First Supplement to Memorandum 84-93

Subject: Study L-640 - Trusts (Breach of Trust--Accountability for Profits in Absence of Breach)

Draft Section 970 (in Exhibit 1 attached to Memorandum 84-93) provides that the trustee is accountable for a profit made from the administration of the trust even though there is no breach. The purpose of this provision, based on Section 203 of the Restatement (Second) of Trusts, is discussed on pages 4-6 of the memorandum. As anticipated, we have received a negative reaction to this provision form the point of view of the institutional trustee. See the letter from Melvin H. Wilson, attached hereto as Exhibit 1. Mr. Wilson objects that Restatement Section 203 is "punitively excessive", that it imposes liability "irrespective of whether the fiduciary acts in bad faith, and irrespective of whether the transaction may have been of benefit to the trust account." Mr. Wilson describes Section 203 as "a very serious inhibition to the effort of California banks to deliver a quality, economical product to the consumers who utilize their fiduciary services." Mr. Wilson characterizes the result of Section 203 as a "windfall" to the trust account.

Restatement Section 203 is not inconsistent with California law. Consider the following Field Code principles:

Civil Code § 2228. Obligation of good faith

2228. In all matters connected with his trust, a trustee is bound to act in the highest good faith toward his beneficiary, and may not obtain any advantage therein over the latter by the slightest misrepresentation, concealment, threat, or adverse pressure of any kind.

Civil Code § 2229. Use of property

2229. A trustee may not use or deal with the trust property for his own profit, or for any other purpose unconnected with the trust, in any manner.

The high standard of fiduciary conduct required by these provisions and others is continued in the draft statute, although the language differs considerably.

Restatement Section 203 reflects the idea that the duty of loyalty requires something more than merely avoiding breach of trust. An analogous development has taken place in the law governing insiders' dealings on

the part of corporate officers. See Niles, Trustee Accountability in the Absence of Breach of Trust, 60 Colum. L. Rev. 141, 143-44 (1960). However, the limited nature of Section 203 should be kept in mind; its effect or intent should not be exaggerated. Section 203 provides only a liability for profits actually received in recognition of the fact that it applies to innocent as well as guilty trustees. On the other hand, Restatement Section 205, the substance of which was approved by the Commission (see draft Section 972), provides a liability upon breach of trust for loss, depreciation, profit made, or profit that would have been made. Draft Section 973 (drawn from Restatement Section 207) provides additional liability for interest on damages for breach of trust.

Another argument in favor of Restatement Section 203 is that it avoids the need to determine that the trustee has breached the trust, with the consequent damage to reputation and potential loss of commission. Instead, where profits are received in a situation involving some conflict of interest that runs counter to the fiduciary principle, the trustee is accountable for the profit received, and only that amount--no punitive damages, no interest.

As noted by Professor Niles in his 1960 article on trustee accountability:

> A comment to [Restatement] § 203 uses the same fact situation to illustrate an instance of trustee accountability as is used in the comment to § 206: Where the trustee purchased for himself for $3,000 a $5,000 second mortgage on a piece of [trust] property that is also subject to a $10,000 first mortgage, and the property is sold for $16,000 upon foreclosure of the first mortgage, the trustee is only entitled to $3,000 plus interest. In the illustration under § 203, however, the trustee's purpose in purchasing the second mortgage was to protect the trust property; the motive of the trustee in the example under § 206 was apparently solely personal.

Niles, supra, at 141 n.5. Would the benefit to the trust be properly characterized as a "windfall"? If it is a windfall, would it be better public policy to allow the fiduciary to gain approximately $2,000 in speculative profit in this situation? In fact, if the trustee's motive, as suggested in the example under Section 203, was to protect the trust, the benefit of that action should go to the trust, "windfall" or not.

Draft Section 970 (Restatement Section 203) should be read in connection with draft Section 971, which is the same as Restatement Section 204. These two sections are complementary. Draft Section 971

protects the trustee from liability in non-breach situations where there may be a loss or depreciation in the value of trust property or a failure to make a profit. Draft Section 970 is necessarily implied from draft Section 971.

The trustee should look to the compensation provided by the trust or as allowed by the court, and should not hope for "insider dealings" to support a trust business. For the trustee to profit from situations where there is a potential conflict of interest, even in cases where the conflict is only apparent and did not influence a decision, goes counter to the fiduciary principle. As one commentator puts it, "[t]he determination to prevent corruption of motives by the attraction of personal profit is so strong that the fiduciary will not even need to know that he either had been exposed or had succumbed to temptation in an impermissible way." Dawson, Restitution Without Enrichment, 61 B.U.L. Rev. 563, 618 (1981). It also makes sense to protect the beneficiary in situations where the trustee has profited but the beneficiary is not able to prove a breach of trust. Restitution of profits thus deters disloyal conduct in an efficient manner because the court is not required to "wrestle with difficult issues of breach and causally related damages." See Wellman, Punitive Surcharges Against Disloyal Fiduciaries--Is Rothko Right?, 77 Mich. L. Rev. 95, 97 (1978).

Perhaps some of Mr. Wilson's misgivings might be assuaged if draft Section 970 were explicitly limited to situations where there is a potential conflict of interest, even though the trustee is not shown to have violated the duty of loyalty to the beneficiary. Other protections are provided in the draft statute. As for the situation where the bank may have a potential conflict of interest because of independent dealings of its trust and lending departments, the draft of Section 803(c) (on page 13 of Exhibit 1 attached to Memorandum 84-92) protects the financial institution. The comment to draft Section 970 should contain a reference to this provision. It should also be noted that draft Section 970 only applies to profits made by the trustee "through or arising out of the administration of the trust".

Mr. Wilson sets out several situations where he is apparently concerned that the accountability for profit rule would result in "punitively excessive" treatment of trustees. In the following discussion, it is assumed that draft Section 970 will require the taint of a potential

conflict of interest before the trustee may be held accountable. You will need to refer to Exhibit 1 while reading the following discussion which considers Mr. Wilson's scenarios in the order set forth in his letter:

1.a. The trustee would appear to be liable for profit made in indirectly selling shares of stock to the trust. The potential of a conflict of interest in this situation seems undeniable.

1.b. The same answer would seem to apply in this example involving a block trade. In both 1.a. and 1.b. the trustee is responsible for the purchase of the stock for the trust and also is in ultimate control of the trustee's own portfolio. How can it be doubted that under these facts there might be a real conflict of interest?

2. In this case involving the utilization of the bank's escrow department, there would not appear to be accountability for profits since the profit is offset by the reduction in the charge to the trust by the trustee. In any event, under the rule proposed in draft Section 803(c) (discussed supra), the bank would not be found to have any conflict of interest since the provision of ancillary services is excluded (unless some actual conflict is shown). However, it should be noted that under traditional concepts, the acceptance of an extra commission in administration of the trust is the sort of profit that may be required to be returned even though there is no breach and no damages to the trust estate.

3. Again, draft Section 803(c), which states a rule consistent with Estate of Pitzer, would eliminate the conflict of interest problem in this situation, absent a showing of an actual conflict of interest.

4. Apparently in this example the "profit" is in effect applied to the trust accounts through the bank's investment and accounting operations. This situation does not appear to describe a conflict situation that would run afoul of draft Section 970. The additional factor of a common trust fund in this example does not seem to have any effect on accountability.

While it is important to look at the sorts of cases that might concern the banks in this area, the Commission should not lose sight of the examples from the Restatement comment set out in the memorandum. See Memorandum 84-93, at pp. 4-6. If additional special rules are needed to deal with particular problems, as was done in draft Section 803(c), then the banks should offer them for consideration. However,

the general restitutionary rule of Restatement Section 203 should not be abolished outright. What would be the result without a rule like that in draft Sections 970 and 971? Should the policy of the law be that profits derived in a situation fraught with potential conflicts of interest, but unprovable as breach, are icing on a trustee's cake? If there is to be a windfall from dealing with trust property, shouldn't it fall in the vicinity of the beneficiaries rather than the trustee?

Respectfully submitted,

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