XVIII. FIDUCIARY LIABILITY

A. Introduction

The duties and obligations of the fiduciary extend to the trusts and estates being administered and to the beneficiaries of such trusts and estates. Often these obligations may result in conflicts between the fiduciary and the beneficiaries or between the various beneficiaries. The fiduciary's obligations are continuous and must be monitored with increasing vigilance. A fiduciary, whether an individual or entity, has a unique legally mandated fiduciary relationship with each interested party and can be held liable to each of them for breaches of his or its fiduciary duty.

The purpose of this Chapter is to educate the fiduciary as to certain of his responsibilities in the day-to-day administration of a trust or estate and to make the fiduciary aware of the types of issues and consequential liability that he may encounter while carrying out those responsibilities. The following are the topics discussed in this Chapter:

- Duty to Diversify
- Duty of Loyalty and Self-Dealing
- Duty to Deal Fairly With Multiple Beneficiaries
- Payment of Trust Funds to Beneficiary Whose Interest is Terminated or to Non-Beneficiary
- Use of Exculpatory Provisions
- Unauthorized Practice of Law

B. Duty to Diversify

1. General

A fiduciary is under a duty to exercise reasonable care under the prudent investor rule in decisions relating to investment of trust and estate property. The fiduciary must use diligence and care in creating and maintaining a proper trust portfolio. Each time that a fiduciary chooses to make an investment, he must be sure to act within the terms of the governing instrument and in accordance with the applicable law.

One of the generally accepted principles of modern portfolio management is the duty to diversify. The rationale is that, by diversifying, the fiduciary reduces the risk of loss by distributing the risk. A fiduciary who is found not to have diversified can be surcharged for losses to the trust. See *Estate of Janes*, 659 N.Y.S.2d 165 (1997) (co-executor surcharged for failing to diversify high concentration of a single security).

The duty to diversify is imposed on the fiduciary by statute and case law. See 24 A.L.R. 3d 730 (1969) ("Duty of Trustee to Diversify Investments, and Liability for Failure to Do So") and 14 Am. Jur. Proof of Facts 2d 253 (1977) ("Trustee's Failure to Diversify Investments") for an extensive discussion of the history and the case law of the duty to diversify.

a. Uniform Prudent Investor Act. A majority of states have adopted

the Uniform Prudent Investor Act ("UPIA") in one form or another. Section 3 of the UPIA provides that "[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."

b. **Restatement (Third) of the Law — Trusts**. Section 227(b) ("General Standard of Prudent Investment") of the RESTATEMENT (THIRD) OF THE LAW — TRUSTS ("RESTATEMENT (THIRD)") provides that "[i]n making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."

c. **Majority View**. The majority of jurisdictions follow the UPIA and the RESTATEMENT (THIRD) and have taken the view that a fiduciary has a duty to diversify. A large number of the reported cases involve the investment by the fiduciary of a large percentage of the trust assets in a single stock. See *First Alabama Bank of Huntsville, N.A. v. Spragins*, 515 So.2d 962 (Ala. 1987) (a trustee bank was found to have breached its fiduciary duty to its beneficiaries by investing 70-75% of the trust assets in its own bank stock); *Estate of Janes*, 659 N.Y.S.2d at 171 (71% of assets held in a single stock). In addition, the cases focus on a number of additional factors:

- Geographical concentration of investments.
- Sector concentration of investments.
- Size of the trust account.
- Duration of holding securities.
- Purpose of the trust (i.e., was it established to retain family business?).

The fact that the trustee does not diversify is not *per se* negligence, and the circumstances will dictate if the fiduciary is acting prudently. The Comments to the UPIA provide examples of a trustee's reason for not diversifying:

> **EXAMPLE:** If a tax-sensitive trust owns an undiversified block of low-basis securities, the tax cost of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes outweigh the conventional duty to diversify.

d. **Minority View**. A minority of jurisdictions do not impose a common law duty to diversify. See *In re Elkins' Estate*, 20 Pa. D. & C. 483 (1934), *aff'd* 325 Pa. 323 (1937) (the court held there was no duty to diversify in Pennsylvania). The court, however, may find the failure to diversify as evidence of imprudent investing. *Matter of Fleet Trust Co.*, 662 N.Y.S.2d 360 (Surr. Ct. New York Cty. 1997), *rev'd by In re Jakobson*, 683 N.Y.S.2d 860 (App. Div. 1998) ("there is no absolute duty to diversify in all circumstances, and although a failure to diversify will not automatically result in liability, neither is a fiduciary automatically insulated from liability based on a "mere" failure to diversify where the lack of diversification itself presents an unreasonable risk to the assets of the estate or trust"). It is important to note that the common law rule of many of these jurisdictions has been superseded by statutes

adopting the UPIA's duty to diversify. See Section 7204 ("Diversification") of the Pennsylvania Prudent Investor Rule; New York E.P.T.L. 11-2.3(b)(3)(C). Furthermore, notwithstanding the absence of a statutory or common law duty to diversify, a specific provision in the governing instrument requiring diversification will impose a fiduciary obligation to diversify.

2. Measuring the Loss

There is a division among jurisdictions as to how to measure damages caused by a failure to diversify. Some cases have held a fiduciary liable for the actual losses sustained by the trust. Other cases permit a surcharge for "opportunity cost" damages measured by the difference between the actual results achieved and the return that could have been achieved with a properly diversified portfolio. See *105 East Second Street Ass'n v. Bobrow*, 573 N.Y.S.2d 503 (App. Div. 1991), *appeal after remand*, 605 N.Y.S.2d 870 (App. Div. 1993) (the measure of damages for breach of fiduciary duty is the amount of loss sustained, including lost opportunities for profit on the properties by reason of the fiduciary's conduct).

3. Retaining Investment Advisor

A fiduciary can reduce his exposure by seeking investment advice when he deems it necessary and proper. Generally, most wills and trust agreements provide that a fiduciary, at least a non-corporate fiduciary, may retain investment advisors. In addition, the prudent investor rule of most states also allows for the fiduciary to retain investment advisors. See New York EPTL Section 11-2.3(b)(4)(C) (trustee is authorized to "delegate investment and management functions if consistent with the duty to exercise skill, including special investment skills"). Notwithstanding the appointment of an investment advisor, the fiduciary is still obligated to review the investment decisions made by the advisor to determine if they appear prudent under the circumstances. The level of scrutiny that will be required by the fiduciary will depend on the circumstances, including the level of skills of the fiduciary and the types of investments being made.

4. Statutory Exception to Duty to Diversify

Some states have legislated exceptions to the duty to diversify. Under Virginia law, the fiduciary has an absolute immunity from claims that it did not follow the "prudent investor" rule in managing trust assets, provided the fiduciary invests in the assets specified by statute. The Virginia law, § 26-45.1, specifies the securities and a list of stock of which the fiduciary may invest and such investment shall be conclusively presumed to have been prudent. See *Scott v. United States of America*, 186 F. Supp. 2d 664 (E.D. Va. 2002).

5. Direct Authorization to Retain Assets

An express provision in the governing instrument can relieve a trustee from the duty to diversify. SCOTT ON TRUSTS (4th ed.) Section 230.3. Some cases, however, have held that a general authorization in an instrument to retain specific assets will not protect a trustee from

liability for failure to diversify. See *Wood v. U.S. Bank*, 828 N.E.2d 1072 (Ohio.App.

2005) (corporate trustee allowed to retain the trust's stock holdings "as they deemed advisable or proper;" court held that this language was not specific enough to relieve the trustee of its duty to diversify); *Rutanen v. Ballard*, 678 N.E.2d 133 (Mass. 1997) (trustee not allowed to retain unproductive assets notwithstanding general authorization in trust agreement to retain assets); Comments to Section 229 of the RESTATEMENT (THIRD) ("The duty to diversify is not absolute. With or without a general authorization to retain inception assets, other considerations may properly affect the trustee's decision in these matters."). The same may apply if the instrument specifically provides that the trustee may retain a particular asset. See *In re Estate of Saxton*, 686 N.Y.S.2d 573, 577-578 (1998) (trustee of testamentary trust which consisted of high concentration of shares of stock in a single corporation breached its fiduciary duty by failing to diversify trust assets over 30-year life of trust notwithstanding written agreement allowing trustee not to diversify). See also Comments to Section 229 of the RESTATEMENT (THIRD), which provides:

> In most instances a trustee should not take a settlor's authorization to retain specific investments as special justification indefinitely if retention would otherwise be imprudent, especially if an apparent purpose of the authorization becomes outdated by changed circumstances or passage of time.

But cf. *Baldus v. Bank of California*, 530 P.2d 1350 (Wash. Ct. App. 1975) (holding that a trust instrument may relieve the trustee of duty to diversify trust assets in absence of showing that trustee abused its discretion in failing to diversify trust investments).

➔ **Planning Point:** Modern investment theories are focusing on the total return of investments and may impact strategic investing by fiduciaries. The fiduciary is advised not to overly invest in any one stock or group of stocks without the express written authorization of the testator or grantor in the will or trust agreement. Notwithstanding a direct authorization, the fiduciary is further encouraged to seek professional investment advice to ensure that the particular investment objectives under the governing instrument are maintained and should continually monitor investments to ensure that they remain prudent under the circumstances as they may exist from time to time.

C. Duty of Loyalty and Self-Dealing

1. General

One of the most fundamental obligations owed by the fiduciary to the beneficiaries is the duty of loyalty. See SCOTT ON TRUSTS (4th ed.), Section 170. It is this unique relationship that has led courts to place a higher and stricter standard for the fiduciary's conduct whenever there is a conflict between the fiduciary's interests and those of the beneficiaries. As a general rule, the fiduciary is not permitted to directly or indirectly have a personal interest in any transaction involving trust property, regardless of the fairness of the transaction. To do so may constitute

prohibited self-dealing. The fiduciary is normally held to the standard of care of a

reasonably prudent person. However, if the fiduciary engages in self-dealing, the standard of care is raised to a higher level. Judge Benjamin Cardozo is often quoted as having written:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions … Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Meinhard v. Salmon, 249 N.Y. 458, 464 (1928).

The following are instances of potential self-dealing between the fiduciary and the estate or trust being administered:

- Sale of trust property to fiduciary individually.
- Sale of trust property to entity controlled by fiduciary.
- Purchase of trust property by fiduciary directly from trust or at auction.
- Sale by corporate trustee to one of its departments, officers, or directors.
- Loan by trustee to trust.
- Loan by trust to trustee.
- Investment of trust property in fiduciary's own securities or deposit of trust funds in fiduciary's account.
- Employment of fiduciary as accountant or investment advisor for trust or estate.
- Personal use of trust property.

2. RESTATEMENT (SECOND) OF THE LAW — TRUSTS

Section 170 ("Duty of Loyalty") of the RESTATEMENT (SECOND) OF THE LAW — TRUSTS ("RESTATEMENT (SECOND)") sets forth the fiduciary's duty as follows:

- The trustee is under a duty to administer the trust solely for the benefit of the beneficiaries.
- The trustee, in dealing with a beneficiary on the trustee's own account, is under a duty to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the transaction.

The comments to the RESTATEMENT (SECOND) provide that the trustee is acting in a fiduciary relationship with the beneficiary as to the matters within the scope of the relationship and is

under a duty not to profit at the expense of the beneficiaries, unless doing so is in

accordance with the express terms of the documents or is with the beneficiaries' consent or with court approval. The duty of loyalty promulgated in the RESTATEMENT (SECOND) is not limited to trustees; it also extends to other fiduciary relationships (*e.g.*, guardians and executors).

3. Defenses to Self-Dealing

The prohibition against self-dealing is not absolute. The fiduciary has available a number of possible defenses to a claim of impropriety. See Section 802 (Duty of Loyalty) of the Uniform Trust Code (2000) for a list of possible defenses. It is important to note, however, that a fiduciary's assertion that he acted in good faith or that the transaction was fair will not be a sufficient defense.

a. Consent of Beneficiaries. A self-dealing transaction generally will be respected if the beneficiaries consent, unless the fiduciary does not properly disclose all material elements of the transaction or exercises undue influence. See *Ramsey v. Boatmen's First Nat. Bank*, 914 S.W.2d 384, 388 (Mo. Ct. App. 1996) (trustee's failure to communicate with the beneficiary to see if she understood the nature of the transaction or that a conflict of interest existed invalidated acquiescence by beneficiary); *Renz v. Beeman*, 589 F.2d 735, 744 (2d Cir. 1978), *cert. denied*, 444 U.S. 834 (1979); *Beyer v. First Nat'l Bank*, 843 P.2d 53 (Colo. Ct. App. 1992); *Ford City Bank v. Ford City Bank*, 441 N.E.2d 1192 (Ill. App. Ct. 1992).

b. Provision in Governing Instrument Allowing Self-Dealing. A specific provision in the will or trust agreement will exonerate the fiduciary from self-dealing unless the fiduciary acts in bad faith. See *O'Hayer v. de St. Aubin*, 293 N.Y.S.2d 147 (App. Div. 1968); *Renz*, 589 F.2d at 745. Such provisions will be strictly applied. See *In re Kemske*, 305 N.W.2d 755 (Minn. 1981); *Jochec v. Clayburne*, 863 S.W.2d 516, 520 (Tex. Ct. App. 1993). See also the discussion of "exculpatory provisions" later in this Chapter.

c. Court Approval. A fiduciary may petition the court for approval for acts of self-dealing. The court will permit such transactions only after careful scrutiny and determination that the transaction is fair to the beneficiaries. See *Miller v. Miller*, 734 N.E.2d 738 (Mass. Ct. App. 2000) (court approved loan by executor to estate with interest); Comment f to Section 170 of the RESTATEMENT (SECOND) (courts may approve self-dealing transactions). The Uniform Probate Code permits self-dealing if the transaction is approved by the court after notice is provided to all interested parties. Uniform Probate Code Section 3-713. See also Section 5 of the Uniform Trustee's Powers Act (court approval required if conflict of interest exists). The fiduciary may seek approval before or after the transaction. See *Burlington v. Worcester*, 218 N.E.2d 123 (Mass. 1966).

d. Other Exceptions. Certain jurisdictions permit specific acts of "self- dealing" by a fiduciary under principles of common law or by statute. For example, certain jurisdictions allow the trustee to borrow from the trust, or for a corporate trustee to deposit trust funds in its own account during administration. See *Maryland Nat'l Bank v. Cummins*, 588 A.2d 1205 (Md. Ct. App. 1991).

4. Liability of the Trustee

a. **Disgorgement of Profits**. The trustee will be required to reimburse the trust for any loss caused to the trust as a result of the self-dealing and may be required to pay punitive damages in especially egregious situations. See *In re Guardianship and Conservatorship of Jordan*, 616 N.W.2d 553 (Iowa 2000). In addition, some courts also will require the trustee to disgorge any profits made on the transaction even if the trust suffered no financial harm because of the transaction. See *Coster v. Crookham*, 468 N.W.2d 802 (Iowa 1991).

b. **Removal of Trustee.** A court may remove the trustee if a conflict of interest exists between the trustee and the beneficiaries. See *Hanson v. First State Bank and Trust Co.*, 385 S.E.2d 266 (Ga. 1989) (court approved removing trustee where brother of settlor was beneficiary of trust and major shareholder and chairman of the board of the trustee bank; brother was deemed to be *de facto* trustee).

c. **Equitable Remedies.** Courts also may exercise any equitable remedy available to them, including enjoining the trustee from completing the transaction (*i.e.*, stop the trustee from purchasing trust property) or compelling the fiduciary to sell the property. See *Matter of Estate of Rolczynski*, 349 N.W.2d 394 (N.D. 1984). If the transaction has already taken place, the court can vacate the transaction. See Section 3-713 of the Uniform Probate Code (transactions involving a "substantial conflict of interest" are voidable).

➔ **Planning Point:** A fiduciary always must be aware of his primary duty to the beneficiaries and must put that duty before that of his own self interests. In situations where there is a questionable conflict between the fiduciary's interests and those of the beneficiaries, the fiduciary is well advised to seek the consent of the beneficiaries or the applicable court. This holds true notwithstanding a provision in the governing instrument ostensibly permitting such action.

D. Duty to Deal Fairly With Multiple Beneficiaries

1. General

A fiduciary has a duty to deal fairly and impartially with all beneficiaries and to act with due regard for their respective interests. This rule applies whether the respective interests of the beneficiaries are concurrent (*e.g.*, multiple current beneficiaries) or successive (*e.g.*, current beneficiaries v. remainder beneficiaries).

2. Restatement (Third)

Section 183 of the RESTATEMENT (THIRD) provides that "[w]hen there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them."

Section 232 of the RESTATEMENT (THIRD) provides that "[i]f a trust is created for beneficiaries in succession, the trustee is under a duty to the successive beneficiaries to act with due regard to their respective interests."

3. Specific Conflicts Among Beneficiaries

The following are a few of the potential areas where the fiduciary's duty to deal impartially with multiple beneficiaries may arise:

a. <u>Concurrent Multiple Discretionary Beneficiaries</u>. Absent specific direction from the settlor in the governing instrument or otherwise, the trustee of a discretionary trust with multiple current beneficiaries is under a duty to deal impartially with respect to all of the beneficiaries, whether they be income and/or principal beneficiaries. A fiduciary's exercise of discretion will not be disturbed unless the fiduciary acts in bad faith or in an unreasonable manner. See *U.S. v. O'Shaughnessy*, 517 N.W.2d 574 (Minn. 1994) (where trust gave trustee complete discretion to distribute all, some or none of the trust assets, the beneficiary had a mere expectancy interest until the trustee elected to make payments and the court will not interfere absent showing of bad faith or failure to act reasonably); *Dunkley v. Peoples Bank & Trust Co.*, 728 F. Supp. 547 (W.D. Ark. 1989) (under Florida law, trustee must exercise discretion reasonably and with proper motives in interest of beneficiaries). Even though there is no clear standard by which to judge reasonableness, courts generally will intervene in such discretionary decisions only where the trustee acts in contravention of his fiduciary duties, *e.g.*, dishonestly, in bad faith or with intentional disregard of the interests of the beneficiaries. See SCOTT ON TRUSTS (4th ed.) Section 187.2. If a trustee acts in an unbiased manner in the exercise of his discretion and applies the same standards to all distribution decisions absent a direction in the trust instrument to the contrary, his actions are likely to be considered reasonable. *McNeil v. Bennett*, 2001 WL 815443 (Del. 2001) (trustees had a duty to consider the interests of beneficiaries, belonging to multiple family generations, impartially and to act reasonably in making allocation decisions). <u>See also</u> U.S. Trust, Practical Drafting, January 2002 at 6699.

b. <u>Successive Beneficiaries</u>. The trustee also may have to make investment and distribution decisions that have an inverse relationship between the current beneficiaries and the remainder beneficiary. This is often the case with a marital trust requiring that mandatory income and discretionary principal be paid to the spouse and the remainder to the children. Should the trustee invest in high-income-producing assets (*e.g.*, bonds) or low income but high- appreciating securities? Should the trustee make distributions to the current beneficiaries, thereby leaving less for the remainder beneficiary? The trustee has a dual, and potentially conflicting, duty to the beneficiaries. The trustee has a duty to the income beneficiaries to preserve the trust property and to make it productive. He also has a duty to the remainder beneficiaries to preserve the trust principal. As is the case with concurrent beneficiaries, absent specific direction in the governing instrument, the trustee owes a duty of loyalty to all of the beneficiaries and should not adopt a course of conduct that will benefit one class at the expense of the other. See *Dennis v. R.I. Hosp. Trust Nat'l Bank*, 744 F.2d 893 (1st Cir. 1984) (trustee's management of trust assets favored the life tenant to the "very real disadvantage" of the remainder interests in violation of Rhode Island law, which requires the trustee to act impartially

in the interests of both the life tenant and the remainder beneficiary); *Matter of Maxwell*, 704 A.2d 49 (N.J. Superior Ct. 1997), *cert. denied*, 708 A.2d 65 (1998) (allegations that trustees breached their fiduciary duties by failing to impartially administer assets for the

benefit of both the life beneficiaries and the remainder beneficiaries were legally sufficient to maintain cause of action); *Matter of Hamill*, 410 A.2d 770 (Pa. 1980) (trustee was not under absolute duty to maximize current trust income for the benefit of the income beneficiaries, but could exercise discretion in preserving balance between successive beneficiaries).

In upholding the duty of impartiality, the trustee should use his discretion and judgment in light of the purposes and terms of the trust. The trust's terms expressly may affect the trustee's duties to the beneficiaries. See *Stevens v. National City Bank*, 544 N.E.2d 612 (Ohio 1989) ("A settlor has the power to make provisions in a trust which alter or even eliminate the trustee's duties to diversify, to make trust property productive, or even the duty to invest as would a prudent man"). For example, the trust may give the trustee the authority to accumulate income or discretion to pay or apply principal for the benefit of an income beneficiary. The trust instrument may also authorize or direct the trustee to purchase or retain property that might otherwise be considered unproductive or wasting and, therefore, an improper investment.

c. Litigation. Conflict among beneficiaries also may lead to litigation. The fiduciary may not take sides in any conflict between beneficiaries. See *In re Cudahy Family Trust*, 131 N.W.2d 882 (Wis. 1965) (contest between beneficiaries over will construction); *In re James' Estate*, 86 N.Y.S.2d 78 (Surr. Ct. 1948) (conflict over distribution of income). But see *Indian Head Nat'l Bank of Nashua v. Brown*, 455 A.2d 1056 (N.H. 1983) (trustee did not breach its fiduciary duty by suggesting an interpretation of an ambiguous trust instrument that favored one beneficiary over another). It is also improper for the fiduciary to initiate litigation for the purpose of favoring one beneficiary over another. See *Redfield v. Critchley*, 300 N.Y.S. 305 (App. Div. 1937), *aff'd*, 277 N.Y. 336 (1938) (trustees breached duty of impartiality in initiating litigation for judgment declaring that life beneficiary had renounced interest).

d. Administration. A fiduciary owes a duty of impartiality to all beneficiaries in the administration of the trust and must protect the interests of each beneficiary. In *Estate of Sewell*, 409 A.2d 401 (Pa. 1979), a trustee was deemed to have breached its duty of impartiality by making payments to one beneficiary while having failed to locate and make proper payments to another beneficiary.

4. Uniform Prudent Investor Act

The UPIA attempts to reconcile the needs of the different beneficiaries by adopting a modern portfolio theory whereby investors seek a "total return" of current income and capital appreciation. Section 2(b) of the UPIA provides that "[a] trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Modern portfolio theory's emphasis on total return may be in conflict with the fiduciary's duty of impartiality, which requires a balancing of the interests of the income and remainder beneficiaries. Recognizing this conflict, Section 104 of the Uniform Principal and Income Act was amended in 1997 to enable a trustee, under certain circumstances, to adjust between principal and income. The comments to Section 104 provide that the purpose is "to enable a trustee to select investments using the standards

of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents." See also New York EPTL Section 11-2.3(b)(5) (trustee has power to adjust between income and principal).

5. Unitrust Provision

In addition to the power to adjust, New York has enacted legislation permitting the trustee to elect to make payments of a unitrust amount to the current income beneficiaries in place of the trust's stated distribution. See New York EPTL Section 11-2.4. See also La. Rev. Stat. Ann. Section 2068 (the trust instrument may direct the trustee to distribute a unitrust or annuity amount to the current income beneficiary even if such payments exceed current or accumulated income).

6. Court Direction

Courts of equity traditionally have permitted a fiduciary to protect himself by applying to the court for direction in certain instances where there is doubt as to whether an action would be a breach of fiduciary duty. See *Messner v. DeMotte*, 82 N.E.2d 900 (Ind. App. Ct. 1948) ("A trustee need not act at his peril. He may under appropriate circumstances apply to the court for advice and instructions."); *Comtrade, Inc. v. First Nat'l Bank of Highland Park*, 497 N.E.2d 527 (Ill. App. Ct. 1986) (the only prudent course of action for the trustee to take when presented with conflicting claims to the trust fund was to apply to the court for direction). This common law principle has been codified by statute in many states. For example, the Ohio Rev. Code Section 2107.46 ("Action by Fiduciary") permits the fiduciary to "ask direction or judgment of the court in any manner respecting the trust, estate, or property to be administered and the rights of the parties in interest." See also Section 259 of the RESTATEMENT (SECOND) which states that "[t]he trustee is entitled to apply to the court for instructions as to the administration of the trust if there is reasonable doubt as to his duties or powers as trustee." The comments to Section 259 provide guidance as to what matters may be the proper subject of such an application. These include the proper construction of the trust instrument, the extent of the trustee's powers and duties, the identity of the beneficiaries of the trust, the character and extent of the beneficiaries' interests, the allocation or apportionment of receipts or expenditures between principal and income, and the persons entitled to the income or to the trust property on the termination of the trust. See also SCOTT ON TRUSTS (4th ed.) Section 259.

➔ **Planning Point:** Absent specific direction to the contrary, a fiduciary must act with impartiality among the various beneficiaries and should not take actions that may benefit one group over another. The best avenues of protection for the trustee to follow are to seek court approval and to periodically account to the beneficiaries, either judicially or by informal receipt and release.

E. Payment of Trust Funds to Beneficiary Whose Interest is Terminated or to Non- Beneficiary

1. General

A fiduciary is obligated not only to monitor the needs of a beneficiary to determine if distributions should be made to such beneficiary, but also is obligated to continually monitor whether or not the interest of the beneficiary has terminated under the trust (*e.g.*, beneficiary has died). In addition, it is the trustee's obligation to ascertain if the person to whom a distribution is made is indeed a beneficiary (*e.g.*, does an adopted child inherit under the will). A fiduciary who breaches this duty will be held personally liable to the actual beneficiaries. That the fiduciary may have a cause of action against the person to whom the payment was wrongfully made will not exculpate the fiduciary from his own liability.

2. Restatement (Third)

Section 226 of the RESTATEMENT (THIRD) provides as follows:

> If by the terms of the trust it is the duty of the trustee to pay or convey the trust property or any part thereof to a beneficiary, he is liable if he pays or conveys to a person who is neither a beneficiary nor one to whom the beneficiary or the court has authorized him to make such payment or conveyance.

The comments to the RESTATEMENT (THIRD) provide that the trustee should be held liable even if he makes the payment under a reasonable mistake of law or of fact. See also 106 N.Y. Juris. 2d Trusts, Section 568 ("A trustee who distributes trust property under a mistake of law is nevertheless liable irrespective of his good faith and due care. A trustee who distributes property under a mistake of fact is liable only if he was either in a position to discover the facts or could have taken preventive steps to foreclose the known claimant but failed to do so.") If in doubt, the fiduciary is advised to seek judicial guidance from the court.

> ***Query***: A fiduciary under a testamentary trust is directed to pay income to X for life and then to X's "wife" for life and then to X's descendants. At the time the will was signed and the testator died, X was married to Y. Subsequently, X divorces Y and marries Z. At X's death, who is the "wife" and consequentially should receive the income: Y or Z?

3. Specific Situations of Mispayment

The following are a few of the potential scenarios the fiduciary may encounter during administration of an estate or trust:

a. Payment to Deceased Beneficiary. A number of cases have dealt with the situation of a trustee continuing to make payments to a beneficiary who has died. The courts generally have held the trustee liable even if he acted in good faith. See *Darling Stores v.*

Fidelity-Bankers Trust Co., 156 S.W.2d 419 (Tenn. 1941) (trustee found negligent for issuing checks to beneficiary after beneficiary's death that were, with the trustee's knowledge, cashed by the beneficiary's wife; trustee had an ongoing duty to inquire as to the authority of the wife to cash the checks). See also *In re Sniffin's Estate*, 36 N.Y.S.2d

527 (Surr. Ct. Westchester Cty. 1942), *rev'd* 39 N.Y.S.2d 1017 (App. Div. 1943) (trustee liable for making payments to dead beneficiary notwithstanding fraud by third party). Cf. *Lanston v. American Sec. & Trust Co.*, 32 A.2d 482 (Mun. Ct. App. D.C. 1943) (trustee held not liable when payments made to deceased beneficiary were deemed an "honest mistake").

b. Payment to Remarried Spouse. Often a clause in a will or a trust conditions the continued payment to a spouse until such time as the spouse remarries or dies. In *National Academy of Sciences v. Cambridge Trust Co.*, 346 N.E.2d 879 (Mass. 1976), the testator's will provided that upon the death or remarriage of his wife, the trust fund was to pass to a charity. The trustee continued to make payments to the wife for over 20 years after she remarried. The court ordered the trustee to repay the trust for payments erroneously made to the wife. The court was especially troubled that the bank had made false representations concerning the marital status of the wife.

c. Adopted Children. The issue of whether adopted children may take under a will or trust agreement has been continually debated in the courts and has taken on many evolutions. The fiduciary is obligated to determine if the terms of the governing instrument or applicable law allow for an adopted child or grandchild to inherit. The fiduciary's liability can arise when wrongfully making payments to an adopted child, see *Old Colony Trust Co. v. Wood*, 74 N.E.2d 141 (Mass. 1947) (payment made by trustee to adopted child not permitted under will); or for failing to make payments to an adopted child, see *Estate of Sewell,* 409 A.2d 401 (Pa. 1979) (trustee held liable for neglecting to make payment to adopted child).

➔ **Planning Point:** The duty of the fiduciary to monitor the entitlement of a beneficiary to receive distributions is an ongoing obligation. The fiduciary must first determine who are the rightful beneficiaries. If in doubt, the fiduciary should make independent inquiries or seek judicial guidance. Finally, the fiduciary must establish a practice of continually monitoring the beneficiary prior to making any distributions to ensure that the beneficiary's interest has not terminated.

F. Use of Exculpatory Provisions

1. General

Often a will or trust instrument will contain an exculpatory provision relieving and insulating the fiduciary from liability for a breach of a fiduciary duty. The effectiveness of such a provision is not always guaranteed and may depend on a number of factors. Courts readily limit the enforceability of such provisions when the particular breach does not fall within the precise scope of the applicable provision; it would be against public policy to relieve the trustee from liability for the particular breach, or if the provision was improperly inserted in the trust instrument. See SCOTT ON TRUSTS (4th ed.) Section 222.

a. Restatement (Second). Section 222(1) of the RESTATEMENT (SECOND) provides that the trustee generally can be relieved of liability for breach of trust except: (1) for breach of trust committed in bad faith, intentionally or with reckless indifference to the interest of the beneficiary; (2) for liability for any profit which the

trustee derived from a breach of trust; and (3) where a provision relieving the trustee of liability for breaches of trust is inserted in the trust instrument as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor. The comments to Section 222 provide that exculpatory provisions are to be strictly construed and cannot relieve the trustee of liability where to do so would be contrary to public policy.

The Uniform Trust Code ("UTC") was adopted by the Conference of Commissioners on Uniform State Laws in 2000 and has been enacted in 20 jurisdictions. Section 1008 of the UTC is almost identical to Section 222 of the RESTATEMENT (SECOND), except that the UTC permits a settlor to exculpate a trustee for a profit that the trustee made from the trust (other than as a result of bad faith or reckless indifference to the purposes of the trust or interests of the beneficiaries).

b. Majority Approach. A majority of states have either adopted the RESTATEMENT (SECOND) approach to enforceability of exoneration provisions or have adopted a similar approach permitting exculpatory clauses within certain set limits. In these jurisdictions, exculpatory clauses may relieve the trustee from liability for errors of judgment, failure to diversify trust investments, or the acts or defaults of co-trustees. See *Hanson v. Minette*, 461 N.W.2d 592 (Iowa 1990) (exculpatory clause valid to relieve trustee from liability for negligent breach of duty); *Estate of McCredy*, 470 A.2d 585 (Pa. Super. 1983) (trustee relieved of liability for purchase of stock in corporation of which he was an officer, director and stockholder). As a general rule, however, such jurisdictions will not permit exculpatory clauses to relieve the fiduciary for liability beyond ordinary negligence. See *Collins v. Storer Broadcasting Co.*, 120 S.E.2d 764 (Ga. 1961) (settlor may relieve trustee of liability for involuntary, inadvertent, negligent, mistaken, careless or accidental default that does not rise to the level of willful default).

c. New York Approach. New York has adopted a statute severely restricting the enforceability of exculpatory clauses. See New York Estates, Powers and Trusts Law Section 11-1.7. The New York statute provides that any provision in a will exonerating a trustee from liability for failure to exercise reasonable care, diligence and prudence is void as against public policy. Therefore, in *Matter of Allister*, 545 N.Y.S.2d 483 (Surr. Ct. 1989), the court held that a provision authorizing the retention of assets by the trustee in his uncontrolled discretion without liability for any decrease in value was void as against public policy as an attempt to exonerate the fiduciary from the duty of exercising reasonable care and prudence. Similarly, in *Matter of Lubin*, 539 N.Y.S.2d 695 (Surr. Ct. 1989), the court held that a will clause attempting to exonerate the fiduciary for any loss or injury to the property except as may result from fraud, misconduct or gross negligence was void as against public policy because it attempted to exonerate the fiduciary from liability for failure to use reasonable care, diligence and prudence. EPTL Section 11-1.7 does not apply to the trustee of an *inter vivos* trust. See *Bauer v. Bauernschmidt*, 589 N.Y.S.2d 582 (App. Div. 1992) (upholding validity of provision in *inter vivos* trust that fiduciary was not to be held liable for any act or failure to act where he acted in good faith).

d. Texas Approach. Some states, including Texas, have taken a less restrictive approach to exculpatory clauses. Under the Texas statute, the settlor may relieve the trustee of certain duties, liabilities, or restrictions imposed by the Texas Trust Code. V.T.C.A., Property Code §113.059. See *Corpus Christi Nat'l Bank v. Gerdes*, 551

S.W.2d 521 (Tex. Civ. App. 1991) (exculpatory clause enforced even in case of gross negligence); *Burnett v. First Nat'l Bank of Waco*, 567 S.W.2d 873 (Tex. Civ. App. 1978), *writ refuse n.r.e.* (1978) (trustee exonerated of liability for loaning money to companies owned by settlor/beneficiary); *Neuhaus v. Richards*, 846 S.W.2d 70 (Tex. Ct. App. 1992), *reh'g overruled* (1993), *writ granted* (1993), *set aside,* 871 S.W.2d 182 (Tex. 1994) (trustee relieved of duty to comply with prudent person standard).

2. Public Policy

An exculpatory clause may not relieve a trustee of liability where to do so would violate public policy. Therefore, a trustee is liable if he acts in bad faith or with reckless or intentional disregard of the interests of the beneficiaries. See SCOTT ON TRUSTS (4th ed.) Section 222.3; *Feibelman v. Worthen Nat'l Bank*, 20 F.3d 835 (8th Cir. 1994) (under Arkansas law, trust instrument cannot relieve the trustee of liability for breach of trust committed with reckless indifference of beneficiary's interest); *Mest v. Dugan*, 790 P.2d 38 (Or. Ct. App. 1990) (where trust permitted self-dealing by trustees, they are exonerated for self-dealing in the absence of bad faith).

3. Strict Construction

Exculpatory clauses are strictly construed by the courts and a fiduciary is relieved from liability only to the extent it is expressly provided in the trust instrument that he is entitled to such relief. See *Perling v. Citizens & Southern Nat'l Bank*, 300 S.E.2d 649 (Ga. 1983) (trustees were relieved from duty of acting as prudent men in clear and unambiguous terms); *Grizzle v. Texas Commerce Bank*, 38 S.W.3d 265 (Tex. Ct. App. 2001) (exculpatory provisions are strictly construed and the trustee is relieved from liability only to the extent clearly provided in the trust instrument).

4. Abuse of Discretion

An exculpatory provision is not effective to relieve the trustee from liability if it was improperly inserted in the trust instrument, such as where the person named as trustee inserts the provision and in so doing abuses an existing fiduciary or confidential relationship. See SCOTT ON TRUSTS (4th ed.) Section 222.4; *Jothann v. Irving Trust Co.*, 270 N.Y.S. 721 (Sup. Ct. 1934), *aff'd*, 277 N.Y.S. 955 (App. Div. 1935) (reformation permitted where testatrix had little business experience and relied on advice of corporate trustee in preparation and execution of will). The comments to the RESTATEMENT (SECOND) provide the following factors to be considered in determining whether an exculpatory provision was improperly inserted in the trust instrument:

- Whether the trustee prior to the creation of the trust had been in a fiduciary relationship to the settlor, as where the trustee had been guardian of the settlor.
- Whether the trust instrument was drawn by the trustee or by a person acting wholly or partially on his behalf.
- Whether the settlor had taken independent advice as to the provisions of the trust instrument.
- Whether the settlor was a person of experience and judgment or was a person unfamiliar with business affairs or was not a person

of much judgment or understanding.

- Whether the insertion of the provision was due to undue influence or other improper conduct on the part of the trustee.
- The extent and reasonableness of the provision.

Unlike the RESTATEMENT (SECOND), Section 1008(b) of the UTC establishes a rebuttable presumption that an exculpatory clause drafted by the trustee is invalid. To overcome the presumption of abuse, the trustee must establish that the clause was fair and that its existence and contents were adequately communicated to the settlor. The following factors are suggested for consideration in determining whether the clause was fair:

- The extent of the prior relationship between the settlor and trustee.
- Whether the settlor received independent advice.
- The sophistication of the settlor with respect to business and fiduciary matters.
- The trustee's reasons for inserting the clause.
- The scope of the particular provision inserted.

➔ **Planning Point:** The prudent fiduciary will insist that the governing instrument contain an exculpatory provision that affords the fiduciary the greatest protection. The fiduciary, however, must insist that the settlor independently review and approve the scope of the provision, especially where a prior fiduciary or confidential relationship exists between the fiduciary and the settlor.

G. Unauthorized Practice of Law

1. General

Every state prohibits non-attorneys from engaging in the unauthorized practice of law. The penalty for the unauthorized practice of law can range from the fiduciary being required to disgorge profits, being enjoined from acting, and even criminally prosecuted. See New York Judiciary Law Section 478. What activities constitute the "practice of law" is defined by each state's statutes, case law, and advisory and disciplinary opinions, and must be determined on a case-by-case basis.

It is becoming more and more common for banks, trust companies, investment advisors, investment banks, and insurance companies to offer services to their clients that extend beyond their traditional scope. For example, it is rare to find a trust company or investment bank that does not offer estate planning services to their clients. Some companies are even going so far as to prepare estate planning documents for their client (*e.g.*, wills and revocable trusts).

This section will discuss how various jurisdictions treat these activities and what the attorney should be aware of when working with fiduciaries offering such services.

2. Estate Planning Kits and "How to" Books

a. **Estate Planning Kits**. The general view is that the drafting of a

will or the supervision of its execution by a non-attorney constitutes the unauthorized practice of law. See 22 A.L.R.3d 1112. In addition, giving advice as to the contents and legal effect of a will was also deemed the unauthorized practice of law. *Indiana State Bar Ass'n v. Osborne*, 172 N.E.2d 434 (Ind. 1961). Frequently, banks, trust companies, and others sell estate planning kits that discuss estate planning techniques and provide forms for the reader to use when implementing these techniques (*e.g.*, blank will and trust agreement forms). The courts are divided as to whether this constitutes the unauthorized practice of law. In *The Florida Bar v. American Senior Citizens Alliance*, 689 So.2d 255 (Florida 1997), the court held that a corporation in the business of creating and selling estate planning documents was engaged in the unauthorized practice of law when non-attorney employees answered specific legal questions, determined appropriateness of different documents for clients, and assembled and drafted documents. See also *Unauthorized Practice of Law Commission v. Parsons*, 1999 WL 47235 (N.D. Tex. 1999), vacated and remanded 179 F.3d 956 (5th Cir. 1999). Others have held that the "mere gathering of information" by the non-attorney so that an attorney may complete the estate planning documents is not prohibited. See *The Florida Bar Re Advisory Opinion--Nonlawyer Preparation Of Living Trust*, 613 So. 2d 426, 428 (Fla. 1992) ("gathering the information … does not constitute the practice of law, and nonlawyers may properly perform this activity").

b. "How To" Books. A number of cases have held that the publication of "how to" books that advise the reader on general issues of law and how to represent themselves does not constitute the unauthorized practice of law. See *People v. Landlords Professional Services*, 264 Cal. Rptr. 548 (Cal. 1989); *New York County Lawyer's Ass' v. Dacey*, 234 N.E.2d 457 (N.Y. 1967) (publication of "How to Avoid Probate" book did not constitute the practice of law). A number of the cases addressing the "how to" category of cases stress the fact that there is no direct one-on-one contact between the author and the reader.

> ***Query***: What if the non-attorney author discusses the contents of the book at a seminar? Should it matter if there is a question-and-answer portion to the seminar?

c. Drafting and Funding Living Trusts. As more and more attorneys are advising their clients to establish and fund living revocable trusts, ostensibly to avoid the difficulties associated with probate, the issue of what services a non-attorney may offer arises in connection with such trusts. See *The Florida Bar Re Advisory Opinion--Nonlawyer Preparation Of Living* (the Supreme Court of Florida held that the assembly, drafting, execution and funding of a living trust document constitutes the practice of law); *People v. Volk*, 805 P.2d 1116 (Colo. 1991) (the creation and sale of trust documents by non-attorneys constitutes the unauthorized practice of law). See also, *Cleveland Bar Ass'n v. Yurich*, 642 N.E.2d 79 (Ohio 1994) (corporation formed to market and sell living trusts to clients engaged in unauthorized practice of law). As discussed above, however, the mere gathering of necessary information for a living trust does not constitute the practice of law, and, thus, non-lawyers may properly perform that activity. See *The Florida Bar Re Advisory Opinion--Nonlawyer Preparation Of Living* at 428.

3. Providing Estate Planning Advice

The trend towards the offering of estate planning advice by non-attorneys brings to the forefront the issue of what are the limits, if any, of the estate planning advice that the non- attorney can provide.

a. **Prohibited Activity**. In *Green v. Huntington Nat'l Bank*, 212 N.E.2d 585 (Ohio 1965), a bank's repeated practice of giving specific legal information in relation to the specific facts of a client's estate plan for the purpose of obtaining beneficial tax and other legal results was held the unauthorized practice of law. The court did not find it sufficient that the bank advised the client to obtain independent legal counsel. The bank gave the advice with the reasonable expectation that it would receive full compensation in the form of being retained to provide fiduciary services for the client. See also *Trumbull County Bar Ass'n v. Hanna*, 80 Ohio St. 3d 58 (Ohio 1997) (non-attorney financial planner, who reviewed estate planning analysis and advised clients that *inter vivos* trusts would be suitable for their needs, held to have engaged in unauthorized practice of law).

b. **Permitted Activity.** A fiduciary may discuss estate planning techniques with a client as they are generally applied (*i.e.*, discussion of the structure of the estate and gift tax laws and general use of marital and by-pass trusts in estate planning). In addition, a bank or trust company is permitted to discuss and cooperate with counsel for the client, who is a prospective customer of the bank, any and all of the legal problems involved in the planning and administration of a particular client's estate planning needs. *Green v. Huntington*; see also *Pietz v. Toledo Trust Co.*, 577 N.E.2d 1118 (Ohio Ct. App. 1989) (trust company not engaged in unauthorized practice of law when it advised testator's attorney to make changes to trust agreement). In addition, once a bank is appointed as trustee, it may handle most of the probate and other legal work necessary to administer the trust, including appearing in court. The fiduciary, however, should be careful when undertaking certain tasks associated with the attorney's traditional role, especially if the individual is not a corporate fiduciary. See *In Re Graham*, 30 Pa. D. & C. 531, 534 (Pa. 1935) ("any person not licensed to practice law who prepares and files an inheritance tax return, without the advice and consent of legal counsel for the personal representative, renders legal advice, and, therefore, engaged in unauthorized practice of law").

4. Attorney Abetting in Unauthorized Practice of Law

The attorney is ethically and legally prohibited from assisting non-attorneys in the unauthorized practice of law. Accordingly, the attorney must familiarize himself with what constitutes the unauthorized practice of law by the non-attorney.

Model Rule 5.5 provides that an attorney shall not "assist a person who is not a member of the bar in the performance of activity that constitutes the unauthorized practice of law." Model Code DR 3-101(A) ("[a] lawyer shall not aid a nonlawyer in the unauthorized practice of law"). These rules are brought into question each time the attorney assists a fiduciary in any of the activities discussed earlier in this section. See Illinois State Bar Association, Opinion No. 91-10 (October 25, 1991) (attorney held to be aiding unauthorized practice of law when attorney participates in a financial planning company's arrangement whereby the company gathers information necessary to prepare estate planning documents, prepares the documents, and send the documents to the client's selected attorney for review, legal advice, and execution); *People v. Boyls*, 591 P.2d 1315,

1316 (Colo. 1979) (lawyer suspended for one year for aiding non-attorney "educators" in marketing living trusts).

- ➔ **Planning Point:** Any fiduciary contemplating offering services that extend beyond their basic administrative functions should be careful not to offer legal services to the client. Often, the type of services being offered may become secondary to the manner in which the services are being provided. As a general rule, the fiduciary should speak to the general benefits of the estate planning techniques, rather than the application and the benefits to the client's specific facts. Finally, although the fiduciary may gather the information necessary to implement the estate plan, he should not draft or prepare the documents.