

Third Supplement to Memorandum 85-73

Subject: Study L-640 - Probate Code (Comments of Attorney General on
Comprehensive Trust Law)

Attached to this supplement are comments of Mr. James R. Schwartz on behalf of the Attorney General concerning the draft trust law. (See Exhibit 1.) These comments are discussed below:

§ 16002. Duty of loyalty

Mr. Schwartz objects to the alteration of the language in Civil Code Sections 2228, 2231-2233, 2235, and 2263 which relate to fiduciary duties. (See Exhibit 1.) He argues that if there is no specific objection to the language, then it should not be deleted. There are several reasons for not continuing the language of the Field Code. The language of the Restatement represents the more common phrasing of trustee's duties. The Field Code is not as comprehensive as the Restatement; when it came to setting out a list of duties, it made sense to take the Restatement language rather than the Field Code as a general rule.

Our research has not uncovered any case where the peculiar language of the Field Code has led to a different result than would be achieved under the Restatement. There is certainly no attempt to dilute the duty of loyalty by taking the Restatement language. We could add a statement to the comments to the effect that the elimination of the language "highest good faith" is not intended to alter the duty of loyalty. As for Civil Code Section 2263, its substance is continued in Section 16004(b).

Mr. Schwartz also objects to Section 16002(b) which permits the trustee to engage in transactions between trusts of which it is the trustee if the transaction is fair and reasonable with respect to the trustees of both trusts. Mr. Schwartz states that this is illegal,

bad public policy, and has an enormous potential for abuse. It is not, however, true that this sort of transaction is forbidden by the Restatement--the statement in the Comment to Section 16002 to that effect should be deleted. Comment r to Section 170 of the Restatement provides as follows:

r. Duty of trustee under separate trusts. Where the trustee is trustee of two trusts if he enters into a transaction involving dealing between the two trusts, he must justify the transaction as being fair to each trust. If the circumstances are such that the interests of the beneficiaries of the different trusts are so conflicting that the trustee cannot deal fairly with respect to both trusts, he cannot properly act without applying to the court for instructions.

This seems a reasonable position and it is the approach taken in Section 16002(b). See the revised version of Section 16002 in Memorandum 85-86, Exhibit 1, p. 24.

§ 16222. Participation in business

Mr. Schwartz objects to the power to participate in a business as it was set out in the draft statute attached to Memorandum 85-73. At the September meeting, however, the Commission decided that the trustee should be able to continue operation of a business only if authorized to do so in the trust or by court order, thereby anticipating Mr. Schwartz's objection. For a redraft, see Memorandum 85-86, Exhibit 1, p. 33.

Mr. Schwartz also objects to the automatic power to change the form of a business. Should this power be tied to court or trust authorization? It seems to the staff that if the power to continue or participate in the operation of a business is subject to court or trust authorization, the automatic power to effect a reorganization in such business does not create any significant added risk. Of course, if the trustee is not authorized to continue a business, the power to effect a reorganization would have not object for its exercise.

§ 16400. Breach of trust

Mr. Schwartz is concerned that the statutory designation of a breach of trust as a fraud against the beneficiary is not continued in this section. (The reference to Section 16401 in Mr. Schwartz's letter should be to Section 16400.) He states that the fraud language is "extremely useful from an enforcement standpoint--serving as the basis for imposing punitive damages as well as extending the statute of limitations."

It is not clear to the staff that this "constructive fraud" section has these effects. If it did, the statute of limitations for fraud (see Code Civ. Proc. § 338(4) (three years from date of discovery)) would be the usual statute of limitations for breach of trust cases instead of the general four-year statute of limitations (see Code Civ. Proc. § 343 (four years from accrual of cause of action)) which has been applied in several cases. (See the Comment to Section 16460 in the draft attached to Memorandum 85-73.)

It is also not clear that the categorical reference to fraud in the Field Code has the effect of making punitive damages available. The staff has not seen a reported case that supports this proposition, as discussed in Memorandum 85-86.

The draft statute attempts to deal explicitly with the questions of liability, limitations, and measure of damages. We would prefer to remedy any defects in this scheme by altering specific rules, rather than by retaining the vague and doubtful proposition that every breach is a fraud.

§ 16440. Measure of liability for breach of trust

Mr. Schwartz notes that this section does not include punitive damages. Of course, the existing statutes also do not refer to punitive damages. The question of punitive damages is discussed briefly in Memorandum 85-86 on pages 5-6.

Mr. Schwartz objects to extending the good faith exception as set out in Section 16440(b). You should read his remarks on page 2 of his memorandum. The policy issue raised is whether the court should have discretion to excuse a trustee from liability where the trustee has acted in good faith and it would be equitable to do so. It is true

that in theory a court could excuse the trustee from all liability under this standard, as stated by Mr. Schwartz. However, one must not lose sight of the requirement that liability cannot be excused unless it would be equitable to do so. Should subdivision (b) be further limited so that the court does not have any discretion to excuse liability for amounts such as losses to the trust principal, as in Estate of Talbot? Another approach might be to apply subdivision (b) only to the measure of liability stated in subdivision (a)(3), i.e., liability for profit that would have accrued if the breach had not occurred.

In any event, if a broad form of subdivision (b) is retained in the draft statute, the comment to this section should be revised to expand the discussion of Estate of Talbot to note that the court excused liability for appreciations damages on the basis of good faith, but found a technical breach and held the trustee liable for the loss to the corpus (capital gains taxes and expenses of sale) plus interest.

§ 17000. Subject matter jurisdiction

Mr. Schwartz argues that placing exclusive jurisdiction over internal trust affairs in the probate court is unnecessarily restrictive. He suggests that jurisdiction be placed in the superior court and leave the division of business to the particular court system. The staff agrees with this suggestion. This change would also make the trust statute consistent with a decision made in connection with probate administration, as noted on page 13 of Memorandum 85-73.

§ 17203. Notice

Mr. Schwartz suggests that notice be required to be given the Attorney General in any proceeding involving charitable trusts and also provide authority for the Attorney General to waive further notice. The staff agrees with this suggestion. See also the discussion of notice to the Attorney General on page 14 of Memorandum 85-73.

§ 18000. Personal liability of trustee to third persons on contracts

Mr. Schwartz expresses concern that this section will result in the trust being liable for the ultra vires acts of the trustee. The staff does not believe that the effect will be dramatic since the trustee will be liable to reimburse the trust in such situations. This and related sections are designed to improve the position of the trustee in the commercial world and to protect third persons who reasonably rely on appearances.

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

EXHIBIT I

JOHN K. VAN DE KAMP
Attorney General

State of California
DEPARTMENT OF JUSTICE



September 20, 1985

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Stan C. Ulrich, Esq.
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Re: Attorney General's Objections to Proposal to
Revise Comprehensive Trust Law

Dear Mr. Ulrich:

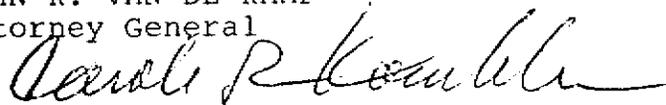
Upon further review and analysis of the draft revision of California's Comprehensive Trust Law, provided to our office on September 6, 1985, we have discovered several proposed section amendments which would adversely affect the Charitable Trust enforcement responsibilities of the Attorney General, and could contribute to loss or diversion of charitable trust assets. The challenged sections relate to duties and powers of trustees, liability of trustees for breach of trust and to third parties, remedies and jurisdiction.

These concerns are summarized with specificity in the attached memorandum of September 19, 1985, prepared by Deputy Attorney General James R. Schwartz. Mr. Schwartz will be available on October 10-11 to address Commission members at their next meeting on the Attorney General's concerns and to work with you to attempt to resolve these problems. Please confirm your meeting plans directly with Mr. Schwartz, by telephone at (415) 557-1664.

Thank you for providing the Attorney General with this timely opportunity to comment on this important proposed legislation.

Very truly yours,

JOHN K. VAN DE KAMP
Attorney General


CAROLE RITTS KORNBLUM
Assistant Attorney General

Att.

cc: James Schwartz, SF
Jeff Fuller, Sacramento
Andrea Ordin, LA

CRK:lv

Memorandum

To : Carole Kornblum

Date : September 19, 1985

File No.:

Telephone: ATSS ()
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From : Office of the Attorney General

Subject: Revision of Trust Law
(Law Revision Commission Proposal)

Pursuant to your request, I have reviewed the Law Revision Commission's proposed revisions in the trust law. I have listed below the major sections which, I feel, need to be addressed.

I. DUTIES OF TRUSTEES

- A. Section 16002(a) - The Commission comment indicates that this provision continues the duties of loyalty owed by trustees under Civil Code §§2228, 2231, 2232, 2233, 2235 and 2263. This is simply not true. For example, Civil Code § 2228 contains the specific language setting forth the standard of "highest good faith" - this is wholly deleted from the new provision.

Unless there are specific objections to the language of § 2228, et seq., I see no reason why they should be deleted.

- B. Section 16002(b) - The provisions allows a trustee to handle transactions between two different trusts under its control. In effect, it allows trustees to represent two competing interests in the same transaction. This is illegal under current law, contrary to the provisions of the Restatement of Trusts and bad public policy. Simply put, no trustee can effectively serve competing interests without enormous potential for abuse and they should not be permitted to try.

II. POWERS OF TRUSTEES

- A. Section 16222 - This section provides the trustee with the unlimited power to continue any business

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September 19, 1985
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enterprise that is part of the trust property and to change the organizational structure of the business. Given our past history of problems in this regard, I suggest the provision require court approval for the continued operations of a business entity over a certain length of time (one year?) and/or any changes in the organizational structure thereof.

III. LIABILITY OF TRUSTEES

- A. Section 16401 - This section replaces Civil Code section 2234 and constitutes a significant weakening of the provision. Specifically, it deletes the language making breaches of trust a fraud on the beneficiary. The deleted "fraud" language is extremely useful from an enforcement standpoint - serving as the basis for imposing punitive damages as well as extending the statute of limitations.

IV. REMEDIES FOR BREACH OF TRUST - MEASURE OF LIABILITY

- A. Section 16440(a) - This section is extremely limiting and, for example, does not include punitive damages.
- B. Section 16440(b) - This is a crucial provision and is absolutely objectionable. It purports to codify the good faith exception to the general rules re trustee liability and to be consistent with Civil Code § 2238 and the case of Estate of Talbot, 141 CA2 309. This is at best in error and, at most, an intentional misrepresentation so as to disguise a major change in trustee liability rules.

Simply put, § 16440(b) would allow courts the discretion to make "good faith" a complete defense to breach of trust actions. Currently, under Civil Code § 2238 and Estate of Talbot, good faith is a limited defense and only serves to limit liability to the actual damages suffered by the trust beneficiary at the time of the breach. Current law does not permit the defense of "good faith" to absolve the trustee from liability - however, this is exactly what the proposed revision would accomplish.

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V. JURISDICTION - VENUE - NOTICE

- A. Section 17000 vests exclusive jurisdiction for trust enforcement cases in the Probate Department of the Superior Court. It occurs to me that this is unnecessarily restrictive.

There may well be trust enforcement actions that should, at the discretion of the Presiding Judge, be heard in other Superior Court departments. I would suggest that jurisdiction be in the Superior Court and that the individual courts can decide the appropriate department.

- B. Section 17203(b) - This section contains the notice provisions to the Attorney General in the case of charitable trusts. It is restricted to five specific items. We should require notice to the AG of any proceeding in which there are charitable interests involved and include provisions permitting us to waive further notice at our discretion. Thus, for example, where all charities named in a will are represented, we could waive notice at the outset.

VI. LIABILITY OF TRUSTEE TO THIRD PERSONS

Section 18000 changes current law and absolves a trustee from personal liability on a contract entered into in his representative capacity provided he makes full disclosure of said representative capacity. This significantly limits the practical level of protection for the trust in cases effected thereby and, combined with the repeal of Civil Code § 2267, will make the trust itself liable for ultravires contracts entered into by a trustee.

The foregoing represent my thoughts upon a initial review of the Law Revision Commission proposals. Let me know if additional information is needed.

JAMES R. SCHWARTZ
Deputy Attorney General
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