

## Title

### Residual liability in the trust context of excluded fiduciaries

## Summary

Some states by statute have introduced into their trust jurisprudence the concept of the excluded fiduciary: In the case of a trust the terms of which allocate fiduciary functions between the trustee and, say, a trust protector, the trustee is an excluded fiduciary as to those functions that have been allocated elsewhere. South Dakota is just such a state. *See* SDLC Chap.55-1B. Section 1B-2 of the statute is essentially a hold harmless provision on steroids that is clearly intended to all but eliminate any co-fiduciary liability that the excluded fiduciary might otherwise have incident to *the protector's* carrying out of his allocated functions. Here is a link to the section:

[http://sdlegislature.gov/Statutes/Codified\\_Laws/DisplayStatute.aspx?Type=Statute&Statute=55-1B-2](http://sdlegislature.gov/Statutes/Codified_Laws/DisplayStatute.aspx?Type=Statute&Statute=55-1B-2).

One wonders how safe this harbor actually is, the trust being a creature of equity, not legislation. There are three principles of equity that may not have been effectively negated, namely that (1) One may not knowingly participate in a breach of trust, such as by facilitating the transfer of the trust property in derogation of the trust's terms; (2) A trustee on actual notice of a breach must take reasonable steps to remedy it; and (3) the beneficiary is entitled to all the information in the trustee's possession that would further the beneficiary's ability to protect the equitable interest. To the extent the trustee fails to fully disclose that information on the trust accountings (or in the trustee's reports), then constructive fraud doctrine may be implicated as well.

Assume a purpose of a trust is to retain and operate a closely held corporation. The trust's terms allocate to a trust protector the power to direct how the company is managed and to the corporate trustee the duty to manage a separate portfolio of publicly-traded securities that is also held in the trust. The protector in breach of the trust's terms and in violation of the duty of loyalty directs the sale of the company to himself for less than what the company is clearly worth. The trustee acquiesces. The trustee knows or should know about the protector's breaches of trust if only because it prepares the trust accountings (reports). It would seem that the trustee risks co-fiduciary liability should it fail to attempt non-judicially to get the protector to remedy the situation, and if the protector is uncooperative then fail to put the matter before the court. To make matters worse, a failure to disclose the breaches on the accountings (or in the trustee's reports) might well constitute constructive fraud. Constructive fraud in the trust context is taken up generally in §8.15.60 of *Loring and Rounds: A Trustee's Handbook* [pages 1268-1270 of the 2017 Edition]. The section is reproduced in its entirety below:

## Text

### §8.15.60 *Constructive Fraud* [from *Loring and Rounds: A Trustee's Handbook* (2017)].

Constructive fraud has all the elements of fraud, except the element of intent to defraud or deceive: "The principle is well settled, that if a person makes a representation of a fact, as of his own knowledge, in relation to a subject matter susceptible of knowledge, and such representation is not true; if the party to whom it is made relies and acts upon it, as true, and sustains damage by it, it is fraud for which the party

making it is responsible.”<sup>975</sup> The negligent misrepresentation must be incident to some legal or equitable relationship.<sup>976</sup> Parties in a contractual relationship generally have a legal duty to deal fairly and in good faith.<sup>977</sup> The fiduciary in an equitable relationship, *e.g.*, an agent or a trustee, has a panoply of duties incident to that relationship, duties that are enumerated and discussed in Chapter 6 of this handbook.

In the trust context, the doctrine of constructive fraud and the *Cambridge Trust Case*<sup>978</sup> will be forever linked in the minds of trust professionals on this side of the Atlantic. The case involved a testamentary trust for the benefit of the settlor's widow. Upon her remarriage, the trust was to continue for the benefit of a charity. The trust was funded in 1932. In 1945 the widow remarried but through the employment of elaborate ruses she managed to hide the fact of her remarriage from the trustee until her death in 1967. Thus, the trustee in violation of the terms of the trust and to the detriment of the charity continued to pay the net trust accounting income to the widow until her death, when at last it discovered its mistake.

The charity sought to have the court reopen a number of the trustee's previously allowed accounts and order the trustee to make the trust whole out of its own pocket, if necessary, for the amounts that it had misdelivered. By statute, allowed trustee accounts generally cannot be reopened, except for fraud or manifest error.<sup>979</sup> While it was clear that the trustee had not intended to misrepresent the widow's marital status on the accountings, it was also clear that the trustee's inattention, in the words of even the dissent, was “pathetic.”<sup>980</sup> In fact, the trial court found that the trustee had exerted no effort whatsoever to ascertain the widow's marital status, not even going so far as to solicit from her periodic affidavits. Accordingly, the court found that the trustee's negligent misrepresentation of the widow's marital status on the face of the accountings, a misrepresentation that was occasioned by the absence of even a halfhearted effort to ascertain the critical fact of the widow's marital status, constituted a constructive fraud perpetrated by the trustee against the charity warranting a reopening of the trustee's previously allowed accounts.

One court, this time in New York, has ruled that misrepresentations of law and fact made by a corporate cotrustee's counsel to a beneficiary, *i.e.*, by an agent of the corporate cotrustee, were grounds for opening and vacating a decree that had judicially settled the intermediate accounts of the cotrustees, notwithstanding the fact that the beneficiary had signed a general waiver and release running to the cotrustees.<sup>981</sup> The time for appeal had long passed. As it happened, the testamentary trust during the period covered by the intermediate account had sustained substantial realized losses from the sale of stock in the corporate cotrustee.<sup>982</sup> Granted the stock was an inception asset; but the will contained no language expressly authorizing its retention. All things being equal, the presence of such language would have been a defense to allegations that the corporate cotrustee had breached its duty of loyalty to the beneficiary in retaining its own stock in the trust.<sup>983</sup> Trust counsel's statements to the beneficiary to induce the beneficiary to execute the waiver and release, namely, “that nothing could be done about ... [the

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<sup>975</sup>Page v. Bent, 43 Mass. 371, 374 (1841) (Chief Justice Lemuel Shaw rendering the opinion).

<sup>976</sup>*Cf.* Estate of Draper v. Bank of Am., N.A., 288 Kan. 510, 205 P.3d 698 (2009) (“Constructive fraud is a ‘breach of a legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others or violate a confidence, and neither actual dishonesty [n]or purpose or intent to deceive is necessary.’”).

<sup>977</sup>Wells v. Stone City Bank, 691 N.E.2d 1246 (Ind. Ct. App. 1998).

<sup>978</sup>Nat'l Acad. of Sci. v. Cambridge Trust Co., 370 Mass. 303, 346 N.E.2d 879 (1976).

<sup>979</sup>*See generally* §6.1.5.2 of this handbook (duty to keep and render accounts).

<sup>980</sup>Nat'l Acad. of Sci. v. Cambridge Trust Co., 370 Mass. 303, 313, 346 N.E.2d 879, 885 (1976).

<sup>981</sup>*In re Gillies' Will*, 98 N.Y.S.2d 853 (Sur. Ct. 1950).

<sup>982</sup>*See generally* §6.1.3.2 of this handbook (trustee invests in its own stock).

<sup>983</sup>*See generally* §7.1.2 of this handbook (defenses to allegations that the trustee breached the duty of loyalty).

shrinkage in value of the trust estate]... and that the signing of the release would save time and money,” constituted at least constructive fraud such that a reopening of the accounts was warranted.<sup>984</sup> The fraud having been perpetrated by an agent of the corporate cotrustee, the court imputed it to the cotrustee.

A trustee seeking a waiver or release who fails to disclose to the beneficiary all material facts, including those facts that are not in the interest of the trustee to disclose, perpetrates a fraud against the beneficiary.<sup>985</sup> If the failure to disclose is *not* coupled with an intent to deceive, then the fraud is constructive.<sup>986</sup> To the extent trust counsel is involved in a continuing deliberate effort to defeat the rights of the beneficiary through the withholding of material information, communications between the trustee and trust counsel made in the course of that effort may not be privileged.<sup>987</sup> They are said to come within the crime-fraud exception to the attorney-client privilege.

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<sup>984</sup>*In re Gillies' Will*, 98 N.Y.S.2d 853, 856 (Sur. Ct. 1950).

<sup>985</sup>*First Union Nat'l Bank v. Turney*, 824 So. 2d 172, 188–189 (Fla. 2002).

<sup>986</sup>*First Union Nat'l Bank v. Turney*, 824 So. 2d 172, 191 (Fla. 2002).

<sup>987</sup>*First Union Nat'l Bank v. Turney*, 824 So. 2d 172, 191 (Fla. 2002).