

Duty Limitations and Exculpation Clauses: Trust Drafting Considerations

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Introduction

My experience suggests that many trust documents are drafted with inadequate understanding of the duties imposed on California trustees by common law and statute. Indeed, it is not uncommon to see a trust that has only one provision expressly easing a trustee's responsibilities—a provision stating that a successor trustee has no duty to audit or investigate the administration or accounts of a prior fiduciary. Unfortunately, the trustee duties imposed by law, most notably including the duty of loyalty, with its strict prohibitions against self-dealing and related conflict-of-interest transactions, are sometimes inconsistent with the expectations (justified or otherwise) of family-member trustees—not to mention possible objectives, assumptions, and expectations of settlors. Just ask the successor trustee who is astonished to learn that she risks the equivalent of a lawsuit by another beneficiary (who is already angry about something else) if she retains her son as the listing agent for purposes of selling Mom's house.

Problems can become even more complicated when the asset is the operating business itself.

Part of the problem is that settlors often really want the trustee to make the decisions the settlors would have made if present—not the decisions required by laws the settlors have never read. A related part of the problem is that the settlor often didn't really want a trust in the first place—but just wanted to avoid probate or save some taxes. As practitioners, we need to better address these issues, making sure settlors have a sense of trustee obligations and the justifications for those obligations. When statutory and common law duties might conflict with the accomplishment of settlor objectives, the possibility of including trust provisions easing or modifying trust duties must be considered, and the settlor must be educated in the pros and cons of such provisions.

Failures to expressly address "trustee duty" matters in trust documents can create problems that are far more consequential than a family member's loss of a brokerage commission—particularly when a successor trustee had a predeath financial connection to property owned by a now-deceased settlor's revocable trust. For example, the successor trustee may be a child of a settlor who for many years has leased trust real estate for purposes of farming, operating a fast-food franchise, or selling automobiles. As soon as the lease comes up for renewal after the settlor's death, the trustee likely will be confronted with serious self-dealing problems—not only with respect to the amount of future rent, but also the question of whether the lease should be renewed at all. Problems can become even more complicated when the asset is the operating business itself—the farm corporation, the restaurant, or the automobile dealership. In such cases, the trustee may confront conflicts of interest concerning the trustee's own salary, voting trust stock to elect the trustee as chair of the board, decisions concerning the employment of other family members to perform legal, accounting, or other services for the business, and even the fundamental question of whether the trustee can retain the business as a trust asset notwithstanding impartiality, prudence, and diversification requirements.

We don't want to be writing legal memoranda on trust law at the finger-pointing stage.

Although these problems are not new, it may be that the trend toward codification of trust law—often in language far less flexible than common law doctrine—has increased the need for trust drafters to

identify and address situations in which the desires and expectations of settlors and their family members are inconsistent with the statutes. As a matter of advocacy, a black-and-white statute makes it more difficult to argue in court that the circumstances surrounding the creation of the trust imply a settlor intent to permit trustee actions that are expressly prohibited by that statute. In California, the advocacy problem may be further complicated by Prob C §16000, which states:

On acceptance of the trust, the trustee has a duty to administer the trust according to the trust instrument and, except to the extent the trust instrument provides otherwise, according to this division [the Trust Law].

This statute appears to require an express trust provision to overcome a statutory duty. In contrast, the Uniform Trust Code (UTC) and the Restatement (Second) of Trusts more broadly provide for determining trustee duties by looking at the “terms” of the trust, which are then more broadly defined as including, with modest variations of language, “the manifestation of the settlor’s intent regarding a trust’s provisions as expressed in the trust instrument or as may be established by other evidence that would be admissible in a judicial proceeding.” UTC §103(18). Restatement (Second) of Trusts §§4, 164 (1959). See also Restatement (Third) of Trusts §4 (2003) and Restatement (Third) of Trusts §76, Tentative Draft No. 4 (Apr. 5, 2005; approved May 17, 2005) (both hereinafter referred to as Restatement (Third) of Trusts).

Even if the potential advocacy problems can be effectively addressed in the courtroom, it remains important to address statutory trust duties in trust documents and limit those duties when appropriate, for the simple reason that we don’t want to end up in court in the first place. We don’t want to be writing legal memoranda on trust law at the finger-pointing stage, and (in appropriate cases) we don’t want chosen trustees to be bullied by beneficiaries who may be desperately looking for ways to attack the trustee.

This article discusses statutory duties of California trustees and circumstances that may call for modification of those duties insofar as modification is permitted. The discussion is selective and generally limited to issues that arise with respect to protecting, investing, and otherwise managing the trust estate—thereby excluding issues that arise with respect to distributions. As a prelude, this article repeats, with modest editing, the discussion previously published in *Trustee Administration Powers: Drafting Considerations*, 25 CEB Est Plan R 68 (Dec. 2003), concerning the drafting importance of distinguishing among clauses that confer trustee powers, those that modify trustee duties, or those intended to protect the trustee from liability for the breach of a duty.

Distinguishing Among Grants of Powers, Modifications of Duties, and Protections From Liability (Exculpation)

If we are to draft clauses that effectively modify trustee duties, we need to be very mindful of the distinctions among clauses that confer trustee powers, clauses that modify trustee duties, and clauses that relieve trustees of liability for breaches of their duties. Many trust documents attempt to modify trustee duties by using clauses that grant powers to the trustee. Confusing a trustee power with a duty modification is a trap. Consider a clause that says something like “The trustee has the power to collect, hold, and retain property received from the settlor or any other person without diversification.” Now suppose the trustee receives a trust estate that is obviously not diversified. Perhaps the bulk of the estate is the stock of the publicly traded company where the settlor worked for 40 years, or maybe it’s stock of a family corporation. Maybe the main asset of the estate is that family farm, restaurant, or automobile dealership. Further suppose that the trustee retains this property for 2, 3, or 10 years and that the property loses much of its value. A trust beneficiary petitions a court to remove and surcharge the trustee on the ground that the trustee failed to diversify investments.

Does the clause authorizing retention without diversification protect the trustee? The answer depends on what the settlor intended—an issue that may be decided by a judge with a crowded calendar who until last year had spent her entire legal career prosecuting crimes in the District Attorney’s office. Before answering, consider Prob C §16202, which, consistent with common law and UTC §815(b), states:

The grant of a power to a trustee, whether by the trust instrument, by statute, or by the court, does not in itself require or permit the exercise of the power. The exercise of a power by a trustee is subject to the trustee's fiduciary duties.

See also *First Alabama Bank v Spragins* (Ala 1987) 515 So2d 962, discussed in Restatement (Third) of Trusts: Prudent Investor Rule §229, Reporter's Notes on Comments c and d (1992), in which a trustee was held liable for a failure to diversify despite a trust provision expressly authorizing the trustee to make investments "as to it may seem suitable . . . regardless of any lack of diversification, risk, or nonproductivity."

Confusing a trustee power with a duty modification is a trap.

Under Prob C §16202, if we interpret our trust language as conferring a "power," the language will do relatively little to protect the trustee. The trustee will still be exposed to the argument that the failure to diversify was a breach of a trustee duty under the circumstances because the trustee's fiduciary duties, as determined by consideration of the objectives of the trust, made it improper to fail to diversify.

The trustee might counter with the argument that the trust provision—although couched in the language of a power—was actually intended to override the Prob C §16048 duty to diversify investments. A settlor might desire such a provision, wisely or otherwise, if the main trust asset was the family business. A settlor might also desire such a provision in a trust that is intended to hold a specific asset that constitutes a relatively small portion of total family wealth—perhaps a life insurance trust.

Such arguments concerning settlor intent can often be resolved favorably for the trustee by looking at circumstances and other trust provisions, but the fact remains that a legal dispute could be avoided if the drafter had perceived the possible ambiguity of the clause and taken steps to address it.

It is sometimes similarly important to avoid using exculpatory language in an attempt to narrow a duty. Consider, for example, a trust document that states, "The trustee shall not be liable to any beneficiary for any loss resulting from retention of property transferred to the trust by the settlor." This clause is an exculpation clause that protects the trustee from surcharge, subject to the provisions of Prob C §16461, which states, in relevant part:

(a) Except as provided in subdivision (b) ..., the trustee can be relieved of liability for breach of trust by provisions in the trust instrument.

(b) A provision in the trust instrument is not effective to relieve the trustee of liability (1) for breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interest of the beneficiary, or (2) for any profit that the trustee derives from a breach of trust.

The provision does not address the separate issue of what happens if a beneficiary seeks a court order compelling the trustee to sell a particular asset—perhaps the automobile dealership operated by his sister—on the ground that the trust portfolio is not diversified or because trust ownership of the asset creates some form of conflict-of-interest problem. The mere fact that the trustee may be protected from a surcharge order if the trustee retains the property does not resolve the question of whether the court can properly order the sale. After all, the purpose of an exculpation clause is to relieve a trustee of liability for a breach of trust, not to authorize the breach.

We are left needing to understand more about settlor intent. Again, other trust terms and the circumstances may provide clarification. Perhaps the asset is the family farm, the trustee is the primary or favored beneficiary, and the settlor did not want the property sold against the trustee's wishes. Perhaps not. In any case, it would have been helpful to have a clearer statement of settlor intent in the trust document.

A Suggested Classification Scheme

An examination of these interpretation problems suggests that a great deal of ambiguity can be avoided if the drafter expresses settlor intent in a manner that makes clear what a particular clause is intended to do. Is it intended to:

- Confer a “power” in the sense of making it possible for the trustee to perform an act upon which a third party can safely rely?
- Impose a trustee duty to perform or not perform a particular act?
- Modify or eliminate a trustee duty that might otherwise exist as a consequence of statute, common law, or more general terms of the trust?
- Provide the trustee with some protection from surcharge even if the trustee breaches a duty?

Once the objective of a possible trust clause has been determined, it will usually be easier to state that objective. The objective may also influence the organization of the trust document. For example, the drafter may determine that the boilerplate-laden “Trustee Powers” section of the trust document is not the ideal location for a provision authorizing the trustee to lease the family farm to herself as an individual.

California Statutory Trustee Duties

For purposes of this discussion we will define a trustee duty as an obligation of the trustee that can result in imposition of a judicial remedy if the obligation is not met. A court has the power to compel a trustee to perform the trustee’s duties and may enjoin the trustee from violating duties. Prob C §16420(a)(1)–(2). A violation of a duty is a breach of the trust. Prob C §16400. In the event of such a breach, the court may remove the trustee and may compel the trustee to redress the breach by payment of money (a surcharge) or otherwise. Prob C §16420(a)(3), (5).

As noted above, Prob C §16000 requires that trusts be administered according to the trust instrument and, except to the extent the trust instrument provides otherwise, according to California’s “Trust Law.” Probate Code §16000 is followed by a list of statutory duties (Prob C §§16001–16015), including the following in statutory order:

- Duty of loyalty;
- Duty to deal impartially with beneficiaries;
- Duty to avoid conflicts of interest;
- Duty not to undertake adverse interests;
- Duty to take control of trust property;
- Duty to make trust property productive;
- Duty to keep trust property separate and identified;
- Duty to enforce claims;
- Duty to defend actions;
- Duty not to delegate acts to others;
- Duties concerning cotrustees; and
- Duty to apply any special skills of the trustee.

Other statutory duties are found in Prob C §§16002(a), 16003, 16045–16054 (concerning prudent investing under the Uniform Prudent Investor Act); Prob C §§16060–16064 (concerning requirements for reports and accounts to beneficiaries as well as notices when a trust becomes irrevocable or the trustee changes); Prob C §§16080–16082 (concerning the exercise of discretionary powers); and Prob C §§16100–16105 (concerning special duties of trustees of charitable trusts).

In any particular case, the list of statutory duties may be perfectly consistent with the objectives of the settlor of a trust; in all cases, the drafter does not want to go overboard in attempting to eliminate duties. Trustee duties are necessary and important. In the absence of any trustee duties, there would be no trust. As the traditionally accepted definition is stated in Restatement (Third) of Trusts §2:

A trust, as the term is used in this Restatement when not qualified by the word “resulting” or “constructive,” is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee.

Even if preliminary consideration of trust objectives and trustee duties leads the drafter to consider limiting the application of some statutory duties, other options should be explored first. This is particularly true in the context of trusts having tax objectives—we don’t want to lose an intended marital deduction or charitable deduction, and we frequently don’t want to give a trustee so few duties with respect to property that the trustee might be deemed to hold an unintended general power of appointment over the property for purposes of taxation, asset protection, or public benefits qualification. Apparent conflicts between trust objectives and statutory trustee duties are often better addressed by other strategies, including provisions for appointment of independent special trustees who can be authorized to perform tasks that would confront the primary trustee with self-dealing, conflict of interest, or tax problems.

We don’t want to lose an intended marital deduction or charitable deduction.

That said, there are times when provisions limiting duties are appropriate. The balance of this article briefly discusses selected statutory duties, issues raised by those duties, and the possibility of modifying them. Because California law may not always apply to a trust, or some of its provisions may be amended, the discussion frequently cites the Uniform Trust Code (UTC), the Restatement (Second) of Trusts, and the Restatement (Third) of Trusts.

The Duty of Loyalty

Probate Code §16002(a) states: “The trustee has a duty to administer the trust solely in the interest of the beneficiary.” One might argue that this statement is not so much a codification of common law as an incorporation of it by reference. Indeed, the California Law Revision comments for this section remind us that the language is based on Restatement (Second) of Trusts §170(1) and that “[t]his article does not attempt to state all aspects of the trustee’s duty of loyalty, nor does this article seek to cover all duties that may exist. See Section 15002 (common law as law of state).” 18 Cal L Rev’n Comm’n Reports 1370 (1986). Also, Probate Code §15002 provides that “[e]xcept to the extent that the common law rules governing trusts are modified by statute, the common law as to trusts is the law of this state.” Discussions of the duty of loyalty can be found at Restatement (Second) of Trusts §170; 2A Scott & Fratcher, *The Law of Trusts* §§170–170.25 (4th ed 1987); Restatement (Third) of Trusts §78; and Comment to UTC §802.

Explication of the duty of loyalty is well beyond the scope of this article, and we will leave for later discussion below the fact that some aspects of the duty of loyalty are more expressly stated in other statutes. For the moment, we will quote excerpts from UTC §802 for the purpose of alerting drafters to the possibility that a particular trust document may need custom provisions modifying the duty of loyalty if the trustee will be expected to engage in transactions that may violate the duty.

(a) A trustee shall administer the trust solely in the interests of the beneficiaries.

(b) Subject to the rights of persons dealing with or assisting the trustee as provided in Section 1012, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee’s own personal account or which is otherwise affected by a conflict between the trustee’s fiduciary and personal interests is voidable by a beneficiary affected by the transaction unless: (1) the transaction was authorized by the terms of the trust; (2) the transaction was approved by the court; (3) the beneficiary did not commence a judicial proceeding within the time allowed by Section 1005; (4) the beneficiary consented to the trustee’s conduct, ratified the transaction, or released the trustee in compliance with Section 1009; or (5) the transaction involves a contract entered into or claim acquired by the trustee before the person became or contemplated becoming trustee.

(c) A sale, encumbrance, or other transaction involving the investment or management of trust property is presumed to be affected by a conflict between personal and fiduciary interests if it is entered into by the trustee

with: (1) the trustee's spouse; (2) the trustee's descendants, siblings, parents, or their spouses; (3) an agent or attorney of the trustee; or (4) a corporation or other person or enterprise in which the trustee, or a person that owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment.

(d) A transaction between a trustee and a beneficiary that does not concern trust property but that occurs during the existence of the trust or while the trustee retains significant influence over the beneficiary and from which the trustee obtains an advantage is voidable by the beneficiary unless the trustee establishes that the transaction was fair to the beneficiary.

(e) A transaction not concerning trust property in which the trustee engages in the trustee's individual capacity involves a conflict between personal and fiduciary interests if the transaction concerns an opportunity properly belonging to the trust.

(f) An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment otherwise complies with the prudent investor rule of [Article] 9....

(g) In voting shares of stock or in exercising powers of control over similar interests in other forms of enterprise, the trustee shall act in the best interests of the beneficiaries. If the trust is the sole owner of a corporation or other form of enterprise, the trustee shall elect or appoint directors or other managers who will manage the corporation or enterprise in the best interests of the beneficiaries.

(h) This section does not preclude the following transactions, if fair to the beneficiaries: (1) an agreement between a trustee and a beneficiary relating to the appointment or compensation of the trustee; (2) payment of reasonable compensation to the trustee; (3) a transaction between a trust and another trust, decedent's estate, or [conservatorship] of which the trustee is a fiduciary or in which a beneficiary has an interest; (4) a deposit of trust money in a regulated financial-service institution operated by the trustee; or (5) an advance by the trustee of money for the protection of the trust.

(i) The court may appoint a special fiduciary to make a decision with respect to any proposed transaction that might violate this section if entered into by the trustee.

Generally, the duty of loyalty provides a sound default rule without modification. Restatement (Third) of Trusts §78, comment b, explains:

The fiduciary duty of undivided loyalty in the trust context, as stated in Subsection (1) and amplified in Subsection (2), is particularly intense so that, in most circumstances, its prohibitions are absolute for prophylactic reasons. The rationale begins with a recognition that it may be difficult for a trustee to resist temptation when personal interests conflict with fiduciary duty. In such situations, for reasons peculiar to typical trust relationships, the policy of the trust law is to prefer (as a matter of default law) to remove altogether the occasions of temptation rather than to monitor fiduciary behavior and attempt to uncover and punish abuses when a trustee has actually succumbed to temptation. This policy of strict prohibition also provides a reasonable circumstantial assurance (except as waived by the settlor or an affected beneficiary) that beneficiaries will not be deprived of a trustee's disinterested and objective judgment.

Nevertheless, particularly in cases in which the trustee is a beneficiary—and likely the favored beneficiary—who will necessarily engage in transactions that involve the trustee's personal interest, some custom drafting will be necessary. If, for example, it is the drafter's desire to permit the settlor's daughter to continue to edit and publish the *Duckberg Toot* regardless of whether the paper makes a profit, an express statement to that effect will be needed to make clear that the daughter, in her capacity as trustee, has not breached the trust by failing even in difficult times to convert the newspaper into mutual funds. Specific language is needed—a boilerplate power-to-retain-assets clause is not going to carry the day a decade later when the *Toot* is awash in red ink and other beneficiaries have petitioned the court for an order requiring sale of the paper.

Duty to Deal Impartially With Beneficiaries

If a trust has two or more beneficiaries, the trustee must deal impartially with them “taking into account any different interests of the beneficiaries.” Prob C §16003. See also Restatement (Second) of Trusts §183; Restatement (Third) of Trusts §79; and UTC §803. Although we have generally excluded distribution issues from the scope of this article, it is appropriate to mention the implications of the

duty of impartiality in connection with trusts that provide for the distribution of income. As stated in Restatement (Third) of Trusts §79(2):

(2) If a trust is created for two or more beneficiaries or purposes in succession and if the rights of any beneficiary or the expenditures for a charitable purpose are defined with reference to trust income, the trustee's duty of impartiality includes a duty to so invest and administer the trust, or to so account for principal and income, that the trust estate will produce income that is reasonably appropriate to the purposes of the trust and to the diverse present and future interests of its beneficiaries.

It is beyond the scope of this article to address most of the issues raised by the Uniform Principal and Income Act (Prob C §§16320–16375) and the Uniform Prudent Investor Act (Prob C §§16002(a), 16003, 16045–16054), including problems that may arise with respect to the Prob C §16336 adjustment power, and the possibility of conversion to a unitrust under Prob C §§16336.4–16336.6. Suffice it to say that the drafter should be very sensitive to the risk of future litigation in situations in which the trustee is either the income beneficiary or the remainder beneficiary of a trust providing for the distribution of income. Problems in this area are frequently complicated by limitations imposed by tax objectives. For example, a trust may fail to qualify for the marital deduction if the spouse cannot compel the trustee to make unproductive property productive.

Generally, these problems should not be addressed by directly stating that the trustee does not have a duty of impartiality. If the settlor desires to preserve unproductive property, the planner might route that property to a trust that does not require the payment of income. If the settlor wants to facilitate investment decisions that might permit large income distributions from an IRC §2056A qualified domestic trust benefiting a noncitizen spouse, the trust can expressly state that the spouse is the favored beneficiary. For a discussion of trust distribution alternatives, including methods of favoring particular beneficiaries, see *Drafting California Revocable Trusts*, chap 7 (4th ed Cal CEB 2003).

Duty to Avoid Conflicts of Interest

Under the somewhat questionable heading of Duty to Avoid Conflicts of Interest, Prob C §16004 contains a grab bag of provisions. The statute states:

(a) The trustee has a duty not to use or deal with trust property for the trustee's own profit or for any other purpose unconnected with the trust, nor to take part in any transaction in which the trustee has an interest adverse to the beneficiary.

(b) The trustee may not enforce any claim against the trust property that the trustee purchased after or in contemplation of appointment as trustee, but the court may allow the trustee to be reimbursed from trust property the amount that the trustee paid in good faith for the claim.

(c) A transaction between the trustee and a beneficiary which occurs during the existence of the trust or while the trustee's influence with the beneficiary remains and by which the trustee obtains an advantage from the beneficiary is presumed to be a violation of the trustee's fiduciary duties. This presumption is a presumption affecting the burden of proof. This subdivision does not apply to the provisions of an agreement between a trustee and a beneficiary relating to the hiring or compensation of the trustee.

To some extent, these provisions state duties that are commonly treated as elements of the duty of loyalty. See UTC §802 and Restatement (Third) of Trusts §78(3). The earlier discussion of the drafting considerations involving the duty of loyalty need not be repeated here. With respect to Prob C §16004(c), it should be emphasized that the statute refers to transactions that are not trust transactions. Accordingly, it is probably not possible to override the statute by a provision in the trust document. This might be a concern, for example, if a trustee is trying to acquire additional shares of a family corporation for his personal account and purchases shares from the beneficiary of the trust.

Duty Not to Require Beneficiary to Relieve Trustee of Liability

Enacted in 2003, Prob C §16004.5 states:

(a) A trustee may not require a beneficiary to relieve the trustee of liability as a condition for making a distribution or payment to, or for the benefit of, the beneficiary, if the distribution or payment is required by the trust instrument.

(b) This section may not be construed as affecting the trustee's right to: (1) Maintain a reserve for reasonably anticipated expenses, including, but not limited to, taxes, debts, trustee and accounting fees, and costs and expenses of administration. (2) Seek a voluntary release or discharge of a trustee's liability from the beneficiary. (3) Require indemnification against a claim by a person or entity, other than a beneficiary referred to in subdivision (a), which may reasonably arise as a result of the distribution. (4) Withhold any portion of an otherwise required distribution that is reasonably in dispute. (5) Seek court or beneficiary approval of an accounting of trust activities.

It is difficult to imagine a circumstance in which settlor objectives would be advanced by attempting to override this duty. Further, it is doubtful that a court would enforce a waiver of liability that was procured by coercion in any event. However, the statute is a reminder that it is not uncommon to encounter a beneficiary who believes that he or she is entitled to immediate, complete distribution on a settlor's death without awaiting a reasonable period of administration. Many drafters use clauses that expressly authorize delaying distributions for such a period.

Duty Not to Undertake Adverse Trust

Probate Code §16005 states:

The trustee of one trust has a duty not to knowingly become a trustee of another trust adverse in its nature to the interest of the beneficiary of the first trust, and a duty to eliminate the conflict or resign as trustee when the conflict is discovered.

This statute is traceable to former CC §2232, which was adopted as part of the Field Code in 1872 and rarely cited by the courts. It is less than a model of clarity and appears, initially at least, to be at odds with Restatement (Third) of Trusts §78, comment (c)(7), which, consistent with Prob C §16002(b), states:

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.

It appears that Prob C §16005 should be construed only to prohibit a person from serving as trustee of multiple trusts that have objectives that fundamentally conflict—as might be the case if two trusts were engaged in competing enterprises. Presumptively, the owner of the local Burger King probably would not want her trustee later to become trustee of another settlor's trust that operates a McDonald's across the street.

Duty to Take Control of Trust Property

Probate Code §16006 provides that:

The trustee has a duty to take reasonable steps under the circumstances to take and keep control of and to preserve the trust property.

See also Restatement (Third) of Trusts §76(2)(b) and UTC §809. This duty raises problems for successor trustees of revocable trusts when trust property remains in the possession of a settlor of diminishing capacity. Predators separate elders from their funds in an astonishing variety of ways, so depriving the settlor of possession and control of property may be prudent. However, the situation is complicated by the fact that the ability of the successor trustee to act in these situations is uncertain until the settlor's lack of capacity is beyond reasonable dispute. A competent settlor will have the power to revoke or amend the trust—possibly disinheriting the trustee who tried to be helpful by putting Mom's jewelry in a safe deposit box. Thus, the successor trustee confronts the risk that

remainder beneficiaries may claim a breach of duty if there is a failure to deprive the settlor of control of property—perhaps tangible personal property, an automobile, or a family business—but the successor confronts difficult alternatives. Fortunately, the duty is limited to “reasonable steps under the circumstances.” In any event, a clause that provides that the trustee does not have a duty to take possession of some types of tangible personal property (or the family business) during the life of the settlor is something to consider. As a matter of trust administration, some of the trustee’s exposure sometimes can be reduced by maintaining adequate insurance for trust property.

Duty to Make Property Productive

Probate Code §16007 provides that:

The trustee has a duty to make the trust property productive under the circumstances and in furtherance of the purposes of the trust.

The problems that can arise under this statute are not limited to those involving income productivity—*i.e.*, the right of an income beneficiary to receive a suitable level of trust income. Indeed, problems most frequently occur during a period of settlor incapacity. Does the trustee sell or lease the vacation home that has traditionally been used by some, but not all, family members? Does the trustee sell the marginal business that is providing employment for another family member? Similar questions arise in connection with boats, motor vehicles, some hobby assets, and a variety of other tangible personal property assets that are depreciating or at least not likely to appreciate sufficiently to justify their retention on an economic basis. Problems are also confronted with respect to bypass trust and QTIP trust assets when a surviving spouse loses capacity and can no longer enjoy his income interest by using property in kind. There are no boilerplate solutions for these problems, just a need for drafters to identify client circumstances that need to be addressed. As noted earlier, the dictates of trust law are not always consistent with the desires of settlors who may expect the successor trustee to make the decisions the settlor would have made if the settlor retained capacity.

Duty to Keep Property Separate and Identified

Probate Code §16009 provides that:

The trustee has a duty to do the following:

- (a) To keep the trust property separate from other property not subject to the trust.
- (b) To see that the trust property is designated as property of the trust.

Many trust documents override these duties. Indeed, Prob C §16238 confers the power to hold trust property in bearer form or in the name of a nominee—a power that also appears in UTC §816(7)(B). Of course, as noted earlier, the mere possession of a trustee power does not in itself justify the exercise of the power. Prob C §16002. Many trustees do not separate and separately title the assets of various trusts created under the same document. This lack of separation may be permissible if there are adequate records designating the assets of the various trusts and persons other than the trustee have access to those records. For further discussion, see Restatement (Third) of Trusts §84.

Duties to Enforce Claims and Defend Actions

The duties to enforce claims and defend actions listed in Prob §§16010–16011 are unremarkable, but the duty to enforce claims can be a problem if a claim is against a beneficiary. If the trust holds a claim against a beneficiary as a result of a loan by the settlor to the beneficiary or otherwise, it may be helpful to provide the trustee with guidance on enforcement—particularly if that beneficiary is the trustee, or if the trust instrument provides for forgiveness of the note on the settlor’s death (or distribution to the obligor as part of the obligor’s share on death) but fails to guide the trustee as to desired action during a period of settlor incapacity.

Duty Not to Delegate

Probate Code §16012 provides that:

(a) The trustee has a duty not to delegate to others the performance of acts that the trustee can reasonably be required personally to perform and may not transfer the office of trustee to another person nor delegate the entire administration of the trust to a cotrustee or other person.

(b) In a case where a trustee has properly delegated a matter to an agent, cotrustee, or other person, the trustee has a duty to exercise general supervision over the person performing the delegated matter.

(c) This section does not apply to investment and management functions under Section 16052.

Probate Code §16052, a portion of the Uniform Prudent Investor Act, permits delegation of investment and management functions. Delegation is now permitted in California, except, perhaps, in connection with exercises of distribution discretion. In most cases the settlor will not desire delegation of distribution discretion. Probate Code §16052 states:

(a) A trustee may delegate investment and management functions as prudent under the circumstances. The trustee shall exercise prudence in the following: (1) Selecting an agent. (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust. (3) Periodically reviewing the agent's overall performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent has a duty to exercise reasonable care to comply with the terms of the delegation.

(c) Except as otherwise provided in Section 16401, a trustee who complies with the requirements of subdivision (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this state, an agent submits to the jurisdiction of the courts of this state.

Duty With Respect to Cotrustees

Probate Code §16013 provides:

If a trust has more than one trustee, each trustee has a duty to do the following:

(a) To participate in the administration of the trust.

(b) To take reasonable steps to prevent a cotrustee from committing a breach of trust or to compel a cotrustee to redress a breach of trust.

The statute closely follows the language of Restatement (Second) of Trusts §184. A literal reading of the statute would certainly make a typical cotrustee think twice before letting another cotrustee have access to the checkbook. The statute is consistent with UTC §703(g), but it lacks the safeguard of UTC §703(f), which provides that “[e]xcept as otherwise provided in subsection (g), a trustee who does not join in an action of another trustee is not liable for the action.” The rule that a cotrustee is required to participate in the administration of a trust is premised on the notion that the settlor had a purpose for appointing multiple trustees that will not be accomplished if a cotrustee does not actively participate. In some cases, this assumption is incorrect. For example, a settlor might name children as cotrustees in order to avoid favoritism or to assure that all children have the opportunity to participate if they desire. In such cases, the power-of-delegation clause in the previous section can be modified to expressly authorize delegation to a cotrustee. Drafters may also want to consider giving different cotrustees different functions. In some cases the investment function is assigned to only one of multiple trustees.

Duty to Use Special Skills

Probate Code §16014 provides:

(a) The trustee has a duty to apply the full extent of the trustee's skills.

(b) If the settlor, in selecting the trustee, has relied on the trustee's representation of having special skills, the trustee is held to the standard of the skills represented.

So, if you are a trusts and estates attorney and you name yourself as trustee of Mom's trust, it would be a really good idea not to let Mom's file drift to the bottom of the pile on your desk or office floor.

Duty to Diversify Investments

Probate Code §16048 provides that:

In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

This section (adapting familiar language from the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001–1461)) is part of the Uniform Prudent Investor Act (Prob C §§16002(a), 16003, 16045–16054). It is rarely prudent not to diversify investments. See Restatement (Third) of Trusts: Prudent Investor Rule §227 (1992). Nevertheless, there are various reasons why it might be appropriate to limit the duty of diversification for a particular trust. For example, a trust might be created to hold a specific asset that is only one of many assets comprising total family wealth. A life insurance trust may fall into this category. Even if lack of diversification is unwise or at least debatable (as may be true with many family businesses), the settlor may intend that the trustee hold without diversification business interests that provide employment for family members or allow the family to remain in control of a business entity. Indeed, the settlor may even approve of the trustee acquiring additional interests in the business. In some cases, settlors want businesses, land holdings, and other assets preserved more for reasons of preserving a monument to themselves than for reasons of providing financial benefits to others. Generally, a clause limiting the duty of diversification should be focused as sharply as possible, identifying the assets to be retained. Because lack of diversification is rarely prudent from an objective point of view, the clause may not accomplish its purpose if it implicitly requires the retention to be prudent or reasonable.

Duty to Report and Account

The Probate Code imposes a general duty to report to beneficiaries (Prob C §16060), a specific duty to give notice to both beneficiaries and heirs at law when a trust becomes irrevocable (Prob C §§16061.5–16061.7), a specific duty to give notice when there is a change of trustee (Prob §16061.7), and a general duty to account annually to beneficiaries (Prob C §16062). The two specific duties cannot be waived in the trust document. Prob C §16061.7(i). The duty to report and account can be waived in the trust document unless the trustee is a disqualified person under Prob C §21350.5. Prob C §§16062(e), 16064(a). Subject to the exceptions listed in Prob C §21351, disqualified persons under §21350.5 include persons involved in drafting the trust document and care custodians. In addition, even if the trust document waives the duties to report and to account, a court can order reports and accounts “upon a showing that it is reasonably likely that a material breach of the trust has occurred.” Prob C §16064(a). Complete waivers of reports and accounts are rarely advisable. Lack of disclosure creates distrust by the beneficiaries and increases the risk of a breach of trust. If the beneficiary is genuinely hostile and litigious, an alternative is to provide that the trustee is entitled to additional compensation and reimbursement of costs in the event of a demand for a complete account and underlying documentation. Some beneficiaries have a propensity for demanding a remarkable amount of detailed information and then contending that the trustee’s normal compensation should cover the work of satisfying those demands.

Duties Regarding Discretionary Powers

Probate Code §16080 provides that, except as provided in Prob C §16081, a discretionary power conferred on a trustee is not left to the trustee’s arbitrary discretion, but shall be exercised reasonably. Section 16081 further provides that, when a trust document confers “absolute,” “sole,” or “uncontrolled” discretion on a trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust. That section and Prob C §16082 provide additional restrictions on a trustee power that permits distributions to or for the benefit of the trustee. These additional restrictions are intended to avoid the possibility that overly exuberant drafting will result in the trustee having an unintended general power of appointment under IRC §§678, 2041, and 2514.

Duties Regarding Charitable Trusts

Probate Code §§16100–16105 impose various special duties on trustees of charitable trusts, split-interest trusts, and private foundations. These provisions are intended to ensure that such trusts qualify for tax deductions when the drafter has failed to include all necessary provisions in the trust document. The drafter of such trusts should not attempt to override or modify these duties. More generally, drafters should exercise great care when limiting trustee duties for a trust intended to qualify for a charitable tax deduction.

Exculpation Clauses

As noted earlier, an exculpation clause may protect a trustee from a surcharge for a breach of trust. It does not prevent an improper act from constituting a breach of trust. Nor, for example, does it prevent a beneficiary from obtaining a court order to compel compliance with fiduciary duties or insulate the trustee from the risk of removal. A court might also take the view that such a clause does not prevent the court from taking the extent and quality of the trustee's performance into account when determining reasonable compensation. Additionally, as noted earlier, Prob C §16461(b) states:

(b) A provision in the trust instrument is not effective to relieve the trustee of liability (1) for breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interest of the beneficiary, or (2) for any profit that the trustee derives from a breach of trust.

Drafting California Revocable Trusts §16.23 (4th ed Cal CEB 2003) provides the following example of an exculpation clause:

Exculpation of Trustee. A trustee of any kind nominated by this document, otherwise designated by a settlor, or designated as authorized in this document, shall not be liable to any beneficiary for the trustee's acts or omissions, except in cases of willful misconduct, bad faith, or gross negligence. The previous sentence does not relieve a trustee of any obligation to restore to the trust any benefits received by the trustee as a result of a breach of the trust. This paragraph does not apply to a person who regularly engages in the business of acting as a trustee.

Such a clause may be particularly appropriate when the trustee is a family member who will probably serve without compensation. It may also be appropriate in situations where circumstances present a high risk that a contentious and disgruntled beneficiary will attempt to bully the trustee into making larger discretionary distributions from a trust containing assets that the beneficiary believed should have been given to the beneficiary outright. The quoted clause does not apply to professional trustees. It is often appropriate to further limit the application of the clause to specific trustees—particularly when future trustees are unknown—as is often the case when the future termination of a trust many years down the road will cause the creation of new trusts for any distributees who are minors.

Exculpation clauses are not particularly useful in the situations discussed earlier in which it is anticipated that the trustee will engage in self-dealing. If, for example, the trustee will be leasing the family farm to herself, the exculpation clause will not protect the trustee in the event of a dispute, because Prob C §16461 states that the clause cannot relieve the trustee of liability for any profit that the trustee derives from a breach of the trust. Similarly, if the settlor desires to allow the trustee broader than ordinary judgment in matters of management or distribution, an exculpatory provision is no substitute for language of liberalized discretion or broadened purposes.