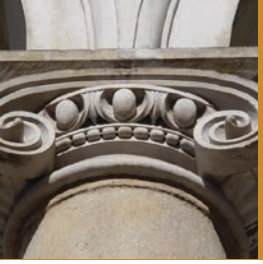

By **Kim Kamin**

Ethical Considerations in Thorny Trusteeships

Don't get pricked by complacency

Being a trustee always has challenges. Trustees must fulfill their duties of loyalty by avoiding conflicts and putting beneficiaries' interests before their own. Some trusteeships, however, can be particularly thorny in that they have inherent structural conflicts requiring careful navigation. For example, when an advisor or beneficiary is also a trustee or when the trustee function is divided among separate parties, the potential for conflict and complication increases. Just because the governing laws or instruments purportedly permit such conflicts or appear to relieve trustees of liability, trustees aren't necessarily fully excused from their ethical duties to avoid favoring self-interest and protect beneficiaries from harm. Pure reliance on the protections given to them under the governing statutes or the governing instruments may lull them into complacency. Without paying careful attention to the ethics of the situation, the beneficiaries or the trustees themselves may get pricked.

Moreover, from a relationship perspective, beneficiaries often find it disconcerting when they perceive their trustee as more concerned with self-protection than with protecting the beneficiaries' interests.

Professional Advisors as Trustees

Attorneys,[1] accountants,[2] life insurance agents[3] and financial advisors[4] who serve as trustees are governed not only by fiduciary and civil malpractice laws, but also by the ethical standards of the rules of their professions.[5] While, generally, there aren't ethical or legal prohibitions against an advisor being a trustee, professional firms often prohibit, or at least discourage, their partners and employees from serving in that capacity. Sometimes advisors, particularly attorneys and accountants, are viewed as good trustee candidates because they have specialized skills, knowledge and ethical training that can be useful when administering trusts.[6] However, such advisors must have the requisite knowledge and experience necessary to comply with the competency requirements of their profession. Other pointed concerns arise both with drafting conflicts and administration conflicts.

A trusted advisor being named as trustee risks overreaching or unduly influencing the client simply because of the pre-existing relationship.[7] Accountants and other advisors run this risk, yet have an added layer of insulation because the drafting attorney serves as intermediary. Drafting attorneys don't have such protections. Under the current American Bar Association Model Rules (the Model Rules), attorneys can seek appointment as a fiduciary, but must not allow self-interest to cloud their exercise of independent professional judgment in recommending trustees.[8] When there's a significant risk that the attorney's independent professional advice will be "materially limited," the attorney must obtain the client's informed consent in writing.[9] An attorney may prepare an instrument appointing himself as trustee only if the client is properly informed, the appointment doesn't violate the conflict of interest rules of Model Rule 1.7 and the appointment doesn't result from undue influence or improper solicitation by the attorney.[10]

Exculpatory provisions. Including exculpatory provisions that attempt to insulate the drafting attorney from liability as trustee is another bramblebush. Such provisions seek to exonerate trustees from liability for certain acts and omissions. But, courts will strictly construe such clauses, and those clauses won't apply to breaches of fiduciary duties falling outside the clauses'

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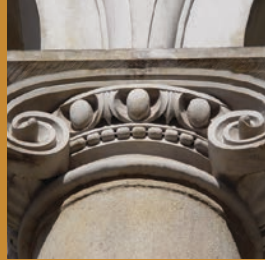

scope.[11] Exculpatory clauses won't relieve a trustee of liability for breaches of trust committed intentionally, in bad faith, with reckless indifference to the beneficiary's interests or for profits the trustee derived from the breach.[12] In determining whether an exculpatory clause was inserted into the trust instrument as a result of an abuse of a fiduciary or confidential relationship, factors to consider include the extent and reasonableness of the provision, as well as whether: (1) a fiduciary relationship existed prior to the creation of the trust; (2) the settlor received independent advice; (3) the settlor is a person of experience and judgment; and (4) the provision was inserted due to undue influence or other improper conduct.[13] Further, under Uniform Trust Code (UTC) Section 1008, an exculpatory clause is unenforceable to the extent it:

> . . . relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.[14]

Compensation. The heart of any advisor's potential ethical conflict in serving as trustee is the possibility that the advisor is seeking to secure a future stream of trustee fees. Accordingly, the advisor should discuss with the settlor the possibility that, as trustee, the advisor may (or perhaps intends to) select his firm to serve as the attorney, accountant or financial advisor for the trust, with the result that additional fees for such service would be received. The trust instrument should specifically authorize the trustee to hire his own firm, but typically, the most ethical course of action is to avoid charging overlapping fees for multiple services. It's also advisable to inform the beneficiaries of the potential conflicts and other facts surrounding the representation. Moreover, drafting attorneys can avoid the appearance that they seek to receive a lifetime annuity as trustees by including a process for their removal.

In some jurisdictions, the compensation of attorneys acting as trustees is either prescribed by statute or subject to court approval or regulation. Applicable court-approved statutory compensation rates should be persuasive in establishing the reasonableness of the compensation that the attorney receives for such services.[15]

If trust terms don't specify otherwise, the trustee is entitled to compensation that's reasonable under the circumstances.[16] However, most states don't provide a statutory schedule defining a "reasonable" fee. If an attorney will be acting as trustee, he must inform the client of the proposed basis for compensation, whether the amount is subject to statutory limits or court approval and how the compensation will be calculated and approved.[17] Further, the attorney should inform the client what skills he'll bring to the job, as well as what skills and services he expects to pay others to provide, including investment management, custody of assets, bookkeeping and accounting.[18] For professionals who typically bill hourly, fee structures based on their hourly rates and time expended are preferable to flat fees or contingency-based arrangements, as the final fee reflects the actual work done and can clearly be communicated to the client.[19] Regardless of how fees are charged, they should always be checked and adjusted as necessary for reasonableness.

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Representation conflicts. An attorney acting as trustee also faces ethical conflicts between the duties of a fiduciary and the interests of clients being represented. For example, if the attorney/trustee also represented a beneficiary in a claim against the trust and, as trustee, was obligated to oppose the claim, the representation would be materially limited under Model Rule 1.7(a). In that case, representing the beneficiary isn't permissible, even with client consent, because the attorney can't possibly provide competent and diligent representation to the beneficiary while simultaneously defending the trust as trustee.[20] While the Model Rules permit an attorney/trustee to represent a trust beneficiary in unre-

lated matters with the client's consent, the attorney, nonetheless, shouldn't do so if he contemplates any risk that the beneficiary's interests might be compromised by the attorney serving in that role or if, in the attorney's judgment, the beneficiary's consent isn't well informed or well advised.[21]

Because a trustee owes fiduciary duties of loyalty to the beneficiaries regardless of which hat the trustee is wearing, a trustee should avoid putting himself into an unnecessary conflict. For example, an attorney who's acting as trustee of a trust for all of a client's grandchildren may find it impossible to then assist the client in disinheriting some of those grandchildren from the rest of the plan. Taking actions that hurt one or more of the beneficiaries would be inconsistent with the ethical duties to those beneficiaries.

Acknowledging the thorniness and trying to be fair is the hallmark of an ethical trustee.

Beneficiaries as Trustees

When an individual beneficiary serves as trustee, countless exercises of discretion could be ethically compromised by structural conflict. A trustee is bound to the terms of the trust instrument when making allocations of the income and principal. However, the appointment of the individual beneficiary as trustee can create conflict issues when the individual has the ability to favor himself over the other beneficiaries. While these conflicts potentially can be solved within the trust instrument itself, the individual beneficiary/trustee must deal with conflicts ethically and fairly.

For example, when the trustee is an income beneficiary entitled to receive mandatory distributions of all income, he may be tempted to invest the trust so as to increase the income, rather than focus on growing the principal. An individual beneficiary may also be entitled to make discretionary distributions of principal to himself subject to an ascertainable standard, such as health, education, maintenance and support. In situations in which the trustee has the discretionary power to invade the principal if income is insufficient for support, there's a greater danger that the trustee will unduly favor himself over the other beneficiaries. While the settlor may have waived this conflict issue by placing the trustee beneficiary in the situation, the individual should, nonetheless, behave ethically and avoid appearances of impropriety while making decisions. Acknowledging the thorniness and trying to be fair is the hallmark of an ethical trustee.

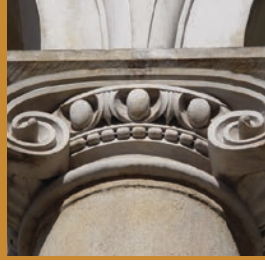
Some states have addressed these issues statutorily. For example, a New York statute formerly prohibited the exercise by a trustee of a discretionary power to distribute to himself, even if the trust instrument authorized the exercise subject to an ascertainable standard. As amended in 2003, the New York statute now contains an exception when the trust instrument allows exercise of a discretionary power, provided there's an ascertainable standard.

These conflicts often can be resolved by delegating to or appointing additional or substitute independent trustees to handle certain aspects of the trust administration. However, many courts have decided that when the settlor creates a conflict by appointing the beneficiary as trustee, the trustee may administer the trust even with the potential danger that he'll favor himself over the remaining beneficiaries.[22] In these situations, it's more important than ever for the beneficiary trustee to focus on his ethical and legal duties and moderate decision-making and actions accordingly.

Divided Trusteeships

A trust instrument can create a directed trust structure when the trustee is mandated to follow the distribution and/or investment directions of other parties. A directed trust limits the trustee's authority and requires the trustee to follow instructions from a third party. Even under a directed trust, the trustee may want to think twice about turning a blind eye or facilitating a breach of trust when the directing party is engaged in an activity that appears unethical. The extent to which the directed trustee will be found liable, however, rests on the applicable local law. It also can be helpful to look to the Employee Retirement Income Security Act as a model for how a directed trustee should behave.[23]

Acting as a directed trustee can be challenging because the directed trustee has limited authority and,



likely, limited access to information. Many states now provide additional protection in these arrangements by enacting directed trust statutes that clarify that a directed trustee who follows such instructions won't be liable for doing so.[24] Under a directed trust, the trust instrument provides that a third party will direct one or more of a trustee's responsibilities. The third party has the power to direct the trustee as to the matter under the third party's control, and the trustee usually has no discretion over that particular area. This arrangement is different from a delegated trust, in which the trustee contracts with a third party to perform certain fiduciary acts on the trustee's behalf. If the director holds the power for his own benefit, the trustee needs only to determine whether the exercise of the power is properly within the scope of the power set forth in the trust. Conversely, if the director holds power in a fiduciary capacity, then the director essentially becomes a co-fiduciary with the trustee, and the trustee must verify that the director's actions don't violate a fiduciary duty.

Under UTC Section 808, while a trust is revocable, the trustee may follow a direction of the settlor that's contrary to the terms of the trust because the settlor has the power to change the terms governing the trust assets. In all other cases, if the terms of a trust confer on a party the power to direct certain actions, the trustee shall act in accordance with that party's directions unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a breach of a fiduciary duty that's owed to the trust beneficiaries. The holder of a power to direct is liable for any loss that results from a breach of a fiduciary duty. A directed trustee needn't specifically delegate the fiduciary duties conferred on the other empowered fiduciary because that transfer of duty is already integrated into the divided structure. However, the trustee must review applicable local law to determine the extent to and circumstances under which the trustee may be liable for the actions (or inactions) of the other empowered fiduciary. Some state statutes further limit the liability of the directed trustee, protecting the trustee from liability when the directed trustee follows the director's instructions. Other state statutes impose liability on a directed trustee only if the trustee's action or inaction results from willful misconduct or gross negligence.[25] Liability may also arise when a directed trustee fails to intervene if that trustee is found to be under an obligation to monitor the director's actions.

For example, in *Rollins v. Branch Banking & Trust Co. of Virginia,* the trust instrument vested the authority to sell, retain or purchase investments with the beneficiaries. The trustee sold stock at the direction of the beneficiaries at a fraction of the original value, and the beneficiaries sued, claiming that the trustee failed to diversify and warn the beneficiaries of the declining condition of the trust investments. The court held that the trustee couldn't be found liable for failing to diversify trust investments because under Virginia law at the time, the trustee couldn't be liable "for any loss resulting from the making or retention of any investment pursuant to such authorized direction."[26] As to the second claim, the court found that the statute didn't exonerate the trustee from liability for "failing to participate in the administration of trust or for failing to attempt to prevent a breach of trust."[27] Thus, a directed trustee could potentially be held liable despite a directed trust arrangement if such trustee failed to warn the beneficiaries or directing party of relevant facts or permitted the party to act in an unethical and blatantly wrong manner. Importantly, in 2012, Virginia amended its directed trustee statute so that a directed trustee today would be less likely to be found liable for failing to protect beneficiaries under such circumstances.

Mennen v. Wilmington Trust et al. also supports the notion that a directed trustee should refuse directions it believes are improper and warn beneficiaries of breaches of duty by a directing trustee.[28] The action was initiated in 2012 by Wilmington Trust filing a petition for instructions seeking, among other things, to remove the directing trustee who was acting improperly. To justify lower fees, it's important for directed trustees to be relieved of a duty to monitor, and many statutes purport to excuse the directed trustee from a duty to warn. However, an attorney acting as directed trustee may have independent duties as a fiduciary to warn beneficiaries, and an ethical corporate trustee should do what Wilmington Trust did by seeking court instructions when a directing trustee appears to be acting inappropriately or directing in a way that violates the trust terms.

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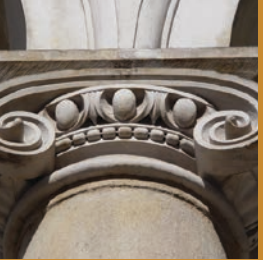

Endnotes

1. *See generally* Amy Kanyuk, "Perils and Potential Profit of a Lawyer Serving as Trustee," 41 *Estate Planning Journal* (2014); Charles D. Fox IV, "Ethical Considerations in Acting as an Executor or Trustee: Do You Really Want to Do This?" 49 *U. Miami Heckerling Inst. on Est. Plan.* Ch 14 (2015).
2. Under the American Institute of CPAs (AICPA) Code of Professional Conduct, an accountant serving as trustee is required to possess the requisite skills and knowledge necessary to render services competently. Similar to attorneys, accountants must: (1) advise the client of the potential benefits and risks of selecting the accountant as trustee, (2) ensure the beneficiaries are aware when the trust is paying trustee fees versus paying for accounting services that the trustee provides, and (3) strive to remain impartial when contending with differing opinions from individual beneficiaries. *See, e.g.,* Ron Klein, "Minimizing Risk Exposures in a Trusteeship," *The CPA Journal* (2009); Douglas D. Wilson, "Providing Guidance to Executors and Trustees," *Journal of Accountancy* (1997), *www.journalofaccountancy.com/issues/1997/oct/wilson.html;* Patricia M. Annino, "What to consider if you're asked to serve as a trustee," *CPA Insider* (2013), *www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2013/CPA/0 ct/ServeTrustee.jsp.*
3. Insurance agents are often required by the state granting them their licenses to take continuing education in ethics. While not as formal or carefully regulated as the ethical guidelines for attorneys and accountants, insurance professionals do have a Code of Professional Responsibility (the origin is in the Code of Ethics of the American Society of CLU & ChFC, the predecessor organization of the Society of Financial Service Professionals). *See* Code of Professional Responsibility of the Society of Financial Service Professionals, *www.financialpro.org/public/code_resp.cfm.* Those with the Chartered Life Underwriter designation must adhere to the American College of Financial Service's Code of Ethics.
4. Registered investment advisors acting as trustees can cause their firms to be treated as having custody of trust assets under the Security and Exchange Commission (SEC) Rules. *See* Question II.2 regarding trustees under SEC "Custody Rule" 206(4)-2 in the Investment Advisers Act of 1940. "Staff Responses to Questions About the Custody Rule," SEC (2013), *www.sec.gov/divisions/investment/custody_faq_030510.htm.*
5. Edward D. Spurgeon and Mary Jane Ciccarello, "The Attorney in Other Fiduciary Roles: Policy and Ethical Considerations," 62 *Fordham L. Rev.* 1357 (1994). Similarly, CPA tax practitioners are subject to many different standards and ethics rules, including AICPA enforceable tax ethics, Circular 230, the Internal Revenue Code, state licensing boards and other regulatory agencies, professional associations and various other laws and regulations. "Tax Ethics & Professional Standards," AIPCA, *www.aicpa.org/interestareas/tax/resources/standardsethics/pages/default.aspx.*
6. Paula A. Monopoli, "Drafting Attorneys as Fiduciaries: Fashioning an Optimal Ethical Rule for Conflicts of Interest," 66 *U. Pitt. L. Rev.* 411 (2005).
7. Spurgeon and Ciccarello, *supra* note 5.
8. American Bar Association Formal Opinion 02-426, "Attorney Serving as Fiduciary for an Estate or Trust" (May 31, 2002). The ABA Opinion is based on the ABA Model Rules.
9. *Ibid. See also* Model Rules of Professional Conduct (MRPC) 1.7 ("Conflict of Interest: Current Clients").
10. "Commentary on Model Rule 1.7," American College of Trust and Estate Counsel Commentaries on the MRPC (4th ed., 2006).
11. 4 *Scott and Ascher on Trusts*, Section 24.27.2; Charles E. Pieterse and Charles W. Coates III, "Exculpatory Clauses May Give Trustees Extra Protection From Liability," 37 *Estate Planning* 26 (March 2010).
12. *Restatement (Second) of Trusts* Section 222(2).
13. *Ibid.,* Section 222 cmt. 3.
14. *See, e.g., Rutanen v. Ballard,* 678 N.E.2d 133 (1997) (trustee found to have abused fiduciary relationship by including an exculpatory clause).
15. ABA Opinion *supra* note 8, *citing* Spurgeon and Ciccarello, *supra* note 5 (providing an overview of statutes and case law regulating compensation when attorney serves as both trustee and attorney for the trust).
16. *See supra* note 12, Section 242 (1959) and Uniform Trust Code Section 708.
17. ABA Opinion *supra* note 8.
18. *Ibid.*
19. Fox, *supra* note 1 *citing* ACTEC Commentaries, MRPC 1.5. In Illinois, it's per se unreasonable for an individual executor or estate attorney to charge fees based solely on a percentage of the estate's asset value. *See, e.g., In Re Estate of Weeks,* 950 N.E.2d 280 (Ill. App. Ct. 2011).
20. ABA Opinion, *supra* note 8. *See also Restatement (Third) of the Law Governing Lawyers,* Section (2000), cmt. c (fiduciary duties that materially and adversely affect lawyer's representation of a client require withdrawal from either the representation or the fiduciary position).
21. *Ibid.* Representation of creditors of a trust in unrelated matters also requires the client's informed consent and, depending on the jurisdiction, the consent of the beneficiaries. ABA Opinion, *supra* note 8.
22. *See, e.g., Lovett v. Peavy,* 316 S.E.2d 754 (Ga. 1984).
23. In Field Assistance Bulletin 2004-3, the U.S. Department of Labor has addressed this issue and provided general guidance regarding certain responsibilities of directed trustees under the Employee Retirement Income Security Act (ERISA). Such directed trustees may not act contrary to the governing instrument or ERISA and may not rely on a representation by the directing party that the fiduciary knows or should know is false.
24. *See* Richard W. Nenno, "Directed Trusts: Making Them Work," 38 *Est. Gifts. & Tr. J.* 159 (March 2013); *See also* Joseph F. McDonald, III "Emerging Directed Trust Company Model," *Trusts & Estates* (February 2012) at p. 49.
25. *See, e.g.,* S.D.C.L. Section 55-1B-2(3); 12 Del. C. Section 3313(c).
26. *Rollins v. Branch Banking & Trust Co. of Virginia,* 2001 WL 34037931 (Va. Cir. Ct.) 1, 2 note 1.
27. *Ibid.* at 3.
28. *Mennen v. Wilmington Trust Company,* C.A. No. 8432-ML, Master LeGrow (Del. Ch. Dec. 8, 2014) (Master's Final Report).