DUTY OF LOYALTY: HOLD ON TO YOUR HAT

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I. DUTY OF LOYALTY GENERALLY

A. Standard of Care

"A trustee shall administer the trust solely in the interests of the beneficiaries." Uniform Trust Code § 802(a). The duty of loyalty is "perhaps the most fundamental duty of the trustee" and is "sometimes expressed as the obligation of the trustee not to place the trustee's own interests over those of the beneficiaries." Uniform Trust Code § 802, cmt.

The personal representative of an estate "shall observe the standards of care applicable to trustees." Uniform Probate Code § 3-703(a). A personal representative has "a duty to settle and distribute the estate…consistent with the best interests of the estate" and "shall use the authority conferred upon him…for the best interests of successors to the estate." Id. "If the exercise of power concerning the estate is improper, the personal representative is liable to interested persons for damage or loss resulting from breach of his fiduciary duty to the same extent as a trustee of an express trust." Uniform Probate Code § 3-712.

B. Self-Dealing

Fiduciary and personal interests occasionally conflict in the investment or management of trust property. Transactions which are "affected by a conflict" are generally voidable by an affected beneficiary. Uniform Trust Code § 802(b). Exceptions include transactions authorized by the trust instrument, approved by court, or ratified by the beneficiary, and those for which objections are barred by the applicable period of limitations. Id.

A substantially similar formulation applies to personal representatives in Uniform Probate Code states. See Uniform Probate Code § 3-713(providing that transactions "affected by a substantial conflict" are voidable by any person interested in the estate "except one who has consented after fair disclosure," unless the decedent expressly authorized the transaction via Will or contract, or unless court approval is obtained).

II. HAT TRICKS

Self-dealing is also an inseparable aspect of the relationship between the fiduciary and beneficiary. During the course of administration, the fiduciary must balance its own interest against the beneficiary's interest in negotiating fees and exculpatory terms, determining disclosure obligations, and obtaining final releases.

A. Throwing Your Hat into the Ring

The duty of loyalty begins before the fiduciary even accepts office. Agreements between the fiduciary and beneficiary are voidable unless "the transaction involves a contract entered into or claim acquired by the trustee before the person became or contemplated becoming trustee." Uniform Trust Code § 802(b)(5). Presumably, if a person is negotiating the terms of his or her own compensation or exculpation, then that person has already "contemplated" becoming trustee.

1. Setting Fees

As an exception to the general rule of voidability, a trustee may enter agreements which are "fair to the beneficiaries" relating to the trustee's appointment or compensation, and a trustee may pay "reasonable compensation" from the trust. Uniform Trust Code §§ 802(h)(1), (h)(2) ; Restatement (Third) of Trusts § 38(1) (2003).

Reasonableness is generally based on facts and circumstances substantially similar to the reasonableness of attorney's fees, namely: "custom of the community; the trustee's skill, experience, and facilities; the time devoted to trust duties; the amount and character of the trust property; the degree of difficulty, responsibility and risk assumed in administering the trust, including in making discretionary distributions; the nature and costs of services rendered by others; and the quality of the trustee's performance." Uniform Trust Code § 708, cmt.; accord Restatement (Third) of Trusts § 38, cmt. c (1) (2003); cf. Model Rules of Professional Conduct R. 1.5(a).

As with attorney's fees, trustee's fees which are set by written agreement will be adjusted by the Court, if they are unreasonably high. See Uniform Trust Code § 708(b)(2); Restatement (Third) of Trusts § 38, cmt. c (1), cmt. e (2003).

Fee disputes tend to center on the reasonableness of the amount, rather than the propriety of the trustee's conduct during the initial negotiation process. See, e.g., In re Six Flags Claims Trust v. Hughes, 2008 Cal. App. Unpub. LEXIS 5435 (Cal. Ct. App. July 2, 2008). Under the trust instrument in Six Flags, the trustee's compensation required prior approval by a majority of the beneficiaries, and the trustee determined not to take any compensation until the resolution of pending litigation. Id. at *5, *7.

The trustee then sent each beneficiary a consent solicitation statement, providing disclosures and seeking approval of a 1% trustee's fee, amounting to approximately $6.4 million. Id. at *8. The consent solicitation statement also sought approval of an additional $38.4 million in professional fees for other advisors and attorneys. Id. Although a majority of the beneficiaries approved the fee awards, a minority objected on the grounds that the solicitation statement contained misleading statements with respect to the $38.4 million in other professional fees. Id. at *10-11. The Trial Court found that the trustee had not acted in bad faith, but had negligently failed to ensure the accuracy of the statement. Id. at *12, 30. On that basis, the Trial Court disallowed the entire trustee's fee. Id. at *12.

The Appellate Court reversed, holding that the trustee's negligence with respect to the other professionals' fees was not a material fact underlying the beneficiaries' approval of the trustee's own compensation. Id. at *32-33. The Appellate Court directed payment of the agreed upon trustee's fee. Id. at *40. Presumably, the trustee's fee amount was deemed reasonable. See id. at *32, n. 15 (commenting that fee amount was modest in relation to size of "fabulous recovery" for beneficiaries).

The objecting beneficiaries in Six Flags took the position that the misleading solicitation statement showed the trustee had a "reckless disregard for the interests of the beneficiaries" which impacted their willingness to approve the 1% trustee's fee. Id. at *9, 30. Nevertheless, the trustee's fee was approved in its entirety, due to the reasonableness of the amount.

2. Negotiating Exculpation

Special scrutiny applies to exculpation agreements. An exculpation clause is invalid to the extent that it "was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor." Uniform Trust Code § 1008(a)(2).

If the trustee drafted the clause or caused it to be drafted, then the clause is per se abusive unless the trustee proves it is "fair under the circumstances and that its existence and contents were adequately communicated to the settlor." Uniform Trust Code § 1008(b).

If the trustee did not draft the clause or cause it to be drafted, then the facts and circumstances relevant to its enforceability may include, inter alia:

whether the trustee prior to or at the time of the trust's creation had been in a fiduciary relationship to the settlor, such as by serving as the settlor's conservator or as the settlor's lawyer in providing the trust instrument or relevant part(s) of it; whether the settlor received competent, independent advice regarding the provisions of the instrument; whether the settlor was made aware of the exculpatory provision and was, with whatever guidance may have been provided, able to understand and make a judgment concerning the clause; and the extent and reasonableness of the provision.

Restatement (Third) of Trusts § 96(1), cmt. d (2012).

Not all jurisdictions have adopted a presumption of abuse where the trustee was the drafter of the clause. See, e.g., Mass. Gen. Laws. ch. 203E, § 1008(b) (providing that "exculpatory term drafted or caused to be drafted by the trustee *may* be invalid" unless trustee

proves that its existence and contents were adequately communicated to settlor)(emphasis added); accord Marsman v. Nasca, 573 N.E.2d 1025, 1027, 1032 (Mass. App. Ct. 1991)(upholding exculpatory clause, where trial court failed to make finding of overreaching or abuse by trustee who drafted clause); Cal. Prob. Code § 16461 (invalidating exculpation for intentional breaches, gross negligence, bad faith, or reckless indifference, but providing no elevated scrutiny for exculpation drafted by trustee); Nev. Rev. Stat. § 163.160 (same); Tex. Prop. Code § 114.007(b) (invalidating exculpatory clause inserted by abuse of trustee, but not raising presumption of abuse if trustee was drafter).

The use of independent counsel may sometimes be a prerequisite for, and certainly will help to cleanse, a trustee-drafted exculpation clause. In Fred Hutchinson Cancer Research Center v. Holman, 732 P.2d 974 (Wash. 1987), the attorney-trustee drafted Will provisions exonerating the trustee from any loss or damage incurred in reliance on legal counsel and deeming the trustee's good faith actions to be conclusive and binding on all interested parties. Id. at 976-77. The trustee then relied on legal opinions prepared by himself regarding the reasonableness of his trustee's fee, and also relied on the good faith clause, to defend against a surcharge for excessive fees. Id. at 980. The Court held that as the attorney who drafted the testator's Will, the trustee was "precluded from reliance on this clause to limit his liability when the testator did not receive independent advice as to its meaning and effect." Id.; but see Wash. Rev. Code § 11.98.107(b) (raising presumption of abuse "unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the trustor," but not specifying that use of independent counsel must be part of this showing).

B. Keeping It under Your Hat: Disclosure and Privilege

Trustees must place beneficiaries' interests before their own. See Uniform Trust Code § 802(a). If a dispute arises, an innocent trustee may defend himself or herself despite any incidental benefit to the trustee's self-interest. See Restatement (Third) of Trusts § 88, cmt. d (2007) (providing for indemnification if trustee is cleared of charges).

While defending against misconduct charges, and "[w]hether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter." Restatement (Third) of Trusts § 78(3) (2007).

1. Duty to Disclose Material Facts

The trustee's duty of disclosure will supersede the trustee's self-interested considerations. The trustee does not have the option of sitting on material facts which could be hazardous to the trustee and waiting for a beneficiary to force a disclosure.

In Janowiak v. Tiesi, 932 N.E.2d 569 (Ill. App. Ct. 2010), the defendant found himself in the tricky, but not uncommon, position of a conflict between his fiduciary duties as attorney for Father and trustee for Son. Son asked the trustee for information regarding the value of his trust's stock in the family company. Id. at 574. The trustee declined to provide valuation information without Father's consent. Id. The trustee then resigned, citing a general conflict of interest as Father's attorney, and naming Son as successor trustee. Id. After resigning, the defendant obtained a general release from Son for actions or omissions as trustee. Id. at 588. Father then bought out Son's trust's share of the family company on the basis of a valuation report which allegedly understated its value by approximately 65%. Id. at 574-75.

The Court held that Son could state a claim for breach of fiduciary duty on the basis of the trustee's alleged failure to disclose material information about Father's valuation of the company. Id. at 582-83. Even though Son could have obtained similar information by asserting his own shareholder rights, the Court held that "a trustee cannot simply delegate his own duty to provide information to his beneficiary or force the beneficiary to find other avenues for information he is rightfully owed." Janowiak, 932 N.E.2d at 583-85; see also In re Green Charitable Trust, 431 N.W.2d 492 (Mich. Ct. App. 1988)(finding breach of duty of loyalty where attorney served as co-trustee of charitable trust which sold real estate to client of attorney's law firm, attorney purportedly recused himself as trustee from decision to accept client's offer but still participated in sale negotiations, and attorney failed to disclose full extent of attorney's prior representation of client who purchased trust's real estate and failed to give beneficiaries prior notice of material facts about proposed sale).

In Ramsey v. Boatmen's First National Bank, 914 S.W.2d 384 (Mo. Ct. App. 1996), the settlor's son and a bank were acting as co-trustees of the settlor's revocable trust. Id. at 386. The settlor was elderly and unsophisticated in financial matters. Id. The bank passively allowed the settlor's son to invest the trust heavily in limited partnerships in which the son was interested and to make unsecured loans to himself which were ultimately discharged in bankruptcy. Id. at 386-87. Even though the settlor consented to these investments in writing at her son's request, the Court held the bank liable for breach of fiduciary duty. Id. at 387-88.

The Court found that the bank had a duty to advise the settlor of the "conflict of interest created by investing in a co-trustee's ventures and in making the loans." Id. at 388. The bank also breached its duty by failing to communicate directly to the settlor the material fact that the bank "had a policy of not investing in limited partnerships of this kind because [the bank] considered such investments nonquality investments for trusts" and had in fact divested another client's trust of identical investments by selling them to the settlor's trust. Id. at 387-88.

2. Privileged Communications

Beyond the trustee's duty to communicate material facts, the so-called "fiduciary exception" to attorney-client privilege in some jurisdictions might require a trustee to produce attorney communications which do not contain material facts. The fiduciary exception "stems from a principle of English trust law that requires a trustee to comply with a beneficiary's request to produce all legal advice that the trustee has obtained on matters concerning administration of the trust." Hammerman v. Northern Trust Co. (In re Kipnis Section 3.4 Trust), 329 P.3d 1055, 1059 (Ariz. Ct. App. 2014).

In general, "[a] trustee is privileged to refrain from disclosing to beneficiaries or co-trustees opinions obtained from, and other communications with, counsel retained for the trustee's personal protection in the course, or in anticipation, of litigation (e.g., for surcharge or removal)." Restatement (Third) of Trusts § 82, cmt. f (2007). In jurisdictions which recognize the fiduciary exception, a trustee can be compelled to produce "legal consultations and advice obtained in the trustee's fiduciary capacity concerning decisions or actions to be taken in the course of administering the trust." Id.

The distinction between "personal" and "fiduciary" communications does not always correspond to the ultimate liability for the attorney's fees. Id.; accord Hammerman, 329 P.3d at 1062-63 (finding that content determines applicability of fiduciary exception and that personal communications "do not cease to be privileged merely because the trustee used trust funds to compensate the attorneys"). A trust must generally pay attorney's fees for the defense of a trustee who has been vindicated, even though the trustee's "personal" interest was also at risk. See Restatement (Third) of Trusts § 88, cmt. d (2007). If the trustee is held to be in breach, then the trustee must pay its own attorney's fees, but does not forfeit the attorney-client privilege. See Uniform Trust Code § 709, cmt.

The Uniform Trust Code remains intentionally silent on "the extent to which a trustee may claim attorney-client privilege against a beneficiary seeking discovery of attorney-client communications between the trustee and the trustee's attorney. The courts are split because of the important values that are in tension on this question." Uniform Trust Code § 813, cmt. .

Courts on both sides of the divide agree that a trustee's duty to communicate material facts is not curtailed by privilege. A trustee might not have to produce a specific communication which contains a material fact, but the trustee must still disclose the material fact itself. See, e.g., Uniform Trust Code § 813, cmt. (noting that trustee has duty to communicate to beneficiaries such "material facts necessary for them to protect their interests, which could include facts that the trustee has revealed only to the trustee's attorney"); Hammerman, 329 P.3d at 1061 (holding that "attorney-client privilege does not permit a trustee to withhold "material facts" from a beneficiary simply because the trustee has communicated those facts to an attorney"); Huie v. DeShazo, 922 S.W.2d 920, 923 (Tex. 1996)(holding that duty to disclose material facts "exists independently of the rules of discovery" and "extends to all material facts affecting the beneficiaries' rights," unlimited by any attorney-client privilege); Wells Fargo Bank v. Superior Court, 990 P.2d 591, 597 (Cal. 2000)(granting privilege to trustees will not shield deliberations about trust administration, because facts themselves do not become privileged "merely by being communicated to an attorney").

The corporate trustee's position in Hammerman is cringeworthily familiar. The beneficiary exercised its right to remove Northern Trust as trustee, following disagreements over real estate management. 329 P.3d at 1058. In the time period leading up to its removal, Northern Trust exchanged e-mails with its attorneys seeking advice on how to respond to the beneficiary's threats of litigation. Id. at 1058-59. The beneficiary then moved to compel Northern Trust to produce all of its e-mails with its attorneys, and Northern Trust withheld a small group of e-mails on the grounds of privilege. Id. Adopting the fiduciary exception to privilege, the Court held that the trial court should review all of the withheld e-mails, in chambers, to determine whether their content related to trust administration or to Northern Trust's self-protection. Id. at 1061, 1065. (The real lesson, of course, is not to put embarrassing comments in e-mails.)

Jurisdictions which have declined to adopt the fiduciary exception often cite the same policy reasons underlying the doctrine of attorney-client privilege in general. See, e.g., Huie, supra, 922 S.W.2d at 923-24 (finding that "trustee must be able to consult freely with his or her attorney to obtain the best possible legal guidance. Without the privilege, trustees might be inclined to forsake legal advice, thus adversely affecting the trust, as disappointed beneficiaries could later pore over the attorney-client communications in second-guessing the trustee's actions. Alternatively, trustees might feel compelled to blindly follow counsel's advice, ignoring their own judgment and experience.").

C. Hats Off: Negotiating Releases

A trustee's failure to communicate material facts will impact the enforceability of any releases, as will the way in which the release is postured. "A release by a beneficiary of a trustee from liability for breach of trust is invalid to the extent:

1. it was induced by improper conduct of the trustee; or

2. the beneficiary, at the time of the release, did not know of the beneficiary's rights or of the material facts relating to the breach."

Uniform Trust Code § 817(c); see also Uniform Trust Code § 1009; Restatement (Third) of Trusts § 97 (2012).

1. Improper Conduct Inducing Release

Like fee agreements, exculpations, and disclosure requirements, the negotiations surrounding beneficiary releases raise inherent conflicts between a trustee's self-interest and the beneficiary's interest. If a trustee crosses the line between insisting on an orderly winding-up and abusing its power to obtain a release, the release may not hold.

The common practice of withholding distributions until releases are signed can constitute "improper conduct" under certain circumstances. In California, for example, a trustee "may not require a beneficiary to relieve the trustee of liability as a condition for making a distribution or payment to, or for the benefit of, the beneficiary, if the distribution or payment is required by the trust instrument." Cal. Prob. Code § 16004.5(a). The statute is intended to protect beneficiaries from having to choose between an overreaching release and litigation costs which may be prohibitive. See Bellows v. Bellows, 125 Cal. Rptr. 3d 401, 405 (Cal. Ct. App. 2011)(citing legislative history).

In Bellows, the beneficiary objected to certain expenses in the trustee's accounting. Id. at 402. The trustee offered to settle the objection by splitting the difference with the beneficiary, since the trustee was himself a 50% beneficiary in his personal capacity. Id. at 402-03. However, the trustee tried to condition the beneficiary's entire distribution, and not just the portion in dispute, on a complete release. Id. at 403.

The Court refused to enforce the release, stating that the trustee could not "extract from the beneficiary an agreement to accept a compromise concerning a disputed issue as a condition of receiving a distribution to which the beneficiary is unquestionably entitled." Id. at 405. Instead, the trustee should have distributed the undisputed portion, then offered to settle the disputed portion for a separate payment, or filed a petition for instructions regarding the disputed amount. Id. at 404-05.

Even in states without special statutory protections like Cal. Prob. Code § 16004.5(a), a conditional distribution might be deemed improper conduct. See, e.g., Stout v. Arwood (In re Robert Stout Revocable Trust), 2014 Mich. App. LEXIS 137, at *17-19 (Mich. Ct. App. Jan. 23, 2014). The trustee in Stout expressly stated that the trustee would not make a final distribution to the beneficiary until the beneficiary signed the trustee's

release and indemnification agreement. Id. The Court held that nothing in the trust instrument, or applicable law, authorized the trustee to withhold a mandatory distribution on the basis that the beneficiary had not signed a receipt. Id. at 19, 22-23. The withholding of the distribution was a breach of fiduciary duty. Id. at 25.

2. Permitted Holdbacks

If a specific amount from an accounting is in dispute, the trustee may withhold the disputed amount. See, e.g., Bellows, 125 Cal. Rptr. 3d at 405 (finding that trustee could have settled disputed fee expense with beneficiary).

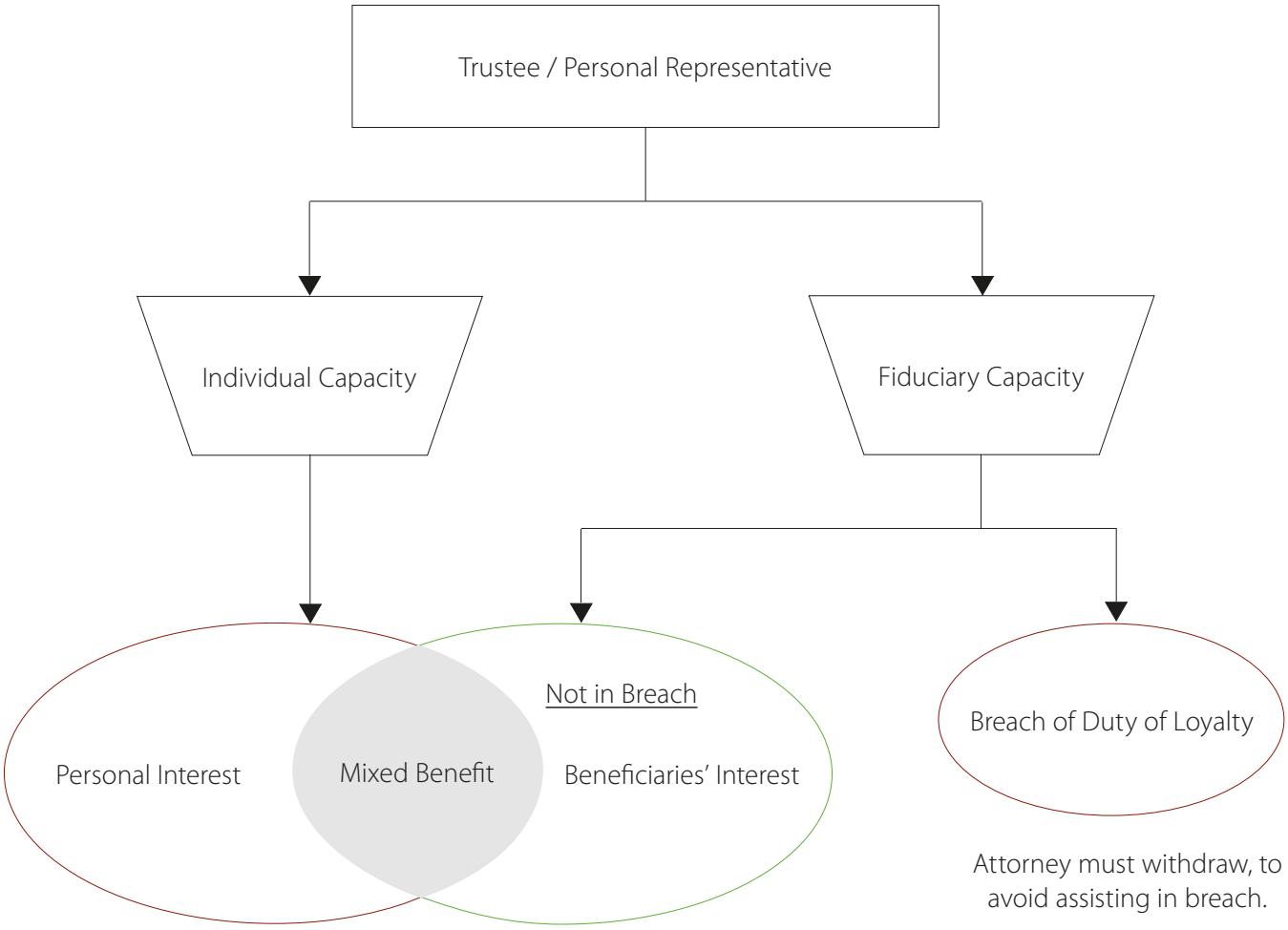
The timing of a final reserve distribution may be delayed until all claims have been resolved, either by private settlement or by instructions from the court. See, e.g., Restatement (Third) of Trusts § 38, cmt. b (2003); Uniform Trust Code § 817(b); Hastings v. PNC Bank, 54 A.3d 714, 728 (Md. 2012); In re Caswell Silver Family Trust, 2011 U.S. Dist. LEXIS 157682, No. CIV 10-934 BB/SMV, at *5, 11-12 (D.N.M. Aug. 15, 2011) (mem. op.); First Midwest Bank/Joliet v. Dempsey, 509 N.E.2d 791, 794, 797 (Ill. App. Ct. 1987) (finding no breach where trustee withheld final distribution when beneficiary refused to sign release, citing trustee's right to approval of its accounts before final distribution, and noting that amount of time required for winding up is based on circumstances).

Communications with the beneficiary should carefully delineate the beneficiary's options to make it clear that distributions will not be withheld indefinitely, pending execution of the trustee's preferred format of release. For example, the corporate trustee in Hastings offered to make a final trust distribution without a formal court accounting, in exchange for the beneficiaries' release and indemnification. Id. at 720-21. The beneficiaries alleged that the trustee breached its duty of loyalty by withholding final payments until execution of the release and indemnification. Id. at 722. The Court held that if the terms of a release would be valid with consent, the trustee does not breach its duty of loyalty merely by giving the beneficiaries the option of executing the release. Id. at 726 (reasoning that "[i]t almost goes without saying that, if the law countenances consent to what would otherwise be a breach of the duty of loyalty, the law also must countenance requests for consent. If not, then a trustee would be unable to solicit consent without first breaching the duty").

The beneficiaries also alleged that the terms of the release were so favorable to the trustee that they breached the duty of loyalty by putting the trustee's interest ahead of the beneficiaries' interest. Id. at 725. The Court acknowledged that a few terms of the release agreement were materially different from the protection that the trustee could have obtained through court approval of its accounting and discharge. Id. at 728. Since the differences were "of degree rather than kind" and "not a radical departure from the common law protection and statutory right" to which the trustee was already entitled, the trustee did not breach its duty to put the beneficiaries' interests first. Id. The beneficiaries had the option of negotiating a more limited release or rejecting the release and accepting the delays of formal court proceedings. Id.

Similarly, the trustees' offer to distribute 90% and hold back 10% for final taxes and expenses, including attorney's fees to resolve disputes with the beneficiaries, was found to be reasonable in Caswell Silver. 2011 U.S. Dist. LEXIS 157682, at *5, 11-12. The trustees had the right to refuse the beneficiaries' demand for an immediate distribution of the entire trust estate and to file a petition for instructions and discharge. Id. at *10, 12-13.

DUTY OF LOYALTY



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