

## THE BASICS OF TRUST LAW

Is that investment really good for the trust?



Perry E. Kaufman  
General Counsel  
Commissioners of the Land Office  
P.O. Box 26910  
5801 N. Broadway, Suite 200  
Oklahoma City, Oklahoma 73126  
Phone: 405.604.8151  
Fax: 405.604.8199  
[perry.kaufman@clo.state.ok.us](mailto:perry.kaufman@clo.state.ok.us)

July 2008

## THE BASICS OF TRUST LAW

Is that investment really good for the trust?<sup>1</sup>

How does a trustee decide which investment is good for the Trust? The answer is sometimes not very clear unless you ask some very pointed questions.

The stated mission of CLASS is “As guardians, educate and advocate on behalf of the beneficiaries for prudent and profitable management of the school trust lands and permanent funds to sustain each child's birthright to the best possible education.” This makes each of you the reviewing advocate of the various school trusts to insure all actions taken by the trustees are well reasoned and within the allowed trust parameters.

### General Creation of the Trusts

Most States in the United States were created by federal Enabling Acts. These Acts are federal legislation allowing a proposed state or territory to become a state in the United States. Historically the Acts included conditions for the territory to comply with in order to be accepted as a State. Almost all States entering the United States, after the original 13, had some sort of grant from the federal government to assist in setting up an education system and internal infrastructure. Many legislatures diverted and spent the federal grants in the first few years of statehood. Subsequently the federal grants included provisions establishing progressively more strict trusts to benefit education.

---

<sup>1</sup> This discussion is based upon the School Land Trust structure in Oklahoma, your state's structure may be different and your state's law may be different

A trust in this sense is created with a Settlor, the United States, the Trustee, the resulting State, and the Beneficiary, the state funded education system.

### Duties of the Parties

A Trust is an agreement between two entities for the establishment of a fund for a beneficiary. School trusts are sometimes called compacts since the agreement is between sovereigns.

The Settlor is generally the maker or creator of the trust and specifies the terms and conditions of the trust which must be followed by the trustee. For purposes of our discussion the United States government is the Settlor. In Oklahoma, the compact is the terms of the Enabling Act and the acceptance in the Oklahoma Constitution, which form the trust agreement between the two sovereigns.

The Trustee is the one who actually administers the trust and manages its assets in accordance with the terms and conditions of the trust. This is the agency, department or board charged with the authority to manage the trust property, whether real or personal. The trustee owes a fiduciary duty to the trust in fulfilling its duties. The fiduciary duty is sometimes a hazy term we will talk about later, but generally requires the trustee manage trust property better than he would his own property, it includes a requirement of undivided loyalty to the trust and beneficiaries.

The Beneficiary is the primary schools or universities entitled to receive the benefits of the trust. The specifics of the benefits are usually detailed in the trust agreement.

#### Administration of Trusts - A few examples for discussion

The trust document can allow changes to enhance the administration of the trust and to serve trusts purposes. How a trust document is interpreted can be important to determine authority of the Trustee to take action.

- Constitutional change violates trust document  
State v. Mac Q. Williams, 301 P.2d 655 (Okla. 1956)

In this instance, the people of the State of Oklahoma voted on and passed a constitutional amendment allowing all oil and gas receipts from Trust property to be deposited into a special fund to aid school districts in acquiring buildings.

At first blush, this use is for educational purposes; however, the court ruled this use was inconsistent with the terms and conditions of the trust document. The Oklahoma Supreme Court stated,

We hold the regulations in the Oklahoma Enabling Act herein mentioned and touching the care and disposition of the federally granted lands and the proceeds to be derived therefrom by the sale of any part or portion thereof, and including the sale of oil and gas leases thereon, are within the regulating power of Congress, and accordingly that said regulations exist as valid laws of the United States, which may not be modified, restricted or changed by an Act of the Oklahoma Legislature or the people of Oklahoma in amendment of the Oklahoma Constitution.

The Oklahoma Enabling Act dictates only the interest earned from the trust property, both real and personal, can be used to support education. In this

instance, the plan was for both principal and interest to be available for use by the school districts. In its simplest terms, this is due to the supremacy clause in the U.S. Constitution, which requires federal law be supreme over all subordinate laws which are the State constitution and statutes.

Although not discussed by the court, since they had already ruled against the provision, there was also an equal benefit argument. The Oklahoma constitution requires the funds distributed by the trust to be to the equal benefit of all the people in the state. If just a few school districts use the funds for acquiring property, the other districts may suffer.

- Legislation requires trustee to violate trust terms and conditions  
OEA v. Nigh, 642 P.2d 230 (Okl. 1982)

This violation involved the Oklahoma legislature enacting legislation requiring the Commissioners of the Land Office (CLO) to issue farm loans for a percentage rate of 8½%, without regard to the market rates. The time frame of this lawsuit was the early 1980's during which interest rates for typical mortgages was approximately 16 to 18%.

The Oklahoma Enabling Act and the Oklahoma Constitution did not, at the time, include a requirement to earn market rates for trust investments. The Oklahoma Education Assoc. filed a legal action to force the CLO to not issue mortgages at below market rates.

The OK Supreme Court found the Trustees of the trust had "...an irrevocable duty to maintain the trust estate for the exclusive benefit of the

beneficiaries and to return full value from the use and disposition of the trust property.”.

So even though the duty was not specifically spelled out in the trust documents (Enabling Act & OK Constitution), the court found the trustees still had this duty to obtain the maximum return for trust property under basic trust law principles and duties.

This case includes a great deal of information about the duties of trustees, their express or implied duties, and I encourage you to review it if you have the time and desire.

- Timber Investment  
Okl. A.G. Opin. No. 02-36

In 2002 the CLO was interested in expanding the investment portfolio and began to look into investing in timber and timberland. The CLO’s authorization for investing is limited to “bonds issued in the United States and United States dollar denominated or other investments settled in United States dollars or traded on the United States exchange markets.”. 64 O.S. §51.

It was argued by one member of the Board the term “other investments” should include timber and timberland, even though the staff opinion was otherwise. The Oklahoma Attorney General issued an opinion, using statutory interpretation rules, finding the term “other investments” did not include investments in timber or timberland.

The determination of authority to invest in a particular type of investment is a common theme in trust case law.

- Drought refunds  
Okl. A.G. Opin. No. 02-47

Also in 2002, the panhandle of Oklahoma was experiencing one of the worst droughts in 50 years and the trusts own and lease approximately 300,000 acres of land in the panhandle. The lessees of that CLO land requested the CLO refund and or reduce their annual rent due to the drought conditions. The Board ordered staff to issue notice letters and determine refund amounts of the effected lessees. A State Representative requested the Oklahoma Attorney General issue an opinion on the legality of these lease changes.

The Attorney General found there was no authority in the Constitution, statutes or lease agreement for the CLO to issue refunds or rebates to its lessees. In fact the CLO was duty bound to obtain the maximum return for the use of trust property and it could not lease property for less than the fair market value.

#### Fiduciary Duty – The Grey Zone

Under trust law the Trustee is charged with a fiduciary duty to the trust. The fiduciary duty places a higher burden of doing the right thing on a Trustee than is expected of a person normally. The Oklahoma Supreme Court in Corr v. Smith, 178 P.3d 859 (Okl. 2008)

A trustee is a fiduciary of the highest order in whom the hope and confidence of the settlor are placed with the expectation that the trustee will exercise the obligations of the office for the exclusive benefit of those holding beneficial interests. Without exception, a trustee owes its beneficiaries the most abundant good faith, absolute and perfect candor, openness and honesty.

In Oklahoma the fiduciary duty of the Board responsible for managing the trust is stated at Article XI, §6, of the Oklahoma Constitution,

\* \* \*

B. The Commissioners of the Land Office shall be responsible for the investment of the permanent common school and other educational funds, and public building funds solely in the best interests of the beneficiaries and:

1. For the exclusive purpose of providing maximum benefits to current and future beneficiaries, and defraying reasonable expenses of administering the trust funds;
2. With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like enterprise of a like character and like aim would use;
3. By diversifying the investments of the trust funds so as to minimize the risk of large losses; and
4. In accordance with the law, documents and instruments governing the administration and investment of the permanent common school and other educational funds and public building funds.

C. The Legislature shall provide by law conditions upon which the permanent common school fund, other educational funds and public building funds may be loaned or invested and shall do all things necessary for the safety of the funds and permanency of the investment.

\* \* \*

This definition is sometimes called the “modified prudent person” rule. In subsection C, the legislature has the authority to set out parameters the types of investments allowed.

The reason I refer to the fiduciary duty as the grey zone is in consideration of the unlimited explanations to support a decision. To be sure there are definite allowed and disallowed investments. An example of a generally allowed

investment is a trustee investing in a large capitalization stock fund, assuming it is allowed by the Trust document. An example of a generally disallowed investment is a trustee investing in his cousin's commercial development.

But say for instance, can the trustee invest in a risky hedge fund which is using mortgaged backed securities as its basis? The return on the investment could be very good, say 25% per year, but if not handled properly all the money could be lost. A number of factors could be evaluated to determine if this investment should be allowable. One factor could be whether the investment is a small part of a much larger portfolio or part of an overall strategy. Other factors could be the extent of risk in the investment, the timetable for the investment, the history and the forecast. Depending upon a number of factors there could be many other parts to the decision making process.

### Conclusion

Hopefully this will help you in reviewing actions taken by the people managing school trust property. Generally the Trustees are trying to do what is right for the trust, but sometimes other duties get in the way and cloud the decision making process.

The best part is you can ask questions, read information and make phone calls to find out the explanations of the actions taken by the Trustees. Additionally, you can give them another perspective to think about which may sway the decision to the best interests of the trust.