Study L-640 7/20/84

First Supplement to Memorandum 84-22

Subject: Study L-640 - Trusts (Comments on Trustees' Powers)

The Commission considered part of Memorandum 84-22 relating to trustees' powers at the June meeting. This supplement considers comments of various groups on the remaining material in Memorandum 84-22. The comments on the powers already considered in June were raised orally at that time and are not repeated here.

Draft § 4446. Mineral leases

The California Bankers Association (CBA) suggests that this section, which authorizes the trustee to make mineral leases, should include authority to enter into leases that extend beyond the term of the trust. (See Memorandum 84-58, Exhibit 4, p. 6.) The staff is not opposed to this suggestion, but we note that this language is not really necessary since draft Section 4444 permits leases for any purpose beyond the term of the trust.

Draft § 4464. Borrowing money

The Executive Committee of the Estate Planning, Trust and Probate Law Section of the State Bar (State Bar Committee) suggests in effect that this section be revised to read: "The trustee may borrow money for a trust purpose to be repaid from trust property or otherwise." (See Memorandum 84-58, Exhibit 2, p. 3.) The Executive Committee of the Probate and Trust Law Section of the Los Angeles County Bar Association (LABA Committee) joins in this suggestion. (See Memorandum 84-58, Exhibit 3, p. 4.) The staff is not opposed to this suggestion, but we note that the existing authority to borrow is not explicitly so limited. See Prob. Code § 1120.2(3).

Draft § 4472. Loans to beneficiary

The CBA proposes that draft Section 4472 be revised:

> This section enhances Financial Code § 3377.1 which allows the trustee to make a loan to the trust. The ability of the trustee to make a loan to the beneficiary on adequate security and at a fair rate of interest is appropriate, however, the section should be clarified to indicate whether the trustee personally may make this loan or whether the trust may make the loan. The provision should allow both the trustee personally and the trust to make such a loan.

(See Memorandum 84-58, Exhibit 4, p. 6.)

This section was added to the list of powers by the Commission in May 1983 to make clear that the trustee has the power to loan trust funds to beneficiaries. It is not intended to have any bearing on the propriety of a bank loaning money to a beneficiary of a trust of which the bank is also a trustee. This is a conflict of interest question, not a question of powers. As discussed at the June meeting, the powers listed in the draft statute, just as those in existing Probate Code Section 1120.2, relate exclusively to the actions that may be taken by the trustee when acting as trustee. The question of powers does not arise in a case where the person who is a trustee is acting in some other capacity. The whole purpose of providing trustees' powers in a statute is to avoid any argument that a trustee is unable to act for the trust or deal with trust property because the office of trustee does not carry with it sufficient powers. The draft statute has not adequately expressed this idea, apparently, since there seems to be confusion about some of the powers provisions.

The staff thinks the statute would be clearer if the word "may" in each power section is replaced with "has the power to". Draft Section 4472 would then read as follows: "The trustee ~~may~~ has the power to make loans to the beneficiary out of trust funds on adequate security and at a fair rate of interest."

Draft § 4478. Hiring persons

The CBA would add accountants to the list of persons the trustee has power to hire. (See Memorandum 84-58, Exhibit 4, p. 6.) The staff has no objection to this addition. As noted on page 11 of the memorandum, Texas law lists accountants.

The LABA Committee would replace the word "administrative" in subdivision (a) with "his or her". (See Memorandum 84-58, Exhibit 3, p. 3.) No reason is given for this suggested change, and it does not seem an improvement to the staff. In any event, we would like to avoid using "his or her" since a large number of trustees are institutions.

The LABA Committee and the CBA express concern that subdivision (b) allows the trustee too much leeway in relying on advice of employees. The LABA Committee wrote:

> Perphaps careful investigation of the agents prior to hiring should entitle the trustee to rely on their advice once they are hired. On the other hand, there should be some periodic assessment

of performance. Just how these two concerns interrelate and how much to try to regulate by statute is a concern of our committee.

(See Memorandum 84-58, Exhibit 1, pp. 4-5.) The CBA suggested:

> Section 4478(b) should be amended so that the fiduciary must personally investigate and have responsibility for hiring the second tier of a trustee's responsibility should be carefully considered by the Commission: i.e., Does the trustee have a responsibility to personally investigate the adequacy of an attorney's opinion? If the hiring process was done correctly, the answer is arguably "NO".

(See Memorandum 84-58, Exhibit 4, p. 6.) The State Bar Committee finds this section to be "too broad", especially to be an automatic power. (See Memorandum 84-58, Exhibit 2, p. 3.) The memorandum discusses the controversy over this provision on pages 11 and 12. The policy question for Commission resolution is whether the trustee's duty to act prudently and the duty not to delegate the entire administration of the trust provide sufficient safeguards. Again it must be remembered that the existence of a power is not a license to use that power in a manner that violates the duties of the trustee.

The LABA Committee would omit subdivision (c) relating to administration of the trust by employees:

> It has long been the general rule that trustees may delegate administrative duties but not discretionary duties. This is especially true with regard to discretions which are "sole, absolute or uncontrolled." We believe that rule should be continued and subsection (c) removed.

(See Memorandum 84-58, Exhibit 1, p. 4.) The LABA Committee draws a distinction between administrative and discretionary duties that is not reflected in the draft section. This distinction is artificial and unworkable. Consider the following:

> It is obvious that no trustee can reasonably be expected to perform personally every act of trust administration. Such a method of operation would make the trustee's work so burdensome that few would accept trusteeships. Many duties of the trustee require special skills and knowledge which the trustee does not possess, so that he could not be expected to perform such work without advice and aid.
>
> In deciding what part of his work the trustee must do by his own hand and what part he may delegate to others, at least two different rules have been suggested. The first is that the trustee may assign to employees "ministerial" powers but may not delegate the performance of "discretionary" acts. This is a vague rule and not believed to be accurate or desirable. There are few, if any, acts of trust administration which are purely mechanical and which do not entail the use of some judgment and discretion. . . .

> A preferred method of stating a standard is that which makes delegation a matter of usual business practice among ordinarily prudent business men managing property such as the trust subject-matter for the ends which are to be accomplished by the trust, namely, usually the production for a time of a constant flow of income and the conservation of the capital fund for later owners. When a property manager having such objectives would act through others if an absolute owner, he may do so when he is a trustee. . . .

G. Bogert, Handbook of the Law of Trusts § 92, at 330-31 (5th ed. 1973) [footnotes omitted]; see also Restatement (Second) of Trusts § 171 comment d (1957). Again, the distinction between powers and duties must be kept in mind. The trustee has a duty "not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform." Id. § 171. But it goes too far to suggest the trustee is without the power to delegate any part of administration of the trust that involves discretion. The staff agrees with Professor Fratcher that trustees should be empowered "to delegate the exercise of their powers, including discretion, whenever a prudent man would do so in the management of his own property for the trust purposes." Fratcher, Trustees' Powers Legislation, 37 N.Y.U. L. Rev. 627, 661 (1962).

Draft § 4402. Conflict of interest in exercise of power

Little discussion was devoted to this section at the last meeting. Draft Section 4402 permits the trustee to act in a situation involving a conflict of interest only when authorized to do so by a court, except that no court approval is needed in a limited number of transactions involving self-dealing. Where self-dealing is allowed without court approval, the exercise of the power involved is still subject to the duty of prudence. These powers are collecting and holding property, making deposits in insured accounts, borrowing money, advancing money, and hiring employees and agents. (The power to acquire an undivided interest under draft Section 4428 is also listed in draft Section 4402(b) but will not be included when the draft is revised because the Commission decided at the June meeting to delete Section 4428.)

Mr. Melvin H. Wilson on behalf of the CBA outlines some factual situations involving self-dealing that illustrate the difficulty of applying general, abstract rules of fiduciary behavior in situations where a bank through its lending operations has a potential conflict of interest with its trust department. (See Exhibit 1, attached hereto.) Ultimately, Mr. Wilson suggests codification of the following rule stated in Estate of Pitzer, 155 Cal. App.3d 979, 988 (1984):

> Based upon the preceding cases [in California, Pennsylvania, and New Jersey], it is clear that a factual determination surrounding the circumstances of each loan was necessary for the court to determine whether or not a breach of trust had resulted. Accordingly, as a matter of law, the outright loan by the commercial department of a bank or lending institution to a third party, for the purchase of trust property, where that lender also acts as testatmentary trustee representing the sale of that trust property does not constitute an impermissible act of self-dealing or conflict of interest absent sufficient evidence of same.

In Pitzer, however, the bank was found to have violated the duty of loyalty and to have engaged in impermissible self-dealing (see Civil Code §§ 2228, 2229) on the basis of undisputed facts and was surcharged over $25,000.

The staff is uncertain whether the rule in Pitzer provides sufficient guidance to justify codification. What does the Commission wish to do?

Respectfully submitted,

Stan G. Ulrich
Staff Counsel

EXHIBIT 1

MEMORANDUM NO. 4

CLRC Study L-640, Memorandum 84-23

To: Paulette Leahy

From: Melvin H. Wilson

Date: June 11, 1984

Subj: Breaches of Trust - I - Self Dealing - Loans to Purchaser of Trust Property

I bring to your attention a rather common occurance that creates a "Catch 22" for the 45 or so California banks which also engage in the trust business. I believe this problem area is a typical symptom of the ills which are inherent in maxims which are intended to regulate conduct of fiduciaries. There may not be a rational, manageable, solution to the Catch-22 situation, but I believe it would be useful if the LRC were to reflect upon it while revising the basic statutory law.

The problem arises out of CC 2229 and 2230, which prohibit self dealing and comes about in the following typical scienarios.

A. Basic Factual Situation

T , a Bank, is trustee of an irrevocable trust (either testamentary or inter vivos and has full investment management discretion. An asset of the trust is a parcel of real property. T properly decides that it is in the best interest of the beneficiaries to sell the property for cash. T puts the property on the market specifying the terms are all cash. B, makes an all cash offer, subject to an escrow for a customary (30 to 60 days) period. B says nothing about the source of the purchase funds, or even that B will borrow the funds. T accepts the offer and B and T open

escrow on the same terms. B then wanders into one of T's branches and applies for a conventional first trust deed real estate loan.

B. Consequences of Basic Factual Situation.

The important factor to focus on is that if T makes the loan, then, at the conclusion of escrow, there will be concurrently recorded a grant deed from T to B and a first trust deed from B to T. Under CC 2229, the recordings constitute a prima facie case of self dealing on the part of T.

C. Different Scenarios.

1. T's loan officer asks B "Who are you buying the property from?" B says "Your Trust Department." The loan officer says "I cannot grant your request for a loan because some court will, at the least, make us disgorge the interest we will earn on the loan to the trust." (Parenthetically, at today's interest rates, the total interest will be around 2 1/3 times the amount of the loan.)

a. If B cannot get a loan elsewhere, B may default.

b. If B defaults, B may assert a cause of action against T, which means T, win or lose, may face a long and expensive suit.

c. If B defaults, and a second sale nets the trust less, or consequential damages to the trust beneficiaries result from the delay in finally effecting a sale, the beneficiaries may have a cause of action against T.

d. If T makes the loan, the beneficiaries may have a cause of action against T for the profit (the interest) it realized from its self dealing.

2. The land is unimproved and B, a subdivider, makes an offer subject to B obtaining approval of a tract map within one year after escrow is opened. T accepts. Three months later, C, a builder

approaches B and offers to take an assignment of B's interest at a substantial profit to B, conditioned however, on B prosecuting the application for a final tract map prior to the end of the one year escrow. B accepts. Six months later, the tract map all but final, C walks into T's branch where he has some other construction loans and applies for a loan to fund the purchase in escrow. T's loan officer does not attempt to determine who the seller is because that is not material to the issue of C's creditworthiness. The loan is made, and escrow closes. A month after escrow closes, C then applies to the same loan officer for a construction loan, which is granted and the subdivision is built out and sold. T's Trust Department first learns of the two loans three years after the loans are made and a year after they are paid off.

a. Should T be required to disgorge to the trust the several hundred thousand dollars of interest which it received from C?

3. A variation is T is executor, the property is an asset of the residuary estate and T sells the property for cash and the sale is confirmed to B by the Probate court. T makes the purchase loan to B.

a. If T is named as trustee of a residuary trust, and thus, the owner under probate Code 300, subject only to the executor's possessory rights, is T self dealing?

4. Another variation of Scenario 3 is if T is conservator and makes the loan to B. Should T be deemed to be guilty of self dealing?

5. B conditions his cash offer on obtaining a loan, the terms of which are acceptable to him, but does not identify the prospective lender.

a. Does T's trust officer have a obligation to inform B that T cannot accept the offer if T is to be the lender?

b. If B in fact applies for a loan from T, we have the same issues as Scenario 1.

c. If B in fact obtains a loan from T, can T now refuse to consummate the sale because the funds are "tainted?" What happens to T if T allows the sale to consummate?

6. B conditions the offer on obtaining a loan from T. Since this clearly places T in a posture of possible self-dealing, shouldn't the situation be viewed as being different from the situation where the selection of a lender is made by B independently of his negotiations with T regarding the sale of the property?

a. But, assume B's offer is the only offer which has been made after the property has been on the market for six months. Even if a sales contract is conditioned on B obtaining a loan from T, one begins to wonder whether T is obtaining an illicit benefit at the expense of the beneficiaries or whether the beneficiaries are receiving a possibly gratuitous benefit from T. I suggest gratuitous because T assumes the intire risk of the extension of credit.

D. Case Law

Estate of Pitzer (May 16, 1984) Court of Appeal, Second District, Division Five, 2d Civ No. 69713 (Certified for Publication), is Scenario 2 above. Pitzer discussed Estate of Weymss (1975) 49 Cal. App. 3d 53, 122 Cal. Rptr 134, which was a proceeding to remove Bank of Stockton as testamentary trustee for similar aleeged conflicts of interest. Prior to his death, decedent entered into a contract to sell, effective on his death, closely held corporate stock and a proprietorship on terms, secured by the stock and assets. As executor, the bank obtained a court

order authorizing execution of the agreement. The purchaser made the required down payment and some payments on the purchase note. Requiring additional funds to make capital improvements on corporate property, the buyer borrowed $150,000 from the bank secured by a mortgage on the property. The court concluded that the loan by the bank in its capacity as a commercial lender did not adversely affect its fiduciary obligation to the beneficiaries of the trust, stating at page 61: "A loan by the commercial department, unless made to secure an advantage to the bank adverse to the estate does not require removal of the bank as trustee." The court also found that although the loan transaction disclosed a potential conflict between the bank's interest as trustee and its interest as lender, no evidence was offered of mismanagement or of actions detrimental to the trust.

Two other cases discussed in Estate of Pitzer are In re Lerch's Estate (1960) 399 Pa. 59, 159 A.2d 506, and Breman v. Central Hanover Bank & Trust Co. (1946) 138 N.J.Eq. 165, 47 A.2d 10. The Pitzer decision, page 15, summarized the cases by stating: "Based upon the preceding cases, it is clear that a factual determination surrounding the circumstances of each loan was necessary for the court to determine whether or not a breach of trust had resulted. Accordingly, as a matter of law, the outright loan by the commercial department of a bank or lending institution to a third party, for the purchase of trust property, where the lender also acts as testamentary trustee representing the sale of that trust property does not constitute an impermissible act of self-dealing or conflict of interest absent sufficient evidence of same." (Emphasis supplied)

Perhaps the above holding could be codified.

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