N.Y.S.2d 57 (S. Ct. 1958) (executor not required to account for corporate activities in estate accounting because daughter held controlling interest in her individual capacity and not as executor).

- (2) The Trustee owns a minority interest as trustee and a minority interest individually, but the combined interests represent a majority of the shares.

E. Trust Beneficiary's Ability to Sue for Improper Actions of Officer/Director in Texas

Does *Adams* mean that a trust beneficiary has no right to relief for mismanagement of the corporation by

the trustee acting in his capacity as a corporate director or officer? Can a trustee simply transfer the trust assets to a corporation and avoid all fiduciary duties? While there are no Texas cases on point, the answer must be "no." Otherwise, a wrong would exist without a remedy. Where the trustee, as a shareholder, fails to pursue a proper claim for corporate mismanagement or take other action to protect the trust's interests in the corporation, the beneficiary should be able to sue the trustee and/or the officer/director.

1. Trust Beneficiary's Claims Against Trustee

a. Fiduciary Duty to Supervise Corporate Management

Although a trustee is not liable, as a trustee, for his actions as an officer or director of a corporation controlled by the trust under *Adam*, the trustee should have a fiduciary duty to exercise his control for the benefit of the trust beneficiaries. This would require the trustee to supervise corporate management to ensure that the officers and directors of the corporation are at all times managing the corporation in the best interest of the beneficiaries of the trust. SCOTT §193, 193.2, at 155 ("The trustee will be held accountable by the court if in the exercise of his power of control over the corporation he acts for his own interest rather than for the interest of the beneficiaries."); *Johnson v. Witkowski*, 573 N.E.2d 513, 519 (Mass. App. Ct. 1991); *In Re Koretzky's Estate*, 86 A.2d 238, 248 (NJ 1951) ("In voting shares of stock fiduciaries are under a duty to vote in such a way as to promote the interests of the beneficiaries. 2 Scott on Trusts, sec. 193.1, p. 1047. . . . And where a fiduciary holds sufficient shares to control actually or substantially the conduct of the corporation he is under a duty to exercise that control for the benefit of the trust. 2 Scott on Trusts, sec. 193.2, pp. 1049, 1050."); *In the Matter of Hubbell*, 97 N.E.2d 888, 891 (N.Y. 1950); *In the Matter of the Estate of Sakow*, 601 N.Y.S.2d 991 (N.Y. Surr. Ct. 1994); *In the Matter of the Estate of Schulman*, 568 N.Y.S.2d 669 (N.Y. App. Div. 1991); *Jennings v. Speaker*, 571 P.2d 358 (Ca. Ct. App. 1977).

b. Fiduciary Duty Regarding Corporate Dividends

A fiduciary duty to supervise corporate management would include scrutiny regarding the corporation's payment of reasonable and appropriate dividends to the trust for distributions to the trust beneficiaries in accordance with the trust distribution provisions. Trusts often provide for distribution of "income" and "principal" to different beneficiaries and/or under different standards. Thus, improper

suppression of dividends by the corporation could significantly affect the distribution rights of the trust beneficiaries.

(1) Character of Receipts from Entities as Trust Income or Principal

Texas Trust Code Section 116.151 provides that money received by a trust from a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, or common trust fund shall be treated as **income** to the Trust except that the following receipts shall be allocated to **principal**:

1. Property other than money;
2. Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
3. Money received in total or partial liquidation of the entity; and
4. Money received from an entity that is a regulated investment money or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

TEX. TRUST CODE §116.151(a)-(c). A distribution will be treated as received in partial liquidation if the entity designates the distribution as in partial liquidation or if the total amount of the distribution or series of related distributions is greater than 20% of the entity's gross assets reflected in the year-end financial statements immediately preceding the initial receipt. TEX. TRUST CODE §116.151(d). Money is not received in partial liquidation if it does not exceed the amount of income tax that the trust or beneficiary must pay on taxable income of the entity that distributes the money. TEX. TRUST CODE §116.151(e).

The characterization of such receipts is of particular importance when the trust income beneficiary and principal beneficiary are not the same person. If the trustee owns a controlling interest in the corporation or is the director with sufficient authority to control distributions, the trustee's fiduciary duty of loyalty to the trust beneficiaries would seem to require that the trustee monitor the trust's rights to dividends (or other

distributions) and use his control to prevent any abuse that would harm any trust beneficiary.

The trustee has a clear fiduciary duty to properly characterize any corporate distributions as trust income or principal. Despite language in the trust instrument that the trustee has "sole and absolute discretion" to determine distributions in accordance with a specified standard, there is no such thing as absolute discretion. This well-settled principle has now been codified in the Texas Trust Code Section 113.029(a) (effective 9/1/09):

Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of terms such as "absolute," "sole," or "uncontrolled," the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

A court generally will not substitute its own discretion for that of a trustee. However, the court will not permit a trustee to abuse his discretion. *See Coffee v. William Marsh Rice University*, 408 S.W.2d 269 (Tex. Civ. App. – Houston 1966); *Brown v. Sherck*, 393 S.W.2d 172 (Tex. Civ. App. – Corpus Christi, 1965, no writ); and *Nations v. Ulmer*, 122 S.W.2d 700 (Tex. Civ. App. – El Paso, 1938). A trustee's discretion is not unbridled discretion. *State v. Rubion*, 308 S.W.2d 4 (Tex. 1957); *First National Bank of Beaumont v. Howard*, 229 S.W.2d 781, 785 (Tex. 1950); *Anderson v. Menefee*, 174 S.W. 904 (Tex. Civ. App. – Ft. Worth 1915, writ ref'd); SCOTT §187 p. 986.

A trustee may abuse his discretion if the trustee acts outside the bounds of "reasonably judgment." SCOTT §187. Use of the terms "absolute," "uncontrolled," "sole" and "exclusive" in granting discretion to a trustee does not completely absolve the fiduciary from acting reasonable. *First National Bank v. Howard; Thorman v. Carr*, 412 S.W.2d 45 (Tex. 1967).

It is an abuse of discretion for a trustee to fail to exercise judgment at all, no matter how broad the standard. SCOTT §187.3. The trustee's discretion must be "reasonably exercised to accomplish the purposes of the trust according to the settlor's intention and his exercise thereof is subject to judicial review and

control.” SCOTT §§187, 187.1, 187.2, and 187.3; *Kelly v. Womack*, 268 S.W.2d 903, 907 (Tex. 1954); *Powell v. Parks*, 86 S.W.2d 725 (Tex. 1935); *Davis v. Davis*, 44 S.W.2d 447 (Tex. Civ. App. – Texarkana 1931, no writ).

(2) Income Tax Issues

The taxable income from a pass-through entity such as a Subchapter S Corporation, a limited liability, partnership or other entity for which such tax election has been made, is taxed to the owners of the entity whether or not any distributions have been made. Such “taxable income,” however, is not “trust income” for trust distribution purposes. Thus, a trust shareholder could have taxable income from the entity but receive no distributions from which to pay the tax on that taxable income. To avoid this problem, pass-through entities typically make cash distributions at least equal to the estimated amount of the income taxes payable by the owners on their share of the entity’s “taxable income.” Only these cash distributions for taxes, however, constitute “receipts” to the trust for purposes of Section 116.151 of the Texas Trust Code. Under such section, those receipts would be characterized as income rather than principal. A trustee holding a controlling interest in the corporation may have a duty to the trust beneficiaries to seek to compel such “tax distributions.”

c. Failure to Pursue Shareholder Claims

The trustee of a trust that owns only a minority interest in a corporation has no ability to control the corporation’s affairs. The only duties the trustee has to the trust beneficiaries would be to exercise the rights of a minority shareholder as the trustee deems reasonable and prudent. If the trustee fails or refuses to exercise such rights (e.g., if the trustee individually is the alleged wrongdoer as an officer/director), a trust beneficiary should be entitled to exercise the rights on behalf of the trust. In addition, the trust beneficiary may have a claim for breach of fiduciary duty against the trustee for failing to exercise such minority shareholder rights.

2. Claims by Trust Beneficiary Against Officer/Director/Majority Shareholder

a. Shareholder Derivative Suit

A corporate officer owes a fiduciary duty to the corporation, but, absent some contract or special relationship, he does not owe a fiduciary duty to an individual shareholder. *Redmon v. Griffith*, 202 S.W.3d 225, 233 (Tex.App. – Tyler 2006, pet. denied). Furthermore, “a corporate shareholder has no individual

cause of action for personal damages caused solely by a wrong done to the corporation.” *Id.* Likewise, individual stockholders generally “have no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock.” *Perry v. Cohen*, 285 S.W.3d 137, 144 (Tex.App.-Austin 2009, pet. denied) (quoting *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex.1990)). “Accordingly, an action for such injury must be brought by the corporation, not individual shareholders.” *Id.* Thus, “to recover for wrongs done to the corporation, the shareholder must bring the suit derivatively in the name of the corporation so that each shareholder will be made whole if the corporation obtains compensation from the wrongdoer.” *Redmon*, 202 S.W.3d at 234 (citing *Faour v. Faour*, 789 S.W.2d 620, 622 (Tex.App.-Texarkana 1990, writ denied)). “[T]he right to proceed against an officer or former officer of a corporation for breaching a fiduciary duty owed to the corporation belongs to the corporation itself.” *Grinnell v. Munson*, 137 S.W.3d 706, 718 (Tex.App.-San Antonio 2004, no pet.). In a shareholder derivative suit, “the individual shareholder steps into the shoes of the corporation and usurps the board of directors’ authority to decide whether to pursue the corporation’s claims.” *In re Crown Castle Int’l Corp.*, 247 S.W.3d 349, 355 (Tex.App.-Houston [14th Dist] 2008, orig. proceeding).

The Texas Business Organizations Code provides the statutory requirements for shareholder derivative proceedings. TEX. BUS. ORGS. CODE ANN. §§ 21.551–.563 (Vernon Supp. 2010)). These provisions prescribe specific steps that a shareholder derivative plaintiff must take before filing a shareholder derivative suit, including making a demand on the corporation, allowing the corporation to conduct an investigation, and allowing the corporation, based on that investigation, to determine whether litigation is advisable and in the best interest of the corporation.

There is no Texas law on whether a beneficiary of a trust that owns corporate stock may file a shareholder derivative suit where the trustee fails to do so. Texas Business Organizations Code Section 21.551 defines a “shareholder” to include a beneficial owner whose shares are held in a voting trust or by a nominee on the beneficial owner’s behalf. In *Demoulas v. Demoulas Supermarkets, Inc.*, 677 N.E.2d 159 (Mass. 1997), the beneficiary of a trust that owned stock in a corporation filed a shareholder derivative suit (SDS) alleging usurpation of corporation opportunities, self-dealing and other claims against corporate officers and

directors. The defendants argued that the plaintiff lacked standing to file the SDS because the plaintiff was only a beneficiary of a trust that owned stock, and legal title to the stock was in the trustee. The court held that the trust beneficiary did have standing to file the SDS on behalf of the corporation. The court stated that “the beneficiary is not required to depend on the trustee to bring such an action” where the trustee is the director whose operation of the corporation is being challenged. *See also Jones v. Taylor*, 348 A.2d 188 (Del. 1975) (For purposes of a shareholder derivative action, the term “stockholder” as used in the stockholder derivative action statute “includes an equitable owner.” See 8 Del. C. § 327); and *In Re Stewart’s Estate*, 3 N.Y.S.2d 985 (Surrogate’s Court, Monroe County New York, 1937) (trust beneficiary may file minority stockholder action as the equitable owner of the stock if, after demand, trustee refuses to do so).

These holding are consistent with the rule in Texas that, although only the trustee of a trust generally has standing to pursue claims of the trust, if the trustee refuses or fails to do so, a beneficiary of the trust may assert the claim on behalf of the trust. *Inter-First Bank-Houston v. Quintana Petroleum Co.*, 699 S.W.2d 864, 874 (Tex. App. – Houston [1st Dist.] 1985, writ ref’d n.r.e.). *In Guerra v. Guerra*, 211 WL 3715051 (Tex. App. – San Antonio)(no designated for publication), discussed *infra*, a beneficiary of an estate holding 37% of the stock of a company sued the executor for breach of his duties of an officer and director by filing a shareholder derivative suit. The Court expressed no concern regarding the beneficiary’s procedural right to file a shareholder derivative suit, but found that the beneficiary lacked standing because she did not assert a corporation claim but rather a personal claim against the director who owned her no personal duty. However, in *Cleaver v. Cleaver*, 935 S.W.2d 491, 496 (Tex.App.–Tyler 1996, no writ), the court appears to reach a contrary result. Husband (in a divorce case) claimed that Joe, who held a majority of the stock and was the CEO and Managing Director of two corporations in his individual capacity and also was the trustee of a trust holding a minority interest in each of the corporations, wrongfully suppressed dividends by not distributing to the trust its share of corporate earnings. The Court held that corporate management had the sole responsibility to determine the payment of dividends, and that the claim that the corporation had wrongfully withheld dividends is an attack on the business decision of corporate management. Thus, the required procedure to attack such decision is through a shareholder derivative suit. The court found that neither of the Cleavers was “a

record or beneficial owner of shares” in the corporations and thus had no standing to bring a derivative suit.

b. Direct Claims

A corporate shareholder has no individual cause of action for personal damages caused solely by a wrong done to the corporation. *Redmon v. Griffith*, 202 S.W.3d 225, 233 (Tex.App.–Tyler 2005, pet. denied). A shareholder may file a direct claim against a corporate officer, director or majority shareholder only if there is a specific and unique injury to that shareholder. Otherwise, the shareholder must file a shareholder derivative suit to complain about the actions of the officers/directors (including the trustee individually). *Redmon* at 233. A “special injury” arises where the majority shareholder violates a fiduciary duty to the minority shareholder which is independent of the fiduciary duties owed to that minority shareholder along with all the other shareholders. 20A TEX. PRAC. BUSINESS ORGANIZATIONS § 41.7 (2d Ed.). Examples of duties owed to the corporation which will not support a direct claim by a minority shareholder are failing to hold shareholder meetings, suppressing dividend payments, failing to prevent the dissipation of the corporation’s assets, improper loans by the corporation, and causing the stock in the corporation to lose value. *Faour v. Faour*, 789 S.W.2d 620, 621 (Tex.App.–Texarkana 1990, writ denied); *Guerra v. Guerra*, 211 WL 3715051 (Tex. App. – San Antonio)(not designated for publication), discussed *supra*.

However, a shareholder may have an individual action for wrongs done to him where the wrongdoer violates a duty arising from a contract or otherwise and owing directly by him to the shareholder. *Faour*, 789 S.W.2d at 622; *Redmon* at 234. A shareholder also may have a cause of action for “shareholder oppression” or “oppressive conduct.” *Redmon* at 234 and cases cited therein. Oppressive conduct has been defined as follows:

1. [M]ajority shareholders’ conduct that substantially defeats the minority’s expectations that, objectively viewed, were both reasonable under the circumstances and centra to the minority

shareholder's decision to join the venture; or

2. [B]urdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.

Redmon at 234; *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex.App.-Houston [14th Dist.] 1999, pet. denied).