

First Supplement to Memorandum 84-24

Subject: Study L-640 - Trusts (Comments on Liability of Trust and Trustee to Third Persons)

This supplement reviews the comments we have received on the materials in Memorandum 84-24 concerning the liability of the trust and the trustee to third persons. Comments of the Executive Committee of the Probate and Trust Law Section of the Los Angeles County Bar Association (LABA Committee) and the California Bankers Association (CBA) are included in letters attached to Memorandum 84-58. Additional comments by Melvin H. Wilson on behalf of the CBA are attached as Exhibit I to this supplement.

Draft § 4521. Personal liability of trustee arising from ownership or control of trust estate

Draft § 4522. Personal liability of trustee for torts

The LABA Committee expresses concern with the words "personally at fault" in draft Sections 4521 and 4522. (See Memorandum 84-58, Exhibit 3, p. 7.) Similarly, the CBA suggests that these provisions "be clarified to include specific language indicating for what act the trustee has liability." (See Memorandum 84-58, Exhibit 4, p. 7; and Exhibit 1, attached hereto.) The LABA Committee prefers the language of Restatement (Second) of Trusts Section 265, while the CBA would revise draft Sections 4521 and 4522 to make the trustee liable only if the trustee has committed willful misconduct causing loss to the trust.

The staff is puzzled at the confusion over the "not personally at fault" language. Although the draft sections are derived from the Uniform Probate Code, the language in question is no stranger to either California law or the Restatement. Under California case law, the right of reimbursement of a trustee or executor for torts committed by persons employed on behalf of the trust or estate depends upon whether the trustee or executor is "personally at fault". *Johnston v. Long*, 30 Cal.2d 54, 62-63, 181 P.2d 645 (1947). The comments to the relevant sections of the Restatement also employ the personal fault concept. For example, Restatement Section 247 comment b reads, in part:

Where a tort to a third person results from the negligence of an agent or servant properly employed by the trustee in the administration of the trust, and the trustee is not personally at fault,

although the trustee is liable to the third person, he is entitled to indemnity out of the trust estate.

Comment a to Restatement Section 264 reads, in part:

The rule stated in this Section is applicable whether the trustee committed the tort intentionally or negligently or without fault, whether his conduct consisted in action or failure to act, and whether or not he was violating his duties as trustee in acting or failing to act.

Thus it can be seen that the concept "without fault" is used as distinct from intentional or negligent behavior. The suggestion of the CBA to protect the trustee from negligent conduct is at odds with the draft sections previously approved. The effect of the draft sections is to avoid any liability on the part of the trustee for acts of employees if the trustee is not personally at fault. The common law relieved the trustee by providing indemnification in such cases, whereas the draft sections based on the Uniform Probate Code answer the question more directly in terms of liability. Nevertheless, as noted in the comment to draft Section 4524, one purpose of the UPC scheme is to avoid the need to litigate ultimate responsibility in every case. The UPC scheme adopted in the draft statute also is intended to simplify procedures by permitting suit against the trustee in a representative capacity even where the trustee is personally liable. See draft Section 4523 and its comment.

As an alternative, the Commission could retain the UPC structure, but expand the right to indemnification. This question is discussed on pages 6 and 7 of Memorandum 84-24.

Draft § 4524. Liability as between trustee and trust estate

In connection with this section, the CBA raises the issue of probate court jurisdiction. (See Memorandum 84-58, Exhibit 4, p. 7.) This question will be considered in the First Supplement to Memorandum 84-29 (Judicial Administration).

Duty to Beneficiary Not a Duty to Third Persons

The CBA "strongly" suggests the addition of a provision substantially as follows: "A duty owed by a trustee to a beneficiary by reason of a trustee acting in such capacity shall not be imputed as a duty owed to a person who is not a beneficiary." (See Memorandum 84-58, Exhibit 4, pp. 7-8.) The CBA argues in favor of this provision as follows:

This proposed provision would clarify the position of the trustee vis-a-vis a creditor of the beneficiary. Except under the conditions of a garnishment, which is appropriate, a creditor should not be able to attack a trust for the beneficiary's debts, and should not have the ability to interfere in the trust's internal affairs. This provision would alleviate the trust's expensive involvement in litigation in which it is not an appropriate party.

It seems clear to the staff that a duty owed the beneficiary is not owed someone who is not the beneficiary. Two Restatement rules bear on this question:

§ 126. Incidental Beneficiary

A person is not a beneficiary of a trust if the settlor does not manifest an intention to give him a beneficial interest, although he may incidentally benefit from the performance of the trust.

§ 200. Persons Other Than Beneficiaries

No one except a beneficiary or one suing on his behalf can maintain a suit against the trustee to enforce the trust or to enjoin or obtain redress for a breach of trust.

The staff draft should be clear on the question of duties and proper parties; some confusion necessarily results because the draft statute is incomplete and distributed among many memorandums. If additional ammunition is required in this case, however, perhaps a statement could be added to a comment to a section on trustee's duties and also to the section describing who may petition. However, we do not think a section along the lines suggested by CBA is necessary. In fact, the staff has some misgivings, not because of the language of the section proposed, but because of the interpretation given it in the CBA letter quoted above. The staff is uncertain of what is meant by the reference to an "attack" on the trust for the beneficiary's debts. Surely the existence or nonexistence of a trust is an issue separate from questions relating to breach of duties and the trustee's liability. Creditors' remedies against property held in trust are governed by the provisions of the Enforcement of Judgments Law and other bodies of law, such as the Uniform Fraudulent Conveyance Act.

Draft § 4530. Repayment of trustee for expenses

The LABA Committee considers this section to be an improvement of existing law. (See Memorandum 84-58, Exhibit 3, p. 7.)

Draft § 4531. Trustee's lien

The LABA Committee also considers this section to be an improvement. (See id.) The CBA suggests that the section be revised to speci-

fically refer to a lien for the trustee's compensation. The staff assumes that compensation is merely one type of expense of administering the trust, but we have no strong objection to listing compensation in the comment or the section. The larger issue, as discussed in the memorandum on pages 7 and 8, is whether the trustee's lien should be retained at all. The staff suggests that a lien is nonsensical when the trustee already has title and that a better approach to the problem of reimbursing the trustee is to provide a direct right to retain property and withhold payments as against the beneficiary.

Draft § 4540. Protection of third person dealing with trustee

The LABA Committee finds this section to be an improvement over existing law. (See Memorandum 84-58, Exhibit 3, p. 7.)

Draft § 4544. Effect on real property transactions where beneficiary undisclosed

Draft Section 4544 continues part of Civil Code Section 869a, for the purpose of discussion. The memorandum on page 10 suggests that Civil Code Sections 869 and 869a be eliminated and reliance placed on the general rule set out in draft Section 4540. The CBA, however, suggests some changes in draft Section 4544 to conform the provision to common practice. (See the discussion in Exhibit 1, attached hereto.) The suggestion is made that the reference to the lack of a beneficiary designation in the instrument affecting real property is too limited and that it should be sufficient if the instrument is identified. The staff has no objection to this change if draft Section 4544 is to be continued.

Creditors' Rights (Memorandum 84-24, pp. 11-14)

The memorandum discusses the question of creditors' rights to reach certain inter vivos trusts. On page 13 of the memorandum, the staff suggests that the statute provide that creditors may reach interests of a trustor to the extent that the trustor has retained powers over the trust property exercisable in his or her own favor. This right would continue after the death of the trustor. The LABA Committee is in support of this approach:

Once again we suggest that the appropriate treatment of creditors' rights to reach the assets of inter vivos trusts created as estate planning vehicles (will substitutes) be addressed. While we believe that the arguments are strong that a power to revoke is essentially equivalent to a general power of appointment and cred-

itors may reach such a trust under Civil Code Sections 1390.3 through 1390.5, we believe that a statutory change which eliminates distinctions and which clarifies the law would be desirable. We believe that a power to revoke should be treated the same as a general power of appointment. While a power to revoke passes with the decedent, so does the power to presently exercise a general power of appointment. We believe that language essentially similar to Civil Code Section 1390.3(b) or 1390.4 should be adequate to allow creditors of the donor-trustor of a revocable inter vivos trust to reach the deceased trustor's assets in that trust. If such a statute is enacted, and we believe it should be, then we believe there should be an optional procedure for publishing a notice of death in order to give the trustee the option of shortening the statute of limitations for creditors' claims. An advantage of allowing such an option is that it does permit the trustee to promptly distribute trust assets to a beneficiary without fear of later problems in dealing with creditors.

(See Memorandum 84-58, Exhibit 3, p. 8.) Civil Code Sections 1390.3(b) and 1390.4, referred to by the LABA Committee, read as follows:

§ 1390.3

. . . .
(b) Upon the death of the donee, to the extent that his estate is inadequate to satisfy the claims of creditors of the estate and the expenses of administration of the estate, property subject to a general testamentary power of appointment or to a general power of appointment that was presently exercisable at the time of his death is subject to such claims and expenses to the same extent that it would be subject to the claims and expenses if the property had been owned by the donee.

. . . .

§ 1390.4

Property subject to an unexercised general power of appointment created by the donor in favor of himself, whether or not presently exercisable, is subject to the claims of creditors of the donor or of his estate and to the expenses of the administration of his estate.

The intent of both the staff and the LABA Committee would be to eliminate the distinction between the law of trusts and the law of powers in this area.

The suggestion for an optional four-month creditors' claims period was also made in a letter from Estelle M. Depper attached as Exhibit 4 to Memorandum 84-24. The staff is in favor of this proposal, although there may be objections we have not yet discovered.

Formalities for Revocable Trusts

The LABA Committee disagrees with the suggestion of Robert A. Schlesinger, discussed in the memorandum on page 14, that revocable

trusts be subjected to the same formalities as wills. (See Memorandum 84-58, Exhibit 3, p. 8.)

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

EXHIBIT 1

MEMORANDUM NO. 5

CLRC Study L-640, Memorandum 84-24

To: Paulette Leahy
From: Melvin H. Wilson
Date: June 11, 1984
Subj: Relations With Third Parties

To reiterate a comment in Memorandum No. 1, §4531 does not include a trustee's compensation as one of the items for which the trustee has a lien.

Sections 4521 and 4522 both impose personal liability if a trustee "is personally at fault." I don't know what that means.

Section 4544(a) perpetuates a portion of former CC §869a. One problem we have encountered with CC869a is the requirement that a beneficiary be "indicated in the instrument." This seems to require that a beneficiary be identified in the conveyance. It is fairly common practice for conveyances to trustees to use the following terminology: " Zuma Beach Bank, as Trustee of Trust No. 12345" or "John Q. Jones, as trustee of the Smith Family Trust dated June 11, 1984." Both forms indicate that there is a specific, identifiable trust agreement under which the trustee acts, but the identity of the beneficiary can only be determined by inspection of the governing instrument.

In view of the desirability of confidentiality in inter vivos trust arrangements, the statute should clearly indicate that an indication of the instrument establishing the fiduciary relationship should suffice. Suggested wording would be "If an interest in or lien or encumbrance on real property is affected by an instrument in favor of a person in trust and neither the identity of the instrument establishing such trust nor beneficiary is

indicated in the instrument, it is presumed that the person holds the interest, lien or encumbrance absolutely and free of the trust."

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