

Second Supplement to Memorandum 84-93

Subject: Study L-640 - Trusts (Breach of Trust)

We have just received some comments from the California Bankers Association on the draft statute attached to Memorandum 84-93 relating to breach of trust. A copy of these comments is attached hereto as Exhibit 1. The staff has the following reaction to the more serious points raised by the CBA letter:

§ 950. Breach of trust

The CBA states that the "language of this section is ambiguous and misleading." This conclusion apparently follows from the argument that there is some important distinction to be made between a "breach of fiduciary obligation" and "the more narrow concept of a breach of the trust." The staff does not understand the objection. The CBA does not cite any authority supporting its position. Draft Section 950, on the other hand, is essentially the same as Section 201 of the Restatement (Second) of Trusts. The staff does not believe that any distinction between duties imposed on the trustee by general law and duties imposed by the trust instrument is relevant to the question of whether a violation of a duty may have occurred that constitutes a breach of trust.

§ 951. Liability of trustee for acts of agents

The staff proposed adoption of the limitations on liability drawn from Restatement Section 225(2). See Memorandum 84-93, at p. 1. The CBA agrees that without the limitations the section is too broad, but also argues that liability should be tied to control. Thus, apparently, a trustee would not be liable unless it had "control" over the agent. The staff is not clear on what the CBA means by control. Would it include a case where the trustee negligently failed to control the agent? What if the situation where the trustee neglects to take proper steps to compel the agent to redress the wrong? What if the trustee was negligent in selecting or retaining the agent? The staff thinks that making control a prerequisite to liability would be too limiting. We would be interested to know if the CBA has any examples from California case law or from other jurisdictions where trustee liability is so limited.

§ 952. Liability of trustee for acts of cotrustee

The CBA concurs with the staff concern with draft Section 952, but the CBA also has problems with adopting the Restatement rule as suggested in the memorandum. The CBA suggests adoption of the rule of Texas Trust Code Section 114.006 protecting minority trustees. See Memorandum 84-93, p. 3.

The proposal to apply the same liability rules as to third persons, on page 4 of the memorandum, is withdrawn. However, if Texas Trust Code Section 114.006 is adopted, it should govern both liability to beneficiaries and third persons.

§ 953. Liability of successor trustee

The CBA would mention exculpation in this section. The rules on exculpation are set out in draft Section 981 and need not be repeated in each section where they might be relevant. The staff proposes to add a cross-reference to the exculpation provision in the comment to sections dealing with trustee liability for breach.

§ 960. Remedies for breach of trust

The CBA expresses concern about equity-law distinctions. However, the point of the draft statute is to eliminate the unproductive use of one terminology or the other. What is the point of having to refer to both decrees and orders when the statutory procedure is unified and complete? Why talk of both damages and surcharge when the measure is specified by statute regardless of terminology? The previous draft contained a reference to payment of damages, restitution, and surcharge, but the last two terms were deleted as surplus. This was a good decision. The comment to draft Section 960(c) makes clear that "damages" includes liability that might be characterized as restitution or surcharge.

The CBA also seems to object to listing removal of the trustee as a remedy for breach. This is existing law and would seem to be unassailable.

§ 961. Common law applies

§ 962. Other remedies preserved

The CBA appears to suggest that the statutory list of remedies for breach should be exclusive. At the same time, the CBA is arguing in connection with Section 960 that the list should be substantially trimmed. The staff finds these positions inconsistent and overly rigid.

§ 970. Accountability for profits in absence of breach of trust

The CBA reemphasizes its objection to this provision. This question is discussed fully in the First Supplement to Memorandum 84-93 (sent 12/26/84).

§ 973. Trustee's liability for interest

The CBA outlines a proposal that would make punitive damages a thing of the past and that would provide a more mechanical rule for determining the rate of interest. (See Exhibit 1, pp. 3-4.) The staff thinks that the interest rate under the CBA proposal could be higher in many cases than under draft Section 973 which gives the court discretion to set a rate lower than the legal rate.

§ 980. Limitations on proceedings against trustees

The CBA raises several objections against this provision which, in fact, is more protective of trustees than existing law. The CBA asks what "fully discloses" means in Section 980(a)(1). This is a matter that will have to be determined on a case by case basis. In any event, Section 980(a)(2) covers the situation where the trustee has not fully disclosed the subject of the claim.

§ 981. Exculpation of trustee

The CBA argues that subdivision (c) is "almost valueless since a Trustee by definition holds a fiduciary and confidential relationship vis-a-vis the Trustor" and finds that establishing that insertion of an exculpation clause was not the result of an abuse would be a heavy burden for the trustee. Subdivision (c) must be read as a whole. The question is whether the exculpatory clause was inserted in the trust as a result of the trustee abusing a fiduciary relationship that was existing when the trust was created. The existence of some fiduciary relationship between the trustee and trustor after creation of the trust is not relevant. The comment to this part of the Restatement suggests consideration of the following factors:

- (1) 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 a guardian of the settlor;
- (2) whether the trust instrument was drawn by the trustee or by a person acting wholly or partially on his behalf;
- (3) whether the settlor has taken independent advice as to the provisions of the trust instrument;
- (4) whether the settlor is a person of experience and judgment or is a person who is unfamiliar with business affairs or is not a person of much judgment or understanding;
- (5) whether the insertion of the provision

was due to undue influence or other improper conduct on the part of the trustee; (6) the extent and reasonableness of the provision.

Restatement (Second) of Trusts § 222 comment d (1957). This rule seems entirely appropriate and understandable to the staff, but of course its specific application depends upon the equities of a given case, as is typically the situation in this area of the law.

§ 982. Nonliability for following instructions under revocable trust

The CBA states that draft Section 982 is a "reversal of the protections afforded by" Section 2258(b). We do not understand this point. Civil Code Section 2258(b) reads as follows:

(b) With respect to a revocable trust, the trustee shall follow all written directions acceptable to the trustee given from time to time to the trustee by the person or persons then having the power to revoke the trust or that portion thereof with respect to which the direction is given or by the person or persons other than the trustee to whom the trustor delegates the right to direct the trustee. In acceding to and carrying out such direction, the trustee shall incur no liability to any person having a vested or contingent interest in the trust and may follow such instructions regardless of any fiduciary obligations to which the directing party may also be subject.

The staff believes that draft Section 982 continues the substance of Section 2258(b) insofar as it concerns the trustee's liability under a revocable trust. The portion of Section 2258(b) that imposes a duty on the trustee to follow acceptable directions is not here relevant and is continued elsewhere in the comprehensive draft statute.

Respectfully submitted,

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EXHIBIT 1

CBA Comments, January 10, 1985

Memorandum 84-93: Breach of Trust

Section 950. Breach of Trust

1. The language of this section is ambiguous and misleading. A breach of fiduciary obligation is not to be confused with the more narrow concept of a breach of the trust. The latter refers to a violation of the expressed terms of the governing trust agreement. The former concept pervades a broad range of violations, such as a breach of the fiduciary obligation of loyalty.

2. We strongly recommend a clear distinction between these concepts be made and codified in definition form.

Section 951. Liability of Trustee for Acts of Agents.

1. We concur with the staff's view that the Trustee's liability for acts of agents must have limitations.

2. We disagree with the staff's limitations recommendations, however.

3. Requisite to liability is control. Perhaps staff has assumed Trustee control over the agent, but the language of Section 951 does not seem to require control as a condition precedent to Trustee Liability.

4. We can only support the principal espoused when conditioned upon trustee control over the selection and actions of the agent.

Section 952. Liability of Trustee for acts of Co-Trustee.

1. Without the limiting language of Civil Code §2239, to wit: "But for no others," §952 as written takes away Trustee liability protection granted by existing statutory law.

2. We concur with the staff's view that a better approach would be to substitute the substance of Restatement 224; however, we too have concern about it being unduly burdensome to make one trustee responsible for overseeing acts of a co-trustee and liable for not taking action to remedy breaches by co-trustees, Estate of Hensel notwithstanding.

3. Restatement 224(2)(a),(c) are clearly acceptable as is, but (b),(d) and in particular (e) need a clear statement with more guidance to the Trustee of what conduct is and is not going to produce liability to the beneficiary.

4. In concurring with the staff's view, we believe a clause similar to that taken from the Texas Trust Code (§114.006) should be added to §952 to cover the majority rule approach adopted by the Commission.

5. We strongly disagree with the staff's view that §952 should apply to third parties as well as beneficiaries. A Trustee owes fiduciary obligations to beneficiaries of the Trust it administers, not third parties.

Section 953. Liability of Successor Trustee.

Before we would assess liability to a successor trustee for acts (and should we not also be looking at omissions to act?) of a predecessor, express mention of exculpation by way of the trust terms or informed beneficiary consent should be provided in the statute for the sake of clarity.

Section 960. Remedies of Breach of Trust.

1. The proper distinction between breach of trust versus breach of fiduciary obligation, discussed in #1 under §950, supra, takes on special significance when remedies and damages are being considered. Until these equity concepts are defined, one cannot intelligently determine whether the various clauses being offered by the Staff are or are not appropriate. Comments will nevertheless be made regarding those clauses which would warrant concern irrespective of whether a proper distinction has been drawn; particularly where law versus equity jurisdictional and procedural considerations are involved.

2. Subdivision (c), by using the term "damages" rather than restitution or surcharge further muddles the law/equity status upon which the trustee's liability may rest. In none of the Civil Code sections cited by Staff is the term "damages" used.

3. What is the substantive difference between subdivision (d) and the first portion (i)? As a practical matter, setting aside most transactions will impair rights of bona fide purchasers.

4. Since §960 permits a beneficiary to commence a proceeding predicated upon some perceived trustee threat to breach, we foresee abuses to be rid of a trustee who refuses to "cooperate" with the beneficiary (subdivisions (d) or (e)) or to force substantial reductions in trustee compensation (subdivision (g)).

Section 961. Common Law Applies.

Remedies for breach of fiduciary obligation should be a matter of sound legislative policy, as codified.

Section 962. Other Remedies Preserved.

Because the jurisdiction of the Equity Court applies to Probate and Trust matters, this language only creates confusion. The equitable remedies available in the Probate and Trust area should be specifically codified.

Section 970. Accountability for Profits in Absence of Breach of Trust.

1. Section 970 is not acceptable to the California Bankers Association.

2. Refer to Mel Wilson's letter of November 19, 1984 to Commission focusing upon practical implications of this clause. The Law Revision Commission staff has indicated agreement that ancillary services may be provided to a trust by a corporate trustee. Not allowing profits to the Bank for providing those ancillary services is directly contrary to provisions already codified, such as in ERISA. State law should allow profits for the provision of ancillary services, as well.

Section 971. Non-Liability for Loss in Absence of Breach of Trust.

This appears acceptable.

Section 972. Measure of Damages in Case of Breach of Trust.

1. The terms should be defined: Breach of Trust versus Breach of Fiduciary Obligation.

2. Subdivision (3) most often will border on rank speculation and conjecture.

Section 973. Trustee's Liability For Interest.

1. Subdivision (a) refers to "damages." Refer to previous comment under §960 for the confusion caused by use of this terminology.

2. We recommend a slightly modified concept:

(a) Trustee shall be liable for the greatest of interest actually received (if known); the legal rate on judgments or the Bank discount rate. Statute would provide that restitution or surcharge plus interest is the maximum recoverable from the trustee for breach (of trust or of fiduciary obligation).

(b) The Court is given no discretion in determining the rate, but

(c) Add a "good faith" or "Goodboy" clause similar to §972(b).

3. No material objection to compound interest provisions.

Section 980. Limitations on Proceedings Against Trustees.

1. Without a definition of what constitutes "fully discloses," this trustee protection is illusory. The terminology is nowhere defined, and there is no distinction between material facts which must be disclosed and facts which may simply interest the beneficiary but would not cause the decision to be made one way or another.

2. We recommend a definition of "minor person's representative," notwithstanding the staff comments, since "conflict of interest" in the comment is undefined.

Section 981. Exculpation of Trustee.

1. Define "reckless indifference."

2. See comments, supra, regarding Breach of Trust versus Breach of Fiduciary Obligation.

3. Subdivision (c) would appear to be almost valueless since a Trustee by definition holds a fiduciary and confidential relationship vis-a-vis the Trustor. Establishing that the insertion of such a clause was not the result of "an abuse" would indeed be a heavy burden for the Trustee.

Section 982. Non-Liability for Following Instruction Under Revocable Trust

1. Section 982 may be similar to Civil Code §2258(b) but is a reversal of the protections afforded by the section.

2. The language in Civil Code §2258(b) should be retained, as it reflects the current legislative intent on the subject.