

## Title

Draining the marital trust first in the face of different remaindermen: What about the trustee's duty of impartiality?

## Text

The trustee is the current beneficiary of both the marital trust and the credit-shelter trust, with a power to invade so much of the principal of each as the trustee shall deem necessary for the trustee's own personal support. Her step-children are entitled to the remainder in corpus of the marital trust; her grandchildren are entitled to the remainder in corpus of the credit-shelter trust. The trustee has been exclusively invading the principal of the marital trust. The step-children objected. The Court ruled that they were not entitled to discover information on the administration of the credit-shelter trust and that the trustee need not take into account the trustee's equitable property rights under the credit-shelter trust in determining what is necessary for the trustee's support from the marital trust. See *Matter of William J. Raggio family Trust*, 460 P.3d 969 (Nev. 2020). Perhaps the two trusts should have been sharing pro rata the burden of the principal distributions or, in the alternative, the step-mother should not have been serving as trustee of the marital trust. See *Loring and Rounds: A Trustee's Handbook* §6.1.3.6 (2020 Edition), which section is reproduced in its entirety in the Appendix hereto.

## Appendix

### §6.1.3.6 Breaches of Duty of Loyalty Not Involving Self-Dealing

[from *Loring and Rounds: A Trustee's Handbook* (2020), with enhancements.]

*Most cases involve conflicts of duty rather than conflicts of interest. In other words, the professional owes duties to two clients with conflicting interests.*<sup>545</sup>

In every case, a breach of the duty of loyalty involves some conflict of interest. In most cases, as we have seen, the conflict is between the interests of the trustee and the interests of the beneficiary. In other words, the breach will have a self-dealing component to it. A trustee, however, can breach the duty of loyalty without engaging in acts of self-dealing.<sup>546</sup>

**When the trustee favors one trust over another.** Here is an example of how a trustee can favor one trust over another in violation of his duty of undivided loyalty to the beneficiaries of each: John Jones is trustee of Trust 1 and Trust 2. Part of each trust's investment portfolio is 50 shares of X Corporation. Jones knows that X has become an imprudent investment and must be sold. To sell all 100 shares at one time, however, would be imprudent because of market conditions. Jones sells Trust 1's 50 shares. X goes bankrupt before Trust 2's shares can be sold. We have here a possible breach of the duty of loyalty. In this case, however, it involves not an act of self-dealing but a breach of the "duty of impartiality as to the several trusts."<sup>547</sup> Jones should have sold 25 shares from each trust,<sup>548</sup> *i.e.*, there should have been a pro rata partial liquidation.<sup>549</sup>

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<sup>545</sup>David Halpern, *Conflicts of Interest*, 2(1) Trust Q. 28 (2004). See, e.g., *In re Estate of Klarner*, 98 P.3d 892 (Colo. Ct. App. 2003) (involving trusts with conflicting interests), *rev'd on other grounds*, 113 P.3d 150 (Colo. 2005).

<sup>546</sup>Lewin ¶120-01 (England).

<sup>547</sup>See generally 2A Scott on Trusts §170.16. See also §6.2.5 of this handbook (trustee's duty of impartiality, particularly the trustee's duty of loyalty to all beneficiaries *within the same trust*).

<sup>548</sup>2A Scott on Trusts §170.16.

<sup>549</sup>3 Scott & Ascher §17.2.15 (Duty of Trustee Under Separate Trusts).

Here is another example of a trustee favoring one trust over another in breach of the duty of undivided loyalty: Trust 1 is a charitable trust. Trust 2 is a noncharitable trust for the benefit of someone's issue. The trustee, in violation of the terms of Trust 2, decants stock valued at \$1 million into Trust 1. The charitable purposes of Trust 1 have been unjustly enriched by the trustee's disloyalty to the beneficiaries of Trust 2.<sup>550</sup> What is the procedural equitable judicial remedy? The trustee holds the stock as a constructive trustee for the benefit of the beneficiaries of Trust 2.<sup>551</sup> What is the central substantive equitable judicial remedy? It is restitution.<sup>552</sup> A specific performance order to pour the stock back into Trust 2 is issued against the trustee. There also may be incidental substantive equitable judicial remedies to which the beneficiaries of Trust 2 are entitled, such as denial of trustee compensation and an assessment of legal fees against the trustee personally.<sup>553</sup>

Or take the trustee of a marital trust and a credit-shelter trust who is also the current beneficiary of each. She possesses the right to invade so much of the principal of each as she shall deem necessary for her own personal support. The remaindermen of the marital trust are her step-children; her grandchildren are the remaindermen of the credit-shelter trust. She, as trustee, has been exclusively invading the principal of the marital trust. The step-children objected. Sidestepping altogether the loyalty issues, the court held that they were not entitled to discover information on the administration of the credit-shelter trust, and that the trustee need not take into account the trustee's equitable property rights under the credit-shelter trust in determining what is necessary for the trustee's support.<sup>1</sup> Still, a good case can be made that the two trusts should have been sharing pro rata the burden of the principal distributions or, in the alternative, the step-mother should not have been serving as trustee of the marital trust. Had she not been trustee of the marital trust her loyalties, *at least with respect to the competing sets of remaindermen*, would not have been divided.

**Trust-to-trust transactions where the trusts share the same trustee.** Another loyalty pitfall not involving self-dealing is when the trustee of one trust sells to himself as trustee of another trust.<sup>554</sup> The trustee must take care that the transaction is fair to both trusts.<sup>555</sup> The Restatement (Third) of Trusts is fairly accommodating when it comes to such trust-to-trust transactions:

The duty of loyalty does not preclude trustees in their fiduciary capacity from dealing with other trusts or with decedents' or conservatorship estates, including trusts and estates of which the trustee is a fiduciary. Any such sale, exchange, loan, or other transaction, however, must be consistent with the purposes of each fiduciary relationship and for a consideration that is fair to the beneficiaries of the relationships. Even the fair-consideration requirement does not necessarily apply if the arrangement is appropriate to the terms or beneficial interests of those relationships and to the applicable requirements of impartiality.<sup>556</sup>

The English default law is probably not as accommodating as the Restatement (Third) of Trusts when

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<sup>550</sup>See, e.g. Reinhardt Univ. v. Castleberry, 318 Ga. App. 416, 734 S.E.2d 117 (2012).

<sup>551</sup>See, e.g. Reinhardt Univ. v. Castleberry, 318 Ga. App. 416, 734 S.E.2d 117 (2012). See generally §7.2.3.1.6 of this handbook (the constructive trust).

<sup>552</sup>See generally §7.2.3.3 of this handbook (restitution).

<sup>553</sup>See generally §7.2.3.7 of this handbook (denial of trustee's compensation and assessment of attorneys' fees against the trust personally).

<sup>1</sup> See Matter of William J. Raggio family Trust, 460 P.3d 969 (Nev. 2020).

<sup>554</sup>Bogert §543(H).

<sup>555</sup>UTC §802(h)(3). See generally 3 Scott & Ascher §17.2.15; 2A Scott on Trusts §170.16.

<sup>556</sup>Restatement (Third) of Trusts §78 cmt. c(7).

it comes to sales between trusts sharing a common trustee, although there is now some doubt as to whether the no-further-inquiry rule in all its severity should be applied.<sup>557</sup> This doubt, in large part, is being fostered by the American courts, which for some time have been applying a fairness test to such trust-to-trust transactions.<sup>558</sup>

Of course, the trustee's duty not to self-deal also would be implicated if a trustee of two separate trusts, say Trust X and Trust Y, were to misappropriate funds from one, say Trust X, and later make restitution with funds misappropriated from Trust Y. The trustee, of course, would be personally liable to make both trusts whole out of his own funds, if necessary, thus rendering any impartiality and other loyalty-related issues moot.<sup>559</sup> If the trustee, however, were judgment proof, Trust X would likely prevail over Trust Y, provided the Trust X beneficiaries were BFPs, as would likely be the case.<sup>560</sup> In other words, the funds would stay in Trust X and not return to Trust Y. As we have noted elsewhere, the transfer of money in satisfaction of an antecedent debt can satisfy the BFP value requirement.<sup>561</sup> In this case, the antecedent debt would be the trustee's equitable obligation to make Trust X whole.<sup>562</sup> On the other hand, the beneficiaries of Trust Y would be entitled to recover from any surety on the bond of the trustee that might have been issued to the trustee in his capacity as trustee of Trust X.<sup>563</sup> "The beneficiaries of...[Trust X]...could have sued on the bond, and when they are paid with the funds of...[Trust Y]..., the beneficiaries of...[Trust Y]...are entitled to be subrogated to their rights on the bond."<sup>564</sup>

**When the trustee unnecessarily puts the interests of creditors ahead of the beneficiary's.** A third example of a loyalty breach that does not involve self-dealing is when the trustee places the interests of creditors ahead of the interests of the beneficiary when the law does not require it. In one case, a trustee of a revocable trust successfully thwarted the postmortem creditors of the deceased settlor by making distribution to the trust beneficiaries prior to the creditor's claim having been reduced to a judgment.<sup>565</sup> Had the trustee not pursued this course of action, he could well have been in breach of his duty *to the beneficiaries* of undivided loyalty.

**When the trustee is the agent of an independent third party in a transaction involving the trust.** A fourth example of a loyalty breach that does not necessarily involve self-dealing is when the trustee purchases the trust property for the benefit of an independent third party.<sup>566</sup> Of course, if the trustee is to receive compensation from the third party for his agency services or is somehow indirectly benefited by the transaction, then the trustee would be self-dealing.

**Mistake-based reformation actions brought by trustees.** A fifth example of a loyalty breach that does not necessarily involve self-dealing is when the trustee seeks to reorder the equitable interests by bringing a mistake-based reformation action.<sup>567</sup> Legal title to the property of a trust being in the trustee, it

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<sup>557</sup>Lewin ¶20-76 (England).

<sup>558</sup>Lewin ¶20-76.

<sup>559</sup>See generally §7.2.3 of this handbook (types of equitable relief for breaches of trust).

<sup>560</sup>See generally 5 Scott & Ascher §29.7 (Transfer in Restitution for Wrong).

<sup>561</sup>See generally §8.15.63 of this handbook (doctrine of bona fide purchase; the BFP).

<sup>562</sup>Cf. §2.3 of this handbook (wrongful defunding of the trust: "A reasonable argument can be made that the absent trust property has merely been transformed into another type of property, namely the equitable personal obligation of the wrongdoer").

<sup>563</sup>5 Scott & Ascher §29.7 (Transfer in Restitution for a Wrong). See generally §3.5.4.3 of this handbook (bonds and sureties).

<sup>564</sup>5 Scott & Ascher §29.7.

<sup>565</sup>See *Dobler v. Arluk Med. Ctr. Indus. Grp.*, 107 Cal. Rptr. 2d 478 (Ct. App. 2001), *aff'd in subsequent appeal*, 11 Cal. Rptr. 3d 194 (Ct. App. 2004).

<sup>566</sup>See generally 3 Scott & Ascher §17.2.1.3.

<sup>567</sup>See generally §8.15.22 of this handbook (reformation actions).

is likely that the trustee would have standing to bring such an action.<sup>568</sup> Whether under equitable principles the trustee should do so is another matter. If the trustee is seeking to bring about a reordering of the equitable property interests at the expense of one or more of the beneficiaries designated within the four corners of the governing instrument, then his initiating the reformation action, and certainly his appealing of any lower court decision not to reform, would be difficult to square with his fiduciary duties of loyalty and impartiality, not to mention his duty to defend the trust, a topic we take up in §6.2.6 of this handbook.<sup>569</sup> Even as a nominal defendant in a mistake-based reformation action brought by someone else, the trustee should be wary of taking a position that is adverse to any designated beneficiary.

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<sup>568</sup>*See, e.g.*, Reid v. Temple Judea & Hebrew Union Coll. Jewish Inst. of Religion, 994 So. 2d 1146 (Fla. Dist. Ct. App. 2008).

<sup>569</sup>*See* §6.2.5 of this handbook (the trustee's duty of impartiality).