FAMILY FARMS AND THE PRUDENT INVESTOR RULE'S REQUIREMENT OF DIVERSIFICATION

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I. INTRODUCTION

Inevitably, people must think about how they want to leave the things they have collected over a lifetime. These things may be as small as family heirlooms or as large as ownership interests in companies worth millions of dollars. In either case, people usually want to leave their possessions and assets to people and charities that they care about. In the legal world, this goal is accomplished through instrumentalities such as wills and trusts, which further the settlor's intentions regarding their property after they die. This Note discusses those inten-

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tions and their derivative consequences in the narrow view of trusts and family farms.

Family farms have held a special place in American history. Some of these operations have been in a single family's name for generations, leading to the term "century farms."[1] This Note ultimately concerns the benefits and consequences of the modern Prudent Investor Rule and its role in effectuating the settlor's intent and delineation of trustees' duties. Thus, the framework for this Note begins with the history of the Prudent Investor Rule and identifies some of its more pertinent sections. Next, this Note will discuss some of these sections in the context of trusts containing family farms as the key asset. Then, this Note will delve into some solutions to common problems that exist when a family farm is the key asset in the trust. Finally, this Note will discuss future and/or continuing problems that may exist for drafters and fiduciaries in their duties to further a settlor's intent.

II. TRUSTS AND FAMILY FARMS

A trust is a vehicle that a settlor uses for an infinite number of reasons and purposes. By definition, "[a] trust is a device . . . under which property is held by one or more persons for the benefit of others, the management powers and the beneficial interests being separated."[2] The trustee is the person that the settlor has chosen to execute his wishes through the trust by holding the trust property.[3] In regards to the trustee's duties of financial management, "the trustee . . . has the powers expressly or impliedly granted by the terms of the trust and . . . has a duty to conform to the terms of the trust directing or restricting investments by the trustee."[4]

Trusts are used by people who have family farms because they provide a way to shelter their beneficiaries and keep some control over their life's work. As a result, assets in the trust are usually "heavy" with farm real estate and operations, meaning that the family farm is a large percentage of the total assets in the trust. A trust consisting largely of a family farm implicates the trustee's duty of diversification under the Prudent Investor Rule. Under the Uniform Prudent Investor Act (a model codified version of the Prudent Investor Rule), "[a] trustee shall invest and manage trust assets as a prudent investor would, by considering

1. Linda Rosky, Century Farms Program: Taking Pride in Our Rural Heritage, http://www.agriculture.state.ia.us/CenturyFarmsProgram.asp (last visited Nov. 19, 2010) (recognizing those who have owned their land for over 100 years).

2. EUGENE F. SCOLES ET AL., PROBLEMS AND MATERIALS ON DECEDENTS' ESTATES AND TRUSTS 299 (7th ed. 2006).

3. *Id.*

4. RESTATEMENT (THIRD) OF TRUSTS § 91(b) (2007).

the purposes, terms, distribution requirements, and other circumstances of the trust."[5] There are many facets to this rule, but ultimately it is a default rule.[6] Thus, it may be restricted, eliminated, or expanded by the terms of the trust.[7]

The Prudent Investor Rule creates special issues and problems in the context of a trust with a family farm as the major asset. The critical question is whether the trustee must, may, or may not sell the family farm to uphold their duty of diversification. Secondary problems arise when the beneficiaries disagree about what actions should be taken with the farm. These issues are enhanced when certain beneficiaries receive income from the trust. Compounding the problem even further is the fact that the Prudent Investor Rule gives little guidance about the level of diversification needed to uphold the trustee's fiduciary duty.[8] Finally, outside market forces may pressure a trustee's duty to the trustor. In other words, what action is needed if the value of the family farm starts to drop gradually or severely?

III. HISTORY OF THE PRUDENT INVESTOR RULE

A. *The Prudent Man Rule*

The history of the Prudent Investor Rule begins so long ago that it had a different name.[9] In *Harvard College v. Amory*, the court constructed the "Prudent Man Rule."[10] This rule defined a trustee's level of care—what a normal person would do.[11] This meant that the trustee had a duty to conduct himself in good faith and to use wise discretion.[12] The rule worked adequately for some time, but developed several problems that led to its demise.[13] First, the trustee did not have to account for inflation, so the purchasing power of the assets likely

5. UNIF. PRUDENT INVESTOR ACT § 2(a), 7B U.L.A. 20 (2006), *available at* http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.htm.

6. *Id.* § 1(b).

7. Christopher P. Cline, *The Uniform Prudent Investor and Principal and Income Acts: Changing the Trust Landscape*, 42 REAL PROP. PROB. & TR. J. 611, 618 (2008).

8. *See* UNIF. PRUDENT INVESTOR ACT § 2(a), 7B U.L.A. 20 (2006), *available at* http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.htm.

9. Harvard Coll. v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).

10. *Id.* ("All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs . . . .").

11. *See id.*

12. Raymond C. Radigan, *What it Takes to be a Prudent Fiduciary—Especially in a Volatile Economy*, *in* PRACTISING LAW INST., TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES 299, 305 (2008) [hereinafter Radigan 2008].

13. *See id.* at 306-07.

decreased.[14] Secondly, there was no duty to diversify the assets; the trustee was only required to create reasonable income levels and maintain the principal.[15] Modern studies have shown that "diversification can eliminate certain risks . . . without sacrificing [rates of] return."[16] Third, each investment made by the trustee was judged in isolation from the other assets.[17] Thus, a trustee was discouraged from investing in risky assets even though they might have balanced out losses of the portfolio.[18] Finally, the Prudent Man Rule did not allow a trustee to delegate his responsibilities to someone more capable.[19] The fiduciary trustee had the sole responsibility of managing the trust through investment of the trust's assets, regardless of whether he had any investment knowledge.[20] These problems made the Prudent Man Rule obsolete as the financial markets grew and became more sophisticated.

B. *The Prudent Investor Rule and Modern Portfolio Theory*

In 1990, the American Law Institute replaced the Prudent Man Rule with the "Prudent Investor Rule," the Institute published in the Restatement (Third) of Trusts in 1992.[21] In 1994, the Uniform Prudent Investor Act was established.[22] Today, this rule is still considered the dominant theory in financial trust management.[23] As of early 2009, forty-six states, including the District of Columbia, have adopted the Uniform Prudent Investor Act.[24] The Restatement provides that "[t]he trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust."[25]

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14. *Id.* at 306.
15. *Id.*
16. *Id.* at 306-07.
17. *Id.* at 307.
18. *Id.*
19. *Id.*
20. *Id.*
21. Jerold I. Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust*, REAL PROP. PROB. & TR. J. 1, 4 (1998); *see* RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (current version at RESTATEMENT (THIRD) OF TRUSTS § 90 (2007)).
22. UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 1 (2006), *available at* http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.htm.
23. *See id.*; Horn, *supra* note 21, at 5-6.
24. UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 1 (2006), *available at* http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upia94.htm.
25. RESTATEMENT (THIRD) OF TRUSTS § 90 (2007).

Notably, the Prudent Investor Rule, as formulated in the Restatement, incorporates modern portfolio theory by focusing on the portfolio as a whole.[26] When applied in practice, this theory requires broad investment diversification.[27] The rationale for this requirement is more than cautious conservatism; it is a warning to trustees to exercise their duty with care and skill and to not take unwarranted risks of volatility and potential loss without the opportunity for gain.[28] Comment h(2) of section 90 of the Restatement provides an illustrative example of the type of "whole portfolio" analysis required by a prudent investor when considering a change—"real estate tends to have a negative or limited covariance with stocks and bonds. Traditionally, it has also tended to offer a long-term hedge against inflation."[29]

"There are two [distinct] kinds of investment risks, systemic risk and specific risk."[30] Systemic risk is that which affects the whole market and the correlation of the asset's value to the market as a whole.[31] Specific risk affects the specific stocks or assets of a particular industry.[32] "A trustee can virtually eliminate the specific risk in a portfolio through diversification,"[33] which involves purchasing different instruments in different industries. Under a diversification theory, an investor may buy speculative, i.e. risky, individual stocks since the portfolio is already diversified, meaning there are conservative investments that will offset the risk created by the speculative stock purchase.[34]

These purchasing decisions create a problem for investment fiduciaries.[35] "[T]he Prudent Investor Rule creates greater . . . potential for liability, because it imposes higher investment standards . . . ."[36] There is no longer a "safe harbor" list of investments,[37] perfect set of investment categories, or a road map showing the correct way to diversify.[38] To add to this higher standard, there are few exceptions to the rule.[39] The fiduciary must diversify unless "the objectives of both

26. *Id*. § 90(a).
27. *See id.* § 90 cmt. g.
28. *Id*.
29. *Id*. § 90 cmt. h(2).
30. Mark R. Gillett, *Investing Trust Assets: Prudence Redefined*, 29 OKLA. CITY U. L. REV. 505, 511 (2004).
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.* at 513.
35. David R. Hodgman, *Fiduciary Investments: Drafting for Nonconformity*, 23 EST. PLAN. 489 (1996), *available at* 1996 WL 768130.
36. *Id.*
37. *Id.*
38. Gillett, *supra* note 30, at 536.
39. *See* RESTATEMENT (THIRD) OF TRUSTS § 90(b) (2007).

prudent risk management and impartiality can be satisfied without doing so, or unless special considerations make it prudent not to diversify in the particular trust situation."[40] However, these exceptions are abstract and not well defined. The Restatement does specify that a fiduciary's departure from diversification is justified due to special circumstances, as well as for "specialized investment capabilities of or available to the trustee; special interests or managerial abilities of beneficiaries; or special settlor objectives, including particular asset holdings that are preferred or encouraged by the terms of the trust."[41] However, the further the trustee strays from diversification, the heavier the burden is to show that the investment strategy was justified.[42]

Building on modern portfolio theory, the Prudent Investor Rule requires that the individual assets of a trust be evaluated for their role within the context of the whole trust.[43] Thus, analogous to the "safe harbor" provision, there is no classification of individual assets as prudent or imprudent.[44] Even if an asset is under-productive, it may still be part of the investment strategy.[45] This allows the trustee to ascertain the purpose of the trust and then find suitable investments that contribute to that purpose.[46] Therefore, a trustee can become fairly creative, within reason, in their choices of investments as long as the purpose of the trust is still upheld. This provision is especially important with family farms; if the purpose of the trust is to maintain the farm for future generations, it may become extremely difficult to satisfy both the purpose of the trust and the requirement of diversification.

A final aspect of the Prudent Investor Rule to consider is timing.[47] If a lawsuit were filed against the trustee based on their investments, what time frame would be used to make the judgment? The Restatement makes it very clear that when dealing with the prudence of a trustee's conduct, the trustee will "be judged as of the time the investment decision in question was made, not with the benefit of hindsight or by taking account of developments that occurred after the time of a decision to make, retain, or sell an investment."[48] This equitably lowers the level of trustees' liability by keeping the analysis of their decisions confined to the context of when they were actually made.

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40. *Id.* § 90 cmt. g.
41. *Id.* § 90 cmt. f(5).
42. *Id.*
43. *Id.* § 90(a).
44. *Id.* § 90 cmt. e(1).
45. *Id.*
46. *Id.*
47. *See id.* § 90 cmt. b.
48. *Id.*

To truly understand the effect of the Prudent Investor Rule, a comparison is needed to the former Prudent Man Rule. The five major differences between them are indicative of the role a trustee plays in a trust and are essential to understanding the issue faced in the family farm context.[49] The first change is the switch from analyzing each individual investment to the modern portfolio theory of looking at the investments as a whole.[50] This was discussed previously and is likely the biggest shift in theories. Second, the central consideration for a trustee is now the tradeoff between risk and return.[51] Thus, a trustee may invest in high-risk stocks as long as they are balanced with conservative investments.[52] Third, there are no more categorical restrictions on the type of investment that the trustee can purchase.[53] There is no more safe harbor or fool-proof investment choice for trustees.[54] The fourth shift is that the fiduciary must now diversify as a matter of prudent investing.[55] These last three changes strongly coincide with the incorporation of the modern portfolio theory. Finally, while family members may still be trustees, the Prudent Investor Rule now allows the trustee to delegate their duty to a third party subject to certain safeguards.[56]

> [T]he applicable requirements of care and skill allow responsible individuals of ordinary intelligence to serve as trustees and to adopt reasonable investment strategies of types that are appropriate to their skills. Yet the standards require fiduciaries possessing special facilities and skills to make those advantages available to the trust and its beneficiaries.[57]

Therefore, the prudent delegation test is "whether ordinary prudent businessmen would delegate the specific task to a third person."[58] These changes show not only the importance of the Prudent Investor Rule, but also how it is applied to a trust.

49. *See* Ronald R. Volkmer, *The Latest Look in Nebraska Trust Law*, 31 CREIGHTON L. REV. 221, 230-31 (1997).
50. *Id.* at 230.
51. *Id.*
52. *See* Gillett, *supra* note 30, at 513.
53. Volkmer, *supra* note 49, at 231.
54. Hodgman, *supra* note 35.
55. Volkmer, *supra* note 49, at 231.
56. *Id.*
57. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. d (1992).
58. Gillett, *supra* note 30, at 547.

IV. Fiduciary Diversification Considerations

Now that the theories behind the Prudent Investor Rule have been discussed, this Note will discuss different considerations of the fiduciary when deciding which assets to invest in light of the duty to diversify. There are several major factors that the fiduciary needs to consider:

> i) the terms of the trust; ii) the intent of the grantor; iii) risk tolerance; iv) the size of the portfolio; v) estimated duration of the fiduciary relationship; vi) general economic and market conditions; viii) [sic] possible effect of inflation or deflation; ix) tax consequences; x) the expected total return of the portfolio; and xi) the current and future needs of the beneficiaries.[59]

These help narrow the scope of the almost infinite list of assets in which a fiduciary may invest and tailor it to the individual intent of the trustor and the specific needs of the beneficiaries. Although these ten considerations may give the fiduciary more direction as to which assets to purchase or keep, the duty to diversify is still present and is still a requirement. However, there are some instances when this duty to diversify may be altered.

The Prudent Investor Rule specifically states that "[i]n investing the funds of the trust, the trustee . . . has the powers expressly or impliedly granted by the terms of the trust and . . . has a duty to conform to the terms of the trust directing or restricting investments by the trustee."[60] This language leaves open the possibility that diversification may not have to be followed in all circumstances. In Iowa, the legislature has codified a provision that requires the fiduciary to take into account "[a]n asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries."[61] Closely-held businesses or a family farm may fall under this exception to total diversification.[62] In instances where there is a high concentration of ownership in one individual or several people, problems arise because the holdings may be the overwhelming majority of the trust's assets, but they are not liquid assets. The trustee's decisions about what to do with these heavy assets may be influenced not only by their special value within the estate, but also by their "special relationship to some objective of the settlor that may be inferred from the circumstances."[63] To make matters worse for the trustee, courts have generally viewed the

59. Raymond C. Radigan, *What it Takes to be a Prudent Fiduciary—Especially in a Disastrous Economy*, *in* Practising Law Inst., Tax Law and Estate Planning Course Handbook Series 253, 272-73 (2009) [hereinafter Radigan 2009].

60. Restatement (Third) of Trusts § 91(b) (2007).

61. Iowa Code § 633A.4302(3)(h) (2009).

62. Restatement (Third) of Trusts § 92 cmt. a (2007).

63. *Id.*

"special circumstances" as a question of fact.[64] This means that there is no bright line rule that will protect the trustee from litigation; rather, they will be subject to a determination on a case-by-case basis.

The question then becomes: what happens if the trustee follows trust provisions that are inconsistent with the diversification rules? In litigation, a trustee's liability for disregarding his duty of diversification depends on the reasonableness of his reliance on the trust provisions.[65] To be considered a "reasonable reliance," it must be based on specific direction or language in the trust.[66] A general authorization by the settlor to retain the initial assets of the trust will not likely overcome the duty of diversification for the trustee.[67] However, a general authorization to keep specific assets, combined with an express provision limiting the requirements of prudence and diversification in regards to those assets, may be enough.[68] Furthermore, "a more general investment provision specifically limiting or altering the trustee's default duties of prudence or diversification under state law" may reach the same goal in some jurisdictions.[69] Thus, there are some options to consider when writing the trust provisions. However, none are perfect or work in all jurisdictions, which leaves the door open for liability on the part of the trustee as well as the lawyer who drafted the trust. The Restatement and courts do provide some guidance in this area by defining and discussing the distinctions between mandatory and permissive provisions in a trust and their role in the duties of the trustee.[70]

V. MANDATORY V. PERMISSIVE PROVISIONS

A. *Mandatory Provisions*

Mandatory provisions are those that direct the trustee to act in a specified way,[71] giving the fiduciary little or no discretion.[72] These provisions have been found to replace the duty of prudence required by the trustee in directing or re-

64. W. CURTIS ELLIOTT, JR. & BRIANI L. BENNETT, CLOSELY HELD BUSINESS INTERESTS AND THE TRUSTEE'S DUTY TO DIVERSIFY, at III(A) (2009), *available at* 2009 ABATAX-CLE 0109044 (Westlaw) (citing Brackett v. Tremaine, 693 N.W.2d 514, 520-21 (Neb. 2005); Wood v. U.S. Bank, 828 N.E.2d 1072, 1079 (Ohio App. 2005)).

65. *Id.* at III(B).

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at III(C)(1).

72. *See* RESTATEMENT (THIRD) OF TRUSTS § 91 cmt. e (2007).

stricting trust investments.[73] However, court orders can complicate, as well as alleviate, certain problems arising from mandatory provisions.[74] "[A] trustee may not reasonably rely on a mandatory provision where a court order directs or authorizes noncompliance . . . ."[75] Thus, there are no assurances that a court will not find the provision unacceptable under the circumstances and direct the trustee to disregard the provision. A trustee may also request, and in fact may have a duty to request, a court order altering or modifying the compliance required under a mandatory provision.[76]

In this circumstance, the Restatement states that unless the provision violates public policy, a court order, or a law, a mandatory provision is normally binding.[77] The Restatement states that a trustee may receive a court order when "as a result of circumstances not anticipated by the settlor, deviation from or modification of the provision will further the purposes of the trust."[78] Thus, it is important to state the purposes of the trust within the trust document itself to avoid complications down the road.

B. *Permissive Provisions*

Permissive provisions differ from mandatory provisions in several aspects.[79] First, the trustee has no duty to comply with permissive provisions in handling the investments.[80] Second, the level of "special consideration to specifically authorized investments" that the trustee is required to give is very unclear, if any is required at all.[81] Third, just because there is authorization to keep certain investments, the duties to diversify and act with prudence are not exculpated or relieved from the trustee.[82] Therefore, "[b]ecause permissive provisions do not abrogate the trustee's duty to act prudently and because diversification is fundamental to prudent risk management, trust provisions are strictly construed against dispensing with that requirement altogether."[83] However, the level of diversification may be relaxed if there are special opportunities for the trust or for special

73. *Id.*
74. ELLIOTT & BENNETT, *supra* note 64, at III(C)(1).
75. *Id.*
76. *Id.*
77. RESTATEMENT (THIRD) OF TRUSTS § 91 cmt. e (2007).
78. *Id.*
79. *See* RESTATEMENT (THIRD) OF TRUSTS § 91 cmt. f (2007).
80. ELLIOTT & BENNETT, *supra* note 64, at III(C)(2) (citing RESTATEMENT (THIRD) OF TRUSTS § 91 cmt. f (2007)).
81. *Id.* (citing RESTATEMENT (THIRD) OF TRUSTS § 91 cmt. f (2007)).
82. *Id.* (citing RESTATEMENT (THIRD) OF TRUSTS § 91 cmt. f (2007)).
83. RESTATEMENT (THIRD) OF TRUSTS § 91 cmt. f (2007).

objectives of the settlor.[84] The Restatement of Trusts contains a fitting family farm hypothetical.[85] The hypothetical adds a twist by stating that the terms of the trust expressly authorize the trustee to liquidate assets so that the trust can buy more farm land, making it even less diverse.[86] This would be an example of a permissive provision.[87] The Restatement suggests this is vague enough to make the trustee's duty unclear.[88] Therefore, "despite the presence of a permissive provision of this type, some reasonable justification must be found in the settlor's intentions or purposes or in some special opportunity . . . available to the trust."[89] Furthermore, the settlor's intentions or purposes may give an indication of when the special considerations of the authorization are no longer needed.[90]

Thus, in permissive provisions the mere authorization does not give unconditional power to retain assets if it would be an abuse of discretion. However, if the trust provides authorization for the retention of specific assets, it is more likely that this will overcome the duty of diversification.[91] Changes in circumstances may negate indefinite retention of those assets, of course, if continued retention would be an abuse of discretion.[92] The drafter should discuss with the settlor what those circumstances would be and incorporate them into the trust.

So what should a trustee look for in the terms of the trust to identify what type of provision is provided and what impact it has? Factors that may be important include:

> whether, in effect, the settlor has intended to encourage or merely to authorize retention of the investments; whether an authorization to retain applies to specific investments, to particular types of investments, or to all property received as a part of the trust estate; the character of the original trust property in question; and the purpose of the trust generally, and especially any identifiable purposes underlying the particular grant of authority.[93]

Regardless of how the trust is set up for beneficiaries, in order to be prudent, the trustee must take into account the needs of similar and different beneficiaries.[94] Similar beneficiaries will likely have the same interests but may have different ideas on how to reach their goals. In contrast, there can be issues with

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84. *Id.*
85. *Id.* § 91 cmt. f, illus. 7.
86. *Id.*
87. *See id.*
88. *See id.*
89. *Id.*
90. *Id.*
91. Gillett, *supra* note 30, at 520.
92. *Id.*
93. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 229 cmt. d (1992).
94. Gillett, *supra* note 30, at 530-31.

different category beneficiaries, such as a spouse receiving income and children receiving principal. In these situations, it is important for the trustee to balance several factors: "1. The obligation to make regular distributions to a beneficiary; 2. The possibility of making extraordinary distributions in the future; 3. The size of the trust estate; 4. The needs of the beneficiaries; and 5. The purposes for which the settlor established the trust."[95] When balancing such beneficiaries, it is important to remember that there is a duty of impartiality,[96] meaning that the trustee cannot favor the interests of one beneficiary over the other.[97] However, if there is an income requirement along with the duty of impartiality, "the requirement applies not investment by investment but to the portfolio as a whole."[98]

VI. Application to the Family Farm Scenario

Now that the basic features and issues surrounding the Prudent Investor Rule have been discussed, a real world application in regards to family farm operations will be addressed. First, why is the family farm such an important issue within the Prudent Investor Rule? To understand its importance, one needs to consider the Taxpayer Relief Act of 1997.[99] This Act made it easier for relatives to preserve family farms and family-owned businesses.[100] Prior to this enactment, it was difficult for family operations to be transferred to the next generation without severe tax consequences crippling the farm or business.[101] This transferability is important because when a family farm or business is placed in a trust, it generally makes up a large percentage of the total assets in the trust, which would have previously incurred a large tax penalty and would have ultimately gone against the modern portfolio theory of diversification.

Second, the change in value of family farms has a strong effect on the trusts that hold them. In the last decade, farm land prices in Iowa have risen dramatically.[102] From 2000 to 2009, the value per acre of farm land rose from

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95. *Id.* at 531 (citing RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 cmt. e (1992)).

96. *Id.*

97. *Id.* at 540-41.

98. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. i (2007).

99. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 26 U.S.C.).

100. *See* Dennis I. Belcher, *The Son of Frankenstein? Section 2033A- The Family-Owned Business Estate Tax Exclusion, in* 3 ALI-ABA CONTINUING LEGAL EDUC., ESTATE PLANNING IN DEPTH 1287, 1289 (1998), *available at* 1998 SC75 ALI-ABA 1287 (Westlaw).

101. *Id.*

102. Michael D. Duffy, Iowa State Univ. Extension, *2009 Farmland Value Survey*, AG DECISION MAKER, Dec. 2009, at 1 fig.1, http://www.extension.iastate.edu/agdm/wholefarm/pdf/c2-70.pdf.

$1,857 to $4,371.[103] This is an increase of 235%.[104] This dramatic increase can be attributed mostly to two factors—high grain prices and low interest rates.[105] Accordingly, as farm land values have increased at unprecedented levels,[106] the values of trusts with family farms as their major asset have increased as well. It should be noted, however, that farm land values have leveled off and have a very unpredictable future.[107] According to respondents of the 2009 Farmland Value Survey, farm land values are expected to be negatively influenced by lower grain prices, higher input costs, and the poor economy in general.[108] Herein lays the major issue of this Note. If a family farm's value is expected to fall or is falling, at what point does the fiduciary have a duty to diversify the holdings? By their inherent nature, family farms are exceedingly difficult to diversify. Is a fiduciary required to sell all of the farm assets to maintain prudence? Or sell a certain portion, which may be exceedingly difficult to separate out. Adding to the difficulty is the abstract sentimental value the farm may hold for not just the settlor, but also for some or all of the beneficiaries.

The first key to constructing a trust, including one with a family farm, is to ask questions of the settlor and the beneficiaries, i.e. who gets what? Who has authority? Are beneficiaries operating the family farm only for their lifetime or will the responsibilities be given to their heirs? The more preliminary questions asked, the easier it will be to create a trust customized to the specific facts surrounding it. Luckily, the Restatement of Trusts has given several hypotheticals and illustrations in the comments dealing with family farm situations.[109]

A. *Mandatory v. Permissive Provisions in the Family Farm Context*

Restatement section 91, comment e states that unless violating public policy, mandatory provisions "are legally permissible and are ordinarily binding on the trustee in managing the trust assets, thus often displacing the normal duty of prudence."[110] Following comment e, illustration five presents the situation of a family farm in a trust with a mandatory provision to retain the farm.[111] The farming operation was very profitable for ten years, but for a couple of years the farm

103. *Id.*
104. *See id.*
105. *Id.* at 1.
106. *See id.*
107. Iowa State Univ. Extension, Average Value of Iowa Farmland Nears $4,500 an Acre in 2008 Survey (Dec. 16, 2008), http://www.extension.iastate.edu/news/2008/dec/061601.htm.
108. Duffy, *supra* note 105, at 1.
109. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 91 (2007).
110. *Id.* § 91 cmt. e.
111. *Id.* § 91 cmt. e, illus. 5.

showed a loss to the trust.[112] The illustration states that the trustee is not liable for losses as long as he acted prudently because retention of the farm was required.[113] Therefore, it seems that the trustee is free from liability since he had no discretion to deviate from the provision requiring the farm to be retained. However, the next illustration adds the threat of an irreversible pattern of frequent losses.[114] Illustration six states that a court may find this pattern, caused by circumstances not anticipated, enough to authorize a deviation from keeping the family farm if it will further the purposes of the trust.[115] While this seems fairly straightforward, there is no magic line at which point deviation will be proper; thus, little guidance is given regarding when deviation from a mandatory provision to retain the family farm may be attempted or when it is required.

Comment f of the Restatement continues in analyzing the effects of permissive provisions.[116] In the family farm scenario, the permissive provision is usually going to be a specific provision "specifically permit[ting] retention or expansion of the trust's holdings of particular property, such as assets that may be of special interest to some or all of the beneficiaries . . . ."[117] Illustration seven continues the fact pattern from illustration five with the additional fact "that the trust terms expressly authorize T to liquidate other investments in order to acquire additional land to expand the farming operation."[118] The illustration provides that such a "provision would allow T to acquire suitable additional land,

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112. *Id.* ("The terms of the trust direct [trustee] T to retain a farm that had been owned by S and operated jointly under informal agreement by S, D, and H since the time of S's partial retirement, when he and W left the farm and moved to a nearby town. . . . During the first [ten] years, farm operations were quite profitable overall, much as they had been before S's death. During two of the last five years, however, the farming operation showed a loss to the trust, and the net income of this five-year period averaged just under one percent per year. Unless T has failed to manage the farm investment prudently, T is not liable for the losses incurred during the two bad years or for failure in the last five years to achieve an income yield approximating some typical portfolio of a comparable trust. Retention of the farm was required, not merely authorized, by the terms of the trust and therefore was not a matter within T's discretion.").

113. *Id.*

114. *Id.* § 91 cmt. e, illus. 6 ("The same facts as in Illustration 5 but, after a number of additional years, it can be shown that the accomplishment of the trust's purpose is now threatened by an irreversible pattern of frequent losses, and of low yields even in relatively good years. (On potentially troublesome points assumed in this statement of the facts, see Reporter's Notes.) Under this set of facts, the proper court may authorize deviation from the direction to retain the farm if, 'because of circumstances not anticipated' by S, deviation from the direction to retain the farm 'will further the purposes of the trust.' Furthermore, T has a duty to apply for such a court order if the grounds for that action are or should be known to T." (internal citations omitted)).

115. *Id.*

116. *See id.* § 91 cmt. f.

117. *Id.*

118. *Id.* § 91 cmt. f, illus. 7.

provided it is otherwise reasonable and prudent to do so, even though [it] necessarily aggravates the trust's diversification situation."[119] Thus, the illustration emphasizes that the task of interpretation can be very difficult due to a lack of specificity in the language used by the settlor's lawyer.[120] What circumstances does the settlor want to be present for the trustee to be authorized to purchase additional land? Under what circumstances would the settlor not want the trustee to make an additional purchase?

The illustration points out that the "special competence or interest of some of the beneficiaries" could be the reason for the trustee's permissive authorization.[121] These reasons should be stated plainly in the trust language so that when those special circumstances or opportunities expire, the trustee can re-evaluate the diversification of the trust.[122] Thus, the drafter of the trust should find out why the settlor is authorizing specific retention of a farm and under what circumstances that authorization is expected. For example, is it because there is someone that the settlor feels is competent to operate the farm profitably and that is the only reason they feel comfortable not diversifying the portfolio? Or is there such a sentimental value to the settlor that the property should *never* be sold to anyone outside of their family? The drafter should also find out under what circumstances this authorization should not be implemented.[123] The Restatement provides that the relevant justifications should be able to guide the trustee in not only when to follow the authorization, but also when it "should no longer be given special consideration."[124]

B. *Evaluate, Write, Re-evaluate*

Once the provisions have been written, the Restatement provides that the trustee's duties have just begun. "The trustee has a duty, within a reasonable time after the creation of the trust, to review the contents of the trust estate and to make and implement decisions concerning the retention and disposition of original investments in order to conform to the requirements of §§ 90 and 91."[125] This duty is ongoing, so even if the provisions of the trust use specific language, it is the trustee's duty to always re-evaluate for any changes in circumstances of beneficiaries and assets.[126] The Restatement provides an illustrative example of a

119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.*
123. *See id.*
124. *Id.*
125. RESTATEMENT (THIRD) OF TRUSTS § 92 (2007).
126. *Id.* § 92 cmt. a.

farm that was to be devised equally through a will to the devisee's two children had they reached the age of twenty-four at the time of the devisee's death.[127] Because they had not both reached twenty-four, the farm went into a trust, which would terminate at the time the younger child turned twenty-four.[128] Even though neither the will nor the trust contained language concerning retaining or selling the farm, the Restatement concludes that there is no duty to sell the farm for diversification purposes absent circumstances making it inappropriate, imprudent, or against the settlor's intention.[129] Furthermore, "[t]hese facts are sufficient to support a reasonable decision the trustee might make to preserve the farm assets and the opportunity they represent for [the children] . . . ."[130] Thus, the Restatement makes it clear that the outright devise of the farm in a few years would be a sufficient reason for the trustee to retain the farm rather than look to diversify the assets.[131]

VII. CASE LAW

Although the Restatement provides some guidance, case law demonstrates how the Restatement will be interpreted in a "real world" context.[132] The only case that is directly on point for this issue is a Nebraska case, *Brackett v. Tremaine*.[133] In that case, the court found that saving a family farm was a special circumstance that did not require the trustee to sell the farm for reasons of diversification.[134] Furthermore, it gave the impression that the special circumstances may be enough independently to alter the duty to diversify the trust.[135] In *Brackett*, the trustee was attempting to buy part of the farm land that was included in the trust, claiming that the sale was required in order to diversify the assets of the trust.[136] While the court found the sentimental meaning of the farm to the beneficiaries and the permissive language on diversification in the trust relieved any duty to diversify, one cannot help but wonder what role the self-dealing and conflict of interest of the trustee played in the decision.[137] However, the key point is

127. *Id.* § 92 cmt. d(2), illus. 2.
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. *See, e.g.*, Brackett v. Tremaine, 693 N.W.2d 514 (Neb. 2005).
133. *See id.*
134. *Id.* at 521.
135. *Id*.
136. *Id.* at 518.
137. *See* Andy Kirkpatrick, *A Global Approach to Diversification*, PROB. & PROP., Mar.-Apr. 2008, at 45, 48.

that the family farm was found to be a special circumstance, which limited the duty of diversification.[138]

Another case, decided before the Prudent Investor Rule was enacted, clarified the level of specificity that may be required.[139] In *First Alabama Bank of Huntsville v. Spragins*, the court came to the conclusion that "mere boilerplate language is largely unhelpful" if the settlor does not want certain investments diversified.[140] In *First Alabama Bank*, the grantor's assets consisted largely of the bank's stock.[141] The bank argued that it had the power "to make new investments from time to time as it may seem necessary or desirable, regardless of any lack of diversification."[142] The court ruled against them, leading to the conclusion that the drafter should use language that is very specific and strongly conforms to the settlor's true intentions to override the duty of diversification.[143] Although the assets in *First Alabama Bank* were much more liquid and more easily transferrable than a family farm, the focus is the same—specificity in the language regarding the settlor's intentions is extremely important.

These two cases and others give some guidance on how the family farm scenario may be handled by the trustee, but overall it is still very unclear.[144] The only inference one can take away is, "unless otherwise specifically and clearly mandated by the settlor, a trustee is protected in retaining particular investments of the trust so long as the beneficiaries are compliant enough to not sue the trustee."[145] In *Wood v. U.S. Bank*, the court gave some guidance in this area for proper drafting.[146] The court stated that using specific directive language to retain a large portion of the assets in a single investment was necessary rather than a general authorization.[147] Second, there should be language relieving the trustee of his duty to diversify if that is the intention.[148] Other courts have included a good faith provision as an element of language in the trust that will abrogate the trustee's diversification duty.[149] In *Nelson v. First National Bank and Trust Co. of Williston*, the court held the liability of the trustee for investment decisions was

138. *See Brackett*, 693 N.W.2d at 521.
139. *See* First Ala. Bank of Huntsville v. Spragins, 515 So. 2d 962 (Ala. 1987).
140. Cline, *supra* note 7, at 622.
141. *First Ala. Bank*, 515 So. 2d at 963.
142. *Id.*
143. Cline, *supra* note 7, at 621-22.
144. *See* ELLIOTT & BENNETT, *supra* note 64, at III(C)(2).
145. *Id.*
146. *See* Wood v. U.S. Bank, 828 N.E.2d 1072, 1078 (Ohio Ct. App. 2005).
147. *Id.*
148. *Id.*
149. *See* Nelson v. First Nat'l Bank & Trust Co. of Williston, 543 F.3d 432, 435 (8th Cir. 2008).

limited to decisions not made in good faith.[150] Furthermore, the court rejected the proposition that negligent decisions, which were errors in judgment but made in good faith, constitute bad faith.[151] These cases show that courts are hesitant to punish trustees acting in good faith, leaving a trustee's failure to act in good faith under the prudent investor standard as his greatest exposure to liability.[152] Overall, it is difficult to say whether these cases would be interpreted differently if the trusts' assets were family farms, but the courts' instructive opinions offer some additional guidance for drafting trusts containing family farms.

A. *Inception v. Subsequent Assets*

A final factor to consider, especially in the context of the family farm, is the difference between inception assets and those purchased after the trust was created. Family farms are most likely going to be inception assets. Although there is some case law concerning this issue, the Restatement directly addresses it. First, "[i]f the terms of a trust direct the trustee to retain investments that were a part of the trust property at the time of the creation of the trust, the trustee is not liable for retaining them except as stated in [Restatement] § 66(2) or § 72."[153] Section 66(2) states,

> If a trustee knows or should know of circumstances that justify judicial action . . . and of the potential of those circumstances to cause substantial harm to the trust or its beneficiaries, the trustee has a duty to petition the court for appropriate modification of or deviation from the terms of the trust.[154]

Thus, section 66(2) deals with a trustee's duty to bring the need for trust modification due to unanticipated circumstances to the court's attention.[155] Section 72 states, "[a] trustee has a duty not to comply with a provision of the trust that the trustee knows or should know is invalid because the provision is unlawful or contrary to public policy."[156] Both of these exceptions are straightforward. However, Restatement section 92 continues by providing that "the trustee is subject to liability for failure to retain such investments."[157] It would seem prudent for the drafter to create a provision directing the trustee to retain the inception assets, i.e. the family farm, and specifically state the reasons for doing so. A

150. *Id*.
151. *Id.* at 435-36.
152. Gillett, *supra* note 30, at 526.
153. RESTATEMENT (THIRD) OF TRUSTS § 92 cmt. d (2007).
154. RESTATEMENT (THIRD) OF TRUSTS § 66(2) (2003).
155. *See id.*
156. RESTATEMENT (THIRD) OF TRUSTS § 72 (2007).
157. *Id.* § 92 cmt. d.

future problem is created, however, if more instructions beyond simply retaining the inception assets are not provided, because that directive to the trustee not to diversify at the outset of the trust does not override the duty to diversify future investment choices.[158]

VIII. SOLUTIONS TO POTENTIAL LIABILITY AND RISK REDUCTION TECHNIQUES

The Restatement and case law offer some guidance regarding considerations of a drafter when creating a trust with a family farm as the major asset, yet there is no surefire explicit language that will work for every family farm situation, let alone any concentrated-asset trust. Therefore, there is a balancing challenge of accurately capturing the settlor's intent and providing protection for the fiduciary, while keeping the trust flexible enough to encompass different circumstances that may come about or even those that were not anticipated.[159] One solution is when the "client desires to impose a different investment standard, the trust instrument should unambiguously express that intent by specifically referencing the portion of the Uniform Act that the settlor desires to abrogate."[160] However, the drafter still needs to take into account any conflicts of interest that might arise from a family farm trust where the trustee may have different roles and responsibilities as "an officer, director, or employee of the family business" in addition to his trustee responsibilities.[161]

A. *Tailor to Circumstances*

A second helpful solution is to tailor the investment strategy to the factual circumstances surrounding the trust's purpose as much as possible. The first factor the drafter should analyze is whether there is a small or large percentage ownership in the family farm.[162] If the trust holds only a small percentage of the entire family farm, but that asset is a large percentage of the trust, it may be found that the trust should diversify the trust assets in order to be prudent.[163] However, there are two caveats to consider. First, the trust may be one of several trusts with the same or similar beneficiaries, who as a whole, own all or a large share in the family farm.[164] This could make diversifying directly contradictory to the settlor's overall goals. Second, the settlor's intent may be to keep control

158. Gillett, *supra* note 30, at 516.
159. Hodgman, *supra* note 35, at 490.
160. Gillett, *supra* note 30, at 515-16.
161. Hodgman, *supra* note 35, at 489-90.
162. ELLIOTT & BENNETT, *supra* note 64, at III(D)(2)(iii).
163. *Id.*
164. *Id.*

within a particular family or have a certain share of ownership held by the trust to retain some family participation.[165] In either case it is important to consider the resources and income of the beneficiaries since their needs and reliance on the income from the trust may influence a trustee's diversification decisions.[166]

Additionally, case law suggests that the drafter and trustee should take into account the available market or ability to sell the farm.[167] Farm assets are very different from stock because they are difficult not only to sell, but to sell piece-meal. Public stock shares may be traded through a market, and even those for closely-held corporations are fairly easily split apart, despite the fact that outside buyers are scarce in those circumstances. A farming operation is not easily divided since deciding which assets, pieces of equipment for instance, the farm can continue without is extremely difficult. Other factors deal with whether the trust is newly created or is an existing trust.[168] If it is a newly created trust, the drafter must be as "specific as possible about the purposes of the trust, the settlor's desires regarding negating the duty to diversify, the lack of marketability of the family company stock, and the settlor's vision for the company."[169] The drafter should define the settlor's intentions as to when and how the farm can be sold, such as beneficiary voting (unanimous or otherwise) if land values reach a certain level or when the operations create a certain level of loss of principal. In any case, it is important that the drafter make sure the settlor understands how any change in the trustee's duties put forth in the trust language affects his investment standard.[170]

Existing trusts are somewhat more difficult, since they need to be modified rather than simply created with the desired specifications. The most common alteration is to get a judicial or administrative modification.[171] This can be done even without beneficiary approval "if either unanticipated circumstances not originally contemplated by the settlor would further the purposes of the trust, or if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration."[172] State law may allow modification of a trust's terms with beneficiaries' consent, but this can be difficult as it may require consensus by all the beneficiaries rather than just one settlor.[173] Another option is to create a comprehensive investment plan for the future by adopt-

165. *Id.*
166. Radigan 2009, *supra* note 59, at 259-60.
167. ELLIOTT & BENNETT, *supra* note 64, at III(D)(2)(iii).
168. *See id.* at IV(A)-(B).
169. *Id.* at IV(A).
170. Gillett, *supra* note 30, at 515.
171. ELLIOTT & BENNETT, *supra* note 64, at IV(B).
172. *Id.*
173. *Id.*

ing a trustee resolution.[174] In the resolution, the trustee can state that it was the settlor's desire to retain the farm in the family except in specifically stated circumstances.[175] If the settlor is still alive, it would be influential to have him sign the trustee resolution to give it more power and authenticity.[176]

But what should these provisions look like? Although every situation will be different, it is important to be creative imagining scenarios in which a settlor would agree the family farm should be sold. A simple example would be that the trustee is authorized to (permissive) or must (mandatory) sell if the value of farm land drops by a certain percentage. This will generally be too broad for most settlors, but it can be modified by stating the value must drop by a specific percent and also over a specific time period. A similar provision would be to state in the trust that the family farm must not be sold unless crop or cattle prices dip below a certain level for a certain period of time. This can be tied to the farm's individual operation rather than farm land itself. If a farm focuses on only one area, market prices are easily accessible and serve as a good indicator of what the overall operation's value has become. In the same context, a trust may state it is mandatory to retain the farm unless the beneficiaries have to borrow a certain percentage of the overall value of the farm to keep the operation going. This provision is a mere indicator of the overall financial health of the operation and whether it is economically sustainable under its current operation and ownership structure. A trust could similarly state that if the family farm has financial losses of a certain amount or for a certain number of years in a row, the trustee is authorized to sell the family farm.

A different avenue may be to tie the ownership of the farm to descendants of the settlor still operating the farm. The trust may state that it is mandatory to keep the farm as long as *any* descendant is still the operator of the farm, or it may list several individual descendants that the settlor knows have the skill and capability to run the family farm operation. At the point there is no designated descendant still operating the farm, a trustee may be authorized to sell it if it would be prudent to do so. On a more positive note, the trust may also state that the trustee must retain the family farm unless an offer to buy the farm for a certain percentage above the market value of the farm is made. In that case, the settlor may feel that the increase in overall assets outweighs the value of keeping the family farm. One important caveat to all of these examples is that the settlor should state how the value is to be calculated or what market price index is to be used; then there will be little to no discretion and disagreement in determining the value of the farm.

174. *Id.*
175. *Id.*
176. *Id.*

Another aspect a trustee should consider is an evaluation of all the beneficiaries' needs. Comment c to the Restatement section 90 shows the difficulty of this problem by noting, "the divergent economic interests of trust beneficiaries give rise to conflicts of types that cannot simply be prohibited or avoided in the investment decisions of typical trusts. These problems regularly present the trustee with problems of conflicting obligations to diverse beneficiaries."[177] Therefore, the trustee needs to balance different beneficiaries' interests in a reasonable and fair manner.[178]

Although evaluating the needs of the beneficiaries can be a helpful solution, it in no way will always make things easier for the trustee. There may be conflicts between beneficiaries about how the farm should be handled, making the trustee's job exceedingly difficult if there is no guidance from the settlor in the trust language. This makes the drafting task even more crucial.

B. *Communication*

Finally, communication with the beneficiaries may be the most important solution for the trustee, as it may keep many conflicts out of litigation. There are several key elements to making the communication successful. First, the trustee may be able to draft a private agreement with other trustees, especially family trustees, to limit the independent trustee's duty to diversify.[179] In this agreement, the family trustees may be designated the duty to decide not to sell the family farm except under certain circumstances rather than the independent trustee.[180] Since the family trustees are also likely beneficiaries, this agreement should help alleviate the independent trustee's difficult task of discerning what some of the beneficiaries want.[181] Again, the beneficiaries who are not family trustees could disagree resulting in problems. Second, the trustee may create an agreement seeking liability indemnification by the family trustees and beneficiaries for retaining concentrated holdings.[182] However, the trustee must remember that this does not indemnify him from future unborn remaindermen who will still have a right to bring claims.[183]

Finally, it is very important for the trustee to memorialize in writing the reasons for his decisions and keep a paper trail of all correspondence with bene-

177. RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. c (2007).
178. *Id.*
179. ELLIOTT & BENNETT, *supra* note 64, at IV(B).
180. *Id.*
181. *See id.*
182. *Id.*
183. *Id.*

ficiaries discussing the investment strategy and purposes of the trust.[184] This element is, as mentioned, part of the overall most important solution—communicate regularly and often with the beneficiaries. As long as the trustee continues to discuss the needs and circumstances of the trust and the beneficiaries, the trustee will most likely be sheltered from litigation by those same beneficiaries. Accordingly, the trustee must make certain that they do not "take a 'set it and forget it' approach" to the trust.[185]

IX. CONCLUSION

So what does this mean to drafters and trustees? First, there does not seem to be any definite solution to eliminating liability for trustees across the board. There are too many circumstances in each possible scenario, even just with the family farm, to give any concrete advice that will hold in every situation. However, clear, specific, and unambiguous language will play a vital role in how the trust provisions are interpreted. Mandatory language will as well, if the settlor is willing to add such a provision. Yet there is still going to be some discretional liability involved in almost all cases, which makes the facts of the situation, the process of creating the trust to follow the settlor's true intentions, and communication with beneficiaries and other trustees alike extremely important to the question of whether the trustee has a duty to diversify the trust holdings, or is required or has authorization to keep the family farm intact.

As stated earlier, the value of farm land in Iowa, and likely elsewhere, has increased dramatically in the last decade. This has increased the value of principal in trusts with family farms as the major asset. Beneficiaries have not had much to complain about because the return on investment has been very profitable. But now that real estate markets and the economy are in a general state of flux, some beneficiaries may change their desire to keep the family farm and to not diversify the investments. This will undoubtedly lead to conflict between beneficiaries who want to retain the family farm at all costs and those that want to diversify the holdings to maximize income and principal. This will leave trustees torn between their duties to the settlor and beneficiaries and will most likely give rise to litigation. The case law has not been entirely clear on which way the courts will go, which emphasizes the importance of drafting a trust that is flexible for these insecure financial times but firmly upholds the settlor's intentions.

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184. Radigan 2009, *supra* note 59, at 262.
185. Kirkpatrick, *supra* note 137, at 49.