TRICKS AND TRAPS OF TRUST LOANS TO BENEFICIARIES

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A. Why Would A Trustee Make Loans to a Beneficiary?

a. In many cases an outright distribution may not be allowed by the trust document, but the trust or the law allows a trustee to make loans of trust assets.

b. An outright distribution will increase a beneficiary's taxable estate, but a loan will not.

c. A secured loan may provide needed assistance to a current beneficiary while preserving assets for remainder beneficiaries. The loan may provide that upon the death of the borrower-beneficiary, such individual's estate is liable for making payments on the loan and only if such estate is insolvent should the remaining balance be deducted from the beneficiary's share of trust assets.

d. A loan will assist a beneficiary while still requiring the beneficiary to contribute to the purchase for which he or she is using the loan. Individuals often create trusts to avoid giving large sums of money outright to others. Loans may be useful to protect this intent.

e. A loan from a trust with multiple beneficiaries will assist one beneficiary without making an outright distribution that would exceed such beneficiary's "share" of the trust assets.

B. Considerations When Making a Loan to a Beneficiary

a. Who has authority to execute loan or guarantee documents?

   i. Many trusts will name multiple trustees. In that case, you will want to know whether:

      1. all trustees must approve a loan,

      2. majority consent is sufficient, or

      3. one or more particular trustees have exclusive authority to act.

   ii. Many trust agreements will bifurcate trustee roles, for example, authorizing one trustee to act on administrative and investment matters and another on distributions (directed and directing trustees). As some of these statutes and trust provisions allowing for bifurcation can be somewhat unclear, it is important to look at whether the directing trustee has full authority to sign off on a loan or if the directing trustee must affirmatively direct the directed trustee in writing and both must sign off on such investments.

iii. Most trust agreements grant co-trustees the power to delegate signature authority to just one of the trustees. If properly documented, a delegation generally is acceptable.

b. Spendthrift clause and statute. Almost all trusts have clauses that prohibit a trustee from distributing trust assets to a beneficiary's creditors in satisfaction of the beneficiary's obligation. Illinois also has a statute that holds similarly. However, a trustee who properly contractually binds the trust on a loan, pledge, or guaranty should be able to make good on that contract without running afoul of the spendthrift clause. The trust document or the statute may provide specific direction on how to properly bind a beneficiary without running afoul of the spendthrift provisions.

c. The trustee should look to the document to see if it has specific authority in the trust document to make a loan to a beneficiary. This language may not exist but the trust may allow the trustee in its sole discretion to make loans or investments.

d. Security and valuation

i. Often a beneficiary is requesting a loan to purchase a specific asset or interest. It may be prudent for the trustee secure the loan with such asset or interest. However, other times the beneficiary may be requesting a loan to finance a risky investment or business startup. While such assets may provide the security, the assets likely will be worth next to nothing in the event the investment fails. If such security or investment is a startup or other type of risky investment, the trustee may prefer an outright distribution to a loan.

ii. In the event the borrower defaults, the trustee should consider whether the security will be sufficient to cover the balance of the loan. Considering the value and liquidity of the collateral is part of the process in deciding whether security is worthwhile.

iii. The trustee may want to consider getting valuation of the collateral. Sometimes trustees are satisfied with the beneficiary's word regarding the value of the collateral, but this can be risky. Depending on the situation, the trustee may want to consider a formal valuation or appraisal by a professional third party. This step may protect the trustee if the collateral fails.

iv. Depending on the situation and the type of asset, the collateral may need to be revalued throughout the life of the loan. While this may not be necessary for certain types of assets and loans, it should be considered throughout the relationship.

v. When making the loan, the documents should provide any and all steps necessary to give the trustee the authority and the ability to collect on the security. For example, in one case discussed below, the loan was secured with stock in a company. However, the trustees failed to take possession of the stock or to put a legend on the stock certificates.

vi. A trustee should consider how far it is willing to go to secure the loan in the event a beneficiary defaults.

e. What is the investment standard in the document and under state law?

i. The trust document may provide expressly that loans in general, or more specifically, loans to beneficiaries, do not need to be secured.

ii. Further, some state laws provide specifically that a loan or loan to a beneficiary does not need to be secured.

iii. While the document or state law may give the trustee authority and discretion to determine whether or not to secure the loan, it may still be prudent to secure the loan.

f. Questions to consider to determine whether the loan is a prudent investment.

i. Would the beneficiary be able to obtain the loan in the market?

ii. Are the terms of the loan between the trustee and beneficiary similar to or very different than those in the market?

iii. Will the loan cause a concentrated position of assets? If so, does the trust allow for this?

iv. Is the interest rate higher or lower than the rate of return on the assets prior to the loan? Could other or remainder beneficiaries complain that the assets should have been invested in something more productive thereby alleging that the loan was imprudent.

g. How will the trustee handle the situation if the beneficiary defaults on the loan?

i. For a prudent investor there may be a duty to collect on the defaulted loan or seize the security. However, the trustee must balance the fiduciary duty to the beneficiary within the terms of the law and the trust document.

ii. The trustee also has a duty to the remainder beneficiaries. Depending on the trust provisions, the trustee may be able to make a distribution to the beneficiary in the amount of the outstanding balance. However, other (if any) and remainder beneficiaries may dispute the prudence of the distribution. If the trustee determines that it would simply make a distribution or forgive the loan in the event a beneficiary defaults, the trustee may want to consider an outright distribution in the first place.

C. Special Considerations for Corporate Fiduciaries

a. A corporate fiduciary often wears multiple hats with respect to a beneficiary. The institution may be the trustee, but may be an investment advisor, personal banker or lender to the beneficiary as well.

b. A corporate institution must follow certain laws and regulations when making loans. Do those same regulations need to be followed when making a loan to a beneficiary with non-bank assets?

c. Some courts have held banks liable in cases where a bank officer promised to make a loan but did not keep the promise. *See e.g. Coastland Corp. v Third. Nat'l Mortg. Co.*, 611 F.2d 969 (4th Cir. 1979); *Landes Constr. Co. v. Royal Bank of Canada*, 833 F.2d 1365 (9th Cir. 1987); *Wait v. First Midwest Bank/Danville*, 142 Ill. App. 3d 703 (Ill. App. Ct. 4th 1986); *Bolus v. United Penn Bank*, 363 Pa. Super. 247 (Penn. 1987)). This could occur in the case of a trust officer speaking with a beneficiary. To protect against this most states have enacted statutes similar to the Illinois Credit Agreement Act which requires a written agreement for a purported loan committed to be enforceable. However, some courts have held that e-mails are a sufficient "written agreement" to satisfy the Credit Agreement Act. Considering how much communication occurs by email, this scenario is easy to imagine.

D. Comparison of State Statutory Law

a. Illinois

i. A trustee is to administer the trust according to the prudent investor rule, unless the trust instrument provides otherwise. 760 ILCS 5/5. The trustee has a duty to diversify trust assets unless it is in the interests of the beneficiaries and furthers the purposes of the trust not to diversify. The trustee has a duty, within a reasonable time after the acceptance of the trusteeship, to review trust assets and to make and implement decisions concerning the retention and disposition of original pre-existing investments in order to conform to the provisions of this Section.

ii. Illinois statute gives power to the trustee to "compromise, content, prosecute or abandon claims or other charges in favor of or against the trust estate." 760 ILCS 5/4.11.

iii. Illinois law has no specific provisions regarding the investment in promissory notes by the trustee. However, it specifically grants the trustee the power to execute contracts, notes, conveyances and warranties binding upon and creating a charge upon the trust estate or excluding personal liability. 760 ILCS 5/4.12.

iv. Illinois specifically provides that when a trustee of a land trust is or becomes a secured or unsecured creditor of the land trust, the beneficiaries of the land trust, or a third party whose debt to such creditor is guaranteed by a beneficiary of the land trust, it shall not be a breach of, and shall not be deemed evidence of a breach of, any fiduciary duty owed by said trustee to the beneficiaries. 765 ILCS 415/3.

b. Indiana

i. A trustee is to administer the trust according to the prudent investor rule, unless the trust instrument provides otherwise. Ind. Code. §30-4-3.5.1

ii. Indiana law specifically grants a trustee the power to make loans to beneficiaries and to pledge trust property to guarantee loans made by others to beneficiaries. Ind. Code. §30-4-3-3-(23) and (24).

iii. A trustee may provide written notice to beneficiaries with respect to any proposed action under the Uniform Principal and Income Act and will not be liable to current or future beneficiaries with respect to the proposed action if no beneficiary objects within a specified timeframe. Ind. Code §30-2-14-16. In addition, the Indiana Trust Code provides that a trustee is not liable to a beneficiary for a breach of trust to the extent that the beneficiary consented to or ratified the trustee's actions at a time that the beneficiary knew the beneficiary's rights and all material facts relating to the breach. Ind. Code §30-4-3-19.

iv. A trustee has a duty not to self-deal. Unless the trust provides otherwise, the trustee shall not loan funds to itself, among other prohibit actions. Ind. Code §30-4-3-7.

c. Wisconsin

i. A trustee is to administer the trust according to the prudent investor rule, unless the trust instrument provides otherwise. Wis. Stat. §881.01.

ii. Wisconsin law specifically allows a trustee to makes loans to a beneficiary on terms the trustee considers "fair and reasonable under the circumstances". Wis. Stat. 701.0816(18)

iii. The statute further states that the trustee will have a lien on distributions to the beneficiary for loans made pursuant to the statute. Wis. Stat. 701.0816(18).

iv. A trustee may provide written notice to beneficiaries with respect to any proposed action with respect to the adjustment of income and principal under the principal and income statute and will not be liable to current or future beneficiaries with respect to the proposed action if no beneficiary objects within a specified timeframe. Wis. Stat. §701.1105.

d. Arizona

i. A trustee is to administer the trust according to the prudent investor rule, unless the trust instrument provides otherwise. Ariz. Rev. Stat. §14-10901. Section 14-10804 also provides that a trustee is directed to administer the trust as a prudent person.

ii. Arizona law does not contain any specific provisions with respect to investments in promissory notes by a trust. However, Arizona law specifically grants a trustee the power to make loans to beneficiaries and pledge trust property to guarantee loans made by others to beneficiaries. Ariz. Rev. Stat. §14-10816(18) and (19).

iii. A trustee may provide written notice to beneficiaries with respect to any proposed action under the Revised Uniform Principal and Income Act and will not be liable to current or future beneficiaries with respect to the proposed action if no beneficiary objects within a specified timeframe. Ariz. Rev. Stat. §14-7431. In addition, the Arizona Trust Code provides that a trustee is not liable to a beneficiary for a breach of trust to the extent that the beneficiary consented to or ratified the trustee's actions at a time that the beneficiary knew the beneficiary's rights and all material facts relating to the breach. Ariz. Rev. Stat. §14-11009.

e. Washington

i. A fiduciary is authorized to invest in any kind of property. Fiduciaries shall exercise the same judgment and care that persons of prudence, discretion and intelligence use in their other affairs. If a fiduciary has special skills, they have a duty to use such skills. The statute provides that fiduciaries should use a "total asset management approach" and should consider the following: probable income and probable safety of capital, marketability of investments, general economic conditions, length of the term of the investments, duration of the trust, liquidity needs, requirements of the beneficiaries, other assets including earning capacity, of the beneficiaries, effect of investments on tax liability. RCW 11.100.020.

1. A trustee may think a loan to a beneficiary is simple and straightforward and may even get all beneficiaries of approve of such loan. However, looking at all the different factors may disqualify the loan as prudent.

2. Other statutes state that the fiduciary “may” consider the list of factors. However, Washington states the trustee <u>should</u> consider the listed factors.

ii. A fiduciary shall invest and manage the trust assets solely in the interests of the trust beneficiaries. If a trust has two or more beneficiaries, the fiduciary shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. RCW 11.100.045

1. If a trust has only one beneficiary, a trustee could invoke the first part of this statute to defend against any remainder beneficiaries and argue that the loan to the current beneficiary was in the interests of such beneficiary even if it was not a prudent investment.

2. This provision seems to conflict with RCW 11.100.020 as what may be in the interests of the trust beneficiaries (aka the loan) is not a prudent investment.

f. Florida

i. Florida follows the prudent investor rule. Fl. Stat. 518.11.

ii. A trustee is not liable to a beneficiary for a breach if the beneficiary consented to the conduct constituting the breach. Fl. Stat. 726.1012.

g. Louisiana

i. Louisiana expressly allows a trustee to subject the beneficiary’s interest in the trust to for the repayment of a loan to the beneficiary. LA. R. S. 9:2195

h. Texas

i. A beneficiary must have “full information” to relieve a trustee from liability for actions. The release must be in writing and delivered to the trustee.

ii. Texas follows the prudent investor rule but this can be expanded or restricted by the trust.

i. California

i. A trustee can send notice of a trustee’s actions as long as the notice provides the beneficiary at least 180 days to object (this time limit **cannot** be limited by the trust document)

ii. The notice must be in 12-point boldface type and contain certain language pursuant to the statute.

j. Other

i. Case Law (see attached summaries)

ii. The Restatement Second of Trusts

1. If the trustee makes a loan of trust money to a beneficiary, the beneficiary's interest is subject to the repayment of the amount loaned.

2. The beneficiary's interest is subject to repayment even if the trust is a spendthrift trust.

iii. The Restatement Third of Trusts states that a loan to a beneficiary need not qualify as a prudent investment as it is a "discretionary benefit" and may be made at a market rate of interest or at low or no interest.

E. **Red flags**. In addition to the provisions discussed immediately above, many trusts will also include one or more of the following provisions that could thwart a lender's ability to be made whole, even for a properly made loan

a. Right to substitute property.

i. This is a power generally given to the grantor of the trust to substitute trust property with other property of an equivalent value.

ii. This could be problematic for the lender if a pledge or guarantee is tied to specific trust assets, which are then swapped out.

iii. This could be also be a problem if the substituted property is illiquid.

b. The trust may have a specified termination date or required distribution provisions that could require the trustee to deplete trust assets below those needed to satisfy the loan or guarantee

c. Powers of appointment. Many trusts provide a beneficiary or other party with the ability to direct the distribution of trust property out of the trust either to themselves or other parties.

i. Exercise of the right could deplete the trust assets available to support the loan.

ii. This could be addressed by having the loan "called" in the event of exercise of such power.

d. Right to create subtrusts. Trusts often include the power of a trustee to divide a trust into one or more subtrusts for the benefit of any one or more beneficiaries, to merge a trust with other trusts with similar terms, and similar powers.

    i. Exercise of these rights could deplete the trust assets available to support the loan, though the likelihood is that the resulting trust would continue to be liable on the obligation.

    ii. This could be addressed by including in the loan documents expressly that the loan is "called" in the event of exercise of such power.

e. Trust protector powers. Many trusts (particularly those drafted in the last few years) provide an independent third party, often referred to as a trust protector, with the right to modify trust terms.

    i. The scope of the power is often not well defined. State statutes may provide an undesired scope of power.

    ii. An exercise of the power could result, for example, in the removal of the trustee's authority to satisfy a guarantee or change the trust beneficiaries, thereby calling into question the consideration for the guarantee.

    iii. Loan documents may want to limit the ability to amend in a way that would impact the loan.

f. Nature and liquidity of underlying assets.

    i. With broad investment authority, a trustee may be able to invest trust assets into a family LLC or LP, making it more difficult to foreclose or collect on a loan or pledged assets.

    ii. Similar concerns may arise with other illiquid assets such as closely held stock or real estate.

F. <u>Who Should Be Executing Loan Documents and How?</u>

a. Under the common law of many states, including Illinois, a trust is not a separate legal entity, but rather, a contractual arrangement between the grantor and trustee. Consequently, when a trustee enters into a contract with a non-beneficiary third party, the contract is between the third party and the trustee as opposed to the third party and the trust. The trustee is personally liable for any issues that arise regarding the contract unless some provision of the trust instrument provides that the trustee is not personally liable or the trustee has obtained an agreement from the third party to look only to the funds of the trust.[1] It is not enough that a trustee

[1] *Austin v. Parker*, 148 N.E. 19 (Ill. 1925); *Piff v. Berresheim*, 92 N.E.2d 113 (Ill. 1950); *Laegeler v. Bartlett*, 140 N.E.2d 702 (Ill. 1957).

merely disclose that he or she is acting as trustee.[2] Rather, the contract itself must be clear that the trustee is not bound in his or her individual capacity. Section 5/.12 of the Illinois Trusts and Trustees Act grants a trustee authority to enter into contracts that create a charge on the trust and exclude the trustee from personal liability.[3]

b. Conversely, in states that have adopted the Uniform Trust Code, the trustee is not personally liable on a contract that the trustee entered into in the trustee's capacity as a fiduciary as long as the trustee disclosed the fact that he or she was entering into the contract as trustee.[4] Under the Uniform Trust Code, the trustee has provided the necessary disclosure if he or she signed the contract "as trustee" or otherwise referenced the trust.[5] As of the date of this writing, slightly more than half of the states and the District of Columbia have adopted the Uniform Trust Code in some form or another.[6]

c. In Illinois, a trustee seeking to avoid personal liability for loans to beneficiaries should be certain that the loan documents clearly state that the trustee is entering the contract "not individually, but solely as trustee" of the named trust. Similarly, when the trustee executes the loan, the trustee's signature line should make a similar indication that the trustee is signing only as a fiduciary. The trustee's signature block should do more than merely disclose that an individual is signing "as trustee." Rather, the signature block should indicate that the trustee is not signing in his or her individual capacity, but solely as trustee of the trust. In addition, the loan documents themselves should include a provision in which the parties agree that the trustee is not personally liable for the contract.

d. To protect itself further, a trustee should consider asking the beneficiaries to release the trustee from any liability arising from the transaction.

G. <u>What happens on the death of an individual borrower/beneficiary/guarantor</u>?

a. Revocable Trusts

  i. Assets and obligations of a revocable trust are not always subject to a court supervised probate proceeding, so the successor trustee may move into the trustee role immediately on the grantor's death.

  ii. Claims against a revocable trust generally need to be brought in court within a certain time period following the beneficiary's death. It is important to file a claim if a probate estate is opened, as the rights against the trust may be lost if a claim is not filed in the decedent's probate estate.

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[2] *Laegeler* at 704.
[3] 760 ILCS 5/4.12
[4] Uniform Trust Code § 1010.
[5] Uniform Trust Code § 1010 cmt.
[6] http://www.uniformlaws.org/Act.aspx?title=Trust%20Code

iii. Property passing under the trust is generally understood to pass subject to any obligations associated with the property, but that is not written into the law.

1. If the property remains in trust, this should not be an issue since the trust is already obligated.

2. If the property passes out of trust, then the lender should obtain the taker's obligation as well.

a. The original loan documents should be checked to see if they address the lender's rights under this situation.

b. If the loan documents and trust agreement are silent on this issue, then the lender may be forced to bring a claim.

b. Irrevocable Trusts. Typically the death of a beneficiary of an irrevocable trust should not have any impact upon the obligations of the trust or the rights of the lender,

i. subject only to the issues described under the "Red Flags" section above, or

ii. if the property otherwise passes out of the trust, in which the steps described immediately above regarding a revocable trust would also be applicable.

H. **<u>What happens if a borrower defaults?</u>**

a. The loan documents should be clear on what constitutes a default on the loan, whether there is a cure period, and whether there is a penalty.

b. If there is an incurable default, what should the trustee do?

i. Can the trustee make a distribution to the beneficiary?

ii. Should the trustee seize the collateral?

iii. Who needs to be notified of a default?

I. **<u>Tax Considerations</u>**

a. Original Issue Discount ("OID") (IRC §§ 1271-1275)

i. OID is a type of interest charged on loans when no interest payments or insufficient interest payments are required or made during the life of the loan.

ii. Sufficiency of interest payments is determined relative to the AFR.

iii. In the case of no interest paid during the entire loan, OID is simply the total interest payments that should have been paid as it would be calculated pursuant to the terms of the loan (e.g. AFR and monthly, 7% calculated annually, etc.).

iv. OID is normally taxable at the time the loan is made and it is equal to the total of the interest payments over the life of the loan. In the case of a loan in which the lender knows the borrower will make no payments until the maturity of the loan, this is easy to calculate.

v. However, OID can be incurred during the life of the loan and only during certain time periods in which payments and/or interest goes unpaid. For example, if a beneficiary misses a loan payment or simply if a beneficiary fails to make an interest payment, OID can be incurred on just that one payment or more going forward depending on what the borrower does in the future. Calculating this periodic OID can be complicated as OID (if the rules are applicable) is reported daily and is prorated.

vi. There are various exceptions to the OID rules pursuant to IRC §1272. For example:

1. Loans less than $10,000.

2. Loans with "qualified stated interest" which is interest that is unconditionally payable or will be "constructively received."

3. De minimis exception: OID is treated as zero if the total OID is less than (a) ¼ of 1% of the stated redemption price at maturity, multiplied by (b) the number of whole years until the loan is due.

b. The Borrower may deduct qualified residence interest but only if the loan meets certain requirements. Properly documenting and recording the mortgage protects not only the lender but ensures the Borrower can take any tax deductions to which he or she may be entitled.

J. <u>How Can A Trustee Protect Itself?</u>

a. Only make those loans which would be considered prudent if the loan was being made to a third party.

b. The trustee should balance its duty to the beneficiary with its duty to make prudent investments.

c. If there is no protocol or the loan would not necessarily be a prudent loan made in the everyday course of business, get the other beneficiaries to approve of the transaction and release the trustee from liability.

d. In states that allow virtual representation agreements, it is possible to get beneficiaries with current and remainder interests to sign off on the trustee's actions either by approving of the action itself or clarifying language in the trust that would allow the trustee to take such action.

K. <u>Trustee Right to Borrow, Guarantee, and Pledge</u>

a. Some trust agreements have extensive administrative provisions that explicitly discuss the extent of a trustee's ability to borrow, pledge assets, or guarantee loans.

b. Often, though not always, a trust will authorize a trustee to guarantee or pledge assets in support of a loan made directly to a beneficiary.

c. Even if a trustee is authorized to borrow, pledge, or guarantee, it may still not be advisable under statutory or common law fiduciary duty concepts without other considerations.

    i. A trustee has a duty of impartiality, which means that, unless the trust states otherwise, the trustee owes the same fidelity to all beneficiaries, including contingent beneficiaries, and all trustee actions need to be weighed against that standard.

    ii. A trustee has a duty of loyalty, which means that all of the trustee's actions have to be for the benefit of the beneficiaries rather than himself. Consider whether the trustee is in violation of this duty when pledging trust assets in support of a loan to the beneficiary being made by the trustee.

    iii. A trustee has a duty to invest trust assets prudently. Is providing a guarantee or pledge on behalf of a beneficiary a prudent action? Again, the answer may be yes, but the issue must be considered. Combined with the duty of impartiality, it should be considered with respect to each beneficiary, not just the borrowing beneficiary.

d. As for any other guarantee or contract, there needs to be some consideration (exchanged value) for the trustee to put trust assets at risk for the sake of a beneficiary

e. These issues may not seem to impact the lender (that is, these are issues between the trustee and the beneficiary and the lender should be protected by its contractual rights), but these issues may still result in litigation that could delay the ability of the lender to exercise its rights under the loan documents.

SUMMARY OF CASE LAW

A. *Conant v. Lansden,* 341 Ill. App. 488: This case held that a trustee is only liable for bad loans when the trustee knew or should have known of the borrower's questionable ability to pay back loans. In this case the trustee made multiple loans to a company in which the trust had an interest. The loans were made to "preserve the trust assets" as the company interest was a trust asset. The first loans were held to be prudent because there was no indication that the company could not pay back the loans. The trustee was held to have breached its fiduciary duty on later loans, however, because the company had gone out of business by the time the later loans were made. Further, the loans were made without security and at a time when the trust was not necessarily in need of investments. The court found that the later loans were "hazardous and wholly unsuitable for trust funds."

B. *Smith v. First Nat'l Bank*, 254 Ill. App. 3d 251, 6 (Ill. App. Ct. 4th Dist. 1993). The bank had been working with Judy's family for many years and was acting as trustee of a trust for the benefit of Judy. The bank had also lent money to a couple named the Smiths for the purchase of a bar. The bar did not do well and the Smiths defaulted on their loan. The bank initiated foreclosure proceedings. In an effort to not lose money on the loan to the Smiths, the bank convinced Judy to purchase the bar for $200,000 without telling her it had only appraised for $130,000. In fact the bank made it appear like a good deal by saying it had been listed for $250,000 so that the $200,000 price seemed better. Judy took out a loan from the bank for the purchase price as well as repairs and improvements. These loans were secured by an assignment of Judy's beneficial interest in the trust of which the bank was trustee. After a few years, the bar failed again and Judy had to sell the bar and incur a loss. Judy sued for breach of fiduciary duty. The bank argued it owed no fiduciary duty as the transaction was not related to its position as trustee. The court however found that the fiduciary duty extends to transactions suggested by a trustee which make the trustee a creditor of the beneficiary and give the trustee a security interest in the trust. Simply by using the interest in the trust as security for the loan caused the fiduciary duty to extend to the transaction. As such, the trustee was self-dealing by proposing and encouraging Judy to purchase the bar: "When the trustee does benefit from a transaction with the beneficiary, the transaction is presumed fraudulent and such presumption may only be overcome by clear and convincing proof the transaction was fair and the trustee did not breach its duty of loyalty to the beneficiary."

C. *Mahle v. First Nat'l Bank,* 241 Ill. App. 3d 672 (Ill. App. Ct. 3d 1993). In another Illinois case, the Grantor and sole beneficiary of a revocable trust, directed the trustee of such trust to use the trust assets as collateral for a loan by the Grantor's nephew from a second bank. The trustee advised against using the assets as collateral on multiple occasions (though the beneficiary tried to maintain he did not remember having such conversations). When the nephew defaulted and the trustee paid out trust assets to fulfill the loan from the second bank, the Grantor sued alleging that the trustee did not disclose all the material facts to him and therefore breached its fiduciary duty. The court found that the imprudent investment was not undertaken by the trustee but rather at the direction of the Grantor and beneficiary. Further the trustee did advise the beneficiary about the dangers of the investment.

D. *Randy Curtis Bullock v. BankChampaign, N.A.*, 133 S. Ct. 1754 (2013). The father of Randy had created a trust for the benefit of his five children and of which Randy was the trustee. The only asset of the trust was an insurance policy. During his trusteeship, Randy made multiple loans to himself and his mother, together. All the loans were repaid with six percent interest. Eventually, Randy's siblings sued him for breach of fiduciary duty. While the court did not find that Randy had "malicious motive in borrowing funds from the trust," the loans were clearly self-dealing. The court ordered Randy to pay to the trust the "benefits he received from his breaches." Randy tried to liquidate his interest in the assets he had purchased with his mother but was unable to do so. He filed for bankruptcy. However, the new trustee, BankChampaign, opposed his effort to obtain a bankruptcy discharge of his debt to the trust. The bankruptcy court held that Randy's debt to the trust fell within an exception as a "debt for defalcation while acting in a fiduciary capacity." Randy appealed the case through multiple courts until it reached the Supreme Court. The Court had to determine whether "defalcation" applies in the absence of a finding of ill intent of evidence of a loss of trust principal. Randy argued that not only did he repay the loans, but he did so at a 6% interest rate so there was no loss to the trust. Further, he had no malicious intent in doing so. However, the court disagreed and held that his self-dealing was "objectively reckless" to fall under the defalcation exception. Therefore, his obligation to the trust was not discharged.

E. *Estate of Ralph W. Collins*, 72 Cal. App. 3d 663 (Cal. App. 1977). In this case, the trustees were a business partner and a lawyer of the decedent under whose will the trust was created. The trust had only about $50,000 to invest. One of the lawyer's clients included a real estate developer. The real estate developer told the lawyer it wanted to borrow $50,000. The lawyer was aware that this was because its previous lender had withdrawn. The property was already subject to a $90,000 first deed of trust. The loan would be secured by a second trust deed on some unimproved property. Both the lawyer and the business partner knew the property had been sold two years before for $107,000. The trustees asked two real estate brokers from the area who indicated property in that area could go for a price per acre that could have led the value of the property to be about $180,000. They did not, however, have the property appraised. The trustees also did not determine whether the developer had any foreclosures or lawsuits filed against it. The representatives of the developer also affirmatively told the trustees the company was not in default on other loans and it had no pending lawsuits against the company. In fact, there were six notices of default and three lawsuits pending. The trustees did get and review an unaudited financial statement for the company indicated that it had a net worth of over $2 million. The trustees went ahead and loaned the $50,000. In addition to the second deed, the developer also pledged 20% of its stock as security. The trustees never obtained possession of the stock, placed it in escrow, or placed a legend on the certificates. The individual owners of the company and their spouses also made personal guaranties, but the trustees did not obtain personal financial statements from any of them. Within a short period of time, the developer defaulted on the loan, holder of the first deed of trust foreclosed, and the trust lost the entire investment (including an extra $10,000 in costs in an attempt to forestall the foreclosure and save the investment). The court outlined multiple actions trustees should take: reasonable diversification of assets, avoiding second or junior mortgages at almost all cost, ensuring proper valuation of collateral. The court concluded that the trustees breached all of these duties. The trustees invested almost the entire trust corpus in a company they were aware had problems. The loan was secured by a second deed of trust which the trustees were aware would be insufficient to cover the loan. Finally, they made the investment without adequate investigation of either the companies' nor the individuals' financial statuses. The important takeaway is that the trustees did appear to put some effort into properly securing the loan. The loan was improper to begin with however, so no amount of effort put forth later could protect the trustees.

F. *In re Lunt*, 477 B.R. 812 (Bankr. D. Kan 2012)—In this case, the court applied the doctrine of recoupment to allow the trustee to exercise its power to make distributions within its discretion to set off the failure of a debtor-child to pay back a loan to a trust of which he and his siblings were the remainder beneficiaries. The debtor brought suit against the trustee arguing that since he had declared bankruptcy and the principal balance on the note was therefore discharged, his share could not be reduced because of the interest he would have paid to the trust and therefore to his siblings. However, the trust also provided for unequal distributions of income to the children to effect the intention of the Grantor. The court found that while the bankruptcy operated as an injunction against enforcing the note against the debtor personally, it did not stop the trustee from offsetting the debtor's share using recoupment: "In bankruptcy, recoupment is an equitable doctrine that allows one party to a transaction to withhold funds due to another party where the debts arise out of the same transaction." The court determined that the debt arose out of the same transaction, and therefore the trustee's use of recoupment was proper.

G. *Matter of Anne Hamilton Killian Trust*, 519 N.W.2d 409 (Ct. App. Iowa 1994). A trust was created for the primary benefit of Joan. Pursuant to the trust agreement, the trustee could distribute income and principal to Joan for her health, education and maintenance. Upon termination, the trust would be distributed out to Joan's children, one of whom was Todd. During her lifetime, Joan requested multiple loans from the trustee to improve her personal residence which the trustee granted at an interest rate of ten percent. At some point, a hearing was held regarding the trustee's annual reports to which Todd had filed objections. The trial court ordered that the loans be secured by a mortgage on the property before approving of the annual report, and the trustee argued was an inappropriate challenge to his discretion as fiduciary. The appellate court disagreed and found that the trial court was within its jurisdiction and authority to order that the loans be secured. On the other hand, Todd argued that the trustee should have considered Joan's other property and income before making the loan to her. The trust document stated that the trustee needed to consider Joan's other property and income when distributing income and principal to her. Therefore, the court clarified that only in the case of a distribution, and not a loan, would the trustee need to consider these other sources of income. As loans are an investment of the trust assets, the trustee did not violate the terms of the document by not considering Joan's other assets before making the loan to her. Finally, Todd argued that the loans were not a prudent investment of trust assets. However, the court held that since the trust document mentioned "maintaining the beneficiaries in a manner to which they have become accustomed to living and assisting them in the purchase of a home," the trustee had discretion to determine how best to support and maintain the beneficiaries. Based on the language, the trustee could have made an outright distribution of the amount loaned but chose to make a loan to preserve the trust corpus as well as provide for Joan. The only fault the court found with the trustee's actions was failure to secure the loan.