WHAT TO DO WHEN THE CLIENT SLIPS THE LEASH: REAL-WORLD TRUST LITIGATION AND ETHICS, AS YOU HOPE YOU'LL NEVER HAVE TO SEE THEM

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The following outline addresses some of the issues raised by the hypothetical.

I. Beneficiary claims against the trustee

A. Breach of the duty of loyalty: It is well established that the trustee owes a duty of loyalty to the beneficiary. (Restatement of Trusts, Second, §170). This duty prohibits the trustee from using trust property to benefit himself, which, unless authorized by the trust instrument, is usually forbidden as "self-dealing." In the hypothetical, the trustee uses trust property to benefit the company owned by his significant other, in effect making her the *de facto* beneficiary of the trust, which the law prohibits. (*Id.*, at comment q ["The trustee is under a duty to the beneficiary not to be guided by the interest of any third person"]). Many courts would find that the trustee has therefore breached his duty of loyalty.

1. Benefiting others: The trustee may be disloyal even if he acts to benefit a third party rather than himself. In fact, this is a common breach of the duty of loyalty. (Bogert, *The Law of Trusts and Trustees* (2d Ed. Rev. 1995) Section 543, pp. 228, 235 ("The loyalty rule is applied to many types of cases involving conflicts of interest between the trustee's personal interest and the interest of the trust estate...The most common case is where the trustee, while engaged in a business transaction for the trust, attempts at the same time to secure a financial advantage for himself or persons related to him; this is usually forbidden as 'self-dealing.'"]).

2. Prudence does not necessarily excuse disloyalty: In the hypothetical, the trustee appears to believe that as long as the transaction is prudent, the disloyalty is excusable and any benefit that he gains or benefit that flows to his significant other is appropriate. But the law takes the contrary view. Most authorities view the duty of loyalty as separate and distinct from the duty of prudence, and hence complying with the latter does not in itself excuse compliance with the former. (See Restatement of Trusts, Third, §90(c) ["In addition" to investing prudently, the trustee must "conform to the fundamental fiduciary duties of loyalty and impartiality"]; *Bardis v. Oates*, 119 Cal.App.4th 1, 13 (2004) ["Courts will not permit an investigation into the fairness or unfairness of such a transaction or allow the trustee to show that the dealing was for the best interest of the beneficiaries."]). The beneficiaries have the right to a loyal trustee, not just a reasonable one. Furthermore, trust law generally provides that the trustee cannot keep any profit that he makes by using the trust property. (Restatement of Trusts, Second, §203 [trustee accountable for any profit that he made through the administration of the trust, even if there was no breach], §205(b) [trustee is chargeable with any profits that he made through a breach of trust]). However, when the trustee has breached his duty of loyalty, the issue of reasonableness may be important if the jurisdiction permits the court to excuse liability upon a showing that the trustee acted reasonably and in good faith and that an outcome for the trustee would be the equitable result. (See Restatement of Trusts, Second, §205, comment g; Cal. Probate Code §16440(b)).

3. **Relief:** The trustee has put himself at risk in a number of ways. Under these circumstances, disloyalty opens him to a possible surcharge claim as well as to relief that lies within the court's discretion (i.e., suspension of powers, removal, being ordered to account, etc.). His liability for surcharge may depend on a number of circumstances, including the beneficiaries' election of remedies. For example, if the beneficiaries obtained a constructive trust over the real property at issue by suing the third-party transferee, they could not simultaneously try to surcharge the trustee for the loss of the money that went into that land, since that would represent a double recovery.

B. Breach of duties in connection with a loan: Even if one concludes that this was an actual loan rather than what it appears to be – i.e., that the trustee and friend used the trust funds as seed money for their own personal business, which would be disloyal – the trustee has breached his duties in a number of other ways.

1. **Failure to generate interest:** The trustee must make the trust assets productive if there is an income beneficiary, which is the case here. (Restatement of Trusts, Second, §181, comment c ["In the case of money, it is normally the duty of the trustee to invest it so that it will produce an income"]). The advent of the prudent-investor rule has somewhat lessened the emphasis on the productivity of a given asset, the thought being that the trustee could invest some assets to generate income and others to increase the principal and thus the income beneficiary should have no right to complain, as long as the overall income is sufficient. (Restatement of Trusts, Third, §79, comment e ["This duty of 'productivity' applies to the trust portfolio as a whole, not asset by asset"]). But here, the circumstances may lead to a finding that the trustee committed a breach. The trustee invested a large percentage of the trust's corpus in this nonproductive loan, which causes one to doubt that the rest of the corpus is invested to generate income and that any income would be sufficient for the trust as a whole. Furthermore, the trustee acknowledged that interest was due but never bothered to collect payments, which suggests a breach of duty on his part rather than an investment strategy that involved the generating of income from other sources.

2. **No security:** The trustee should secure any loan with immediate and adequate security. (Restatement of Trusts, Second, §175, comment d; 3 Scott On Trusts, *supra*, §227.8, p. 450 ["it is improper for a trustee to lend trust funds without

security, either to an individual or to a firm or to a corporation"]). Here, the trustee did not do so and thus put the trust's money at improper risk.

3. No debt instrument: The trustee should memorialize any loan with a contemporaneous debt instrument. (Restatement of Trusts, §175, comment d ["If the trust property includes a chose in action, the trustee should take necessary steps to secure payment of principal and income to himself"]). Here, the trustee declined to do so and thus put the trust's money at risk. The existence of debt instrument removes any uncertainty as to the existence of the loan or its terms, and by declining to obtain this, the trustee has failed to take basic steps to protect the trust.

4. Imprudence: The trustee must invest prudently, which means that he must act as a reasonable person would rather than follow his own subjective inclinations. (3 *Scott On Trusts*, (4^{th} Ed.1988), §227, p. 432 ["It is, indeed, not sufficient that he should manage the trust property with the same care and skill with which he manages his own....The standard fixed for the conduct of trustees is an external or objective standard"]). Here, the "loan" may have been imprudent notwithstanding the fact that the interest rate appears sufficient. The rate of return is just one factor that the trustee should consider in deciding whether an investment is appropriate. In this case, an unsecured loan for investment in a foreign country – to a company that seems judgment-proof – may not be prudent, no matter what the interest rate. Whether an investment is proper may depend on the purposes of the trust and the needs and risk tolerances of the respective beneficiaries. (Uniform Prudent Investor Act, §2 [which lists factors in addition to the expected return that the trustee should consider when selecting investments, including general economic conditions, tax consequences, and the need for regularity of income or preservation of capital]). Indeed, the law notes that the duty of prudent investing includes the duty to exercise caution. (Restatement of Trusts, Third, §90, comment e).

C. Breach of the duty to disclose: Ordinarily, the trustee satisfies the duty of disclosure by accounting when required and by responding to reasonable requests for information. (Restatement of Trusts, Second, §173). Here, the trustee might argue that since no one asked him about the loan or his investment intentions, he did not need to give prior notice to the beneficiaries. From their perspective, they might argue that since the trustee was self-dealing and since this transaction was large, there were special circumstances that required advance notice and therefore the trustee breached his duty by remaining silent. (*Allard v. Pacific National Bank*, 663 P.2d 104, 110 (Wash. 1983)).

II. Beneficiary claims against TG Corporation.

A. Transferee liability: The law provides when the trustee transfers an asset to a third party in breach of trust, the trust continues to own that asset unless the transferee was a bona-fide purchaser, i.e., someone who gave value and took without notice of the breach of trust. (Restatement of Trusts, Second, §284; *Harris Trust and Savings Bank v. Salomon Smith Barney*, 530 U.S. 238, 250 (2000) ["it has long been settled that...the third person takes the property subject to the trust unless he has purchased the property for value and without notice of the fiduciary's breach of duty"]). Once the claim is established, the trust is entitled to either a constructive trust over the asset -- or whatever change in form it has undergone -- or damages, depending on the circumstances. (Restatement of Trusts, Second, §291). In the hypothetical, most courts would find that TG Corporation is not a bona-fide purchaser and is therefore liable, since it knew of the breach of trust; the corporation would know that it could not simply approach a bank and obtain an unsecured loan for $3.5 million and that it was receiving this amount only because the trustee was intimate with its principal.

1. **Knowledge of the breach:** The law holds that a third party knew of the breach of trust if a reasonable person would have suspected that something was wrong. (Restatement of Trusts, Second, §297, comment a ["A third person has notice of a breach of trust not only when he knows of the breach, but also when he should know of it"]).

2. **Lack of value:** Whether TG Corporation even gave value for the loan is a debatable question. Under the common law of trusts, a promise to repay the trust in the future only constitutes value for the transfer under certain circumstances. (Restatement of Trusts, Second, §302).

3. **Subsequent remedial efforts:** While TG Corporation eventually provided a deed of trust and promissory note, these would not cure the transferee liability, since TG Corporation provided these after it had knowledge of the breach of trust. (Restatement of Trusts, Second, §301, comment a ["After the transferee receives notice of the breach of trust he cannot improve his position by paying value."]).

B. Liability for participating in breach of trust: Even when the third party is not a transferee, that third party may face liability for participating in breach of trust. (Restatement of Trusts, Second, §326; Bogert, *Trusts and Trustees* (2d Ed. Rev. 1995) Section 901, p. 304 ["One acting with a trustee in performing an act that such person knows or should know is a breach of trust becomes a participant in the breach and subject to liability for any damages that result."]).

III. Potential claims against the law firm.

A. Malpractice claim by the client: If the beneficiaries bring a claim against him, the trustee might eventually sue the law firm for malpractice and argue that he only engaged in the improper loan because the law firm did not advise him of his duties as trustee, or, in the alternative, that he had an interest in TG Corporation and would have made a great deal of money if the loan had been properly arranged, which the law firm would have done but for its neglect. The viability of these claims would depend on facts and circumstances not fully developed in the hypothetical.

B. Suit by beneficiaries: The trust beneficiaries might sue the law firm, but under the facts given, this should not result in liability, for reasons that include the following: (1) the elements for participation in breach of trust are not satisfied, i.e., the law firm did not actively participate in the loan and did not know of the loan when it took place; (2) the beneficiaries may lack standing to bring direct suit against the law firm (Restatement of Trusts, Second, §282); (3) the beneficiaries should not have the standing to assert a negligence claim against the law firm (*Spinner v. Nutt*, 631 N.E.2d 542 (Mass. 1994)); and (4) in some jurisdictions, the law firm would be protected from a conspiracy claim by the "agent's immunity rule" holding that it has no liability to third parties as long as it acted within the scope of its employment and received no financial benefit apart from fees. (*Berg & Berg Enterprises, LLC v. Sherwood Partners, Inc.*, 131 Cal.App.4th 802, 817 (2005)).

C. Suit by TG Corporation: This entity was not a client of the law firm's and thus should not be able to sue for failing to ensure the viability of the loan, since it seems unlikely that the firm would owe a duty of care, given that the firm did not know of the loan and did not invite the third party to rely on its services. (See Restatement of the Law Governing Lawyers, §51).

D. Eventual challenge to attorneys' fees: Even though the beneficiaries should not succeed in a direct action against the law firm, they might object to the trustee's accounting and complain about the incurring of attorneys' fees, particularly when those attorneys stood back and permitted breaches of trust to occur. In general, the court can deny indemnity for attorneys' fees if those services did not benefit the trust. (*Gardner v. Baldi*, 93 A.2d 644, 646 (NJ 1952) ["In making payments of counsel fees without the court's consent, the trustees acted at their peril. To the extent that the court should find the payments to be excessive, the trustees exposed themselves to a surcharge."]). In a worst-case scenario, this might require the law firm to disgorge fees that it received from the trust. The firm might not be in a position to argue that it should be treated as a bona-fide purchaser when it knew that the trustee was acting improperly and allowed this to continue, and if the trustee lacks personal funds or was not required to incur personal liability by the fee agreement, the firm might bear the loss.

IV. Ethical issues

A. Duties to the beneficiaries: Some jurisdictions hold that when a lawyer represents the trustee, that lawyer owes duties to the beneficiaries as well, while others hold that the trustee is the client and hence the lawyer owes no duty to the beneficiaries, other than a duty to avoid affirmative wrongdoing such as fraud. (See Reporters' Note to ACTEC Commentaries to the Model Rules of Professional Conduct, and the Commentary to MRPC 1.2). In jurisdictions where the trustee's lawyer owes a duty to the beneficiaries, the lawyer may have a duty to disclose acts or omissions that constitute breaches of trust and may have a duty to protect beneficiaries from a trustee who is engaged in self-dealing or embezzlement. (*Ibid.*). This may conflict with expectations that the lawyer and client have regarding confidentiality and the attorney-client privilege, and so counsel should consider this matter in light of the laws of their particular jurisdiction. Some commentators suggest that the lawyer address this issue in the initial fee agreement. (ACTEC Commentary to MRPC 1.2, p. 35). Even in jurisdictions that would prohibit such disclosure to the beneficiaries in the absence of trustee consent, the lawyer might be acting unethically by following that direction and might therefore have no legitimate choice other than to withdraw. (See Cal. Rule of Professional Conduct 5-220 [unethical to suppress information that the client has a duty to disclose]). And it generally appears that the lawyer may disclose to third parties when needed to prevent the client from committing a crime or fraud that will result in substantial injury to the financial interests of those third parties, if the client is using the lawyer's services to help further that crime or fraud. (MRPC 1.6(b)).

1. **Lack of case law:** There is a paucity of case law on the ethical duties of a lawyer who is retained for the purpose of administration and then learns that the trustee is intentionally breaching his trust or obtaining an improper personal benefit, and accordingly it is difficult to find examples that illustrate the principles discussed above. One court analogized this situation to that of an attorney who represents a corporation and then is approached by an officer who wants help in concealing a misappropriation; in these circumstances, the attorney may have no choice but to withdraw. (*Borissoff v. Taylor & Faust*, 33 Cal.4th 523, 534 (2004)). Furthermore, given the lack of available case law, it is not readily apparent whether the administrative lawyer's ethical duties mirror the potential liability for malpractice or participation in breach of trust (i.e., it is not readily apparent that if the attorney has no liability under those claims, he has therefore complied with his ethical responsibilities as well).

2. **Candor toward the tribunal:** The lawyer's duty to the court may require disclosure of wrongdoing committed by the fiduciary client. (MRPC 3.3(c) [the lawyer shall not knowingly make a false statement of fact to the tribunal, even if this requires disclosure of information otherwise protected by the duty of confidentiality]). Thus, when the lawyer prepares an accounting to be filed with the court, the lawyer cannot misrepresent or conceal material facts, even if the trustee client instructs the lawyer to that effect.

3. **Communicating with beneficiaries:** If the lawyer does communicate with beneficiaries, the lawyer may not knowingly provide them with false or misleading information. (MRPC 4.1; ACTEC Commentary to MRPC 1.6, p. 73).

B. Defending against the beneficiaries' claims: Defending against claims by the beneficiary is a normal part of representing the trustee when the lawyer has been retained for the purposes of litigation, and services are this nature are normally compensable from the trust under statute or a provision of the trust instrument, assuming that the defense is successful. However, the zealous advocacy required in litigation does not necessarily apply when the lawyer has been retained to do administrative work and realizes that breaches of trust are occurring. In these circumstances, the lawyer was retained for the purpose of ensuring suitable administration and is being paid by the trust to achieve that result, and hence it might be inappropriate for that lawyer to turn a proverbial blind eye to breaches of duty, particularly if those breaches are intentional or result in a personal benefit to the trustee. (ACTEC Commentary to MRPC 1.2, pp. 35-36 ["If a lawyer is retained to represent a fiduciary generally with respect to the fiduciary estate, the lawyer represents the fiduciary in a representative and not an individual capacity – the ultimate objective of which is to administer the fiduciary estate for the benefit of the beneficiaries....In addition, in some circumstances, the lawyer may be obligated to take affirmative action to protect the interests of the beneficiaries."]).

C. Withdrawal: There may be a number of reasons why the lawyer for the trustee does not want to disclose matters directly to the beneficiaries when the trustee opposes that disclosure. The laws of the jurisdiction may prohibit this, or the obligation to do so may be questionable under the facts at hand. When the lawyer and client disagree over disclosure to the beneficiaries, the lawyer should consider withdrawal, particularly if the disclosure relates to material issues or a personal benefit obtained by the trustee. (MRPC 1.16). The failure to withdraw in questionable circumstances may support the argument that the law firm was participating in the breach of trust or was not acting to benefit the trust and should therefore have its fees stricken.