Chapter 16

Liability Issues for Lawyers and Other Fiduciaries

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The law used to protect beneficiaries by limiting the fiduciary’s unsupervised exercise of power. Now fiduciaries generally have the power to act unilaterally, but there are serious consequences if they fail to satisfy a long list of fiduciary duties.¹ Easterbrook and Fischel colorfully describe the difference between the old and new approaches, and the thinking behind the change:

“The fiduciary principle is an alternative to direct monitoring. It replaces prior supervision with deterrence, much as the criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks. Acting as a standard-form penalty clause in every agency contract, the elastic contours of the fiduciary principle reflect the difficulty that contracting parties have in anticipating when and how their interests may diverge.”²

Fiduciary relationships can be obvious: guardian and ward, agent and principal, members of a partnership, lawyer and client, personal representative and estate beneficiary, and trustee and trust beneficiary. Professionals such as accountants, financial planners, insurance agents, appraisers, and brokers may or may not have a fiduciary relationship with the people they serve, depending on the circumstances. Non-fiduciaries might be held to a fiduciary standard if they act as though they are fiduciaries.

For example, a 2006 Ohio case involved a broker who decided one day that the stock market was about to drop precipitously.³ Fearing that his retiree customers would be financially devastated if action were not taken on their behalf, he immediately, unilaterally, and frantically changed their investment portfolios by replacing growth-oriented equities with fixed-income debt instruments. This involved 2,600 trades over a two-day period. He appeared not to be motivated by self-interest. For example, he did not charge a commission on any of these transactions. Unfortunately, the stock market went up and so rather than save his customers from losses, his action caused them to miss out on a significant increase in stock prices. The plaintiffs had an open-and-shut case for breach of contract, but they needed to establish that the broker

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was a fiduciary in order to qualify for punitive damages. Doing so would have been easy if the plaintiffs had authorized the broker to buy and sell securities without their advanced approval (i.e., so-called discretionary accounts). This broker did not have such authority, but, according to the court, a broker who exceeds his authority under a contractual arrangement may thereby assume the duties of a fiduciary:

“If a non-discretionary broker assumes control of his client’s accounts and performs transactions . . . without the client’s approval, the broker must take on the duties of a discretionary broker . . . .”

4

Treatting this broker as a fiduciary made it possible for the court to impose punitive damages. The jury awarded $12 million in compensatory damages and $250 million in punitive damages. The latter number was later reduced to $6 million.

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§ 1600.2 High Standards

Because the beneficiaries of a trust estate cannot always replace a trustee the way shareholders of a corporation can change directors, and because beneficiaries generally cannot sell their interests in a trust estate the way shareholders can sell their stock, trust law tends to set the bar for fiduciaries higher, and scrutinize their behavior more closely, than does corporate law.6 The best judgment rule gives corporate fiduciaries the benefit of doubt by presuming their conduct to be motivated by a bona fide regard for the interests of the corporation.

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“To avoid hindsight bias in suits for breach of fiduciary duty, state common law provides corporate managers [but not trustees] with protection under the business judgment rule. It raises a rebuttable presumption managers made their decisions in good faith, acted with due care, had no interest in the subject matter of the decision, were informed to the extent they reasonably believed appropriate under the circumstances, and rationally believed the decision to have been in the best interest of the corporation. It is up to the party challenging the fiduciary’s conduct to rebut any one or all of these business judgment rule presumptions.”

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The bar for trustees is significantly higher. The most famous formulation of the fiduciary standard comes from a 1928 opinion written by then-judge Benjamin Cardozo:

“Many forms of conduct permissible in a workaday world for those acting at arm’s length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio

4 Id. at 829.
5 Id. at 819–20.
¶ 1600.3 2010 INSTITUTE ON ESTATE PLANNING 16-4

of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”

¶ 1600.3 Lawyers Are Fiduciaries

Except for client trust accounts, lawyers do not usually hold title to other people’s property the way trustees do, but lawyers always owe fiduciary duties to their clients. The Restatement of the Law Governing Lawyers explains the rationale:

“A lawyer is a fiduciary, that is, a person to whom another person’s affairs are entrusted in circumstances that often make it difficult or undesirable for that other person to supervise closely the performance of the fiduciary . . . A lawyer’s work is sometimes complex and technical, often is performed in the client’s absence, and often cannot properly be evaluated simply by observing the results. Special safeguards are therefore necessary.”

As fiduciaries, lawyers must stay focused on client goals: “the lawyer may hope to further the lawyer’s professional reputation and income through a representation, but may do so only as a by-product of promoting the client’s success.”

The lawyer’s fiduciary duties to a client include undivided loyalty and “perfect” candor: “The relationship between attorney and client has been described as one of uberrima fides, which means, ‘most abundant good faith.’ Among other things, this requires “absolute and perfect candor, openness and honesty, and the absence of any concealment or deception.”

¶ 1601 When Fiduciaries Hire Lawyers

When a fiduciary such as a trustee or personal representative retains a lawyer’s services, it is important to identify the client at the outset of the engagement. In most jurisdictions and circumstances, the fiduciary is the client. In a few jurisdictions,

10 RESTATEMENT (THIRD), THE LAW GOVERNING LAWYERS, § 16, cmt. b.
11 Id.
13 Id.
14 See, e.g., John R. Price, Duties of Estate Planners to Non Clients: Identifying, Anticipating and Avoiding the Problems, 37 S. TEX. L. REV. 1063, 1081 (1996) (noting “a majority of the cases and ethics opinions all consider the fiduciary to be the lawyer’s client—not the fiduciary estate or its beneficiaries”); Robert v. Fear, 986 P.2d 690, 694 & n.3 (Or. Ct. App. 1999) (“when an attorney undertakes to represent a fiduciary, he or she represents only the fiduciary”); In re Estate of Gory, 570 So.2d 1381, 1383 (Fla. Dist. Ct. App. 1990) (“the personal representative is the client rather than the estate or beneficiaries”); Wagner v. Lamme, 386 N.W.2d 448, 450 (Neb. 1986) (“no position known as ‘attorney of an estate’”); Wells Fargo Bank, N.A. v. Superior Court, 990 P.2d 591, 595 (Cal. 2000) (“the suggestion that the trustee ‘is not the real client’ of the attorney retained by the trustee directly contracts California law”).
however, the client is the trust or probate estate, rather than the fiduciary.\footnote{See, e.g., Steinway v. Bolden, 460 N.W.2d 306 (Mich. Ct. App. 1990) (“although the personal representative retains the attorney, the attorney’s client is the estate, rather than the personal representative”); Jeffrey N. Pennell, Representation Involving Entities: Who Is the Client, 62 FORDHAM L. REV. 1319, 1334, 1355 (1994); Adam F. Streisand, Will My Real Client Please Stand Up, ACTEC Annual Meeting CLE Outline (March 2009).}

A related issue is whether a trust or probate estate is or can be a juridical person. For example, in a 2009 Virginia case an injured person lost his chance to seek damages for his injuries because he initially sued the deceased tortfeasor’s estate rather than the personal representative of that estate.\footnote{Estate of James v. Peyton, 674 S.E.2d 864 (Va. 2009).} The statute of limitations had expired before the plaintiff corrected the pleadings. According to the court, “the personal representative is a living individual while the ‘estate’ is a collection of property.”\footnote{See also Thompson v. Vinson & Elkins, 859 S.W.2d 617, 623 (Tex. Ct. App. 1993) (an estate or trust cannot be represented, as it is “not a legal entity that can sue or be sued”); Zeigler v. Nickel, 75 Cal. Rptr. 2d 312, 314 (Ct. App. 1998) (a trust “is not an entity separate from its trustees”).}

When there is more than one trustee of a trust or personal representative of an estate, there can be a related question of whether the lawyer is representing all of the fiduciaries individually (joint representation) or collectively (so-called entity or organizational representation). This was a major issue in the Bishop Estate controversy (see ¶ 1604).\footnote{See James R. McCall, Endangering Individual Autonomy in Choice of Lawyers and Trustees—Misconceived Conflicts of Interest claims in the Kamehameha Schools Bishop Estate Litigation, 21 Haw. L. Rev. 487 (1999), and Randall W. Roth, Understanding the Attorney-Client and Trustee-Beneficiary Relationships in the Kamehameha Schools Bishop Estate Litigation: A Reply to Professor McCall, 21 Haw. L. Rev. 511 (1999).}

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¶ 1601.1 Duty to Beneficiaries

In some jurisdictions and circumstances, a fiduciary’s lawyer can owe fiduciary duties to beneficiaries as well as to the fiduciary: “Sometimes a client’s duties to other persons, for example as a trustee . . . , may impose on the lawyer similar consequential duties.” In some circumstances, such a derivative duty may actually “overshadow” the lawyer’s duty to the fiduciary client:

“An attorney [who] undertakes to represent the guardian of an incompetent, assumes a relationship not only with the guardian but with the ward. . . . In fact, we conceive that the ward’s interests overshadow those of the guardian.”

The Director of Loss Prevention at a company that insures lawyers has written that lawsuits against fiduciaries and lawyers who represent fiduciaries are increasingly common, and that lawyers who represent fiduciaries may have a duty to prevent harm to beneficiaries:

“Most such claims involve an allegation that the trustee/executor breached his or her fiduciary obligation to the beneficiaries by failing to manage the assets in a reasonable manner. The law firm is alleged to have aided this breach of fiduciary

17 See also Thompson v. Vinson & Elkins, 859 S.W.2d 617, 623 (Tex. Ct. App. 1993) (an estate or trust cannot be represented, as it “is not a legal entity that can sue or be sued”); Ziegler v. Nickel, 75 Cal. Rptr. 2d 312, 314 (Ct. App. 1998) (a trust “is not an entity separate from its trustees”).
19 RESTATEMENT (THIRD), THE LAW GOVERNING LAWYERS (2000), § 16, cmt. c.
20 Fickett v. Superior Court of Pima County, 558 P.2d 988, 990 (Ariz. Ct. App. 1976). See also, In re Estate of Johnson, 119 P.3d 425, 433 (Alaska 2005) (“the fiduciary duties of the attorney run not only to the personal representative but also to the heirs”); Ruden v. Jenk, 543 N.W.2d 605, 610 (Iowa 1996) (“the estate attorney is hired by an executor or administrator, [but] his obligations, like those of the fiduciary, extend to the estate and all other distributees”); In re Estate of Larson, 694 P.2d 1051, 1054 (Wash. 1985) (“the fiduciary duties of the attorney run not only to the personal representative but also to the heirs”).
obligation. . . . Remember, although the fiduciary is your client, developing law would hold that a lawyer representing the fiduciary has an obligation to prevent the fiduciary from causing known harm to beneficiaries as a result of a breach of fiduciary obligation.”21

¶ 1601.2 Other Possible Clients

There also is a possibility that someone the lawyer perceives as a non-client will form a reasonable belief that she, too, is the lawyer’s client. Whether and to what extent a lawyer-client relationship exists in such circumstances is a question of fact.22

“The essence of the lawyer-client relationship is whether the lawyer’s advice or assistance is sought and received on legal matters. The relationship need not be formalized in a written contract, but rather may be implied from the parties’ conduct. Whether a fee is paid is not dispositive. The existence of the relationship turns largely on the client’s subjective belief that it exists.”23

“A client-lawyer relationship arises when the person reasonably relies on the lawyer to provide services, and the lawyer, who reasonably should know of this reliance, does not inform the person that the lawyer will not do so.”24

Trusts have long been considered relationships rather than entities, but some lawyers argue that this is not necessarily so anymore.25 A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.26 In some situations, the lawyer must give a Miranda-like warning to any such constituents so they understand that the organization’s lawyer has no duty to protect their personal interests:

“In dealing with an organization’s directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization’s interests are adverse to those of the constituents with whom the lawyer is dealing.”27

In 2009 the chief investment officer of the failed Stanford Financial Group filed a $20 million malpractice and breach of fiduciary duty lawsuit against a lawyer who

21 Aaron Hoffman, A Survey of Potential Pitfalls for Estate Planners, manuscript on file with the author. See RESTATEMENT (THIRD), THE LAW GOVERNING LAWYERS (2000), § 51(4), cmt. h, for an example of the “developing law” in this area.


24 RESTATEMENT (THIRD), THE LAW GOVERNING LAWYERS (2000), 14. Comment f to that section adds that, “the lawyer must clarify whom the lawyer intends to represent.”


26 See MODEL RULES OF PROF’L CONDUCT, R. 1.13(c).

allegedly caused her wrongfully to be accused of a crime. Specifically, the plaintiff alleged that the lawyer did not adequately represent her personal interests in a meeting with lawyers from the Securities Exchange Commission. The lawyer reportedly repeated several times during questioning that he was representing the chief investment officer “only to the extent that he was representing the company of which she was an officer,” but the plaintiff’s lawyer has said that the plaintiff did not understand what that meant.28

Engagement and non-engagement letters can be used to clarify who is or is not a client and the degree to which non-client beneficiaries can safely rely on the trustee’s lawyer to watch out for the beneficiaries’ interests. This can be especially important when the fiduciary’s lawyer has previously represented, or is currently representing one or more of the beneficiaries individually:29

“Sometimes a lawyer represents both a fiduciary and the fiduciary’s beneficiary and thus may be liable to the beneficiary as a client . . . and may incur obligations concerning conflict of interests . . . . A lawyer who represents only the fiduciary may avoid such liability by making clear to the beneficiary that the lawyer represents the fiduciary rather than the beneficiary.”30

¶ 1601.3 Privity

Most jurisdictions have relaxed or eliminated the common-law requirement of privity, thereby enabling certain non-clients to sue a lawyer for malpractice.31 This has contributed to a huge increase in malpractice lawsuits against estate planners:

“After the testator has passed away and is unable to testify in support of the lawyer, an heir or beneficiary will claim that the lawyer was negligent in failing to maximize tax savings. Absent documentary evidence that the testator understood precisely what he or she was doing, the lawyer will be faced with accusations that ‘Dad hated to pay taxes and would absolutely have told the lawyer to do everything possible to minimize the estate tax.’”32

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30 RESTATEMENT (THIRD), THE LAW GOVERNING LAWYERS (2000), § 51, cmt. h.

31 See, e.g., Blair v. Ing, 95 Haw. 247 (2001), where children of the deceased clients had standing (as intended beneficiaries of the engagement) to sue the lawyer who assisted the parents. But the children lacked standing to sue a CPA who only assisted the personal representative in the administration of the client’s estate by preparing tax returns. The children were merely incidental beneficiaries of that engagement. For discussion of cases from other jurisdictions, see Id. at 254; see also 1 R. Mallen and J. Smith, Legal Malpractice Sec. 7.12 (2008 edition), and Robert Kehr, Lawyer Error: Malpractice, Fiduciary Breach, Or Disciplinable Offense? 29 W. ST. U. L. REV. 235 (2002).

32 Aaron Hoffman, A Survey of Potential Pitfalls for Estate Planners, manuscript on file with the author.
In a 2009 California case the client’s lawyer declined to draft a new trust agreement requested by his client, saying it would result in a lawsuit. Instead, the lawyer advised the client to undergo psychiatric evaluation to determine if he had the capacity to change the existing estate plan. The client died about 6 weeks later without having changed his estate plan or undergoing psychiatric evaluation. The surviving spouse (who had married the client less than a year earlier) sued the lawyer for breach of fiduciary duty, professional negligence, and intentional infliction of emotional distress. The trial court sustained the lawyer’s demurrer. The appellate court applied the “balancing of various factors” test from Biakanja34 and Lucas,35 including the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to her, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant’s conduct and the injury suffered, the moral blame attached to the defendant’s conduct, and the policy of preventing future harm. This balancing resulted in an affirmation of the lower court decision.

“[W]hen the claim—as here—is that a will or trust, although properly executed and free of other legal defects, did not accurately express the testator’s intent, no duty or liability to the nonclient potential beneficiary has been recognized. That is, where there is a question about whether the third-party beneficiary was, in fact, the decedent’s intended beneficiary—where intent is placed in issue—the lawyer will not be held accountable to the potential beneficiary.”36

¶ 1601.4 Trust Counsel or Personal Counsel

Even when it is clear that the fiduciary is the client there is an additional question of whether the lawyer represents the fiduciary in the latter’s representative or personal capacity. As used herein, the term Trust Counsel refers to lawyers retained to help the fiduciary comply with the law (i.e., assist the trustee in the trustee’s representative capacity in the administration of the trust), and Personal Counsel refers to lawyers retained solely to watch out for the fiduciary’s personal interests.

The duty of undivided loyalty prevents trustees from using Trust Counsel in ways that put the trustees’ personal interests ahead of those of trust beneficiaries:

“A lawyer representing a client in the client’s capacity as a fiduciary (as opposed to the client’s personal capacity) may in some circumstances be liable to a beneficiary for a failure to use care to protect the beneficiary . . . . The duty arises from the fact that a fiduciary has obligations to the beneficiary that go beyond fair dealing at arm’s length. A lawyer is usually so situated as to have special opportunity to observe whether the fiduciary is complying with those obligations. Because fiduciaries are generally obliged to pursue the interests of their benefi-

36 Id.
Personal Counsel is free to advocate zealously on behalf of the fiduciary’s personal interests without regard to the interests of the beneficiaries, and attorney-client privilege can be used by the trustee against the beneficiaries. By comparison, Trust Counsel may have specific duties of care to non-client beneficiaries of the trust, and attorney-client privilege may or may not apply to his communications with the fiduciary client.

The situation is complicated considerably when one lawyer or firm tries to function as both Trust Counsel and Personal Counsel. This can create a nonconsentable conflict of interests.

Trustees commonly hire Personal Counsel in reaction to, or anticipation of, a dispute with trust beneficiaries. In the absence of an explicit agreement to the contrary, a lawyer initially paid with trust funds is generally presumed to be representing the trustee in the trustee’s fiduciary capacity, as Trust Counsel, and a lawyer initially paid from the trustee’s own funds is presumed to be representing that trustee in that trustee’s individual capacity, as Personal Counsel. Normally in such situations, the cost of Personal Counsel ultimately is borne by the losing party. So, for example, a trustee who initially uses personal funds to pay Personal Counsel usually is entitled to reimbursement from the trust estate upon prevailing, and a trustee who initially uses trust funds to pay for Personal Counsel must reimburse the trust estate upon failing to prevail.

## 1601.5 Conflict of Interests

A fiduciary and a fiduciary’s lawyer have a duty to identify any material conflict of interests, and to deal with it appropriately. In most circumstances, conflicts can be waived by the affected parties. When there is doubt about the existence of a conflict, the safer route generally is to explain the situation to the affected parties and seek their informed consents:

“[I]nformed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of the client.”

The communication may need to include “the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-
client privilege and the advantages and risks involved.”

¶ 1601.6 Attorney-Client Privilege

Attorney-client privilege potentially applies to confidential communications between attorneys and their clients, but the privilege “must be strictly limited to the purpose for which it exists.” Because trustees have a fiduciary duty not to use Trust Counsel for personal purposes and not to withhold information reasonably needed by beneficiaries to hold the trustees accountable, such trustees might not need the assurance of confidentiality to communicate freely with Trust Counsel (as opposed to Personal Counsel).

“A trustee is privileged to refrain from disclosing to beneficiaries or co-trustees opinions obtained from, and other communications with, counsel retained for the trustee’s personal protection in the course, or in anticipation, of litigations (e.g., for surcharge or removal).” This situation is to be distinguished from legal consultations and advice obtained in the trustee’s fiduciary capacity concerning decisions or actions to be taken in the course of administering the trust. Communications of this latter type are subject to the general principal entitling a beneficiary to information that is reasonably necessary to the prevention or redress of a breach of trust or otherwise to the enforcement of the beneficiary’s rights under the trust. When the roles and objectives of legal consultation are unclear, the question of who has paid for the legal services, or who ultimately will be required to pay those expenses, although potentially relevant, involves other and complicated considerations (see § 88) so that this matter is not determinative in resolving issues of privilege.”

Although a few courts have allowed trustees to assert attorney-client privilege against beneficiaries even when the trustee’s communication was with Trust Counsel, the majority view is that trustees may not assert the privilege unless the communication in question was with Personal Counsel (as opposed to Trust Counsel):

“In a proceeding in which a trustee of an express trust or similar fiduciary is charged with breach of fiduciary duties by a beneficiary, a communication otherwise [privileged] is nonetheless not privileged if the communication (a) is relevant to the claimed breach, and (b) was between the trustee and a lawyer. . .

44 Id.
46 See generally RESTATEMENT (THIRD) OF TRUSTS (2007) § 78.
47 RESTATEMENT (THIRD) OF TRUSTS (2007) § 82, cmt. f.
48 See Wells Fargo Bank, N.A. v. Superior Court, 22 Cal. 4th 201, 207, 990 P.2d 591, 594–95 (2000) (focusing on statutory wording and noting in dicta that the court stood ready to uphold a trustee’s assertion of attorney-client privilege with respect to administrative matters); Huie v. DeShazo, 39 Tex. Sup. Ct. J. 288, 922 S.W.2d 920, 925 (Tex. 1996) (rejecting a fiduciary exception to attorney-client privilege under Texas law because such an exception “should be instituted as an amendment to Rule 503 through the rulemaking process”).
who was retained to advise the trustee concerning the administration of the trust.”

“Trustee is privileged to refrain from disclosing to beneficiaries or co-trustees opinions obtained from, and other communications with, counsel retained for the trustee’s personal protection in the course, or in anticipation, of litigation (e.g., for surcharge or removal). This situation is to be distinguished from legal consultations and advice obtained in the trustee’s fiduciary capacity concerning decisions or actions to be taken in the course of administering the trust. Communications of this latter type are subject to the general principle entitling a beneficiary to information that is reasonably necessary to the prevention or redress of a breach of trust or otherwise to the enforcement of the beneficiary’s rights under the trust.”

A successor trustee may be able to waive attorney-client privilege with respect to communications between Trust Counsel and a former trustee. The following excerpt from a 2009 California case refers an earlier California Supreme Court decision, Moeller:

“In [Moeller], the files of the attorney for the trustee were deemed part of the property of the trust and were transferable to the successor trustee. The court opined that separate litigation counsel hired to protect the trustee might be covered by the attorney-client privilege if such an attorney were paid separately by the trustee. Moeller has not been applied outside of the trust context. However, the

50 RESTATEMENT OF THE LAW (THIRD) TRUSTS (2007) § 82, cmt. f. See also Martin v. Valley Nat’l Bank, 140 F.R.D. 291, 322 (S.D.N.Y. 1991) (when the trustee is “consulting an attorney to assist him in providing adequate service to the trust, and hence to its beneficiaries, the trustee cannot shield those communications from the beneficiaries”); In re Estate of Baker, 528 N.Y.S.2d 470, 473 (N.Y. Sur. Ct. 1988) (“a fiduciary has an obligation to disclose [to beneficiaries] the advice of counsel with respect to matters affecting the administration of the estate”); United States v. Mett, 178 F.3d 1058, 1064 (9th Cir. 1999) (holding that a trustee may invoke the federal common-law attorney-client privilege against beneficiaries when the trustee “retains counsel in order to defend herself against the . . . beneficiaries,” but not when the “trustee seeks an attorney’s advice on a matter of [trust] administration and where the advice clearly does not implicate the trustee in any personal capacity . . . ”); See, e.g., Comegys v. Glassell, 839 F. Supp. 447, 449 (E.D. Tex. 1993) (“no independent attorney-client privilege exists between a trustee and its attorney to the exclusion of the beneficiaries when the alleged privileged documents relate to the administration of the trust or the trustee’s res”); See generally Rust E. Reid et al., Privilege and Confidentiality Issues When a Lawyer Represents a Fiduciary, 30 REAL PROP. PROB. & TR. J. 541, 560 (1996) (“The general trend is for courts to permit, at a minimum, discovery of attorney-client communications generated in the ordinary course of administering the trust.”); Robert W. Tuttle, The Fiduciary’s Fiduciary: Legal Ethics in Fiduciary Representation, 1994 ILL. L. REV. 889, 940 (1994) (“As a number of courts have found, when counsel is employed at the trust’s expense, communications between a trustee and counsel are not privileged against discovery by the trust beneficiaries.”).

51 See Moeller v. Superior Court, 16 Cal4th 1124 (1997).
similarities between trust and decedent estate administration are sufficient to anticipate that a court may apply the same ruling in an estate action. In that event, it may be difficult to protect the files of an attorney who has represented his client in the dual roles of personal representative and beneficiary. If separate counsel represent the client with dual capacities, keeping the beneficiary matters separate from the client’s fiduciary interests will be substantially easier.\textsuperscript{54}

If a former trustee’s lawyer neglected to explain initially that the attorney-client privilege could be waived later by a replacement trustee, the now-former trustee might feel betrayed and seek some form of recovery from the lawyer.\textsuperscript{55} If a trustee wants to know that the privilege will be there if needed because of a dispute with the beneficiaries, that trustee should use personal funds to pay the lawyer, document that the lawyer is representing the trustee in the trustee’s personal capacity, and not involve that lawyer in trust administration. In short, the trustee should retain Personal Counsel rather than Trust Counsel. If one or more of the above-mentioned factors is missing, there may be some degree of doubt.

\section*{¶ 1601.7 Whistleblowing}

Should a lawyer report the serious misconduct of a fiduciary client? Although the thought of whistleblowing is anathema to most lawyers, there has been movement in that direction in recent years. Whistleblowing is discretionary in circumstances addressed in Section 307 of the Sarbanes-Oxley Act and in Rule 1.13 of the Model Rules of Professional Responsibility (Model Rules).\textsuperscript{56}

The Securities Exchange Commission (SEC) proposed a more stringent rule that would sometimes require a “noisy withdrawal,” which would have been tantamount to mandatory disclosure.\textsuperscript{57} That proposed rule is currently on hold. Model Rule 1.6 seems at first never to require disclosure, but when combined with Rule 4.1 disclosure is sometimes mandatory.\textsuperscript{58}

In a handful of jurisdictions and circumstances, a fiduciary’s lawyer may be required to blow the whistle on a wayward client. Hawaii’s Probate Rule 42(b) provides as follows:

“An attorney for an estate, guardianship, or trust does not have an attorney-client relationship with the beneficiaries of the estate or trust or the ward of the guardianship, but shall owe a duty to notify such beneficiaries or ward of activities of the fiduciary actually known by the attorney to be illegal that threaten the


\textsuperscript{55} See generally Samuel P. King and Randall W. Roth, Broken Trust: Greed, Mismanagement & Political Manipulation at America’s Largest Charitable Trust, (University of Hawaii Press 2006).


\textsuperscript{58} Id. at 200–201.
security of the assets under administration or the interests of the beneficiaries.”

Although this rule does not define the word illegal, dictionary definitions include “unlawful,” “prohibited by law,” “in a manner contrary to law,” and “not according to, or not authorized by, law.” Accordingly, illegal behavior in this context would arguably include any significant breach of fiduciary duty. Hawaii Probate Rule 42(c) also targets fiduciary “nonfeasance” for mandatory whistleblowing:

“An attorney for an estate, guardianship, or trust is an officer of the court . . . . The attorney, after prior notice to the fiduciary, shall have an obligation to bring to the attention of the court the nonfeasance of the fiduciary.”

¶ 1602 Troubled Times for Fiduciaries and Their Lawyers

Many trust beneficiaries watched in horror as market values declined precipitously in late 2008 and early 2009, and may be feeling exceptionally vulnerable. Some are litigious by nature; some are desperate; and some genuinely believe that their sudden decline in wealth is someone else’s fault.

The stock market recouped some of the lost value by the end of 2009, but even increases in value can heighten the odds of fiduciary litigation. For example, real estate values on the island of Kauai have been exceptionally volatile over the years. When values spiked upward, I observed beneficiaries suing fiduciaries who had sold real estate early in that cycle, regardless of the reason. When values collapsed, some beneficiaries sued fiduciaries for not having diversified the estate’s investments (i.e., not selling at least some of the trust’s real estate) before the drop in value. The particulars varied, but the common denominator was volatility.

Fiduciaries and their lawyers often have deep pockets (relatively high net worth or insurance coverage). That and high standards of care can make them tempting targets:

“In the view of the beneficiaries, one is presumed guilty until found judgment proof. The search for deep pockets often leads a beneficiary or heir to the doorstep

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59 HAW. PROB. R. 42(b)
of counsel for the fiduciary or the decedent.”

§ 1602.1 Lawsuit Avoidance

Fiduciaries and their lawyers can theoretically avoid liability by doing a good job. But simply doing a good job may not be enough to avoid a lawsuit, and getting sued can be a nightmare even if the defendant did nothing wrong.

1. The financial costs of defending the action can be substantial, and there often is a considerable strain on the individual defendants.

2. Even a frivolous lawsuit can damage reputations. Media increasingly watch for and report on filed lawsuits, and they usually base much of the initial report on statements in the complaint. Numerous examples of this phenomenon are provided in this chapter.

3. Once a matter gets into the courtroom, anything can happen. Simply being in the right is no guarantee of ultimate success in a lawsuit. Ask any litigator.

4. Experts sometimes say the darnedest things, especially when they assume that every factual allegation in the complaint is accurate.

5. Some judges exert significant pressure to settle rather than go to trial. That tends to benefit unreasonable people to the detriment of reasonable people.

6. Many lawsuits eventually boil down to questions of fact. Having the facts on your side is small consolation if you have the burden of proving them and cannot do so.

§ 1602.2 The Curse of Knowledge

People who have a clear mental picture of something relatively complicated may have a tendency to overestimate the clarity of someone else’s mental picture of that same concept. Elizabeth Newton conducted a study in which participants were divided into two groups: tappers and listeners. Each tapper’s job was to tap the rhythm of a song for an individual listener whose job was to identify that song. After tapping a song, the tapper was asked whether she thought the listener would correctly identify that song. On average, the tappers thought the listeners recognized the song about 50% of the time. But the listeners correctly identified the song less than 3% of the time. Because the tappers already knew the song being tapped, they grossly overestimated a listener’s ability to recognize each song. This has been called “the curse of knowledge.” Some commentators believe that the same phenomenon may apply to litigation lawyers:

“By the time a case reaches a jury, the trial team is waist-deep in depositions, evidence, and briefs . . . . The case is engrained in their minds and, consequently,


65 Id.
they can overestimate the ease with which jurors will understand their case. Attorneys have the benefit and the limitation of knowing too much about the case and the law, often resulting in too many layers of assumptions and presumptions about the messages sent to jurors.\textsuperscript{66}

\section*{1602.3 Contemporaneous Documentation}

Another human proclivity that can increase the risk of lawsuits is the natural tendency to assume that honest people will be believed when they tell the truth. This reflects the curse of knowledge (i.e., an honest person knows what she’s saying is true, so surely others also know that). It also stems from an honest person’s assumption that others are relatively honest.\textsuperscript{67} Truth is at the core of justice as viewed in the abstract, but in actual controversies courts of law focus instead on evidence.\textsuperscript{68}

Facts that are unequivocal and undisputed today could be quite difficult to establish in the future. Even if a defendant remembers every important detail, she might not be believed when she tells the truth. Keep in mind that the defendant’s testimony will naturally be viewed as self-serving since she has an obvious personal stake in the matter at that time. There may also be contradictory testimony from someone else, perhaps because the other person perceived the events differently in the first instance, or maybe because time and self-interest have had a corrosive effect on the other person’s recollection of events. From the perspective of the plaintiff’s perspective, the lack of a written record can make the defendant look like a “sitting duck.” “A common cause of claims against estate planners is the failure to make a record of the client’s instructions.”\textsuperscript{69} Yet some fiduciaries and some of their lawyers simply assume that being good people and doing good work is protection enough: “our egocentric perspective blinds us.”\textsuperscript{70} When working to further the interests of others, it is counterintuitive and somewhat disheartening to think of them as potential adversaries, but that is reality. Anyone who has ever defended against a lawsuit filed by a beneficiary against a fiduciary or by a client against a lawyer will confirm this truism: contemporaneous documentation can make subsequent testimony a lot more believable.\textsuperscript{71}


\textsuperscript{69} Aaron Hoffman, \textit{A Survey of Potential Pitfalls for Estate Planners}, manuscript on file with the author.


\textsuperscript{71} See e.g., Alvin I. Frederick, \textit{The Art of Not Being a Defendant}, 40-Feb FEB MD. B.J. 31 (2007); Donald Lundberg, \textit{Ten Ways to Stay Out of Trouble}, 50-MAY RES GESTAE 30 (2007).
Pronoia is a baseless belief that the world was designed to benefit you (i.e., unknown others are conspiring to make you happy). Its opposite is paranoia. When it comes to avoiding fiduciary liability, pronoia can be very dangerous, and a little paranoia can be helpful.

¶ 1602.4 Hindsight Bias

Hindsight bias is the natural tendency to view a known outcome as having been more foreseeable than it was prior to its occurrence. Hindsight bias is a well-documented psychological phenomenon. Studies show it to be powerful, pervasive, and insidious.

“[W]arning people to ignore or not be influenced by the outcomes, or instructing them to put themselves in the position of the a priori decision maker, has little or no impact. . . . What these studies are telling us is that the hindsight bias is incredibly robust . . . [W]e know of no foolproof ways to prevent this bias. . . . Until we know more, awareness and caution are our best defenses.”

“[W]e might be tempted to say journalists are especially susceptible to the hindsight fallacy. But a truer statement is that [they] thrive on it . . . forever treating every bad outcome as proof of incompetence if not malfeasance, and every good outcome as the result of far-seeing excellence. . . . Take a typical media indictment of Bank of America’s Mr. Lewis, flayed because he ‘overpaid for an asset [Merrill] he could have had for much less had he just waited a few extra days.’ Good grief.”

A. Some Courts “Get it”

The law requires informed decisions, not correct ones, and the law eschews hindsight. The court in Stark said it well when beneficiaries sued a bank trustee for not selling three specific stocks before they tumbled in value:

“A trustee’s performance is not judged by success or failure . . . and while negligence may result in liability, a mere error in judgment will not. Neither prophecy nor prescience is expected of trustees and their performance must be


judged not by hindsight but by facts which existed at the time of the occurrence. . . . It is not inherently negligent for a trustee to retain stock in a period of declining market values, nor is there any magic percentage of decline which, when reached, mandates sale. Indeed, the market’s fluctuations have expressly been rejected as a trustworthy indicia of a holding’s value—especially in times of general economic decline. Similarly, the fact that a stock may not be desirable for long term investment does not mean that a trustee is under a duty to sell it at the first possible opportunity. Stripped to its bare essentials, the plaintiffs’ argument is that the Trustee was negligent and imprudent in retaining these securities because of their sharp drop in market price and allegedly insufficient analysis. Case law is clear, however, that the former charge is irrelevant if the latter charge is unfounded. . . . The Trustee’s retention decisions [in this case] were the result of careful and informed deliberation; the fact that in retrospect they may have been wrong or unwise is no ground for surcharge.”

As simply stated in a 2009 Delaware case, “The conduct of a trustee in administering the trust is not to be determined a violation of any fiduciary duty based on hindsight knowledge of subsequently developed facts and circumstances.”

B. Some Courts Don’t “Get it”

Despite the law, hindsight bias is apparent in some cases. Chamberlain provides an almost humorous example of the ease with which hindsight allowed a jurist to foresee the October 1929 stock market crash:

“It was common knowledge, not only amongst bankers and trust companies, but the general public as well, that the stock market condition [in August 1929] was an unhealthy one, that values were very much inflated, and that a crash was almost sure to occur.”

More recently, the Alabama Supreme Court viewed an unfortunate investment decision as imprudent behavior: “[The trustee] sold these stocks at or near their lowest price levels . . . at the time the country was just beginning to recover from the worst recession since the 1930’s.” Looking back, even this author can see when stock prices were “at or near their lowest price levels,” and when an economy was “just beginning to recover.” Looking forward, the view is not so clear. Unfortunately, fiduciaries and their lawyers regularly must make difficult decisions without the aid of hindsight bias. The smart ones will not assume that others will later ignore the outcome

76 Id. (it helped that the trustee in this situation could show that it had stayed informed and reviewed the trust’s portfolio regularly).
78 In re Chamberlain’s Estate, 156 A. 42, 43 (N.J. Prerog. 1931).
79 First Alabama Bank v. Martin, 425 So.2d 415 (Ala. 1982), as modified on rehearing Jan. 14, 1983, cert. denied, 461 U.S. 938 (1983) (although the court may have been influenced by its knowledge of when the market turned around, the trustee in this case was particularly vulnerable because it did not follow its own guidelines).
of such decisions when passing judgment through a rearview mirror:

“When second-guessed by a hindsightful observer, misfortune appears to have been incompetence, folly, or worse.”

“The effect of the hindsight bias is to make [evaluators] uncharitable second-guessers of [others’] decisions.”

¶ 1603 Timely Issues and Noteworthy Developments

Bad experiences sometimes prove to be instructive: “Good judgment comes from experience, and a lot of that comes from bad judgment.”

Hopefully the rest of this chapter will help fiduciaries and their lawyers learn good lessons and develop good judgment thanks in part to the bad experiences of others.

¶ 1603.1 Ponzi Schemes

There was a significant increase in the number of reported Ponzi schemes during 2008 and 2009. An Federal Bureau Investigation (FBI) website provides a long list, along with interesting details. Some of the alleged schemers are now household names. For example, Bernie Madoff supposedly was “one of the most trusted names on Wall Street.”

His victims include many charitable organizations, at least one Ivy League school, and a large number of well-known individuals and corporations. Investors reportedly were attracted by Madoff’s apparent ability to “deliver steady profits through markets both bull and bear,” and his “unblemished record of value, fair-dealing and high ethical standards.”

Twin City businessman Tom Petters was arrested and jailed in October of 2008 for his role in an alleged $3.5 billion Ponzi scheme. He had been the Chief Executive Officer (CEO) of the company that owned Sun Country Airlines and Polaroid.

R. Allen Stanford stands accused of “defrauding


82 Will Rogers (circa 1930) or Mulla Nasrudin (circa 1208).

83 See generally Federal Bureau of Investigation, Highlighting Recent FBI “Ponzi” Scheme Investigations, Apr. 1, 2009, at http://www.fbi.gov/pressrel/pressrel09/ponzi040109.htm. From that website: “Ponzi schemes are varied in their methods, but usually lure investors with the false promise of high financial returns or dividends not available through traditional investments. [They are] named after Charles Ponzi, who operated an enticing scheme in the early twentieth century that guaranteed investors a 50 percent return on their investment in postal coupons. Instead of investing the money he received, Ponzi simply used it to pay “dividends” to initial investors and pocketed the rest himself. The scheme fell apart when investors grew suspicious and funds dried up, making it impossible to make additional payouts and keep the ruse going.”

84 Thomas Zambito and Greg B. Smith, Feds say Bernard Madoff’s $50 billion Ponzi scheme was worst ever, N.Y. DAILY NEWS, Dec. 13, 2008.

85 Id.

30,000 investors of $7 billion, filing false reports to regulators and investors, diverting more than $1.6 billion into undisclosed personal loans to [himself], and conspiring to obstruct an investigation by the SEC."\(^{87}\)

The following expert testimony makes it sound as though no competent fiduciary would ever be defrauded by Madoff or people like him:

“The biggest responsibility for the failure to discover Madoff’s fraud falls on those . . . fiduciaries who, directly or indirectly, invested with Madoff without apparently doing any normal due diligence and not thereafter exercising any oversight of their investments.”\(^{88}\)

But if that is true, one has to wonder how Madoff managed to steal upwards of $50 billion over thirty years, in some instances from relatively sophisticated investors. If the fraud would have been apparent to those doing “normal due diligence,” how could it have gone on for so long?

People who were defrauded by Madoff or his ilk might sue not only the person behind the alleged Ponzi scheme but also any lawyer who provided legal services to one or more of the alleged perpetrators. There is also the possibility that fiduciaries who have been sued for failure to discover a Ponzi scheme will sue their own lawyers for not doing a better job of helping them understand and fulfill their fiduciary responsibilities. Consider, for example, the allegations in a 2009 case involving an alleged Ponzi scheme:\(^{89}\)

“[O]ne or more Davis Wright Tremaine [DWT] attorneys attended board meetings . . . , helped design and implement the overall business plan . . . communicated directly with investors . . . and provided direct oversight . . . In short, DWT played a critical role in creating, sustaining and propping up the [client].”\(^{90}\)

DWT’s defense counsel contended that the firm “provided excellent, appropriate and ethical lawyering,” and that the client, a chain of retirement facilities, had failed because of the economy.\(^{91}\) Several months after the suit was filed, DWT paid $30 million to settle it, and released the following statement:

“As the . . . litigation proceeded, the facts of the case were unfolding in a positive way, which enabled us to settle the case quickly and to our satisfaction. Although our position was strong, it made more sense to resolve this now, given the inherent cost, disruption and uncertainty of complex litigation. We stand by the legal


\(^{88}\) William Josephson of Fried, Frank, Harris, Shriver & Jacobson, New York, and former head of the New York State Attorney General’s Charities Bureau, responding to questions presented by the Senate Finance Committee (Mar. 25, 2009).

\(^{89}\) See generally Jeff Manning, Portland law firm agrees to $30M Sunvest settlement, OregonLive.com, Oct. 22, 2009; See also D. Weiss, Receiver Sues Davis Wright for $400M, Claims Firm Aided Client’s Ponzi Plan, ABAJournal.com, May 8, 2009.

\(^{90}\) Grassmueck vs. Davis Wright Tremaine, Civil Case No. CV 09-651-ST (June 11, 2009).

\(^{91}\) Manning, supra, note 81.
representation and advice we provided our client and are happy now to move on.”

In another 2009 action, the plaintiffs’ counsel made numerous allegations, including that Holland & Knight (H&K) should have “recommended and insisted on... checks, balances and safeguards,” multi-levels of representation caused “irreconcilable conflicts of interest,” the conflicts of interest were “unwaivable,” any purported waiver would be a nullity because there was “no independent source” from which a waiver could have been obtained, and “H&K failed to discover [a] fraudulent investment program, when even a cursory examination and review of his activity would have revealed his illegal activities.” Again, these are just allegations from the complaint.

H&K’s counsel responded that the plaintiffs had gone after deep-pocketed defendants because the alleged perpetrator of the fraud is not able to repay the victims: “The fact that a firm such as [H&K] is a defendant ‘suggests that no one is immune’... It’s a sign of the times. People are looking to go after professionals.”

In a 2008 case, late investors in a Ponzi scheme sought to recover money from early investors who received distributions from funds contributed by the late investors. To recover, they needed to prove a breach of a special trust, fiduciary relationship, or actual fraud, among other things. The trial court and the appellate court denied relief because the defendants had not been aware of the fraud and were not unjustly enriched by it. In another recent case, however, the court ruled as a matter of law that certain redemption payments based on fictitious profits would have to be refunded to the bankruptcy estate, regardless of good faith. The redeeming investor could not utilize the good faith affirmative defense unless it could establish that it conducted a diligent investigation of each potential problem or red flag.

16-21 LIABILITY ISSUES
¶ 1603.2

Missed Opportunities & Problems
What planning opportunities must be considered in any given situation? Fiduciaries and their lawyers might answer this question differently than would an erudite expert witness blessed with 20/20 hindsight. Consider a 2007 Minnesota case where the husband’s estate had been distributed to two marital trusts (one that was exempt from generation skipping transfer (GST) taxation and one that was not exempt) and

92 Id.
93 Scoop Real Estate vs. Holland & Knight (H&K), Civil Case No. 2009-CA-014887-NC (Aug. 31, 2009).
94 Id.

(Rel.2010-7/2010 Pub.755)
credit-shelter trust. \textsuperscript{98} U.S. Bank served as sole trustee of all three trusts, co-trustee with the surviving spouse of her revocable living trust until she died, and the personal representative of both probate estates. The lawyer for the husband and wife, and for their estates after they died, was listed in \textit{Best Lawyers in America} and \textit{Minnesota Super Lawyers}. After the husband and wife died, their children sued both the bank and the lawyer for not doing enough to help save estate taxes. Specifically, they claimed that a competent lawyer would have recommended use of a family limited partnership or similar entity, and a competent fiduciary would have transferred trust assets to such an entity, to qualify for valuation discounts. Despite an absence of non-tax reasons to form such an entity, and evidence that saving taxes had not been the parent’s primary objective, the lawsuit consumed vast resources. After 34 trial days and testimony from 12 expert witnesses, the court issued a 176-page opinion in favor of U.S. Bank. By then the lawyer had settled for an undisclosed amount.

In a 2007 Florida case a law firm successfully argued that it was not required under the circumstances in that case to recommend use of a family limited partnership. \textsuperscript{99} In a 2008 Kansas case the personal representative of the decedent’s estate sued the decedent’s lawyer and a trust company that had served as agent for the decedent’s self-trusteed revocable living trust, alleging failure to advise the decedent on the use of a family limited partnership. \textsuperscript{100} One of the plaintiff’s experts opined as follows:

“[If the decedent’s lawyer] intended to limit the scope of [the lawyer’s] estate planning services, [the lawyer] had the duty to explain to [her client] the consequences of the limitation and . . . to recommend that [the client] obtain other estate planning counsel.” \textsuperscript{101}

The trial court granted summary judgment for the lawyer and the bank, and the appellate court partly agreed, noting that “an issue of fact exists as to whether [the bank] was relieved of [its] fiduciary responsibility regarding estate and tax planning advice,” \textsuperscript{102} and remanding the case to the trial court to determine whether any damages alleged from the breach of fiduciary duty claim accrued before the decedent’s death.

Banks and other corporate fiduciaries don’t normally have a duty to recommend sophisticated tax-saving strategies, but statements made directly to a specific customer or more generally in marketing materials can expand the scope of their legal responsibility. Similarly, a lawyer’s duty to raise such options depends on the circumstances. For example, a lawyer can limit the scope of an engagement as long as the client makes an informed decision to accept the limitation. \textsuperscript{103} Without a specific limitation, there could be a duty to discuss tax-saving options with a wealthy client. This author has first-hand knowledge of several such controversies:

\textsuperscript{98} \textit{In re Galloway}, 2007 WL 5125298 (Minn. Dist. Ct.).
\textsuperscript{101} \textit{Id.} at 285.
\textsuperscript{102} \textit{Id.} at 305.
\textsuperscript{103} See MODEL RULES OF PROF’L CONDUCT, R. 1.2.
The adult children of a deceased client sued their mother’s estate planning lawyer for not discussing gift-giving with their mother. The lawyer claimed to have raised the topic and that the client rejected it.

Adult children sued their deceased parents’ lawyer for not recommending that the parents utilize a credit-shelter trust at the death of the first one to die. The lawyer claimed he had raised the topic and that the clients rejected it.

A deceased client’s descendants sued the decedent’s estate planning lawyer for not recommending that a GST-exempt trust be funded at the time of the client’s death. The lawyer claimed he had raised the topic and that the client rejected it.

Although it is not clear that any of these defendants committed malpractice, all three of these cases settled for undisclosed amounts. Another common element was that the lawyers had relatively little documentation to support their subsequent testimony about having talked to now-deceased clients about the planning option in question.

Such cases leave observers wondering what tax-saving strategies must be discussed with clients wealthy enough to trigger estate taxes eventually. For example, it is not difficult to imagine an expert witness opining that the estate planning lawyer of a wealthy client has a duty to discuss the \textit{inter vivos} funding of a credit-shelter, GST-exempt trust (which is simply a combination of the strategies involved in the lawsuits noted above). Such an expert might further opine that the discussion with the client had to include discount planning (\textit{i.e.}, the possibility of funding the trust with non-controlling interests in a family entity), as was argued in \textit{Galloway}.\footnote{Supra, note 98.}

The point is not that there is a duty to raise any or all of these possibilities. Any such determination would require careful consideration of facts and circumstances. The simple point here is that it is very difficult in the abstract to say which strategies must be discussed with any particular wealthy client. A related point is that expert witnesses, judges, and juries will view the actions and inactions of others in hindsight (which is likely to bias their thinking to some degree, according to the studies described above). And, of course, there is the obvious point that any such conversations about tax planning options ought to be documented. Without corroborating evidence, self-serving testimony at the time of the lawsuit may not convince the fact finder.

A possible duty to raise tax-saving strategies is just the beginning. Perhaps other opportunities must be raised. For example, a growing number of commentators seem to be saying or implying that estate planners have a duty to advise wealthy clients on asset-protection options: “A lawyer’s ethical obligation to advocate his client’s position competently includes a duty to advise the client of asset protection options.”\footnote{David J. Bernardo, \textit{“Ethical, Civil & Criminal Risks of Asset Protection Transactions,”} 2009 Hawaii Tax Institute Outlines; \textit{See also} Nenno, \textit{Planning With Domestic Asset-Protection Trusts: Part I}, 40 \textit{REAL PROP. PROB. \\& TR.} J. 263, at 284 (Summer 2005) (\textit{“Attorneys might face exposure if they do not advise the client to [engage in asset protection planning] and creditors later reach the client’s assets.”});} And because trustees have a fundamental duty to use reasonable care to
protect a trust from unnecessary loss, some lawyers contend that there could be “an obligation to explore moving [the situs of certain trusts] to more protective jurisdictions.”\footnote{Richard W. Nenno, The Trust from HELL: Can it be Moved to a Celestial Jurisdiction?, PROB. & PROP. 60, 64 (May/June 2008).}

The safe though perhaps impractical path would be to raise everything that any expert might someday say should have been raised. In any event, advisers should consider documenting any discussion of a potentially attractive strategy, together with a brief summary of the client’s reason(s) for rejecting them, and perhaps even the adviser’s reason(s) for not discussing other strategies that some expert might someday say should have been discussed. But keep in mind that discussing a strategy is not necessarily the same thing as explaining it well enough for the client to make an informed decision. There are practical problems with trying to document not only that the matter was raised and rejected, but that the rejection was fully informed. No easy answers here, other than to proceed with caution: “Forewarned is forearmed.”\footnote{Originally “praemonitus, praemunitus” in J. Arderne, TREATISES OF FISTULA (c. 1425); see Gregory Y. Titelman, RANDOM HOUSE DICTIONARY OF POPULAR PROVERBS AND SAYINGS (Random House, 1996).}

There may also be exposure for missed problems (as opposed to missed opportunities):

“A lawyer may . . . face liability when he or she fails to advise a client about a reasonably apparent matter that could affect the client, the client’s rights, or the client’s obligations, even if the client never employed the lawyer to advise about or to perform services in relation to the matter. Lawyers must advise clients concerning collateral matters, or alert the client to the need to seek other legal counsel regarding a matter the lawyer declines or lacks the expertise to handle.”\footnote{Kerry Holleran & John J. Mueller, Advice Attorneys May Not Think to Give: The Peripheral Duty in Kentucky and Beyond, 36 N. Ky. L. Rev. 349, 365 (2009).}

This author has rendered opinions in lawsuits where plaintiffs alleged that their lawyers failed to satisfy a duty to alert the clients to legal issues that were not literally within the scope of the engagement as stated in the engagement letter. In each of these cases, this author concluded that it was not reasonable under the circumstances of

Rubin & Goldberg, Consider the Implications, Trusts & Estates, 44–48 at p. 48 (Nov. 2005) (“Perhaps, once upon a time a well-designed estate plan did not need to involve deliberate consideration of the asset protection implications to the client. That time has long passed.”); Mata, Piercing of Spendthrift Trusts, Family Limited Partnerships, and Other Threats to Estate Planning Structures, ABA RPTE e-Report, July 1, 2008 (failure to advise a wealthy or at risk client of asset-protection possibilities may constitute malpractice if the client’s asset’s are needlessly exposed to a subsequent judgment or other legal claim); Rothschild & Rubin, Asset-Protection Planning: Ethical? Legal? Obligatory?, TRUSTS & ESTATES at 42 (Sept. 2003) (it is only a matter of time before clients make claims against estate planners who did not raise the subject of asset protection planning as part of the planning process—when it arguably would have worked); Mata, ALI-ABA Asset Protection Planning Update-2005, p. 250 (“failure to so advise a wealthy or at risk client may constitute malpractice if the client’s assets are needlessly exposed to a subsequent judgment or other legal claim”).
those particular engagements to expect the lawyers unilaterally to expand the scope of the agreed-upon engagement. Nonetheless, all of these cases settled confidentially for undisclosed amounts.

Is it possible that a trustee could be required to seek a judicial modification of a problematic trust agreement? A trustee successfully sought such a change in a 2007 Washington case.\footnote{In re Riddell, 157 P.3d 888 (Wash. Ct. App. 2007).} The trust had been established by the trustee’s parents to benefit the trustee/beneficiary, but eventually the trust corpus would have to be distributed in equal shares to the settlors’ grandchildren (the trustee’s children). This presented a problem (from the family’s point of view) because one of the remainder beneficiaries was legally incompetent and was currently receiving extensive Medicaid benefits. The trustee sought to modify the terms of the trust so that share would eventually pass to a special needs trust rather than outright to the legally incompetent remainder beneficiary. The lower court ruled against the petition, but the appeals court granted it:

“[T]here is no question that changed circumstances have intervened to frustrate the settlors’ intent. . . . Not only is [the special needs child] unable to manage the funds . . . but there is a likelihood that the funds will be lost to the State for her medical care. It is clear that the settlors would have wanted a different result. . . . Special needs trusts were created in order to allow disabled persons to continue receiving governmental assistance for their medical care, while allowing extra funds for assistance the government did not provide. Given this legal backdrop, the trial court should not have considered any loss to the State in determining whether an equitable deviation is allowed. The law invites, rather than discourages, the creation of special needs trusts in just this sort of situation. . . . Trusts established or funded by the disabled person are subject to 42 U.S.C. Sec. 1396p(d)(4)(A), which entitles the State to receive all remaining trust amounts upon trust termination for medical assistance paid on behalf of the disabled beneficiary. However, the State is not entitled to receive payback upon termination of a third party special needs trust for medical assistance provided for the disabled beneficiary. Here, the trust was established and funded by [the grandparents]. . . . It is a third party special needs trust. The trust is not subject to State assistance payback and is not required to have a payback provision.”

That was a terrific outcome for the family. But one wonders: do comparably situated trustees have a duty to seek a modification in similar circumstances? The answer could be “yes,” according to the Restatement (Third) of Trusts, if the trustee is actually aware that a purpose of the settlor would otherwise be jeopardized.\footnote{See, e.g., Restatement (Third) of Trusts 66(2), cmt. e.} This may be a relatively common situation.

## ¶ 1603.3 Expanded Exposure

A fiduciary’s statements, marketing claims, and actions can increase its scope of responsibility. For example, in one case a corporate trustee held itself out as a trusted adviser on important financial matters and recommended formation of a holding
company to facilitate the making of discounted gifts. The discount strategy failed to work as intended primarily because of problems in implementing the strategy. The lower court granted summary judgment to the trustee, Union Trust, and to the lawyer who did the legal work. The Maine Supreme Court affirmed with respect to the lawyer because the claims against him were time barred under the statute of limitations, but reversed with respect to the claims against Union Trust:

“[A] fact finder could find that Union Trust led [the client] to believe that it would assure that the necessary accounting, tax and legal responsibilities would be complied with. . . . Union Trust increased its role . . . by recommending [the tax-saving strategy] . . . and assumed an even greater role . . . with . . . the transfer of the shares of corporate stock to Union Trust for its management. . . . Because of the degree of management responsibility it had assumed, it was Union Trust’s fiduciary responsibility to assure that the necessary corporate formalities were followed to qualify . . . for most favorable tax treatment. . . . Union Trust, in holding itself out to the plaintiffs and to the public as competent to accept fiduciary responsibility and manage significant assets necessarily holds itself out as capable of insuring compliance with the requisite accounting, tax and legal requirements incident to its responsibilities.”

A corporate trustee in Maryland was liable, along with its customer’s lawyer, for failing to advise the customer that her exercise of a power of appointment might be ineffective (as it turned out to be). The corporate trustee, Mercantile-Safe Deposit & Trust Company (Mercantile), argued that it had not been paid to provide the advice in question and that it would have been the unauthorized practice of law to provide that advice in any event. The Court was unmoved:

“Banks . . . with trust or fiduciary departments customarily provide estate planning services without making a contemporary charge . . . . By virtue of Mercantile’s undertaking to provide estate planning advice to [its customer] in consideration of being named the fiduciary under her will and testamentary trusts, an implied contractual relationship existed between them that was broader than the formal contract governing their agency relationship.”

Examples of statements in promotional materials that could serve to expand a fiduciary’s responsibilities include the following: At X Bank we integrate tax considerations seamlessly into your overall plan, combining sophisticated, specialized tax experience with the personal, customized advice; at Y Bank we assist you in structuring various estate planning trusts and other strategies to help you reduce income and estate taxes; and at Z Bank we monitor your financial situation to anticipate tax consequences and make recommendations to minimize taxes whenever appropriate.

111 Nevin v. Union Trust Co., 726 A2d 694 (Me. 1999).
112 Id. at 699.
113 Merrick v. Mercantile Safe Deposit & Trust Co., 855 F.2d 1095 (4th Cir. 1988).
114 Id. at 1101.
16-27  LIABILITY ISSUES  ¶ 1603.4

Principal and income (i.e., trust accounting) questions can be difficult.115 In the “old days,” the trustee of a trust with an income beneficiary needed to achieve income productivity through investment decisions. Such a trustee is now generally free to invest for optimal total return (i.e., to make a reasonable effort to achieve the highest total return that is suitable to the trust’s purposes and the circumstances of the trust and its beneficiaries, especially risk tolerance) without thereby violating the duty of impartiality. Forty-five states and the District of Columbia have adopted all or portions of the 1997 Uniform Principal and Income Act with its adjustment power, and 28 states now have some form of unitrust-conversion statute, usually as an alternative accompanying the adjustment power. Depending on the circumstances, it may also be possible for the trustee to make a common-law equitable adjustment to satisfy the duty of impartiality.116

Although large losses in stocks during 2008 and early 2009 caused some people to question the wisdom of total-return investing, a day will come when constrained investing (i.e., investing for a target level of income productivity) will predictably produce substandard total returns.117 At that time, some beneficiaries may argue that by investing the “old way,” the trustee virtually guaranteed a substandard total return. Their argument: With the power to invest for optimal total return comes the duty to do so, unless there is a specific, documented reason for not doing so.118

Although having a unitrust-conversion or income-adjustment power paves the way to total-return investing, it leaves unresolved the question of capital-gain tax allocation. With unitrusts, the allocation must be made the same way each year. The income beneficiary will probably want such gains taxed to the trust, and the remainder beneficiaries will want those gains included in distributable net income (DNI) and taxed to the income beneficiary. Alternatively, the income beneficiary may want the trustee to invest in tax-exempt, rather than taxable, bonds (so distributions from the trust will not carry out taxable income with them). What is the trustee to do? Here is some helpful advice:

“If a trustee is using a unitrust regime, the discretion to allocate gains must be exercised consistently. . . . It’s almost counterintuitive to think that the application of a strict mathematical formula to determine a payout could still leave a

116 See RESTATEMENT (THIRD) OF TRUSTS § 79, cmt. i, and Chapter 23 Introductory Note.
118 Optimal total return investing involves making a reasonable effort to achieve the highest total return that is suitable to the trust’s purposes and the circumstances of the trust and its beneficiaries, especially risk tolerance. See RESTATEMENT (THIRD) OF TRUSTS Chapter 23 Introductory Note.
trustee fraught with conflict. Ah, but that’s just what happens. . . . Whoever is saddled with the capital gains tax burden will be saddled with it for the duration of the trust. With respect to both the investment strategy and the allocation of capital gains, it will be very important for the trustee to have all beneficiaries on the same page. . . . A trustee should at least be able to demonstrate that he was cognizant of these issues and made a determination that he considered fair and impartial under the circumstances. . . . Trustees have far more options if they’re operating in a power-to-adjust regime. . . . They’re able to examine the character of the distributions flowing to the income beneficiary, see on whom the burden of the capital gains taxes lies and adjust the payout to the income beneficiary accordingly.”

The trust estate in a 2006 New York case consisted primarily of high-yielding real estate. Because of a unitrust election, the annual payout to the income beneficiary dropped from $190,000 to $70,000. The trustees were the income beneficiary’s stepchildren and trust remaindermen, and chose to make the conversion retroactive (which meant their stepmother had to reimburse the trust estate $120,000 for excessive distributions over the prior three years). The Appellate Division and the Court of Appeals held that the trustees were not prohibited from making the unitrust election despite benefiting personally, and allowed the retroactive change. Unlike an income-adjustment power, the unitrust-conversion statute was not limited to disinterested trustees. The unitrust-conversion statute in New York was later changed to limit retroactivity.

In a 2008 Nevada case the trustees were also beneficiaries and so a bank was appointed special trustee to adjust income pursuant to the state’s version of Uniform Principle and Income Act, Sec. 104. The District Court denied a petition to make a retroactive adjustment for the preceding year, but the Supreme Court reversed, holding that the corrective nature of the adjustment power suggested, at a minimum, that the special trustee could make an adjustment for the year immediately preceding its appointment. In some states, any exercise of an adjustment power must be made within a set number of days. Unless a statutory exception applies, a trustee may be liable for not adjusting income or converting to a unitrust when necessary to achieve an impartial outcome.

A 2007 California case involved a no-contest clause. Despite a trust provision that principal-and-income matters were to be governed by statutes existing “from time to time,” an income beneficiary’s petition to determine whether the trustee should exercise a statutory income-adjustment power would violate a no-contest clause in the

119 Sharon L. Klein, New Dilemmas, Tr. & Est. (March 2006)
121 In matter of Orpheus Trust, 179 P.3d 562 (Nev. 2008).
122 See, e.g., N.J. STAT. ANN. § 3B:19B-4(a) and MD. EST. & TRUSTS CODE ANN. 15-502.3(d)(3/4).
123 See RESTATEMENT (THIRD) OF TRUSTS § 79.
governing instrument, according to the Probate Court and Court of Appeals. In a 2006 New York case the remainder beneficiaries tried unsuccessfully to prevent an adjustment to income that would benefit their stepmother, the income beneficiary.125 The court applied the abuse-of-discretion standard, as required by the applicable statute.126

A 2009 Delaware case involved an elderly woman who had been advised to place most of her life savings in a charitable remainder unitrust with a 10% annual payout to her for life and then to her children for their lives, with the remainder going to five charities.127 There was pressure from the settlor to increase the size of the trust principal so her annual distributions would be higher. In an effort to address the settlor’s needs for larger distributions, the trust company altered the portfolio significantly until it was almost exclusively in equities. Unfortunately for the trustee, the market declined shortly thereafter, resulting in a loss of about 58% of the trust estate’s value. The settlor took steps to remove the trustee and refused to release it from liability, so the trustee sought judicial approval for its actions. The settlor counterclaimed, alleging violation of the prudent investor standard and other breaches of fiduciary duty. The court ruled that the trustee had waived its statute of limitations defense to the charge of imprudent investing when it sought approval for conduct occurring before the two open years. The Delaware judge was unimpressed with the thin record of why the trustee did what it did, and described the decision to invest almost wholly in equities as “disturbing,” yet ruled that the trustee had not breached its fiduciary duties. Interestingly, the court seemed to agree with the plaintiff that it would have been a breach if her requests were the sole reason for the shift in asset allocation:

“Had [the trustee] abdicated its duties and acted solely upon [the settlor’s] request, [the trustee’s] failure to exercise any judgment concerning the shift in investment strategy would have been an abuse of its discretion.”128

Fortunately for the trustee, the court balanced evidence that the beneficiary’s request had been considered with evidence that a senior trust officer, an investment officer, and a trust committee had all reviewed and approved of the change in investment policy. The court allowed the trustee’s legal fees to be paid out of the trust estate, only because the governing instrument conditioned the release of assets to a successor trustee on an

125 Estate of Morse, Index No. 83862 (Sur. Ct., Dutchess Cty. 2006).
128 Id. at 23.
informal release or a judicial approval of the outgoing trustee’s accounts. Otherwise, the trustee’s legal fees would not have been recoverable, because the accounting action was motivated primarily by a desire to protect the trustee rather than to benefit the trust or for the proper administration of the trust, according to the court. The Delaware court seemed to think that the trustee’s duty of impartiality necessitated extraordinary steps to achieve an above-average total return:

“Delaware law is clear that the interests of all beneficiaries must be considered in investment and management decisions. [The trustee] faced something of a fiduciary ‘Morton’s Fork’ when charged with the Trust’s management: either take large risks in an attempt to satisfy its duties to all beneficiaries and fulfill the terms of the Trust Agreement, or concede from the very beginning that the Trust would fail; choosing instead to manage its assets by seeking goals other than those found in the Trust Agreement.”

¶ 1603.5 Declining Values

The law holds fiduciaries to a high standard of care, but does not mandate good results (i.e., that the value of an investment declines dramatically does not mean that the fiduciary necessarily breached a duty). But any such fiduciary better be ready to demonstrate an appropriate level of awareness and conscious decisionmaking.

In a 2009 Hawaii controversy an heir to the $2 billion Campbell Estate sued Central Pacific Bank (CPB) for being “asleep at the switch.” CPB managed an investment account when stocks like AIG, Citibank, and Bank of America began to tumble. For example, CPB paid $69.26 per share for AIG stock in March of 2008 and sold it for $2.17 per share in six months later. That stock eventually bottomed out at about 35 cents per share in March of 2009. According to the complaint, CPB “neglected to take any action to end the hemorrhaging.” The underlying logic of the lawsuit might seem to be that prudent investors must sell declining stocks at some point, rather than watch them go lower and lower. Actually, the focus is likely to be on CPB’s documented thought process when it bought the stocks and while they were declining. According to the complaint, “It appeared that [CPB] was buying and selling stocks with no apparent strategy.”

In a 2009 Pennsylvania controversy the state attorney general has asked for a $168.1 million surcharge on a special trustee of the McCune Foundation. The founder’s family had fought to get a family member appointed as special trustee with authority over the Foundation’s 4.8 million shares of National City stock. National City was a

129 See also Chancery Court Refuses to Remove Trustee of Trust Despite Less Than Ideal Treatment of Old Lady, DELAWARE LITIGATION, Sept. 4, 2009.
130 Id. at 21.
131 Growney v. Central Pacific Bank, Circuit Court No. 1CC09-1-001374 (2009).
132 See also Rick Daysog, Campbell heir blaming CPB for losses, HONOLULU ADVERTISER, June 25, 2009, at B5.
trustee of the Foundation. Between 2004 and 2008, National City stock dropped in value from nearly $40 to less than $5 per share. In his role as *parens patriae*, the state attorney general moved to hold the special trustee personally accountable for the loss. The special trustee’s lawyer told a reporter, “You put 20/20 hindsight into the hands of law enforcement officials, and that’s a very powerful, if not dangerous, tool.”

A 2006 New Hampshire case highlights the importance of making timely decisions. Monsignor Norman Bolduc had devised a $6.5 million stock portfolio to his parents, and chosen a fellow priest to serve as personal representative. The tech-stock bubble burst shortly after Bolduc’s death, and six months later the probate estate was worth only $500,000. Bolduc’s parents argued that the personal representative did not act in a timely fashion to liquidate the estate. According to their lawyer, this was a “perfect storm” of unfortunate events that obligated the personal representative to act quickly: “This estate was on fire. This wasn’t just smoke, there were flames. Not just margins, there were margin calls.” The trial judge faulted the personal representative for ignoring urgent margin calls from brokerage firms and not supervising the law firm he had hired to assist him on estate matters. It surcharged the personal representative $1.256 million. The personal representative then sued the law firm that had assisted him when he was serving as personal representative, funding the litigation with money his parishioners raised specifically for that purpose. These facts were extreme, but they highlight that a duty to act in a timely manner can take on added dimensions when markets are unusually volatile:

“If before the bottom started falling out of the real estate market, a probate lawyer who was dilatory in dealing with an estate could point to the fact that the property had increased in value while he fiddled. Not anymore.”

§ 1603.6 Retention and Exculpatory Language

A governing instrument sometimes instructs or authorizes a trustee to retain an asset that the trustee might otherwise be required to sell—typically because of an overconcentration problem. In some cases, there also is exculpatory language. It can be quite challenging to determine how such language modifies the trustee’s normal duties and/or liability under the prudent investor rule. Some of the following cases are not easily reconciled with others.

In a 2005 Kansas case a revocable trust instrument required the bank trustee to consult the settlor before buying or selling any stock, and then to follow the settlor’s instructions. Because there was a high concentration in one particular stock (Enron), the trustee had the settlor sign a letter directing its retention and relieving the trustee of any responsibility to analyze or monitor that stock. After Enron collapsed, the settlor

134 Id.
sued the trustee for failure to comply with the prudent investor rule. The Court rejected the claim, but noted that the trustee should have explained the consequences of the retention agreement and alerted the settlor when the stock price declined significantly. At least one author thinks the plaintiff should have prevailed: “The Kansas Supreme Court missed an opportunity seized by other jurisdictions to protect the rights of trust beneficiaries.”

In a 2007 Virginia case the income beneficiary of a trust sought the trustees’ removal and an $800,000 surcharge, arguing that the trustees had produced too little income. The lower court granted the trustees’ motion for summary judgment, but the appeals court reversed. Because these trustees allegedly failed to inform the income beneficiary of offers the trustees had received from third parties interested in buying non-income-producing trust properties, the trustees may have breached their duty to communicate information needed to protect the income beneficiary’s interests.

In a 2007 Ohio case a charitable remainder unitrust funded with Proctor & Gamble (P&G) stock contained a clause permitting the trustee to “retain, without liability for loss or depreciation resulting from such retention, original property, real or personal, received from Grantor or from any other source although it may represent a disproportionate part of the trust.” The trustee gradually reduced the concentration of P&G stock, but not fast enough to avoid the consequences of a sharp drop in its value—by the end of the first year the trust estate lost half its value. The bank’s argument that the above language relieved it of a duty to diversify and exculpated it from liability fell on deaf ears. The trial court awarded damages in excess of $1 million. The Court of Appeals affirmed, stressing that a mere authorization to hold a high concentration of stock does not eliminate the duty to diversify.

In a 2005 Ohio case the trust agreement authorized the bank to “retain any securities . . . including shares of a corporate trustee.” During a 20-month winding-down period the bank trustee retained a large concentration of its own stock despite the primary beneficiary’s request that the bank take steps to diversify. The stock’s value rose initially but then dropped substantially in value. The appeals court drew a sharp distinction between authorization to retain (present here) and elimination of the standard duty to diversity (not present here). Authorizing a trustee to hold a particular block of stock is not the same as directing it to do so. A jury had decided in favor of the bank but the Court of Appeals overturned the jury’s verdict and remanded the case for a new trial.

In a 2008 the Michigan Court of Appeals reversed and remanded a lower court decision because the trustee was exempt from the prudent investor rule under the unique language of the governing instrument, which authorized the trustee “to invest

138 Justin Whitney, Taking the Trust Out of Trustee, 46 Washburn L.J. 245 (2006); See also David Horton, Unconscionability in the Law of Trusts, 84 NOTRE DAME L. REV. 1675 (2009).
and reinvest . . . in income-producing assets in accordance with its judgment, not being limited by any present or future investment laws.” The instrument also contained a very specific clause authorizing retention of the stock in question unless it ever became “unproductive of income,” and there was exculpatory language as well. The bank was reimbursed for costs incurred in defending itself in this action.

In 2008 the Eighth Circuit U.S. Court of Appeals upheld a summary judgment in favor of a corporate trustee that did not liquidate a heavy concentration of stock within two weeks of the settlor’s death. The facts heavily favored the trustee. For example, the settlor had directed the trustee to retain the stock notwithstanding any consequent risk and lack of diversification; the settlor had repeatedly expressed his firm belief that the stock was the best investment for the trust; and within the two week period, the trustee had looked closely at the issue of diversification and discussed it with the settlor’s attorney and accountant, and scheduled a meeting with the trust beneficiaries.

In a 2006 Indiana case a bank had been appointed conservator for a descendant of the founder of Eli Lilly & Company (Lilly). To minimize taxes on the ward’s $1 billion estate, the bank requested and got permission from the Probate Court to establish two charitable remainder annuity trusts with retention and exculpatory language: “[A]ny investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments.” Most of the Lilly stock was sold during the trusts’ first year, but not before the stock price declined. The Probate Court granted summary judgment for the bank, and the Court of Appeals affirmed, primarily because the exculpatory clause was found to be valid and binding. The court noted that the plaintiff’s lawyers had expressed no objections to the retention/exculpation language when the trusts were being created.

In a 2008 New York case the trust instrument granted the trustee absolute discretion in managing trust estate, which included a high concentration of closely held stock with an unusual capital structure (class A shareholders controlled the decision to liquidate, but virtually all liquidation proceeds would go to class B shareholders). Beneficiaries alleged failure to diversify, but the court found that the corporate trustee had “made a reasonable determination that it was in the best interests of the beneficiaries not to diversify.” The record indicated that the trustee had made a concerted effort to understand its options and to make informed decisions that would be in the best interests of the trust beneficiaries.

In a 2008 Michigan case general retention language plus exceptionally good communications created a safe harbor for a bank that consciously decided not to

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143 Nelson v. First National Bank, 543 F.3d 432 (8th Cir. 2008).
diversify a large concentration of stock.\footnote{In re Wege Trust v. Fifth Third Bank, 2008 Mich. App. LEXIS 1259.}

In a 2005 Ohio case a trust established by the son of the founder of the J.M. Smucker Company contained the following clause: “The Trustees are expressly empowered to retain . . . without liability . . . any and all securities issued by The J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein.”\footnote{National City Bank v. Noble, 2005 Ohio 6484 (Ct. App.).} The trustees had diversified slowly over several decades and the trust estate had increased over the life of the trust. Even so, the beneficiaries eventually sued for failure to diversify and for conflict of interests (the individual trustee was a director of the company). Citing the retention language in the trust instrument, the Probate Court ruled in favor of the bank and awarded attorney fees incurred in defending the action. The Court of Appeals affirmed.\footnote{Id.}

In a 2006 New York case the bank trustee had been sued for not diversifying a trust estate that consisted almost entirely of Kodak stock.\footnote{In Re Dumont, 791 N.Y.S.2d 868 (2004), rev’d in part, 809 N.Y.S.2d 360 (App. Div. 2006), appeal denied, 813 N.Y.S.2d 689 (App. Div. 2006), appeal denied, 855 N.E.2d 1167 (2006).} The testator had expressed in his will a “desire and hope that [the Kodak] stock will be . . . distributed to the ultimate beneficiaries under this will, and neither my executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they nor it shall be held liable for any diminution in the value of such stock.” Also, “The forgoing shall not prevent my said executors or my trustee from disposing of all or part of the stock of Kodak in case there shall be some compelling reason other than diversification of investment for doing so.” Between 1958 and 2002 there was little investment review process and documentation regarding an investment strategy (e.g., reasons for not diversifying), and the trustee rarely communicated with beneficiaries. The Surrogate Court considered the retention clause “clearly precatory,” stressed that the prudent investor rule requires trustees to diversify assets unless it is in the interests of the beneficiaries not to diversify, and added, “. . . a retention clause does not exculpate [a trustee] from poor judgment and laziness, but instead . . . a retention clause almost requires a greater level of diligence and work . . . .” Finding an “on-going self-perpetuating atmosphere of neglect,” and a “complete lack of documentation” that was “itself a breach of trust,” the Surrogate imposed a $21 million surcharge. The appellate court reversed because the trial court erred in ruling that the stock should have been sold as of an unpleaded date for unpleaded reasons, and because the Surrogate’s finding was based on hindsight (e.g., as of the key date, Kodak had out-performed the Standard & Poor’s 500 index and had recently been praised in a stock report).

An exculpatory clause can relieve a trustee of liability for breach of trust, but not for a breach of trust committed in bad faith or with indifference to the fiduciary duties of

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\text{\footnote{146 In re Wege Trust v. Fifth Third Bank, 2008 Mich. App. LEXIS 1259.}} \\
\text{\footnote{147 National City Bank v. Noble, 2005 Ohio 6484 (Ct. App.).}} \\
\text{\footnote{148 Id.}} \\
\end{align*}\]
the trustee, the terms or purposes of the trust, or the interests of the beneficiaries.\textsuperscript{150} There is an initial presumption of overreaching: “The scrivener/fiduciary has the burden of establishing that the client realized the implications of the clause.”\textsuperscript{151} The court in a 2008 New York case indicated that a lawyer’s attempt to include language holding herself unaccountable “strongly suggests a violation of professional ethics.”\textsuperscript{152}

“Although [most] courts routinely announce that exculpatory clauses are enforceable, in reality courts tend to shield the trustee from liability only in [a few] situations: . . . (2) the trustee is a non-professional or uncompensated; (3) the [provision relates to a] . . . direction that the trustee retain specific, relatively risky investments . . . .”\textsuperscript{153}

\section*{1603.7 Diversification}

Diversification is usually required, but there are times when the trustee need not diversify, and other times when diversifying can be ill-advised or even actionable. Clearly, the decision to sell or retain a specific stock cannot be made in a vacuum. The purposes of the trust and circumstances of the beneficiaries are among the relevant factors.

In a 2005 Pennsylvania case the corporate trustee held a large block of its own stock in a revocable trust that divided into marital and nonmarital trusts for the surviving spouse.\textsuperscript{154} The trustee’s policy was to perform a portfolio review within sixty days of a trust’s funding, yet in this case it took nearly seven months. The portfolio manager eventually made the decision to diversify partly because his reading of the governing document led him to believe that the settlor’s investment goal was to “take advantage of estate tax planning, not necessarily to provide income.” He evidently did this without first inquiring about the health or financial circumstances of the surviving spouse, who was quite ill and survived less than two years. The bank’s investment plan lengthened the investment time horizon, which the trial court ruled grossly negligent under these circumstances: “Diversification cannot become a goal in and of itself.”\textsuperscript{155} The bank did not have a duty to seek the beneficiary’s approval, but it did have a duty to investigate the life tenant’s health and financial circumstances:

“Simply put, there were no reasonable prospects that the Trust could continue in existence long enough to experience capital growth from the chosen diversification

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\textsuperscript{150} \textit{Restatement (Third) of Trusts}, § 96.
\textsuperscript{151} Estate of Kramer, 2003 WL 22889500 (Pa. C.P. 6-15-03); but see Marsman v. Nasca, 573 N.E.2d 1025 (Mass. Ct. App. 1991); UTC § 1008(b); \textit{see also} Matter of Boss, 487 N.W.2d 256 (Minn. Ct. App. 1992); and \textit{Scott and Ascher on Trusts, supra}, 24.27.4.
\textsuperscript{152} \textit{In re Kornrich}, 2008 N.Y. Misc. LEXIS 2049 at 6.
\textsuperscript{155} \textit{Id.} at 490.
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strategy and it was gross negligence to sell safe and high performing assets in the implausible hope that a long-term capital gain could be realized.”\textsuperscript{156}

The corporate trustee made it relatively easy for the court to hold it liable. Marketing brochures had touted “continual supervision . . . by capable specialists.”\textsuperscript{157}

In a 2002 New York case, despite a clear understanding that the bank trustee would avoid selling any of the trust’s highly appreciated stock, the trustee eventually did so in order to diversify.\textsuperscript{158} The lower court granted summary judgment to the trustee, but the Court of Appeals reversed because there was a legitimate question as to whether the investment officer had properly communicated with the administrative officer “to ensure his understanding of the investment objectives.”\textsuperscript{159}

In a 2008 Pennsylvania case the corporate trustee and one of the three individual trustees unsuccessfully urged the other two trustees to diversify the trust estate.\textsuperscript{160} During the stalemate the stock declined in value. The individual trustee who wanted to diversify sued the corporate trustee along with the individual trustees who had refused to diversify. The lower court determined that local law did not require diversification, but the trustees did not have “unfettered discretion” to maintain the stock concentration with impunity. That court imposed more than $1 million in surcharges and fees on the two trustees who were found to have placed their own self-interest above the needs of the beneficiaries. The corporate trustee escaped liability and received reimbursement for its fees and costs in defending itself in the surcharge action, because it had vigorously tried to convince the others to diversify. On appeal the case was affirmed in part, reversed in part, and remanded without a published opinion.\textsuperscript{161}

In a 2001 New York case, several months after a charitable lead trust was funded entirely with IBM stock, a corporate trustee’s investment committee considered diversifying the trust estate, but decided to hold off selling stock until the price recovered from a recent decline.\textsuperscript{162} Rather than bounce back, however, the price continued downward and was worth only about half its original value by the time the trustee rendered an accounting to the beneficiaries. The Surrogate Court found that the trustee had been negligent for not diversifying relatively soon after taking the position. The Appellate Division agreed and noted that the trustee had “failed to follow its own internal protocol . . . [and] failed to conduct more than routine reviews of the IBM

\textsuperscript{156} Id. at 492.
\textsuperscript{157} Id. at 486.
\textsuperscript{159} Id. at 414.
\textsuperscript{161} Id.
An old Hawaii case demonstrates the common-law foundation to the prudent investor rule. The settlor told the trustee on several occasions that he wanted to retain his stock in Hawaiian Pineapple Company (HPC) even though it comprised more than 80% of the trust estate. The governing instrument authorized the trustee to retain that stock, and the settlor’s permission was needed to sell it. HPC eventually suspended its dividend, however, and the trustee sold some of it to diversify. The settlor sued because the sale had been made without the settlor’s permission, and because the trustee had not taken steps to diversify sooner. The lower court found the trustee guilty of breach of trust for selling stock without the settlor’s permission and for not requesting permission to sell years earlier before the stock declined in value, and the Supreme Court affirmed.

“[D]efendant as trustee was not only bound to the duty of exercising the prudence of a reasonably prudent businessman but was also bound to use the higher degree of skill that it possessed as an expert professional fiduciary. . . . The standard is absolute and is not obviated or lessened because a particular breach was honest and well-intentioned.”

The court described a “specific investment duty to diversify trust investments unless absolved from doing so by express direction in the trust instrument, such as a mandate to retain specified assets.” The trustee argued unsuccessfully that the authorization to retain the stock, especially when combined with the settlor’s oral requests to do so, absolved it of its responsibility to advise the settlor to diversify. That the trustee had at all times acted in good faith made no difference.

The governing instrument in a New York case stated the testator’s desire that a named stock be retained by the personal representative and trustee, “unless compelling reasons arise for the disposal thereof.” Within two months of the testator’s death, the trustee sold about half of that stock to diversify the trust estate (which it considered a compelling reason). Then, when the stock went up in value, the widow sued. The Surrogate ordered the trustee to repurchase the stock at its own expense, and to pay the widow’s attorney fees and costs. The Appellate Division affirmed: Diversification was not a “compelling” reason to sell, at least not in light of the widow’s objections.

This should be compared with another New York case where a corporate trustee sold a concentration of its own stock to diversify the trust estate despite a clause that authorized its retention. The court rejected the beneficiary’s claim that the clause

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163 Id. at 665.
165 Id. at 562.
166 Id. at 566.
superseded the prudent investor rule: “Neither the trust language permitting retention of the stock nor the preference of the trust beneficiaries would have insulated [the trustee] from a claim that it breached its fiduciary duty had it failed to achieve appropriate diversification.”169

¶ 1603.8 Communication

The duty of communication requires a fiduciary to provide all the information that beneficiaries need to protect their interests in the trust.170 The outcomes of many cases described elsewhere in this chapter were arguably affected by good or bad communications between the fiduciary and the beneficiaries. In addition to the fiduciary’s duty of communication (which, of course, has its limits), a culture of openness can promote trust, confidence, and goodwill.171

In 2009, years after receiving final distributions from a trust, and signing releases, the beneficiaries of a New York trust sued the trustee and the law firm that had represented the trustee.172 At the heart of this action was an allegation that the trustee had improperly retained a large block of Corning Glass Works stock that declined in value, and that the trustee had a duty to inform the beneficiaries of its duty to diversify and to explain more clearly the legal effect of signed releases. The governing instrument gave the trustee “absolute discretion” to retain “any stocks, bonds or other securities . . . , including securities of Corning Glass Works.” It added that the trustee “shall not be or be held responsible for any loss . . . that may occur in the value [of any such securities].” The plaintiffs also alleged that the law firm fraudulently concealed that it simultaneously represented the bank on other matters. The Surrogate dismissed the actions because they were filed too late. The Appellate Division affirmed, noting that the complaint failed to make a “factually supported allegation” of misrepresentation.173

In another 2009 controversy the settlor of a self-trusteed revocable trust had given Fisher Investments discretionary control over the trust’s portfolio at a time when the asset allocation was cash 27%, fixed income 32%, and equities 41%.174 Fisher

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169 Id. at 670.

170 RESTATEMENT (THIRD) OF TRUSTS, § 82(1)(c), (d), and (e); See generally Frank T. Messina, To Affirmatively Disclose or to Passively Disclose, That is the Texas Trustee’s Question: What Duty of Disclosure Does a Texas Trustee Owe to a Beneficiary?, 1 EST. PLAN. & COMM. PROP. L.J. 237 (2008); Robert Whitman, Dealing Fairly with Estate and Trust Beneficiary Complaints, 22 QUINNIPIAC PROB. L.J. 46 (2008) (providing a fair hearing to complaining beneficiaries can benefit all parties to an estate or trust administration).


173 See Memo & Order, p. 2, supra, note 173.

Investments allegedly changed that to 100% equities. The shift coincided with the dramatic loss in stock values in mid to late 2008. The settlor/trustee had acquiesced in the reallocation, but later claimed not to have understood the degree to which the change would increase the risk of substantial losses. From the complaint:

“Fisher Investments had a duty to manage the . . . account in a manner directly comporting with the needs and objectives of [the settlor/trustee] . . . to keep informed regarding the changes in the market . . . and act responsively to protect [the settlor/trustee’s] interests; to keep [her] informed as to each completed transaction; and to explain forthrightly the practical impact and potential risks of the course of dealing in which Fisher Investments was engaged.”

In a high-profile Delaware case a bank trust company “failed to bring their professional expertise to bear” when assisting lay trustees who had neglected to tell beneficiaries about the exact nature of their interests in the trust. A “black-sheep” beneficiary only found out about his interest in the trust by accident. The instrument gave trustees “extraordinarily broad authority,” their decisions were “not subject to review by any court,” and they were relieved of “all personal liability except for gross negligence or willful wrongdoing.” Nonetheless, the “pattern of deception and neglect” cost the bank one-fifth of the fees that it had earned over a ten-year period. Forbes magazine called it a “public flogging.”

In a 2007 Michigan case the trustee sent a check to someone he described as a contingent beneficiary, but the trustee declined to provide information about the trust. The Court of Appeals found that the beneficiary was entitled to a copy of the instrument and an accounting, and it instructed the Probate Court to remove the trustee for failing to provide information to which the beneficiary was entitled.

In another 2007 Michigan case a lawyer referred his client to a financial planner at American Express Financial Advisors, who recommended a charitable remainder unitrust (CRUT) and irrevocable life insurance trust (ILIT). The idea was to use the CRUT to remove value from the client’s estate without reducing her son’s expectancy by replacing the removed value with a tax-free transfer from the ILIT. But there was a problem qualifying the elderly client for a life insurance policy and that part of the plan never got done. The client’s son claimed “that, in hindsight, [the lawyer] owed him a duty to warn [the client] not to transfer the stock into the trust without first obtaining effective ‘replacement’ insurance.” The son sued the lawyer for malpractice after his mother died. The court held that the theory of malpractice would have only

175 See also, Cody B. Bartlett, Jr., Asset class diversification and suitability, ROCHESTER DAILY REGISTER (July 1, 2009).


177 Brigid McMenamin, Black Sheep Beats Bank, FORBES, Sept. 17, 2001; See also, Frances Foster, Trust Privacy, 93 CORNELL L. R. 555 (2008).


created a cause of action in the client and continued, “Plaintiff fails to demonstrate how [the lawyer] breached any duty to him as personal representative of her estate, trustee of the CRUT, or individually as a potential beneficiary of [the client’s] residuary estate as it existed at the time of her death.” There is no indication of any action against the financial services company, presumably because of a mandatory arbitration clause.

A 2007 Florida case could cause some sleepless nights for estate planners who do not always follow up to determine whether clients actually fund their revocable living trusts. After the client in this matter died, his sons in their capacity of co-personal representatives sued the estate planning law firm for:

1. not making sure that the client funded his revocable living trust,
2. failing to recommend that the client use a family limited partnership to obtain valuation discounts,
3. advising the client on the establishment of a 5-year qualified personal residence trust (QPRT) that the client did not outlive,
4. recommending that the client select one of two named corporate fiduciaries to serve with the sons as co-personal representative and co-successor trustee without explaining that both companies were also clients of the law firm, and
5. failing to tell the client what the selected corporate fiduciary would charge for its services.

The sons also sued the corporate fiduciary, but that action was settled prior to trial. The trial court granted summary judgment for the law firm on the charge that it had failed to advise on the use of a family limited partnership because that claim was “too speculative . . . there was insufficient proof of damages or source of funding,” but submitted to the jury the questions of whether the law firm had implicitly agreed, and therefore had assumed a duty, to fund the client’s revocable trust. The jury awarded to the client’s estate $1.2 million in damages for unnecessary probate costs and taxes, and ordered the law firm to repay all the fees it collected from the client; the trial judge reduced the damage award to slightly more than $1 million; and the appeals court affirmed the judgment and rulings. The firm had given the client a written memorandum explaining that the trust would serve to avoid probate only if funded during the client’s lifetime, and explained that the firm would not assist the client in actually funding the trust unless asked to do so. The firm acknowledged that it never asked the client whether he had funded the trust.

In a 2006 Ohio case the individual trustee delegated investment decisionmaking to an account executive at Merrill Lynch who invested heavily in high-tech stocks. At the time of final distributions, the trust estate has shrunk by 90%. The beneficiary sued for improper delegation, but the court found that the trustee had complied with the prudent investor rule by meeting with Merrill Lynch, reviewing performance reports and account statements. According to the court, the trustee did not “fall asleep at the

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wheel.” The court also noted that losses in high-tech stocks at that time were not unique to this trust, and that a common strategy among such stockholders was to stay the course in hope that the stock prices would bounce back. It probably helped the trustee that the beneficiary had communicated regularly with the account executive at Merrill Lynch when the investment decisions were being made. Supposedly, “the reputation of the investment firm alone was sufficient to constitute a reasonable selection.”

¶ 1603.9 Conflict of Interests

An undetected or poorly handled conflict of interests can make a good situation bad, or a bad situation worse. Most conflicts are consentable, but unless a comprehensive explanation of all relevant considerations is articulated and documented, someone may later claim not to have made an informed consent:

“A trustee is not liable to a beneficiary for breach of trust if the beneficiary consented to the conduct constituting the breach, released the trustee from liability for the breach, or ratified the transaction constituting the breach, unless . . . at the time of the consent, release, or ratification, the beneficiary did not know of the beneficiary’s rights or of the material facts relating to the breach.”

The presence of a conflict of interests might be used against the fiduciary, even if the alleged conflict is unrelated to the complainant’s damages: “[C]onflicts of interest and alleged client misconduct are at the root of most problematic claims against lawyers. . . . Frequently, an allegation of conflict of interests is added to spice up the case, and to provide an alleged motive.”

In a New York case the trust estate consisted of IBM stock. The beneficiaries agreed in writing with a decision not to diversify, but later changed their minds. The court put the burden on the trustee to show that the beneficiaries “had the intent to form a contract and so formed it with actual and full knowledge of all legal rights.” Because the trustee did not warn the beneficiaries “of the effects that their execution of the [waiver] would have on their legal rights or how their direction to hold the entirety of the trust’s corpus in IBM stock would fall far short of what would have been required of a prudent corporate trustee,” they were not bound by their waiver. The court surcharged the trustee more than $6 million.

In this 2007 Texas case a law firm was in the middle of implementing a sophisticated estate plan involving a family limited partnership, private foundation, and grantor retained annuity trusts when the husband died unexpectedly. To avoid $32 million

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183 Uniform Trust Code 1009. See also Restatement (Third) of Trusts, § 78.
184 Aaron Hoffman, A Survey of Potential Pitfalls for Estate Planners, manuscript on file with the author.
in estate taxes at the widow’s subsequent death, she disclaimed the husband’s $65.5 million share of the marital estate. The disclaimed property vested immediately in various charitable organizations, including a private foundation managed by the regional president of the bank that was serving as the husband’s personal representative. Throughout this period, the law firm represented the widow, the bank, and the foundation. The firm sought the widow’s waiver to its conflict in a writing that clearly alerted the client to the conflict of interests:

“There is a clear conflict of interest in our joint representation . . . . By retaining [this firm] and simultaneously acknowledging our potentially conflicting representation . . . you . . . represent that you do not consider our joint representation of you nor our concurrent representation of the [other parties] to be inappropriate, and you consent thereto.”

Six years later, the widow’s son sued the law firm and the bank on behalf of his mother, who by then had been diagnosed with Alzheimer’s disease. He alleged that his mother’s disclaimer had not been fully informed. The jury returned a verdict of $65.5 million which the judge ordered the law firm and bank to pay into an “equitable trust,” to make the widow whole. The jury’s verdict was overturned completely on appeal. Perhaps the lawsuit would have been avoided if the law firm had discussed the engagement letter, conflict of interests, and waiver directly with the widow and her children. Instead, it reportedly sent those documents to the bank, saying that it would “rely on [it] to forward the letters to [the widow] and to discuss the joint representation with her.”

According to the court, the bank never had that discussion with her. The only explanation she received concerning the joint representation/conflicts issue came from the engagement letter.

Hockey star Sergei Fedorov won a $60 million default judgment against his longtime agent in August 2009. Two months later he sued his former lawyers for malpractice and breach of fiduciary duty, claiming that the law firm simultaneously represented him and his agent, and “did not disclose to Mr. Fedorov that in 2008 it was representing [the agent] in litigation against a man who had asserted that [the agent] was operating a huge Ponzi scheme.”

In 2009 the heiress to a founder of mall owner General Growth Properties, Inc. was seeking unspecified monetary damages, disgorgement of fees, and removal of the trustee for having “entered into certain loan transactions and purchased General Growth shares that dropped in value as the company moved toward . . . bankruptcy.” She alleges that a lawyer had a conflict of interests in being legal counsel

187 Id. at 727.
188 Id. at 728.
189 Id.
of the general trust and counsel to and a shareholder of General Growth. Lawyers for the general trust countered, “The lawsuit is a “study in sensationalism” that is “peppered with gratuitous allegations.”

§ 1603.10 Amateur Trustees

In this a Virginia case a decedent left $3.2 million in trust for her widower as income beneficiary and her two children as remainder beneficiaries.\(^\text{192}\) As trustee, the widower commingled the trust estate with his own funds, engaged in day trading, and soon lost $2 million. Shoddy records made it impossible to determine what trust funds were properly excluded from his gross estate. The result appears to have been unnecessarily high taxes on his estate.

An author of diet books, Robert Atkins, died in 2003 with an estate of about $400 million, the bulk of which was directed to a marital trust.\(^\text{193}\) The rest went to a charitable foundation established by Atkins to do diet research. He designated his widow, Veronica, and two others to serve as trustees of the marital trust. Soon after Dr. Atkins’ death, Veronica was befriended by a self-described entrepreneur, an accountant, and a lawyer, who ended up replacing Veronica’s two co-trustees. Each of the new co-trustees received $1.2 million in annual fees, but because this was three times the statutory limit, Veronica paid two of these trustees out of her own pocket. She also entered into long-term employment contracts with them, and she named them beneficiaries of a $15 million life insurance policy on her life. Veronica then met and married a fellow who encouraged her to fire these trustees, which she did. They then sued for breach of contract and $8.7 million in damages, alleging that Veronica’s new husband “has a reputation for hunting rich and single ladies, preferably widows,” and that he “intentionally exerted undue influence over [a woman] unprepared for an opportunist skilled in the art of seduction.” He then accused these three now-former trustees of “preying upon [a] grieving widow.” Meanwhile, Veronica has petitioned the court, seeking a $100 million distribution from the marital trust. The dispute with the former trustees presumably was settled.\(^\text{194}\)

In a 2007 New York case a testamentary trust for the benefit of the testator’s granddaughter authorized the testator’s divorced son (the beneficiary’s father) as trustee to use trust income and principal for her support, education, maintenance, and general welfare until she reached 30 when the trust was to terminate and all assets be distributed to her.\(^\text{195}\) The trustee used trust funds to pay for the beneficiary’s education and medical expense despite being personally obligated under the terms of a divorce settlement to pay those expenses himself. Although he used trust funds “precisely in the manner authorized by the testator,” the court was concerned that the trustee had not sought court approval to use the funds in this way. In some jurisdictions, court...


\(^{194}\) See Estate of Atkins, 238 N.Y.L.J. 105 (2007).

approval is required when there is a conflict of interests. The matter is on remand to
the surrogate court for a hearing to determine whether the expenditures from the trust
for the beneficiary’s secondary school tuition and certain medical expenses were
authorized in good faith and in furtherance of the beneficiary’s interests.

¶ 1603.11 Crimes
The battle over Brooke Astor’s estate morphed from a likely undue influence civil
controversy into criminal convictions for Astor’s 85 year-old son and his 67 year-old
lawyer behind bars:

“[T]he head of the Manhattan district attorneys office’s elder abuse unit said that
Marshall, who is Astor’s son, and lawyer Francis X. Morrissey had ‘exploited’
Astor’s degraded mental capacity to ‘steal’ $60 million that she had intended to go
to charities. JP Morgan Chase had been a court-appointed guardian for Mrs. Astor
before she died at age 105. It challenged a 2003 transfer of Mrs. Astor’s home in
Maine and $5 million to Marshall, claiming that the items should not be treated as
gifts for either gift or income tax purposes. In 2007, JP Morgan Chase and a retired
state appeals court judge were named temporary administrators of Mrs. Astor’s
estate.”196

The jury convicted Marshall of 14 counts, including the following:

(1) Schemed to steal money and property by capitalizing on his mother’s
diminished capacity;
(2) Used more than $600,000 of his mother’s money to maintain the Maine
retreat that she had given him;
(3) Took a $500,000 drawing of dancing dogs from the wall of his mother’s
apartment, and a painting worth $500,000 from the Blue room of her home;
(4) Conspired to amend his mother’s will to leave much of her estate to him
rather than to charity;
(5) Gave himself salary increases without his mother’s consent, raising his pay
for managing her estate to over $1 million;
(6) Conspired to add a codicil to the will that would have meant greater executor
fees for himself and his lawyer.197

The jury also convicted Morrissey. His crimes included scheming to defraud,
conspiracy and forgery.

¶ 1603.12 Settlor Intent

“In 1961, when the A&P grocery heirs Charles and Marie Robertson gave

196 Daniel Wise, Lawyer, Socialite Astor’s Son Stole Millions Intended for Charity, DA Says,” NEW
YORK LAW J., Apr. 28, 2009.
197 Jennifer Peltz, Astor’s Son Found Guilty of Looting Estate, ASSOCIATED PRESS, Oct. 8, 2009. See
also Eric Strauss & Julia Gabel, People vs. Marshall and Morrissey: Brook Astor Trial by the Numbers,
Princeton a $35 million gift endowment, they directed that the money should be used to educate graduate students for careers in government. But in a lawsuit filed in 2002, Robertson descendants claimed that Princeton was misusing the gift, which peaked at more than $900 million in June, spending it on training students for a broader range of careers. Under the settlement, Princeton will pay $40 million in legal fees, and, starting in 2012, another $50 million, plus interest, to a new foundation that will support education for government service. Even without going to trial, each side had spent more than $40 million on the case. Both sides claimed victory. William Robertson, the donors’ son and lead plaintiff in the suit, said in a statement that the settlement was ‘a message to nonprofit organizations of all kinds and throughout our country that donors expect them to abide by the terms of the designated gifts or suffer the consequences.’

Bishop Estate Controversy

The so-called Bishop Estate controversy included allegations of numerous fiduciary breaches and other issues addressed above. The Bishop Estate story began in 1884 when Princess Bernice Pauahi Bishop, the last acknowledged descendant of the Hawaiian monarch Kamehameha, placed the bulk of her estate in charitable trust to establish and maintain two schools, “one for boys and one for girls. called the Kamehameha Schools.” The trust corpus—known as Bishop Estate—has been described by The New York Times as “a feudal empire so vast that it could never be assembled in the modern world,” and by The Wall Street Journal as “the nation’s wealthiest charity.” In 1997, four elders revered in the native Hawaiian community, together with a law professor from the University of Hawaii, alleged massive trust abuse by the state’s most powerful people—among them judges, business executives, and legislators. Then, as described in a book review:

198 Tamar Lewin, Princeton Settles Money Battle Over Gift, N.Y. TIMES, Dec. 10, 2008; See also, Dominic J. Campisi, Bleeding Orange: The Impact of Attorneys’ Fees on the Robertson Litigation and Settlement, ACTEC Newsletter, Vol. 3, No. 2, 45–47 (Fall 2009). See also, Jeffrey A. Cooper, Empty Promises: Settlor’s Intent, The Uniform Trust Code, and The Future of Trust Investment Law, 88 B.U.L. REV. 1165 (2008) (“Whereas trust investment law historically has honored the intent of the settlors who impose such restrictions, some would read the Uniform Trust Code to codify a very different rule. Under this emerging rule, the enforceability of a trust investment restriction would hinge upon objective notions of prudence and efficiency, without regard to a settlor’s subjective intent.”).


“Subpoenas fly, surveillance photos are snapped, phones are bugged, tires are slashed, judges cry in court, suicide factors in. The Internal Revenue Service (IRS) swoops in like a huge predatory bird and threatens to revoke the trust’s tax-exempt status, which would cripple the schools.”

“As a mere story, even if it were fiction, the book would be fascinating reading. Beginning with a sensitive portrait of the cultural and political setting for the Princess’ life and the formation of her values and vision, the book combines the lure of the Islands with the intrigue of a whodunit to draw the reader inescapably into the drama. Like readers of any good novel, we join the plot vicariously, we picture the action, we pick heroes and cheer, and we identify villains and hiss. We turn page after page. But the book is not a mere story. It proves the axioms about fiction that truth is stranger still and that there are some things even the most creative novelist could not make up. The book’s subtitle is Greed, Mismanagement & Political Manipulation at America’s Largest Charitable Trust—seemingly audacious to one who picks up the book for the first time, but if anything, seen as understated by the reader who plunges into the narrative. The events exposed in the book are real. They not only could happen, they somehow did happen, which is bound to get the attention and sharpen the focus of any reader, especially a professional whose practice has anything to do with tax-exempt organizations and charitable giving.”

The following issues are from the Bishop Estate controversy from the late 1990s, which faded from public view in 1999 with the forced resignations of all five trustees and various other collateral consequences:

ATTORNEY-CLIENT PRIVILEGE. Few courts outside of California and Texas allow trustees to use the attorney-client privilege to withhold important information about trust administration (as opposed to communications between the trustees and their Personal Counsel) from the beneficiaries of private trusts, or from the attorney general with respect to charitable trusts. Yet the probate court ruled that the Bishop Estate trustees could use the privilege to withhold documents from Hawaii’s attorney general.

ATTORNEY GENERAL’S “CONFLICT OF INTERESTS.” Bishop Estate trustees argued in court that the attorney general’s responsibility to protect charities (as parens patriae) conflicted with her tax-collecting duties (as in-house counsel for the state Department of Taxation). The trustees’ lawyers asked the judge to disqualify the attorney general because of this “conflict.” They also charged that the attorney general acted improperly by simultaneously heading up the civil and criminal investigations of the trustees. These matters were never finally resolved; they ceased to be relevant when the parties entered into a global settlement agreement.

CO-INVESTMENT. Bishop Estate trustees created a conflict of interests when they invested personal funds in private business deals in which they had also invested trust

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funds. One reason for the restriction on co-investing is that trustees will be tempted to consider their own interests when making subsequent decisions about the investment (i.e., that they will throw good money after bad for the impermissible purpose of salvaging their own private investment). Bishop Estate trustees apparently did exactly that.

COMMUNITY INTERESTS. Trustees of charitable trusts traditionally have been expected to pursue each trust’s specific charitable mission, even to the detriment of other community interests. That may be changing. In 2002 the trustees of the Hershey trust voted to sell the Hershey Foods Corporation for $12.5 billion so they could diversify trust investments and increase dramatically the money available to pursue that trust’s educational mission. The Pennsylvania attorney general and probate court refused to agree, however, in large part because of opposition from community leaders who feared that the new owner would move company headquarters and operations out of the state. Also in 2002 the new Bishop Estate trustees yielded to public pressure and withdrew from a long-standing legal battle over the trust’s right to divert mountain stream water for land-development purposes. Although this decision arguably hurt the trustees’ ability to educate as many children as possible, Hawaii’s attorney general and a court-appointed master supported the decision.

COMPENSATION FROM OUTSIDE SOURCE. Trustees may violate the duty of loyalty by accepting compensation from a source other than the trust estate for acts done in connection with the administration of the trust. Yet Bishop Estate’s lead trustee for asset management reportedly placed himself on the boards of trust-controlled companies and collected large director fees in addition to about $1 million in trustee fees. A more appropriate arrangement might have been to reduce the trustee fees so that the total compensation (i.e., fees received from the trust estate plus fees from trust-controlled corporations) would not exceed the value of that trustee’s services on behalf of the trust.

CONFIDENTIALITY. Fiduciaries are sometimes subject to a duty of confidentiality. One Bishop Estate trustee was accused of violating such a duty when he told friends, and eventually reporters, about what went on at trustee meetings.

CONFLICT OF INTERESTS. Trustees must avoid conflicts of interest and take appropriate action when a conflict cannot be avoided completely. A Hawaii statute sometimes requires more: “If the duty of the trustee and the trustee’s individual interest . . . conflict in the exercise of a trust power, the power may be exercised only by court authorization . . . upon petition of the trustee.” Despite this requirement, Bishop Estate trustees often devised their own ways of dealing with conflicts, sometimes with astonishing results. On one occasion, a trustee “recused” himself as a Bishop Estate trustee just long enough to negotiate for the purchase of Bishop Estate land on behalf of the buyer.

COOPERATION. Co-trustees are generally required to work together in the best interests of the trust, yet Bishop Estate trustees sometimes refused to share important

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204 See generally RESTATEMENT OF THE LAW (THIRD) TRUSTS (2007) § 78.
trust information with each other, and their working relationships became strained to a point approaching physical violence on several occasions.

CRITICIZING JUDGES. Lawyers are allowed to criticize judges, but there are limits. Hawaii’s Supreme Court justices complained publicly that the authors of the Broken Trust essay had “expressly and impliedly impugned the integrity, honesty, ethics, intelligence, qualifications, competence, and professionalism not only of the five members of the Hawaii Supreme Court as individuals, but also of the court as an institution.”\textsuperscript{205} Although these same justices were the ultimate authority on matters of lawyer discipline in Hawaii, they never took formal action against the lawyers who signed the Broken Trust essay.

CYPRES. A trust’s charitable mission can be changed legally only by showing that unforeseen circumstances have made the original mission illegal, impossible, impracticable, or wasteful. The standard is less stringent when the change would affect only an administrative provision (\textit{i.e.}, one that is a means to an end as opposed to the end itself). Bishop Estate trustees and Hawaii’s probate court sometimes have acted as if this rule does not exist. For example, in addition to maintaining the Kamehameha Schools, the trust functions like a land conservancy, providing culturally and environmentally sensitive stewardship for nearly 360,000 acres of non-income-producing land (including 63 miles of ocean frontage and a hundred miles of mountain streams). This is a laudatory endeavor, but Mrs. Bishop’s will says nothing about preserving or protecting the environment or Hawaiian culture.

DELEGATION. Delegation to an outside expert is generally allowed and in some circumstances can be required, but trustees are not generally allowed to divvy up among themselves different aspects of major fiduciary functions. Each trustee must remain responsible for, and exercise supervision and review of, all trust activities.\textsuperscript{206} Despite this rule, the Bishop Estate trustees utilized a “lead-trustee” system in which individual trustees functioned like chief executives for different aspects of the trust’s activities, making important decisions without first consulting with the others.

DILIGENCE. Trustees have a duty to stay informed and to participate in trustee decision making. Yet, one Bishop Estate trustee stopped attending trustee meetings because he considered the chaotic sessions to be a waste of time. He also felt that he could not influence the outcome of any issue because the other trustees regularly ignored or ridiculed what he said.

DISCOVERY ABUSE. When engaged in litigation, it is unethical for a lawyer to make frivolous requests for documents or fail to make reasonable efforts to comply with proper requests from an opposing counsel. Yet studies show that lawyers frequently (in as much as one out of every two lawsuits) seek many more documents than they reasonably need (presumably to burden the opposing counsel) and go to great lengths to avoid turning over embarrassing or damning documents that the opposing party has requested. Hawaii’s attorney general complained that some of the trustees’ lawyers

\textsuperscript{205} Justices reject ‘Broken Trust’ criticisms, HONOLULU STAR-BULLETIN, Aug. 21, 1997.

\textsuperscript{206} See, \textit{e.g.}, RESTATEMENT OF THE LAW (THIRD) TRUST § (2007) § 80.
often failed to provide key documents, but at other times would provide an “avalanche” of seemingly unimportant documents. She asked the court to sanction those lawyers for abusive discovery tactics, but the judge chose not to do so.

DISCRIMINATION. Mrs. Bishop’s will does not limit school admission to native Hawaiians, but it does authorize the trustees to set the admissions policy and to use a portion of each year’s income for “support and education of orphans, and others in indigent circumstances, giving the preference to Hawaiians of pure or part aboriginal blood.” With minor exceptions, Bishop Estate trustees have always reserved admission to Kamehameha Schools for children who have Hawaiian blood. Some critics argue that applicants with a relatively high quantum of Hawaiian blood should gain admission over those with lower levels, regardless of academic ability. Others maintain that any child, regardless of race, who has been informally adopted by a Hawaiian (a cultural practice known as hanai), should be eligible to attend Kamehameha Schools. And then there are those who argue that “Hawaiianness” should be based on culture and interests, not blood quantum or informal membership in a Hawaiian family. A non-Hawaiian applicant, rejected by Kamehameha Schools in 2002, challenged the Hawaiians-only admissions policy in federal court, arguing that it violates a civil-rights statute; the plaintiff initially won (2-1) at the 9th Circuit, then lost (8-7) in a rare en banc rehearing; before the matter could be taken up by the U.S. Supreme Court, the trustees reached a confidential settlement with the plaintiff; the amount paid—$7 million—became known only because of a subsequent controversy over legal fees. The IRS district office had decided in 1999 to revoke Bishop’s Estate tax-exempt status because of its Hawaiians-only admissions policy, but the national office reversed that decision. Since then, to reduce the risk of a 14th Amendment challenge, the trustees have rejected all direct forms of government aid avoided managerial involvement in public (charter) schools.

DIVERSIFICATION. Mrs. Bishop’s will authorizes the sale of inception property as necessary for the establishment or maintenance of the Kamehameha Schools or “for the best interest of my estate,” yet the Bishop Estate trustees retained most of the original estate, which is mostly unimproved land. During the controversy years the Bishop trustees added tens of thousands of acres of additional unimproved land to the estate.

DUE DILIGENCE. Trustees are not allowed to make uninformed investment decisions. They must perform appropriate due diligence before investing trust funds.207 Bishop Estate trustees sometimes skipped that step or appeared not to take it seriously.

DUTY TO PROTECT. Each co-trustee has a duty to use reasonable care to prevent any co-trustee from committing a breach of trust and, if a breach of trust occurs, to obtain redress.208 One trustee tried for years to get the probate court or attorney general to take action against the other Bishop Estate trustees for serious breaches of trust.

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207 See generally RESTATEMENT OF THE LAW (THIRD) TRUSTS (2007) §§ 76 and 77.

also considered filing a lawsuit, but lawyers told him it would cost at least $2 million and have to come out of his own pocket, and that he would probably lose, because of a perceived connection between his co-trustees and the state judiciary. Despite this trustee’s good-faith efforts to get others to do their job of policing the trust, he was later faulted for not filing suit against the other trustees.

FIDUCIARY DUTIES. When individuals agree to serve as trustees—which they cannot be forced to do—they automatically become subject to strict fiduciary duties, regardless of their understanding of those duties. Even so, four of the five Bishop Estate trustees declined to attend sessions on what was expected of them under trust law.

FLAWED ACCOUNTABILITY. According to the IRS and several court-appointed masters, Bishop Estate trustees treated Mrs. Bishop’s estate like their personal investment club and set what some experts have called a “world record for breaches of trust,” yet the Hawaii probate court allowed all five trustees to resign without ordering them to pay any surcharges, damages, or reimbursement to the trust—they were not even required to admit they had done anything wrong.

HIRING PRACTICES. Fiduciary duties limit a trustee’s freedom to provide patronage. Hiring such friends and relatives is not an automatic violation of fiduciary duties, but trustees should proceed cautiously and openly, with a goal of inspiring trust and confidence. According to the IRS and the state attorney general, however, Bishop Estate trustees regularly retained and paid large amounts to such people, with no apparent concern about having to account for such decisions.

IDENTIFYING THE CLIENT. Some of the many lawyers being paid with Bishop Estate funds claimed to be representing the five individual trustees in the trustees’ fiduciary or representative capacity; others said they were representing “the trust,” as if a trust were a separate entity; and some identified the majority faction of the board of trustees as their client. Eventually, two courts in Hawaii rejected the so-called entity theory and determined that these lawyers at all times had five separate clients, the trustees. This resulted in nonconsentable conflicts of interest when trustees started suing each other.

IMPARTIALITY. Trustees are required to know whether the circumstances of any particular trust require them primarily to stabilize current returns, maintain the trust estate’s real value, or something else. They arguably cannot put the interests of future generations of beneficiaries ahead of the current generation. While Kamehameha Schools was admitting only one out of every twelve applicants, Bishop Estate trustees were investing primarily for growth and secretly accumulating more than $350 million of income.

INCORPORATION. Some observers have suggested that Mrs. Bishop’s trust be converted into a not-for-profit corporation, as was done many years ago with what is now the Bishop Museum corporation. Instead of five highly paid trustees who tend to micromanage, there might be a larger number of unpaid directors who would limit themselves to setting policy and providing oversight to a well-paid chief executive and highly qualified staff. Because unpaid directors of not-for-profit corporations have far less legal exposure than do trustees of a trust (by statute in most states), millions of
dollars could perhaps be saved on liability-insurance premiums. Perhaps the organization’s charitable mission could evolve more easily with changing times. For example, a not-for-profit board of directors might legitimately decide to promote Hawaiian culture, conserve non-income-producing land, grant scholarships to Hawaiian students at schools other than Kamehameha, and expand the organization’s outreach programs, all without first establishing that the charitable purpose in the will (the maintenance of two schools) is illegal, impossible, impracticable, or wasteful. Then again, such a board might change the charitable mission in ways that would be totally inconsistent with Princess Pauahi’s values and vision—so-called “mission creep” is a major issue at many corporate charities. Perhaps that is why some donors require that their charities distribute everything within a fixed period following their deaths.\footnote{Bill and Melinda Gates and Warren Buffet are high-profile examples.}

INTERIM REMOVAL. Despite reports submitted by court-appointed masters and court-appointed fact-finder that listed numerous serious, ongoing breaches of trust, the probate judge declined to take definitive action until the IRS issued an ultimatum. When the judge finally did schedule an interim-removal hearing, a trustee who had attempted suicide requested and received a postponement so he could recuperate fully before having to protect his individual interests in court. Meanwhile, he continued to collect nearly $100,000 each month in trustee fees. To some observers, the probate judge appeared to be more concerned about that trustee’s due-process rights than the interests of the trust.

INTERMEDIATE SANCTIONS. Bishop Estate trustees spent nearly $1 million lobbying against the enactment of an intermediate-sanctions law that empowers the IRS to impose large fines on trustees for taking “excess benefits,” such as excessive fees. Because enactment posed a threat only to the trustees (and provided benefits to the trust), the trustees’ lobbying arguably would have been a serious breach of trust even if they had used their own money. They used trust funds.

INVESTMENT OPPORTUNITIES. After the other Bishop Estate trustees rejected a recommendation that they acquire control of Maui Land & Pineapple Company on behalf of the trust, one trustee pursued the opportunity for his personal account. Another trustee described this as a disloyal act even though the first trustee fully reimbursed the trust for the time its staff had spent while investigating the opportunity on behalf of the trust. The second trustee’s attorney expressed uncertainty about the propriety of the first trustee’s actions: “Whether or not [that trustee] engaged in a breach of his fiduciary responsibilities . . . is inconclusive at this time.”

IRS ROLE. Historically, the IRS has played a limited role in regulating charities once it has issued a determination letter, deferring to local officials. But the slow-moving Bishop Estate controversy reached a sudden climax when the IRS refused to communicate with the sitting trustees and threatened to revoke the trust’s tax exemption retroactively if a list of non-negotiable demands were not met. The immediate cost would have been close to $1 billion. That forced the probate court to remove the trustees and reform the trust.
JUDICIAL ACCOUNTABILITY. Judges must adhere to a set code of ethics, and they are supposed to be held accountable when they fail to do so. In Hawaii, a Judicial Conduct Commission is responsible for reviewing alleged misconduct by judges, and a Judicial Selection Commission has the power to deny a judge another term on the bench. Neither of these bodies (nor any other potentially appropriate group) looked into allegations of judicial misconduct related to Bishop Estate.

LACK OF TRANSPARENCY. On paper, the Hawaii Supreme Court supports a policy of openness: “Secrecy of judicial action can only breed ignorance and distrust of courts and suspicion concerning the competence and impartiality of judges. Thus, the openness which serves as a safeguard against attempts to employ our courts as instruments of persecution also serves to enhance public trust and confidence in the integrity of the judicial process. Such trust and confidence is a vital ingredient in the administration of justice under our system of jurisprudence.” Despite this stated policy of openness, judges in the Bishop Estate controversy sealed key records. The replacement trustees also claimed to have a policy of openness, yet they refused to make key documents available to the public. Even the new attorney general refused to share any document that was not already in the public realm.

LAWYER WHISTLEBLOWING. Depending on the circumstances, trust counsel may be prohibited from disclosing a trustee’s serious misconduct (as was the rule in most states for many years), required to disclose any such misconduct (as is the law today in a few states, including Hawaii), or permitted to disclose it (as is the national trend). Despite a “world record for breaches of trust,” there is no public evidence of any lawyer ever attempting to report misconduct by a Bishop Estate trustee.

MANDATORY AND PRECATORY LANGUAGE. Mrs. Bishop used mandatory and precatory language in different sections of her will. For example, she directed that her trustees expend annual income on the schools, publish accountings in a Honolulu newspaper, and hire only Protestants to teach at Kamehameha Schools. By comparison, she only expressed a desire that the trustees provide education in the common English branches, and that instruction in the higher branches always is subsidiary. Bishop Estate trustees frequently refer to Mrs. Bishop’s will as “sacred,” yet they regularly have deviated from not just the precatory provisions, but mandatory ones as well.

OVERSIGHT. Effective oversight is never certain. Each individual Bishop Estate trustee had a duty to monitor the actions of the other four and to take appropriate action when serious breaches of trust became evident. The Hawaii attorney general also had oversight responsibility, as did the probate court and the master it appointed each year to review the trustees’ accounts. Furthermore, trust counsel was supposed to report trustee nonfeasance to the probate court, and Supreme Court justices arguably had on-going responsibility to monitor trustee conduct and to take action in the face of serious misconduct. Despite all this, obvious breaches of trust went unchecked for years.

PARENS PATRIAE. Beneficiaries of non-charitable trusts have legal standing to sue the trustees of their trusts. That enables such beneficiaries to hold trustees accountable. But charitable trusts technically lack beneficiaries other than the public-at-large.
Rather than allow members of the public to sue trustees of charitable trusts, trust law bestows upon the attorney general of each state the power and the responsibility to represent the beneficiaries of every charitable trust. This concept is called parens patriae. Prior to publication of the “Broken Trust” essay, however, a series of attorneys general in Hawaii took no action against Bishop Estate trustees despite obvious breaches of trust.

PERSONAL CONFLICT OF INTERESTS. Shortly after the controversy reached a climax in mid-1999, the governor appointed as attorney general an individual whose wife had been an in-house lawyer for the trustees during the years of abuse and was a named defendant on a billion-dollar lawsuit against the trustees. Explaining that he had gotten an opinion letter from the Office of Disciplinary Counsel (but declining to provide copies), the new attorney general refused to recuse himself from Bishop Estate matters.

PERSONAL OR TRUST COUNSEL? According to the RESTATEMENT (THIRD) OF TRUSTS, trustees can properly hire legal counsel for “personal protection in the course, or in anticipation, of litigation (e.g., for surcharge or removal).” Such lawyers are generally referred to as Personal Counsel, and should be distinguished from Trust Counsel who assist trustees in carrying out their fiduciary duties. Trustees are not required to disclose opinions obtained from Personal Counsel, but communications between trustees and Trust Counsel are subject to the general principle entitling a beneficiary to information that is reasonably necessary to the prevention or redress of a breach of trust or otherwise to the enforcement of rights under the trust. A court-appointed master criticized the Bishop Estate trustees and their trust-paid lawyers for not being clearer about each lawyer’s intended role. The master recommended that the court order some of the trustees’ lawyers pay back millions in legal fees because those lawyers had been retained as Trust Counsel but had functioned more like Personal Counsel.

POLITICAL INVOLVEMENT. Tax-exempt organizations are not supposed to involve themselves in political campaigns, yet Bishop Estate trustees systematically raised money for numerous political campaigns, conducted valuable polling in their behalf, secretly took care of unpaid bills of certain politicians whose coffers were empty, and paid questionable consulting fees, retainers, and salaries to key government officials.

PRIVILEGED MATTERS. Bishop Estate trustees took the position that anything said or done in the presence of the trust’s chief counsel and any documents placed in his care were protected by attorney-client privilege. The privilege is potentially available with respect to communications, but only when the purpose of the communication is to obtain legal assistance, and not when others were present when the communication took place.210

PROSECUTORIAL OR JUDICIAL MISCONDUCT? During the Bishop Estate controversy, grand juries indicted, and twice re-indicted, two of the trustees. Each time, the trial judge threw out the indictments on procedural grounds, and each time

210 See, e.g., RESTATEMENT OF THE LAW (THIRD) TRUSTS (2007) § 82.
the attorney general appealed that judge’s decision. Eventually five substitute Supreme Court justices not only upheld the trial judge’s decisions, but also accused the attorney general’s office of prosecutorial misconduct and prohibited any further attempt to re-indict the trustees. According to the substitute justices, “The State’s interest in prosecuting these crimes is, at this point, clearly outweighed by the lack of fundamental fairness that would ensure were we to allow these prosecutions to continue.”

PROGRAM ASSETS. Trustees are generally required to know the current value of the trust estate, using good-faith estimates as necessary. There is an exception for program assets that the trustees use to carry out the trust’s charitable mission. Bishop Estate trustees do not report the current value of nearly 360,000 acres of non-income-producing land held in trust (including 63 miles of ocean frontage and a hundred miles of mountain streams). They have taken the position that these are program assets being held “for educational purposes.”

PRUDENT INVESTING. Prudent investing generally requires an overall plan, due diligence prior to individual investment decisions, and regular monitoring of existing investments. Bishop Estate trustees reportedly made ad hoc investment decisions based on personal relationships, and without proper due diligence. For example, when Robert Rubin left Goldman Sachs to join the Clinton administration, he reportedly sold his partnership interest back to Goldman Sachs for a $50 million promissory note, and then asked Bishop Estate to guarantee that he would collect the entire amount. His apparent goal was to eliminate a conflict of interests that presumably would otherwise exist as long as his personal finances were intertwined with those of Goldman Sachs. The trustees agreed to guarantee the note, despite not having the expertise needed to ascertain the trust’s exposure and to determine an appropriate price. They also invested tens of millions of dollars in complicated oil and gas exploration deals that individual trustees could not explain when they eventually sued the promoter for defrauding them of nearly $100 million.

PUBLIC CHARITY. When Mrs. Bishop wrote her will, Hawaii was an independent nation with its own tax laws. Now, of course, the trust is subject to the Internal Revenue Code (IRC). Because Bishop Estate has a single benefactress, some people assume it is a private operating foundation. Bishop Estate, however, is a public charity because its charitable purpose is to operate a “school” (which is defined in the tax code as “an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on”). It is unclear to what extent the trustees can pursue other charitable purposes (e.g., outreach programs and land-conservancy activities) before the trust ceases to be classified as a school and therefore becomes a private operating foundation for tax purposes. If it were a private foundation, tax law would require that the trustees expend a minimum of 5% of trust value each year. Even in the years following the removal of five trustees

the amount spent in pursuit of Princess Pauahi’s charitable mission has never come close to 5% of trust value.

PUBLIC POLICY. Trustees should not be able to enter into private contracts that limit the ability of their successors to hold them accountable for harm done to the trust, yet Bishop Estate trustees managed to accomplish that. The successor trustees chose not to seek accountability because of “insured vs. insured” provisions in $75 million of liability insurance coverage the former trustees had purchased with trust funds. The new trustees’ lawyers—including some who had represented the former trustees—reportedly advised against seeking accountability or even cooperating with the attorney general’s office in its effort to hold the former trustees accountable, saying that it would jeopardize the insurance coverage. The new trustees, concerned about the personal strain and financial cost of pursuing the former trustees and the former trustees’ lawyers, chose not to seek a declaratory judgment on the public-policy issue.

RACIAL PREJUDICE. Lawyers are ethically prohibited from attempting to appeal to racial prejudice when such actions would be prejudicial to the administration of justice. Yet a native Hawaiian attorney for the replacement Bishop Estate trustees seemed to be arguing in the courtroom that non-native Hawaiians could not be trusted to act in the best interest of a trust that had special meaning for native Hawaiians. Deputy attorneys general—who were non-native Hawaiians—perceived this as “playing the race card.” Whether or not this was an impermissible appeal to racial prejudice was never resolved.

RECORDKEEPING. Trustees of charitable trusts have a duty to keep reasonably good records and to provide to the attorney general information necessary to protect the public interest.212 By contrast, Bishop Estate trustees appeared on several occasions to be concealing or destroying relevant evidence. For example, a trustee instructed a staff member under questionable circumstances to make sure that selected computer files could be deleted permanently. Shortly after telling the attorney general about the trustee’s demand, the staff member in question received an anonymous threat that law enforcement authorities treated seriously. Shortly after telling the attorney general about the trustee’s demand, the staff member in question received an anonymous threat that law enforcement authorities treated seriously. On another occasion, a trustee neglected to provide documents that had been requested in a properly served subpoena (having to do with a politician’s use of a Bishop Estate credit card in strip bars and casinos). When a third party provided the attorney general with a copy of these documents, the trustee admitted that he had the originals, describing his failure to produce them as a “mistake.”

RECUSAL. The Code of Judicial Conduct directs judges to disqualify themselves when their impartiality might reasonably be questioned. Yet a probate judge whose husband was a partner in the law firm that represented the trustees recused herself only when a lawyer requested it in open court. Similarly, the five Supreme Court justices, who had selected the Bishop Estate trustees while acting “unofficially,” declined to recuse themselves until the attorney general threatened to go public with the details of

an embarrassing ex parte conversation that she had with them about a legal issue that was before the court.  

REGULAR ACCOUNTING. Although trustees have a duty to keep beneficiaries informed about the trust and Mrs. Bishop specifically instructed her trustees to publish an accounting in a Honolulu newspaper each year, Bishop Estate trustees were notorious for providing inadequate information. For example, they routinely used wholly owned corporations to conduct business, but they did not provide consolidated financial statements or crucial details about the corporations. They also reported trust land at values that were nearly 40 years old.

RELIANCE ON OTHERS. Trustees should not seek legal advice from lawyers who have a conflict of interests, nor should they put such a person in control of the flow of information within the organization. Yet when interim trustees replaced the ousted Bishop Estate trustees, they chose as their chief executive the person who had served for the past decade as the former trustees’ top in-house lawyer, and they sought legal advice from outside counsel who had advised the former trustees.

RELIGION. In her will, Mrs. Bishop directed that trustees of her trust and teachers at Kamehameha Schools always be members of the Protestant religion. In the 1960s, a court determined that the requirement that teachers always be Protestant did not violate anti-discrimination labor laws because the school was a private, religious school. In 1994, however, the 9th Circuit ruled that the Protestants-only hiring mandate violated the law because the school had evolved into a secular institution. State Supreme Court justices claimed for years to be following the letter of the will (appointing, among others, a lifelong Catholic who evidently “converted” to Protestantism on the eve of his selection, and a practicing Mormon who claimed to have received Protestant baptism as an infant). Eventually, however, the justices stopped considering religion entirely. Currently the probate judge selects trustees. Presumably she ignores each candidate’s religion since judges cannot ethically consider religion when making such decisions. In short, Mrs. Bishop’s instructions regarding religion are no longer honored.

SECRECY. Bishop Estate employees had no choice but to sign confidentiality agreements. When a senior executive appeared poised to provide evidence of trustee misconduct to the authorities, the trustees fired him and got a court order that effectively muzzled him. He found himself unable to give the documents even to the authorities.

SEX WITH A CLIENT. The Model Rules of Professional Conduct provide that “a lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.” Yet a lawyer for one of Bishop Estate’s wholly owned businesses had a sexual...

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relationship with one of the trustees. The lawyer committed suicide several hours after a security guard happened upon her and the trustee while they were engaged in a sex act in a public restroom of the Prince Hotel.

SILENCING CRITICS. Judge Samuel King had achieved senior status but was still presiding over federal trials when he co-authored the Broken Trust essay. Lawyers working for the Bishop Estate trustees spent several days researching and drafting a memo entitled “Limits on freedom of federal judge regarding public statements on social issues and conclusions of law”—an action that a court-appointed master described as “chilling” and as a “wholly inappropriate” use of charitable trust funds. The master recommended that the judge order the trustees or their lawyers to reimburse the trust estate for such legal costs.

SIMULTANEOUS INVESTIGATIONS. The attorney general simultaneously directed civil and criminal investigations of the Bishop Estate trustees. She instructed members of the criminal team not to communicate about the case with members of the civil team, and vice versa. The criminal team secured a series of grand jury indictments, which the civil team offered as evidence in the civil action. Eventually a judge threw out all the indictments on procedural grounds and a panel of substitute Supreme Court justices ruled that there had been prosecutorial misconduct. (All of the regular justices had recused themselves.) One indicted trustee and members of his family sued the attorney general and selected deputies for alleged civil-rights violations and malicious prosecution. The action was dismissed in state court because of a “global” settlement that had abruptly ended the attorney general’s civil and criminal investigations.

SPLIT-PERSONALITY TRUST. Because Bishop Estate trustees engage extensively in business activities (directly or through profit-seeking “subsidiaries”) while simultaneously operating a public charity, many people view the trust as two separate organizations with two separate cultures: a business, Bishop Estate, and a charity, Kamehameha Schools. A succession of trade names suggests an evolution of self-identity (i.e., what for many years was officially known as Bishop Estate eventually became Bishop Estate/Kamehameha Schools, then Kamehameha Schools/Bishop Estate, and finally Kamehameha Schools). Some observers call this window dressing, and contend that the trustees should become a true charity with only passive-investment assets in its endowment.

STANDING. There is a trend toward granting legal standing to groups that have a special interest in a particular charitable trust when the state attorney general chooses not to take action despite indications of serious abuse. When it became clear that the system of oversight in Hawaii had broken down and that no one with legal standing was taking steps to hold the Bishop Estate trustees accountable, a group of Kamehameha Schools alumni, parents, students, and teachers asked for standing. Hawaii’s attorney general joined with the Bishop Estate trustees in successfully opposing those efforts.

TAX-EXEMPT STATUS. Change came quickly to Bishop Estate after the IRS threatened to revoke the trust’s tax-exempt status. The sitting trustees had apparently violated every condition of IRC section 501(c)(3) status: private inurement (excessive compensation and inappropriate side benefits), private benefit (sweetheart deals for
friends and relatives), commerciality (overemphasis on the business side of trust activities), failure to pursue the charitable mission (less than 1% of estimated value expended on Kamehameha Schools each year), involvement in political campaigns (illegal financial assistance to, and direct involvement in, the campaigns of favored candidates), and self-serving lobbying activities (more than a million dollars of trust funds secretly spent lobbying against federal and state legislation that would limit how much the trustees could pay themselves in compensation).

TRIAL PUBLICITY. Legal ethics sometimes limit what a lawyer can say to the media about matters that are being litigated. With this in mind, lawyers for the Bishop Estate trustees complained to the probate judge that media outlets were regularly quoting Professor Roth (one of the authors of the Broken Trust essay) on how the judge should rule on specific issues, saying that could influence justice. Because the ethical rule applied only to lawyers who were participating directly in the litigation, however, the probate judge took no action.

TRUSTEE SELECTION. Mrs. Bishop directed that Supreme Court justices select all her future trustees. At the time, Hawaii was an independent nation. More than a century later, state justices were still selecting trustees, supposedly in their non-official capacity as ordinary citizens (because the Supreme Court had only appellate jurisdiction over probate matters). By the 1990s, critics concluded that the justices were selecting trustees on the basis of political payback, with no apparent concern for the trust’s intended beneficiaries. A few months after publication of the Broken Trust essay, the justices announced that they would stop selecting trustees, citing a “climate of public cynicism.” Currently the probate judge chooses all Bishop Estate trustees. Hawaii’s last monarch, Queen Liliuokalani, empowered her trustees to select their own successors. While one can easily envision problems with self-perpetuating boards, that approach has worked well for the Queen Liliuokalani Trust. As for the Bishop Estate, critics now question whether a single probate judge can reasonably be expected to withstand the intense political pressures that appear to have influenced the actions of five Supreme Court justices.

UNDIVIDED LOYALTY. Trustees must act at all times solely in the beneficiaries’ best interests, and in so doing they must meet an unusually high standard of care and conduct. The Bishop Estate trustees arguably breached their duty of undivided loyalty when they refused to step aside in the face of an IRS demand to do so in order to save the trust’s tax-exempt status. The trustees called the IRS’s demand “extortion.” It is easy to see how such a threat could be used maliciously, but whether it was fair to the trustees did not matter. The threat to the trust was real, and so the trustees arguably were duty-bound to step down.

UNITRUST. According to Mrs. Bishop’s will, as interpreted by the Hawaii Supreme Court, the trustees were supposed to expend all trust income annually on Kamehameha Schools. This arguably meant that they had a duty to invest assets in such a way as to generate a reasonable amount of annual income. Yet for years the trustees invested primarily for growth rather than income, and secretly accumulated over $350 million of income. Now, at the IRS’s insistence, the trustees expend approximately 4% of the
trust’s endowment value each year (which does not include the estate’s non-income-producing land).

UNPRODUCTIVE ASSETS. Trustees have a duty to make the trust estate productive. Bishop Estate trustees, however, own nearly 360,000 acres of non-income-producing land (including 63 miles of ocean frontage and a hundred miles of ocean streams), worth many billions of dollars. They do not list these parcels of land as investments; instead, they call them “program assets” that are being held indefinitely “for educational purposes.” Bernice Pauahi Bishop expressed a desire that the trustees not sell her land “unless in their opinion a sale may be necessary for the establishment or maintenance of said schools, or for the best interests of my estate.” Critics contend that the trustees should sell the land so they can educate more Hawaiian children, and that the trustees have a duty to do so.

WAIVER OF ATTORNEY-CLIENT PRIVILEGE. The Hawaii Supreme Court threw out criminal indictments against the former Bishop Estate trustees after ruling that grand-jury testimony violated the attorney-client privilege. The new trustees had waived the privilege for this limited purpose, but the justices said the question of who could waive the privilege (i.e., the former or current trustees) was an unresolved question in Hawaii that was best left for another day. Cases in other jurisdictions are mixed. For purposes of resolving the Bishop Estate matter, the justices’ ruling assumed, without so stating, that only the former trustees could waive the privilege.

WASTE. A court-appointed master concluded that the Bishop Estate trustees had wasted trust funds on lawyers who represented the trustees’ personal interests rather than those of the trust. The master recommended that the successor trustees seek disgorgement of millions of dollars in fees already paid. Instead, the successor trustees sought a “second opinion” from a law firm that reportedly advised the new trustees not to attempt to recover any of the fees in question, and expressed an opinion that it would be legally appropriate to rehire lawyers who had served the former trustees for many years. Critics contended that the $1 million cost of the “second opinion” was itself a waste of trust resources.

WILL CONSTRUCTION. Mrs. Bishop’s will gives her trustees discretion “to devote a portion of each year’s income to the support and education of orphans, and others in indigent circumstances.” It is tempting to view this as a second charitable mission, one that is separate and apart from the primary mission of running Kamehameha Schools. So viewed, it would support any number and variety of outreach programs. But Hawaii’s Territorial Supreme Court ruled in 1910 that “support and education,” as used in Mrs. Bishop’s will, must be provided at the Kamehameha Schools:

“The construction contended for by the [attorney general] that the support and education contemplated was to be furnished elsewhere than at the schools and that support can be furnished independently of education would require undue straining of the language used. . . . In our opinion the clause under consideration refers to support and education at the Kamehameha Schools only and not to
support independently of education."

Despite this Supreme Court decision, however, the trustees expend millions of dollars each year on numerous outreach programs, such as $4 million assisting the homeless on the island of Oahu’s leeward coast.

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214 Smith v. Lindsay, 20 Haw. 330 (1910).