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Of Punctilios and Paybacks: The Duty of Loyalty Under the Uniform Trust Code

Karen E. Boxx*

I. INTRODUCTION

Loyalty has been cited as the most desired of traits from those who serve others. Samuel Goldwyn said, “I’ll take fifty percent efficiency to get one hundred percent loyalty.”¹ Elbert Hubbard put a higher price on loyalty: “If put to the pinch, an ounce of loyalty is worth a pound of cleverness.”² Certainly Julius Caesar would have agreed with these assessments.³ President Lyndon Baines Johnson is quoted as saying of a prospective assistant, “I don’t want loyalty. I want *loyalty*,” and continuing with an elaboration of what he meant by *loyalty* that is well known but too salty to repeat here.⁴ One reason that loyalty is so highly valued is that it is impossible to guarantee and impossible to buy. The trust law concept of the duty of loyalty acknowledges that human nature will cause any person to favor his or her personal interests over the interests of another, and it is this assumption of disloyalty that gives rise to the strict prohibitions of trustee conflicts of interest required under the label of “duty of loyalty.”⁵

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1. ARTHUR MARX, GOLDWYN: BIOGRAPHY OF THE MAN BEHIND THE MYTH 348 (1976).

2. ELBERT HUBBARD, *Get Out or Get in Line*, in SELECTED WRITINGS OF ELBERT HUBBARD 59-60 (1928).

3. See generally WILLIAM SHAKESPEARE, JULIUS CAESAR.

4. DAVID HALBERSTAM, THE BEST AND THE BRIGHTEST (1972). Of course, others, from the more cynical world of business, have put a lesser value on loyalty: “The alert company does not deny the value of loyalty, but values competency more.” Eugene E. Jennings, *The Co-Wordly Executive*, in MANAGEMENT OF PERSONNEL QUARTERLY (1971), quoted in QUOTE IT COMPLETELY! 693 (Eugene C. Gerhart ed., 1998). As to the potential danger of loyalty, Archibald Cox commented, “Watergate serves as a reminder that there are limits to the kind of loyalty that is owed and should be given.” Justin Hughes, *Cox Reflects on Watergate Era*, 77 HARV. L. REC. no. 7, Nov. 18, 1983, at 12.

5. See GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543, at 227 (2d ed. 1993) (“It is not possible for any person to act fairly in the same transaction on behalf of himself and in the interest of the trust beneficiary. It is only human that he will tend to favor his individual interest, whether consciously or unconsciously, over that of the beneficiary.”); Robert W. Hallgring, *The Uniform Trustees’ Powers Act and the Basic Principles of Fiduciary Responsibility*, 41

The duty of loyalty has been called “the essence of the fiduciary relationship”⁶ and even has been considered an expression synonymous with fiduciary.⁷ The fiduciary relationship relies on the fiduciary’s loyalty to the beneficiary, and, as the beneficiary is assumed to be on the losing end of any conflict with the fiduciary’s personal interests, loyalty can be preserved only if the relationship is stripped of the possibility of such conflicts. The duty of loyalty is, therefore, not the duty to resist temptation but to eliminate temptation, as the former is assumed to be impossible. The trustee is at the pinnacle of fiduciary duty and is held to the highest standards. As compared to other fiduciaries, the trustee holds the highest level of control over the other’s property.⁸ It, therefore, follows that the trustee’s duty of loyalty will be paramount and unforgiving, at least one hundred percent. Of course, the trustee has a harder job than Mr. Goldwyn’s employees because a trustee’s duty of care is certainly higher than fifty percent.⁹ Generally, if a trustee breaches her duty of loyalty by self-dealing,¹⁰ there is no further inquiry and the transaction is voidable by the beneficiaries regardless of the fairness of the transaction.¹¹ If the breach is a less direct conflict, a trustee may be able to uphold the transaction by proving fairness.¹² The Uniform Trust Code (“UTC”) follows the approach of predecessor uniform statutes and some state codifications in leaving the core of the common law duty of loyalty intact, with only minor relaxations of the duty in specific instances where convenience far outweighs risk. However, the UTC has rearranged somewhat the parameters for determining when a transaction’s

WASH. L. REV. 801, 803 (1966) (“Given human frailty, we cannot expect the fiduciary to put his personal advantage in second place. That ‘no man can serve two masters’ is a commonplace, and the difficulty is compounded where one of the masters is his own self-interest.”).

6. J.C. SHEPHERD, *THE LAW OF FIDUCIARIES* 48 (1981).

7. D.W.M. WATERS, *LAW OF TRUSTS IN CANADA* 33 (1974).

8. As stated by Professor Scott:

Some fiduciary relationships are undoubtedly more intense than others. The greater the independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty. Thus, a trustee is under a stricter duty of loyalty than is an agent upon whom limited authority is conferred or a corporate director who can act only as a member of the board of directors or a promoter acting for investors in a new corporation.

Austin W. Scott, *The Fiduciary Principle*, 37 CAL. L. REV. 539, 541 (1949).

9. See RESTATEMENT (SECOND) OF TRUSTS § 174 (1959) (stating trustee’s duty of care).

10. Self-dealing is defined as “where [a] person in [a] fiduciary or confidential relationship uses property of another for his own personal benefit.” BLACK’S LAW DICTIONARY 1359 (6th ed. 1990).

11. BOGERT & BOGERT, *supra* note 5, § 543, at 247-48.

12. See *In re Estate of Rothko*, 372 N.E.2d 291, 295-96 (N.Y. 1977).

fairness will be available to the trustee as a defense and, in doing so, has added functional tests and clarity. This Article summarizes the common law origins of the duty of loyalty and various past attempts at codifying the duty. It then analyzes the UTC's formulation of the duty and discusses how it provides guidance to both the acting trustee and to the court in determining whether a breach has occurred.

II. COMMON LAW HISTORY AND PURPOSE OF THE DUTY OF LOYALTY

The duty of loyalty requires the trustee to "administer the trust solely in the interests of the beneficiaries."¹³ In general, this duty prohibits the trustee from transacting in her individual capacity with the trust and from entering into transactions where the trustee is not directly dealing with the trust but, nevertheless, has a conflict of interest.¹⁴ The duty of loyalty is joined by the duty of prudent administration in forming the law of fiduciary duty.¹⁵

The law of fiduciary duty was a relatively modern development in the history of the trust. Originally, a trustee's powers were extremely restricted in that the trustee's original role was more of a passive titleholder rather than an active asset manager.¹⁶ For example, in 1719, the British Parliament authorized trustees to invest in the South Sea Company. When the South Sea Company stock sank in value the following year, laws were passed requiring trustees to invest only in securities on a list approved by the legislature.¹⁷ This technique carried over to American trust law, but, in part because of the newness of the American economy and in part due to the modernizing of the economy, the list approach gave way to the prudent man standard.¹⁸ At the same time, the purpose of trusts was evolving from a way to hold and convey real property to management of financial assets.¹⁹ As the role of the trustee shifted from stakeholder to manager, it was necessary to grant the trustee broad discretion. The trend from the beginning of this shift in the nineteenth century to the present day has been to broaden the trustee's powers further and further, to provide the

13. UNIF. TRUST CODE § 802(a)(2000) [hereinafter UTC]; RESTATEMENT (SECOND) OF TRUSTS § 170 (1959).

14. 2A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* §§ 170-170.25, at 311-437 (4th ed. 1987).

15. John Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 655 (1995).

16. Langbein, *supra* note 15, at 633.

17. John H. Langbein & Richard A. Posner, *Market Funds and Trust Investment Law*, 1976 AM. B. FOUND. RES. J. 1, 3-4.

18. J. Alan Nelson, Comment, *The Prudent Person Rule: A Shield for the Professional Trustee*, 45 BAYLOR L. REV. 933, 940-41 (1993).

19. Langbein, *supra* note 15, at 637.

trustee with the full capacity to take advantage of all market opportunities to maximize the trust's value. As the trustee's powers expanded, however, the beneficiaries' interests were increasingly at risk from abuse of that discretion. As the control of limited powers retreated, leaving unprotected ground, the fiduciary principle filled that space with a different type of check on trustee misbehavior.²⁰

Together, the duty of loyalty and the duty of prudent administration imposed on the trustee, and the liabilities for breach of these duties, give the trustee the incentive not to abuse his or her discretion and give beneficiaries a remedy in the event of such abuse. While this scheme does not protect the beneficiary as much as the original scheme of limited trustee powers, the role of the modern trust as management device would not be possible without trustee discretion.

While breaches of the duty of prudent administration are judged on the basis of reasonableness of the trustee's conduct,²¹ a breach of the duty of loyalty is generally voidable at the option of the beneficiary, regardless of whether the transaction was otherwise fair to the trust.²² This "no further inquiry" rule is applicable in all self-dealing transactions, *i.e.*, where the trustee individually is a party to the transaction with the trust, and in any transaction where the trustee's personal interests are "substantially" affected.²³ If the trustee's conflict is not substantial, then the trustee may avoid liability by establishing the fairness of the transaction.²⁴

The duty of loyalty prohibits a broad range of activity by the trustee. The prohibited transactions include the trustee's purchase or lease of trust property for her own account,²⁵ sale of trust property to a third person with an understanding that the third person then will sell to the trustee,²⁶ sale of trust property to a corporation in which the trustee is a substantial owner or serves in

20. Langbein, *supra* note 15, at 637.

21. RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).

22. *Fulton Nat'l Bank v. Tate*, 363 F.2d 562, 571 (5th Cir. 1966). In *Fulton National Bank*, the court stated:

[T]he beneficiary need only show that the fiduciary allowed himself to be placed in a position where his personal interest *might* conflict with the interest of the beneficiary. It is unnecessary to show that the fiduciary succumbed to this temptation, that he acted in bad faith, that he gained an advantage, fair or unfair, that the beneficiary was harmed. Indeed, the law presumes that the fiduciary acted disloyally, and inquiry into such matters is foreclosed.

Id. (emphasis added).

23. SCOTT & FRATCHER, *supra* note 14, § 170.10, at 346.

24. SCOTT & FRATCHER, *supra* note 14, § 170.24, at 432-33.

25. SCOTT & FRATCHER, *supra* note 14, § 170.1.

26. SCOTT & FRATCHER, *supra* note 14, § 170.6.

a management capacity,²⁷ sale of the trustee's individually owned property to the trust,²⁸ purchase by a corporate trustee of its own stock as an investment for the trust,²⁹ and appropriation of a trust opportunity.³⁰ These transactions, as well as other similar conflicts, are all considered self-dealing and are subject to the no further inquiry rule.

For example, in *Pitts v. Blackwell*,³¹ Mr. Blackwell, who happened to be an undertaker, was appointed as co-conservator for an elderly woman.³² The ward held a prepaid burial insurance policy with another funeral home, and Mr. Blackwell and his co-conservator had it transferred to Mr. Blackwell's establishment.³³ When the ward died, the co-conservator made all of the decisions regarding the funeral, which turned out to be the most expensive funeral Mr. Blackwell ever had provided and exceeded the proceeds of the burial policy by more than \$18,000.³⁴ In reversing the lower court's approval of the conservatorship accounting, the court noted that a conservator's duties were similar to, and even more stringently applied than, the duties of trustee, and it quoted a prior court's statement that "[n]othing in the law of fiduciary trusts is better settled than that the trustee shall not be allowed to advantage himself in dealings with the trust estate. He shall not be allowed to serve himself under the pretense of serving his cestui que trust."³⁵ In spite of the indisputable assertion that the funeral services were necessary, the court remanded for a determination of reasonable funeral expenses in light of the deceased ward's estate, with instructions that such amount only could be approved to the extent of actual expenses incurred by Mr. Blackwell, without including any profit to Mr. Blackwell.³⁶

27. SCOTT & FRATCHER, *supra* note 14, § 170.10.

28. SCOTT & FRATCHER, *supra* note 14, § 170.12.

29. SCOTT & FRATCHER, *supra* note 14, § 170.15.

30. RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. k (1959).

31. No. M200-01733-COA-R3-CV, 2001 Tenn. App. LEXIS 938, at *1 (Tenn. Ct. App. Dec. 28, 2001).

32. *Id.* at *2.

33. *Id.* at *2-3.

34. *Id.* at *5.

35. *Id.* at *12-13.

36. *Id.* at *16. While it appears that, in this case, Mr. Blackwell's establishment did not directly control funds under the prepaid funeral policy while the ward was alive, *see id.* at *3 n.1, if the funeral home is the direct seller of the prepaid plan and holds title to the funds while the insured is alive, the funeral home may be treated as a trustee under applicable state law. *See* TENN. CODE ANN. §§ 62-5-401 to -408 (Michie 1997); Judith A. Frank, *Preneed Funeral Plans: The Case for Uniformity*, 4 ELDER L.J. 1, 7-8 (1996). Thus, a person in Mr. Blackwell's situation could well be serving in multiple fiduciary roles.

The no further inquiry rule can have interesting consequences. In *Grynberg v. Watt*,³⁷ co-trustees of a trust entered a Bureau of Land Management lottery for the lease of a parcel of land in their capacity as co-trustees of the trust.³⁸ The co-trustees also filed drawing entry cards in their individual capacity.³⁹ The trust won the drawing, but the Bureau of Land Management rejected the offers from the trust and the trustees because they violated the prohibition against multiple filings.⁴⁰ The trustees appealed, and the court upheld the rejection of the offers.⁴¹ It found that, if either of the trustees had held the winning entry, that trustee would have had to give the entry to the trust because entering the drawing was in substantial competition with the trust and the no further inquiry would apply, requiring the winning trustee to give the opportunity to the trust.⁴² The court rejected the trustees' argument that the competition had to be "substantial" to trigger the no further inquiry rule. It held instead that, here, the multiple entries placed the trustees in a position where conflicts of interest may arise, particularly if the trust received a priority higher than the individual trustee, because the trustee's secondary position might affect the trustee's decision whether to take the lease for the trust.⁴³ Thus, the individual filings by the trustees were equivalent to two additional filings by the trust, thereby disqualifying all of them.⁴⁴

The duty of loyalty also can be breached where the trustee favors not itself but another trust for which it is serving as trustee.⁴⁵ For example, in *Wiggins v. PNC Bank, Kentucky, Inc.*,⁴⁶ the bank was trustee of two trusts for the lifetime benefit of an elderly woman. The trusts had different grantors and different remaindermen.⁴⁷ Each of the trusts allowed the trustee to invade principal for the benefit of the lifetime beneficiary.⁴⁸ Upon the death of the lifetime beneficiary, the remaindermen of one of the trusts sued the trustee for invading principal for her care in a nursing home, without court approval, and the court held that the

37. 717 F.2d 1316 (10th Cir. 1983), *cert. denied*, 466 U.S. 958 (1984).

38. *Id.* at 1317.

39. *Id.* In addition, the trustees put in entries for two related trusts for which they served as trustees.

40. *Id.*; see 43 C.F.R. § 3112.5-2 (1987).

41. *Grynberg*, 717 F.2d at 1317.

42. *Id.* at 1319-20.

43. *Id.*

44. *Id.* at 1317-18.

45. SCOTT & FRATCHER, *supra* note 14, § 170.16.

46. 988 S.W.2d 498 (Ky. Ct. App. 1998).

47. *Id.* at 499.

48. *Id.* at 499-500.

trustee breached its duty to act with “utmost fidelity” toward the remaindermen of both trusts.⁴⁹

The major difficulty with the duty of loyalty is defining its boundaries. Clearly, the trustee is prohibited from dealing directly with the trust. In situations where the trustee stands to benefit personally from a transaction between the trust and a third party, however, the existence of a breach depends on the degree and significance of that personal benefit. The comments to the *Restatement* extend the duty as follows: “The trustee violates his duty to the beneficiary not only where he purchases trust property for himself individually, but also where he has a personal interest in the purchase of such a substantial nature that it might affect his judgment in making the sale.”⁵⁰ Professor Bogert acknowledged that it is disloyal for a trustee to enter into a transaction for the trust “in order to obtain an incidental personal benefit”⁵¹ because the incidental benefit may cloud his judgment about the trust’s beneficial interest in the transaction.⁵² Bogert went on to note, however, that several courts have not found a violation of a duty where the trustee will obtain only an indirect benefit.⁵³ As stated by Scott, “the trustee does not necessarily incur liability merely because he has an individual interest in the transaction.”⁵⁴ The issue whether the transaction is prohibited, therefore, will be determined on a case-by-case basis hinging on the significance of the benefit and the likelihood that the trustee’s judgment could be affected.

The case of *Fulton National Bank v. Tate*⁵⁵ illustrates a court grappling with a situation that is not quite direct self-dealing but is clearly a conflict. In *Fulton*, before Steve Tate became a fiduciary, he was attempting to persuade the Georgia Marble Company (“Marble”) to exchange a piece of property owned by the company with a parcel he owned.⁵⁶ Marble refused, but Mr. Tate persisted in pursuing the exchange.⁵⁷ Subsequently, he became executor of an estate that leased land to Marble, which had a significant capital investment in the leased property and, thus, a strong need to obtain renewals of the leases.⁵⁸ Mr. Tate was careful to keep his roles with Marble separate, “conscious that he had to change coats rather than wear Jacob’s many colored coat.”⁵⁹ Mr. Tate’s relationship

49. *Id.* at 500-01.

50. RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. c (1959).

51. BOGERT & BOGERT, *supra* note 5, § 543(Q), at 383.

52. BOGERT & BOGERT, *supra* note 5, § 543(Q), at 383.

53. BOGERT & BOGERT, *supra* note 5, § 543(Q), at 383-90.

54. SCOTT & FRATCHER, *supra* note 14, §170.24.

55. 363 F.2d 562 (5th Cir. 1966).

56. *Id.* at 565, 567.

57. *Id.* at 567-68.

58. *Id.* at 565, 568.

59. *Id.* at 568.

with Marble was apparently unfriendly, resulting in “litigation, harsh words, and even shootings.”⁶⁰ Eventually, Mr. Tate and Marble worked out a deal for the exchange, but Marble refused to close on the deal until the leases with the estate were renewed.⁶¹ The property exchange and the lease renewal were signed the same day.⁶² The beneficiaries sued to impose a constructive trust on the land Mr. Tate received in the sale, and the issue on appeal was which party had the burden of proving whether Mr. Tate had made a profit in the exchange.⁶³ If Mr. Tate had made no personal profit from the exchange, he would have no liability.⁶⁴ The court noted that “general rules on the fiduciary’s duty of undivided loyalty are necessarily general and offer limited help in resolving a concrete problem in this area.”⁶⁵ The court further noted that there are conflicting policy considerations: the need to hold the beneficiary’s interest as paramount (“the first commandment of fiduciary relations”) versus the danger that the job of trustee would be so treacherous that responsible persons would refuse to do it.⁶⁶ Therefore, “[m]erely vague or remote possible selfish advantages to a trustee are not sufficient to prove such an adverse interest as to bring his conduct into question.”⁶⁷ The court went on to note that the no inquiry rule is punitive rather than compensatory because it is intended to discourage the trustee from putting himself in a conflict position.⁶⁸ The underlying assumption is that human nature will cause the trustee to favor himself over the trust in any conflict of interest.⁶⁹ “Though equity protects the beneficiary with a gentle wand, it polices the fiduciary with a big stick.”⁷⁰ In applying these principles, the court held that the burden was on Mr. Tate to prove that he received no profit, and, if he failed, he would be required to remit to the beneficiaries any profit made by him on the exchange.⁷¹ It was irrelevant whether the lease terms were unfavorably affected by Mr. Tate’s individual transaction.⁷² Mr. Tate tried to argue that his exchange was a separate transaction unconnected to the lease and, therefore, not a breach of his duty as described by the *Restatement* comments.⁷³ However, the court

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* at 569.

64. *Id.*

65. *Id.*

66. *Id.* at 570.

67. *See id.* at 570 (citing *Dabney v. Chase Nat’l Bank*, 196 F.2d 668, 675 (2d Cir. 1952)).

68. *Id.* at 571-72.

69. *Id.* at 571.

70. *Id.* at 572.

71. *Id.* at 570-71.

72. *Id.* at 570.

73. RESTATEMENT (SECOND) OF TRUSTS § 203 cmt. e (1959).

held that, because the two transactions were inextricably linked, it was “tit for tat down to the wire.”⁷⁴

There are easier cases in which a third party is involved but a breach of the duty of loyalty, nevertheless, can be found, such as where the third party is a straw man or where the third party is an entity substantially owned by the trustee.⁷⁵ As the connection becomes less than a complete alter ego, the cases look to whether the common interest is sufficient to affect the trustee’s judgment.⁷⁶

The common law was particularly reluctant to recognize exceptions to the duty.⁷⁷ As described by a mid-century commentator:

Somehow . . . a trustee will assume a halo complex and insist that an exception be made for him; but courts wisely realize that the rule must be adamant and that to allow exceptions to chip it away piecemeal would destroy it just as effectively as if its entirety were shattered with one sledgehammer blow.⁷⁸

If the conflict is not judged to be self-dealing or substantial enough to trigger the no further inquiry rule, then the trustee has the opportunity to avoid liability by proving that the transaction was otherwise fair to the trust. It then becomes a matter of mismanagement because, even in the absence of a conflict, a trustee could be liable for a bad deal. However, liability of the trustee for a bad business deal can be increased where the transaction involved a conflict of interest. *In re Estate of Rothko*⁷⁹ is a classic example of conflicts of interest that affected the fiduciaries’ liability for unreasonable business transactions.

In *Rothko*, the three executors of the estate of the artist Mark Rothko were: Bernard J. Reis, who was director, secretary, and treasurer of Marlborough Gallery, Inc.; Theodoros Stamos, a friend and fellow artist (although much less successful than Rothko) who was represented by Marlborough; and Morton

74. *Fulton Nat’l Bank*, 363 F.2d at 575.

75. SCOTT & FRATCHER, *supra* note 14, §§ 170.6, 170.10.

76. BOGERT & BOGERT, *supra* note 5, § 543(A), at 281-82; SCOTT & FRATCHER, *supra* note 14, § 170.6.

77. See *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.) (“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.”).

78. Judge Earl R. Hoover, *Basic Principles Underlying Duty of Loyalty*, 5 CLEV.-MARSHALL L. REV. 7, 14 (1956).

79. 372 N.E.2d 291 (N.Y. 1977).

Levine, a friend not directly involved with the art world.⁸⁰ Within three months of Rothko's suicide, the three executors had arranged for the sale of 798 paintings.⁸¹ One hundred of the paintings were sold directly to Marlborough A.G., a Lichtenstein corporation affiliated with the Marlborough Gallery.⁸² The sales terms were very favorable to Marlborough; \$200,000 was paid at sale, and a balance of \$1.6 million was to be paid in twelve annual installments, with no interest.⁸³ The remaining paintings were to be consigned to Marlborough Gallery and sold, no more than thirty-five a year, with Marlborough receiving a commission of forty to fifty percent for each sale.⁸⁴

Rothko's will had left the bulk of his estate to the Mark Rothko Foundation, which was controlled by the three executors.⁸⁵ However, Rothko's children successfully made a claim in the estate under New York's mortmain statute, which was then in effect,⁸⁶ and filed claims against the executors for breach of fiduciary duty in disposing of the paintings.⁸⁷ Reis and Stamos argued that their connections with Marlborough were incidental and that, as there was no direct self-dealing, the no further inquiry rule was inapplicable and the transactions would have to be proven unfair to be voidable.⁸⁸ The court replied that the argument that there were no significant conflicts was "sheer fantasy."⁸⁹ The court quoted Bogert: "'While he [, a trustee,] is administering the trust he must refrain from placing himself in a position where his personal interest or that of a third person does or may conflict with the interest of the beneficiaries'"⁹⁰ and went on to state that, because of their close ties with the purchaser, "one must strain the law rather than follow it to reach the result suggested on behalf of Reis and Stamos."⁹¹ Nevertheless, the holding did not turn on an application of the no further inquiry rule because there were significant findings that the

80. *Id.* at 293-95.

81. *Id.* at 293.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.* at 294.

86. *Id.* A mortmain statute, intended to protect testators from undue influence by clergy while on their deathbeds, typically voids a gift to charity if the gift exceeds a certain portion of the estate, the will is executed within a short time before the decedent's death, and there are qualifying surviving family members (such as spouses or children). MARK REUTLINGER, WILLS, TRUSTS AND ESTATES: ESSENTIAL TERMS AND CONCEPTS 215-16 (2d ed. 1998).

87. *Rothko*, 372 N.E.2d at 293.

88. *Id.* at 295.

89. *Id.* at 296.

90. *Id.* (quoting GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, HANDBOOK OF THE LAW OF TRUSTS 343 (5th ed. 1973)).

91. *Id.*

transactions were, in fact, unfair.⁹² The damages assessed against Reis and Stamos were measured differently than the damages assessed against Levine because he did not have conflicts of interest and merely violated the duty of care.⁹³ Levine was liable for the difference between the paintings' true value at the time of the transactions and the price obtained, but Reis and Stamos, because of the conflicts, were assessed "appreciation damages," *i.e.*, the difference between the value of the paintings at time of trial and the price obtained.⁹⁴ The court noted that appreciation damages were appropriate to impose in cases in which a fiduciary has sold an asset that he was required to retain, because only appreciation damages would make the beneficiaries whole.⁹⁵ The court extended that reasoning to impose appreciation damages where there has been wrongdoing by the fiduciaries as a matter of policy.⁹⁶

The duty of loyalty may be relaxed by the settlor of the trust with specific language in the trust instrument, but such clauses are generally strictly construed.⁹⁷ Even if the trust allows the trustee to engage in self-dealing, the trustee must exercise that power with good faith toward the trust.⁹⁸

The settlor implicitly may authorize conflicts of interest by appointing as trustee a person who has another interest in the trust or the trust property. For example, the trustee also may be a beneficiary of the trust, or a trust may be funded in part with stock in the corporate trustee. Whether a court will find such implied authorization of a conflict of interest is uncertain, however. There are examples of holdings of implied authorizations, cited by Professor Bogert in his treatise.⁹⁹ *Shear v. Gabovitch*¹⁰⁰ is a recent example of this. The beneficiary of

92. *Id.*

93. *Id.* at 296-97.

94. *Id.* at 297-99.

95. *Id.* at 297; see RESTATEMENT (SECOND) OF TRUSTS § 208(b) (1959).

96. *Rothko*, 372 N.E.2d at 297.

97. RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. a (1959); BOGERT & BOGERT, *supra* note 5, § 543(U). *But see* TEX. PROB. CODE ANN. § 113.059(b) (Vernon 1980); UNIF. TRUST ACT § 17 (1937) (both incorporating the minority position disallowing exoneration clauses for breach of duty of loyalty).

98. Charles B. Baron, *Self-Dealing Trustees and the Exoneration Clause: Can Trustees Ever Profit from Transactions Involving Trust Property?*, 72 ST. JOHN'S L. REV. 43, 65 (1998).

99. BOGERT & BOGERT, *supra* note 5, § 543(U), at 424-25.

In some cases where the settlor knew when his trust was drawn that the trustee whom he proposed to name was then in a position which, after acceptance of the trust, would expose him to a conflict between personal and representative interests, it has been held that there was an implied exemption from the duty of loyalty in so far as that transaction was concerned.

BOGERT & BOGERT, *supra* note 5, at 424-25; see also Louis C. Haggerty, *Conflicting Interests of Estate Fiduciaries in New York and the "No Further Inquiry" Rule*, 18 Published by University of Missouri School of Law Scholarship Repository, 2002

a trust was challenging the sale of hospital trust shares back to the corporation on several grounds, one of which was that one of the trustees served as an accountant for the hospital, as well as for several shareholders of the hospital and an affiliated corporation.¹⁰¹ However, the court rejected this argument, noting that he was serving as accountant for the various parties at the time he was appointed trustee. The court cited the *Restatement* comment that “[t]he court will not ordinarily remove a trustee named by the settlor upon a ground existing at the time of his appointment and known to the settlor and in spite of which the settlor appointed him” and noted that, in an extremely antagonistic situation, the trustee and his co-trustee were:

Like an attorney who resists the more extreme demands of his clients and thereby serves his client better, required neither by their role as trustees nor by the law to be unthinking sycophants for [the beneficiaries]. Whatever else may be said of the roles [the accountant trustee] filled for the hospital and the trusts, he was not, up to and including the sale of the hospital shares, disloyal to the trusts or to the [beneficiaries].¹⁰²

On the other hand, the *Rothko* case is a severe example of a court ignoring the conflicts imbedded in the trustee appointment that would have been known to the settlor. Mark Rothko signed a long-term consignment contract with Marlborough during his life and sold paintings to the gallery for prices similar to those obtained by the executors.¹⁰³ More significantly, Rothko knew of the ties of the two executors to the gallery and appointed them as directors of the Foundation that was the residuary beneficiary.¹⁰⁴ It was only the New York mortmain statute that created the rights of his children to challenge the executors’ actions. The court, nevertheless, ignored the implied authorization and acceptance of these conflicts on the part of the testator.

In light of all of this ambiguity, the utility of the duty of loyalty, its no further inquiry rule, and the need to maintain it as unbending and without

FORDHAM L. REV. 1, 3 (1949) (“In some cases, the testator or settlor has been responsible for placing the fiduciary in a position of conflicting interests, and the courts have been obliged in the interests of justice to inquire into the facts and then to hold that there had been an implied waiver of the rule against self-dealing.”).

100. 685 N.E.2d 1168 (Mass. App. Ct. 1997).

101. *Id.* at 1171-72.

102. *Id.* at 1190-91.

103. Richard V. Wellman, *Punitive Surcharges Against Disloyal Fiduciaries—Is Rothko Right?*, 77 MICH. L. REV. 95, 113 (1978).

104. *Id.*

exception, can be open to question. The no further inquiry rule is not without its critics. One commentator has complained that:

[i]t may and often does miss its real target, the faithless fiduciary, and hit the one who has acted in the best of faith. It may operate not to protect beneficiaries from wrongdoers but to give them undue and undeserved advantages over fiduciaries who thought they were obeying the rules.¹⁰⁵

The same commentator concluded that the no further inquiry rule:

sounds so plausible; it appears to be so noble of purpose; it rings with such honesty. It has everything except the ability to resist analysis. It is pleasing as rhetoric, but it is bad law, as is any law, statutory or judge-made, which establishes a policy rather than abstract justice as the standard of individual guilt.¹⁰⁶

Professor Langbein, in arguing for a contractarian approach to enforcing trusts, similarly pointed out that “[t]he prophylactic duty of loyalty presses too harshly on trustees and comparable fiduciaries in settings such as *Rothko*.”¹⁰⁷ Professor Langbein’s solution would be to use a contracts analysis to look at “the real nature of the trust deal”¹⁰⁸ and apply the standard of conduct that the parties intended, even if not spelled out in the trust instrument.

One cannot ignore, however, the role that the no further inquiry rule plays in the fiduciary relationship and the impossibility of filling that role in another manner. The early commentators pointed out that strict prohibition, rather than punishment only of fiduciaries who abuse their power in conflict situations, is necessary because mere temptation is too dangerous to the beneficiaries’ interests.¹⁰⁹ Professors Cooter and Freedman subjected what they termed fiduciary misappropriation to an economic analysis and concluded that the economic characteristics of the fiduciary relationship require the strict rules.¹¹⁰ The nature of the relationship makes it difficult for the beneficiary to detect any wrongdoing, and, if the usual tort rules, putting the burden on the victim to discover and prove the wrong, applied in this context, the low risk of getting

105. Haggerty, *supra* note 99, at 2.

106. Haggerty, *supra* note 99, at 28.

107. Langbein, *supra* note 15, at 667.

108. Langbein, *supra* note 15, at 667.

109. BOGERT & BOGERT, *supra* note 5, § 543, at 227.

110. Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991).

caught would encourage fiduciaries to cheat.¹¹¹ The set of rules known as the duty of loyalty, therefore, is needed to deter wrongdoing. These rules do so by either conclusively presuming wrongdoing, in the case of self-dealing or substantial conflicts of interest, or shifting the burden of proof to the fiduciary (as in the corporate fiduciary context).¹¹²

In sum, the duty of loyalty is a necessary corollary to broad trustee discretion. To some extent, ambiguity in its reach is desirable because the trustee must be conservative in order to avoid liability, whereas bright-line tests provide manipulative trustees a blueprint of how far they can go without risking liability. Nevertheless, ambiguity also results in uneven and inconsistent enforcement of the duty, can catch unwitting, well-meaning trustees, and unnecessarily can tie the hands of those trustees whose conflicts are created by the trust settlor.

III. OTHER CODIFICATIONS OF THE DUTY OF LOYALTY

Many states have attempted through statute to clarify the reach or proper resolution of the duty of loyalty. Indiana's statute uses broad language, providing that: "[i]f the duty of the trustee in the exercise of any power conflicts with his individual interest or his interest as trustee of another trust, the power may be exercised only with court authorization."¹¹³ The statute attributes the interests of a trustee's affiliate to the trustee in determining whether there is a conflict with the trust's interest.¹¹⁴

There is additional guidance, however, in the Indiana statutory scheme. A later statute specifically prohibits certain transactions, such as borrowing from the trust, purchasing trust property, selling the trustee's own property to the trust, or holding stock of itself in the trust.¹¹⁵ The statutory restrictions are inapplicable if the transactions are specifically authorized by the trust agreement.¹¹⁶ The statute also specifically allows a corporate trustee to invest in its own obligations, such as savings accounts or certificates of deposit, as long as those obligations are insured.¹¹⁷ Furthermore, the statute allows the trustee to deal with itself as trustee of another trust as long as the terms of the transaction are fair and reasonable, and there is full disclosure to the beneficiaries.¹¹⁸ Finally, the statute requires that all dealings between the trustee individually and the beneficiary,

111. *Id.* at 1051-52.

112. *Id.* at 1054.

113. IND. CODE ANN. § 30-4-3-5(a) (Lexis 2000).

114. IND. CODE ANN. § 30-4-3-5(b) (Lexis 2000).

115. IND. CODE ANN. § 30-4-3-7(a) (Lexis 2000).

116. IND. CODE ANN. § 30-4-3-7(a) (Lexis 2000).

117. IND. CODE ANN. § 30-4-3-7(b)-(c) (Lexis 2000).

118. IND. CODE ANN. § 30-4-3-7(e) (Lexis 2000).

even if permitted by the trust agreement, must be fair and must fully disclose to the beneficiary of all material facts known to the trustee.¹¹⁹ The Indiana statute, therefore, gives significant guidance regarding some specified activities, and by using the term “conflicts of interest,” rather than self-dealing, implies that the duty of loyalty prohibits all conflicts, direct and indirect.

Michigan’s statute does not address the general duty of loyalty, but it prohibits transactions between the trustee individually and the trust, bars the trustee from purchasing for the trust an interest in an affiliate of the trustee (except for bonds and minority stock holdings, which are acceptable), and forbids the trustee from personally deriving a profit from transactions involving trust property.¹²⁰ These prohibitions are subject to modification in the trust agreement, however.¹²¹ The statute, therefore, presents a relatively narrow definition of the duty of loyalty, includes only direct conflicts, and does not appear to prohibit transactions where the trustee’s personal interest is indirect, unless the conflict could be characterized as deriving a profit from transactions involving trust property. The statute specifically allows the trustee to deposit money in a bank or trust company in which the trustee is an officer, director, or stockholder.¹²²

California codifies the *Restatement* definition of the duty of loyalty, which states that “the trustee has a duty to administer the trust solely in the interest of the beneficiaries.”¹²³ The Law Revision Commission comments to this Section of the *Restatement* state 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.”¹²⁴ Nevertheless, California’s statute expands on what may constitute violations of the duty of loyalty and offers some safe harbors. It authorizes transactions between trusts where one trustee serves both, as long as the transaction is fair and full disclosure has been made.¹²⁵ 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.¹²⁶ This broad prohibition would seem to apply to all conflicts, no matter how indirect.

California also has a statutory provision prohibiting the trustee from

119. IND. CODE ANN. § 30-4-3-7(d) (Lexis 2000).

120. MICH. COMP. LAWS ANN. § 700.1214 (West 2000).

121. MICH. COMP. LAWS ANN. § 700.1214 (West 2000).

122. MICH. COMP. LAWS ANN. § 700.1214 (West 2000).

123. CAL. PROB. CODE § 16002(a) (West 1991); RESTATEMENT (SECOND) OF TRUSTS § 170 (1959).

124. CAL. PROB. CODE § 16002 cmt. (West Supp. 1995).

125. CAL. PROB. CODE § 16002(b) (West 1991). This provision is modeled after the Indiana statute. See IND. CODE ANN. § 30-4-3-7(d) (Lexis 2000).

126. CAL. PROB. CODE § 16004(a) (West 1991).

enforcing 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 for the amount that the trustee paid in good faith for the claim.¹²⁷ There is also a statutory presumption of fiduciary violation whenever the trustee enters into a transaction with a beneficiary that 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.¹²⁸ Finally, there is a statutory provision that authorizes a financial institution serving as trustee or that is an affiliate of a trustee to use its own services for in the ordinary course of business.¹²⁹

A North Dakota statute defines the duty of loyalty in the negative:

A trustee shall not use or deal with the trust property for the trustee's own profit or for any other purpose not connected with the trust. If the trustee does so, the trustee, at the option of the beneficiary, may be required to account for all profits made thereby, or to pay the value of the use of the trust property, and, if the trustee has disposed thereof, to replace it with its fruits or to account for its proceeds with interest.¹³⁰

However, if after full disclosure, the trust beneficiaries either consent to or the court approves of the transaction if the beneficiaries lack capacity to consent, a conflict of interest transaction is authorized.¹³¹ With respect to transactions between a trustee individually and a beneficiary, the trustee is prohibited from using the influence that the trustee's position gives the trustee to obtain any advantage from the trust's beneficiary.¹³² There is a statutory presumption that any transaction between the trustee and the beneficiary that is advantageous to the trustee is for inadequate consideration and a result of undue influence.¹³³ The trustee is also prohibited from becoming trustee of another trust whose interests are adverse to the beneficiary of the first trust.¹³⁴

In summary, the state statutes generally offer broad statements of the common law of fiduciary duty, and provide some safe harbors allowing bank trustees to use their own services and allowing fair transactions that are not direct self-dealing, such as transactions with beneficiaries. In some cases, the statutes make broad statements prohibiting all transactions involving conflicts, which

127. CAL. PROB. CODE § 16004(b) (West 1991).

128. CAL. PROB. CODE § 16004(c) (West 1991).

129. CAL. PROB. CODE § 16015 (West 1991).

130. N.D. CENT. CODE § 59-01-10 (1995).

131. N.D. CENT. CODE § 59-01-11 (Supp. 2001).

132. N.D. CENT. CODE § 59-01-12 (1995).

133. N.D. CENT. CODE § 59-01-15 (1995).

134. N.D. CENT. CODE § 59-01-13 (1995).

potentially could muddy the waters more than the ambiguity existing under the common law.

The uniform acts that predate the UTC generally took a similar approach. The Uniform Trusts Act, adopted in 1937, was relatively limited in scope despite its broad title. It did not address the duty of loyalty fully; rather, it contained specific provisions affecting specific circumstances that implicate the duty. For example, it prohibited a trustee from borrowing trust funds and from loaning trust funds to its affiliates, directors, officers, employees, partners, or relatives.¹³⁵ Trustees were also forbidden from “directly or indirectly” buying or selling trust property, or entering into any such transaction between the trust and the trustee’s affiliates, directors, officers, employees, partners, or relatives.¹³⁶ If the trustee served as trustee of multiple trusts, he was prohibited from selling trust property from one trust to another.¹³⁷ A corporate trustee was prohibited from purchasing shares of its own stock or the stock of an affiliate.¹³⁸ The trustee could be exempted from these prohibitions by the trust agreement, except that exoneration for direct self-dealing was prohibited.¹³⁹ Likewise, beneficiaries could relieve the trustee from these duties and restrictions,¹⁴⁰ except for borrowing trust funds,¹⁴¹ purchasing trust property by the trustee individually or selling individual property to the trust,¹⁴² and the duties regarding the deposit of trust funds with a bank trustee.¹⁴³ A corporate trustee was allowed to deposit funds with itself, as long as the deposits were insured or the corporate trustee held a separate fund as security for such deposits, and the deposits were accounted for separately.¹⁴⁴

The Uniform Trustees Powers Act (“UTPA”), adopted in 1964, addressed the duty of loyalty only to create certain exceptions. Section 5 of the Act provided that, whenever a conflict between the trustee’s individual interests and the trust existed, the trustee must obtain court authorization to act, with certain exceptions.¹⁴⁵ The Act explicitly extended the duty of loyalty to situations where

135. UNIF. TRUSTS ACT § 3, 7C U.L.A. 446 (2000).

136. UNIF. TRUSTS ACT § 5, 7C U.L.A. 446 (2000).

137. UNIF. TRUSTS ACT § 6, 7C U.L.A. 446 (2000).

138. UNIF. TRUSTS ACT § 7, 7C U.L.A. 446 (2000).

139. UNIF. TRUSTS ACT § 17, 7C U.L.A. 446 (2000).

140. UNIF. TRUSTS ACT § 18, 7C U.L.A. 446 (2000).

141. UNIF. TRUSTS ACT § 18, 7C U.L.A. 446 (2000) (loaning to affiliates also could not be excused).

142. UNIF. TRUSTS ACT § 18, 7C U.L.A. 446 (2000) (sales to or from affiliates also could not be excused).

143. UNIF. TRUSTS ACT § 18, 7C U.L.A. 446 (2000).

144. UNIF. TRUSTS ACT § 4, 7C U.L.A. 446 (2000).

145. UNIF. TRUSTEES’ POWERS ACT § 5(b), 7A U.L.A. 426 (2000).

an affiliated or subsidiary entity to the trustee would profit.¹⁴⁶ The exceptions to the requirement of court authorizations were: retention of assets received from the trustor in which the trustee was personally interested;¹⁴⁷ acquisition of an undivided interest in an asset in which the trustee held an undivided interest for another trust;¹⁴⁸ deposit of trust funds in a bank operated by the trustee;¹⁴⁹ advancement of money for trust expenses, which advancements would be covered by a lien in favor of the trustee against trust assets;¹⁵⁰ and employment of professionals affiliated with the trustee to assist in trust administration.¹⁵¹

The UTPA met with some criticism for creating exceptions to the duty of loyalty. One commentator expressed concern about allowing the trustee to retain assets in which the trustee had an interest (such as stock in the trustee), allowing a bank trustee to deposit trust funds with itself, and allowing the trustee to delegate duties to professionals who were affiliated with the trustee.¹⁵² The commentator thought that these rather routine conflicts still presented potential conflicts for the trustee that were too great to outweigh the convenience of trust administration.¹⁵³ Another contemporary commentator objected that the exceptions to the duty of loyalty in the Act, taken as a group, were precisely the erosion of the duty of loyalty that courts and commentators warned against.¹⁵⁴ In addition, taking the exceptions individually, the commentator argued that each presented sufficient risk to the beneficiaries to be ill-advised.¹⁵⁵ The commentator had a broader concern about any weakening of the duty of loyalty because, in his view, the duty of loyalty needed strengthening in a climate where trust administration was becoming a source of profits for institutional trustees.¹⁵⁶

The introductory comments to the UTC note that the UTPA “is outdated and is entirely superseded by the Uniform Trust Code, principally at Sections 815, 816, and 1012. States enacting the Uniform Trust Code should repeal their existing trustee powers legislation.”¹⁵⁷ Similarly, the introductory comments state that the Uniform Trusts Act addressed only limited issues, including the

146. UNIF. TRUSTEES’ POWERS ACT § 5(b), 7A U.L.A. 426 (2000).

147. UNIF. TRUSTEES’ POWERS ACT § 3(c)(1), 7A U.L.A. 426 (2000).

148. UNIF. TRUSTEES’ POWERS ACT § 3(c)(4), 7A U.L.A. 426 (2000).

149. UNIF. TRUSTEES’ POWERS ACT § 3(c)(6), 7A U.L.A. 426 (2000).

150. UNIF. TRUSTEES’ POWERS ACT § 3(c)(18), 7A U.L.A. 426 (2000).

151. UNIF. TRUSTEES’ POWERS ACT § 3(c)(24), 7A U.L.A. 426 (2000).

152. Paul G. Haskell, *The Uniform Trustees’ Powers Act*, 32 LAW & CONTEMP. PROBS. 168, 173-77 (1967).

153. *Id.*

154. Robert W. Hallgring, *The Uniform Trustees’ Powers Act and the Basic Principles of Fiduciary Responsibility*, 41 WASH. L. REV. 801, 812-13 (1966).

155. *Id.* at 813-23.

156. *Id.* at 824-27.

157. UTC introductory cmt.

duty of loyalty, and that “States enacting the Uniform Trust Code should repeal this earlier namesake.”¹⁵⁸

The Uniform Probate Code (“UPC”) also contains provisions addressing the duty of loyalty. Section 3-713 provides that:

[a]ny sale or encumbrance to the personal representative, his spouse, agent or attorney, or any corporation or trust in which he has a substantial beneficial interest, or any transaction which is affected by a substantial conflict of interest on the part of the personal representative, is voidable by any person interested in the estate except one who has consented after fair disclosure.¹⁵⁹

There are three exceptions to voidability: (1) if the beneficiary consented after fair disclosure; (2) if the decedent expressly authorized the transaction; and (3) if court approval for the transaction is obtained.¹⁶⁰ This provision is consistent with common law statements of the duty of loyalty. However, it includes as a voidable transaction one “which is affected by a substantial conflict of interest” and does not allow for a defense of reasonableness. The personal representative, therefore, will be required to argue as to whether a given conflict was substantial.

In addition, the UPC has a provision identical to Section 3(c)(24) of the UTPA, which authorizes a fiduciary to hire professionals associated with the fiduciary to advise or assist with the estate administration.¹⁶¹ There is, therefore, one exception to the prohibition of conflicts of interest. The UPC provisions are noteworthy because, with the adoption of the UTC, with its more detailed delineation of the duty of loyalty and clarification of safe harbors,¹⁶² trustees will have more guidance and certainty than personal representatives. The introductory comments to the UTC note that Article VII of the UPC, relating to trust administration, is superseded by the UTC, and UPC sections on representation principles for binding settlements and rules of construction present some overlap with the UTC; however, there is no mention of the gap between the two Codes’ definitions of the duty of loyalty.¹⁶³

158. UTC introductory cmt.

159. UNIF. PROBATE CODE § 3-713 (amended 1998).

160. UNIF. PROBATE CODE § 3-715(21) (amended 1998).

161. UNIF. PROBATE CODE § 3-715(25) (amended 1998).

162. *See infra* Part IV.

163. UTC introductory cmt.

IV. THE UNIFORM TRUST CODE'S DEFINITION OF THE DUTY

The UTC provision begins with the *Restatement's* broad declaration of the duty: "a trustee shall administer the trust solely in the interests of the beneficiaries."¹⁶⁴ The Section then goes on to give a sweeping definition of what type of transaction is voidable by the beneficiary: any transaction entered into by the trustee involving the investment or management of trust property for the trustee's personal account or "which is otherwise affected by a conflict between the trustee's fiduciary and personal interests."¹⁶⁵ This language is broader than the UPC definition and the common law formulations¹⁶⁶ because there is no requirement that the conflict be significant or substantial. The Code includes exceptions to voidability that are consistent with common law exceptions: if the trust agreement authorized the transaction; if there was court approval of the transaction; if the beneficiary consented, ratified, or released the trustee; if the beneficiary did not comply with the statute of limitations; and if the transaction predated the trustee's term as trustee or such time that the trustee expected to become trustee.¹⁶⁷ The comments indicate that the rules of representation for beneficiaries who are under a disability or are unascertained apply when determining whether consent, ratification, or release has been obtained.¹⁶⁸

On its face, the Section, therefore, seems to expand the beneficiary's power to void transactions. As the comments clarify, however, the effect of the Section is actually to rein in the use of the no further inquiry rule. Transactions with trust property entered into by a trustee for the trustee's own account are "irrebuttably presumed to be affected by a conflict between personal and fiduciary interests,"¹⁶⁹ and, therefore, the fairness of the transaction is irrelevant to voidability. There is, however, a looser standard applied to transactions with affiliates of the trustee. A transaction is only presumed to be affected by the conflict of interest if it is entered into with the trustee's spouse or other specified family members, the trustee's agent or attorney, a corporation in which or other person with whom the trustee "has an interest" that "might affect" the trustee's judgment, or corporation in which or another person with whom a person who holds significant ownership interest in the trustee has an interest that might affect the trustee's judgment.¹⁷⁰ This language is taken from a regulation of the Office of the Comptroller of the Currency that is applicable to fiduciary activities of

164. UTC § 802(a); RESTATEMENT (SECOND) OF TRUSTS § 170 (1959).

165. UTC § 802(b).

166. See UNIF. PROBATE CODE § 3-713 (amended 1998); RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. c (1959).

167. UTC § 802(b).

168. UTC § 802 cmt.

169. UTC § 802 cmt.

170. UTC § 802(c).

national banks.¹⁷¹ That regulation provides that a national bank cannot transact as fiduciary with persons or organizations “with whom there exists an interest that might affect the exercise of the best judgment of the bank.”¹⁷² This language omits the requirement that the conflict be “substantial” and, thus, shifts focus to the broader question whether the fiduciary’s interest was affected.

The presumption of fatal conflict can be rebutted, according to the Comment, by a showing that “the transaction was not affected by a conflict between personal and fiduciary interests.”¹⁷³ Evidence that the conflict did not affect the trustee’s judgment includes evidence of the fairness of the transaction.¹⁷⁴ The UTC, therefore, shifts the inquiry from whether the transaction was fair, which can be a moving target,¹⁷⁵ to whether the trustee’s judgment might have been affected. The trustee’s burden is, therefore, higher; a transaction labeled fair supports the argument that the trustee’s judgment was not affected but does not answer the ultimate question. The structure of the UTC sets that ultimate question as whether the judgment of the trustee might have been compromised, which may be answered in the affirmative even if the transaction was within a reasonable range. As noted in the comments, even if the relationship between the trustee and the third person does not fit within the categories that raise a presumption of unfairness, “a transaction may still be voided by a beneficiary if the beneficiary proves that a conflict between personal and fiduciary interests existed and that the transaction was affected by the conflict.”¹⁷⁶

In addition to clarifying and refocusing the critical question to determine what conflicts between the trust and the trustee deserve voidability, the UTC identifies certain situations in which the parties are changed somewhat, but a conflict is, nevertheless, possible. If the trustee takes a trust opportunity for herself, such action constitutes a conflict between the personal and the fiduciary interests of the trustee and is, therefore, irrebuttably voidable by an affected

171. 12 C.F.R. § 9.12 (2002).

172. UTC § 802 cmt. The language of this Section was drafted by Professor Scott, who served on the Office of the Comptroller of the Currency Technical Advisory Committee in 1962 and 1963. Letter from Raymond, Acting Chief Counsel, Comptroller of the Currency, to Honorable Maurice A. Hartnett, III, Supreme Court of Delaware, Chair of UTC Drafting Committee (Sept. 16, 1998) (on file with Author).

173. UTC § 802 cmt.

174. UTC § 802 cmt.

175. As pointed out by one commentator, a fair price set by different appraisers can vary, and the beneficiary in a fairness analysis can be stuck with accepting the lowest “fair” price even though with a disinterested party the trust would have received a price at the high end of “fair.” Hoover, *supra* note 78, at 17.

176. UTC § 802 cmt.

beneficiary.¹⁷⁷ Transactions between a trustee and a beneficiary that are unrelated to the trust property and that provide an advantage to the trustee are voidable by the beneficiary if the transaction occurred while the trust existed or while the trustee retained “significant influence” over the beneficiary, unless the trustee can establish that the transaction was fair.¹⁷⁸ In this setting, the fairness of the transaction is an absolute defense. In addition, the trustee must obtain an advantage from the transaction that otherwise would not be available to a person in an arm’s length transaction.¹⁷⁹

The Code provides a number of safe harbors from a challenge of conflict of interest for certain administrative conflicts. In order to receive this protection, the transaction has to be fair to the beneficiaries.¹⁸⁰ The protected transactions are: agreements between the trustee and a beneficiary relating to the trustee’s appointment or compensation; payment of reasonable compensation to the trustee; transactions between trusts with a common trustee (or between a trust and estate or guardianship with a common fiduciary) and transactions between trusts or other fiduciary estates with a common beneficiary; deposit of trust funds with a trustee-operated bank; and a loan by the trustee to the trust for the protection of the trust.¹⁸¹ With respect to loans from the trustee, the trustee has a lien for repayment under Section 709(b) of the Code. The comments note that such advances are normally small in amount and done in an emergency or for convenience.¹⁸²

There is also an exception for a trustee to invest in mutual funds for which the trustee (or its affiliate) provides services, even if the mutual fund pays the trustee a fee for services provided to the fund.¹⁸³ This exception carries several conditions. First, the investment must be prudent under the prudent investor rule.¹⁸⁴ In order for the trustee to receive a portion of the fees paid to the mutual fund company, as compensation for services rendered by the trustee to the mutual fund company, the trustee must notify the beneficiaries annually about the compensation arrangement.¹⁸⁵ The drafters of the UTC included this provision in recognition that mutual funds can be advantageous investments for trusts because of the ease of diversification and their ability to be distributed in

177. UTC § 802(e).

178. UTC § 802(d).

179. UTC § 802 cmt.

180. UTC § 802 (h).

181. UTC § 802 (h); *see Miller v. Miller*, 734 N.E.2d 738 (Mass. App. Ct.), *cert. denied*, 739 N.E.2d 701 (Mass. 2000) (allowing an executor interest on a loan made by the executor to the estate for the purpose of paying estate taxes).

182. UTC § 802 cmt.

183. UTC § 802(f).

184. UTC § 802(f).

185. UTC § 802(f).

kind from the trust, avoiding the triggering of capital gain. However, problems can arise because institutional trustees often provide services to the mutual funds in which they invest trust funds, leaving the trustee open to disloyalty challenges because the fees received by the trustee from the mutual fund company may cloud its judgment regarding the prudence of the investment, and because the combined fees received from the trust and the mutual fund company may be considered excessive compensation. Subsection (f), which is based on state statutes that allow trustees to receive compensation from funds in which trust funds are invested,¹⁸⁶ provides that such investments are not automatically presumed to be a conflict of interest by the trustee, but an actual conflict still would be voidable. Also, the trustee must comply with the prudent investor rule. These restrictions, together with the annual disclosure requirement, provide sufficient protection to the beneficiaries' interests.

Another provision in Section 802 addresses the trustee's duty of care and loyalty when dealing with corporate assets.¹⁸⁷ The provision requires the trustee to act in the best interests of the beneficiaries when voting stock or otherwise exercising control over business enterprises in the trust, and, if the trust is the sole owner of a corporation or other enterprise, the trustee is required to select managers who will manage the business in the best interests of the beneficiaries. The provision does not directly address the gap between the standard of a trustee's duty of loyalty and the standard of a corporate director's duty of loyalty. However, the comments state that "the trustee may not use the corporate form to escape the fiduciary duties of trust law."¹⁸⁸ The example referred to in the comments involves the duty of impartiality and requires a trustee to elect directors who will issue dividends in a manner that would be fair to both the income and remainder beneficiaries.¹⁸⁹

Trustees have attempted to hide behind the corporate form in other contexts. For example, in *Stegmeier v. Magness*,¹⁹⁰ fiduciaries were accused of self-dealing, and the court had to choose between the stringent standard applicable to trustees or the more lenient standard applicable to corporate directors in judging fiduciaries' actions. The decedent in that case owned real property in a real estate development and eighty-three percent of a construction company, and his will placed his property in two separate trusts.¹⁹¹ One trust, for his wife's benefit, was not at issue, and the other was for the benefit of his wife for life,

186. See, e.g., 760 ILL. COMP. STAT. ANN. 5/5.2 (Supp. 2001) (no notice to beneficiaries required but total fees must be reasonable).

187. UTC § 802(g).

188. UTC § 802 cmt.

189. UTC § 802 cmt.

190. 728 A.2d 557 (Del. 1999).

191. *Id.* at 559.

remainder to his children (three of whom were not the children of the widow).¹⁹² The widow was also named as co-executor of the estate, together with a lawyer, and the decedent's brother was named as trustee of the trusts.¹⁹³ The construction company had significant debt problems because of the poor market in the early 1980s.¹⁹⁴ In order to get financing to develop the real estate, the widow and her brother-in-law, the trustee, individually formed a new, debt-free corporation.¹⁹⁵ The estate (through the co-executors, the widow and the lawyer) sold the land to the new corporation, so the land was never placed into the trust.¹⁹⁶ The new corporation developed and sold the property.¹⁹⁷ Two of the stepdaughters who were remainder beneficiaries sued, claiming that the sale of the land to the new corporation was a breach of the fiduciary duties of the co-executors and of the trustee.¹⁹⁸ The lower court held in favor of the defendant fiduciaries, finding that the remaindermen did not have standing because any profits from the development and sale of the land would have been trust income, and finding the widow as the sole income beneficiary.¹⁹⁹ Furthermore, the lower court held that the fiduciaries did not engage in self-dealing and that there was no loss because the property had been sold to the new corporation for a fair price.²⁰⁰ The lower court dismissed the claims against the lawyer co-executor because he had no other interest in the transactions and found that the brother trustee and the widow (shareholders of the corporate buyer) were not guilty of self-dealing because neither of them could have caused the sale unilaterally.²⁰¹ The trustee could not have forced the sale because the land was still in the estate, and the widow could not have forced the sale because she was only a co-executor.²⁰²

The Delaware Supreme Court held that the lower court applied the wrong standard to determine whether self-dealing had occurred.²⁰³ The trial court applied the standard of duty of a corporate director, who is protected from a claim of self-dealing if a sufficient number of disinterested directors approve the transaction.²⁰⁴ If the transaction has not been approved by enough disinterested

192. *Id.*

193. *Id.*

194. *Id.* at 560.

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.* at 561.

200. *Id.*

201. *Id.*

202. *Id.* at 562.

203. *Id.*

204. *See Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 720 (5th Cir.

directors, then the interested director must prove that the transaction was fair.²⁰⁵ As the court noted, unlike corporate law, self-dealing by a trustee is “virtually prohibited.”²⁰⁶ Under trust law principles, it was irrelevant that the widow and the brother could not sell the land alone because a trustee cannot purchase trust property even if the sale is conducted by someone else.²⁰⁷ Self-dealing occurs “when the fiduciary has a ‘personal interest in the subject transaction of such a substantial nature that it *might* have affected his judgment in material connection.”²⁰⁸ Furthermore, the fiduciaries’ argument that the sale was necessary because of the difficulty in obtaining financing to develop and sell the property was also irrelevant. Although that may be true, the fiduciaries still had to obtain advance approval of the beneficiaries or of a court.²⁰⁹ Because the lots already had been sold to third parties, the court agreed that the beneficiaries were entitled to the profits received by the fiduciaries as a result of the sale.²¹⁰ The court held, however, that, because the new corporation had made significant improvements to the property before selling it, including building houses on the lots, the profit on sale of the property was due to the new corporation’s efforts.²¹¹ Therefore, the trust was only entitled to the difference between the fair market value of the land and the price paid by the new corporation.²¹² The burden of proving the fairness of the purchase price was, however, on the fiduciaries rather than on the beneficiaries, as the trial court had held.²¹³ Therefore, the fiduciaries were able to defend the transaction on remand on the basis of fairness of purchase price, which normally is not available under the no further inquiry rule. However, the court arrived at that result by holding that the fiduciaries would have received no profit unless the price was unfair, and rescission of the transaction was impossible because of bona fide purchasers.²¹⁴

In *Estate of Schulman*,²¹⁵ Schulman, an accountant, was trustee of several trusts established for the daughter and grandchildren of his friend and client.²¹⁶ The trusts held the shares of a family corporation, which, in turn, held marketable securities and was essentially a personal holding company for the

1984).

205. *Id.*

206. *Stegmeier*, 728 A.2d at 563.

207. *Id.* at 564.

208. *Id.* (citation omitted, emphasis in original).

209. *Id.* at 565.

210. *Id.* at 565-66.

211. *Id.*

212. *Id.*

213. *Id.* at 567.

214. *Id.*

215. 568 N.Y.S.2d 660 (App. Div. 1991).

216. *Id.* at 661.

family.²¹⁷ The daughter held forty-four percent of the shares outside of the trusts.²¹⁸ Schulman acted as secretary to the family corporation, and there was a finding that he exclusively conducted the company's business and was in sole control of investment decisions.²¹⁹ He loaned most of the family corporation's assets to another company in which he was a shareholder and director, and subordinated the loan from the family corporation to a bank loan.²²⁰ The borrower company went bankrupt, leaving the majority of the loan to the family corporation unpaid.²²¹ Schulman's estate argued that the loans were made in Schulman's role as corporate officer of the family corporation and his actions, therefore, should be judged under the business judgment rule.²²² The court disagreed, noting that Schulman acquired control of the family corporation as a result of his role as trustee and, therefore, had to be held to the standard of trustee in his actions.²²³

The UTC presumably would clarify and confirm the results in *Stegmeier* and *Schulman*, applying a trust standard to the conduct of the trustees in managing corporate assets held by the trusts. Neither the Code nor its comments directly address whether the trustee could elect herself as director or officer. The Code Section states only that the trustee must elect managers consistent with the beneficiaries' best interests. Professor Bogert noted that the case law on this issue is "not harmonious."²²⁴ One court that took a strict view that such an action would be a conflict (and was reversed on appeal) compared it colorfully to "mirror, mirror on the wall, who's the fairest of them all?"²²⁵ Another court, in *Estate of Snapp*,²²⁶ found authority for the trustee to appoint himself president of the estate's corporations in the trust's broad grant of power to the trustee to manage the family business.²²⁷ The court, however, remanded the case for a determination of whether the compensation paid to the trustee in his capacity as president of the companies was excessive.²²⁸ The facts of that case were unusual and illustrate how a trustee must be cautious as to whether all beneficiaries consent to the trustee's actions. The trust in question was set up by the trustee's

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* at 662.

222. *Id.*

223. *Id.*

224. BOGERT & BOGERT, *supra* note 5, § 543(N).

225. *Cleveland Trust v. Eaton*, 229 N.E.2d 850, 861 (Ohio Ct. Com. Pl. 1967), *rev'd*, 256 N.E.2d 198 (Ohio 1970).

226. 502 N.W.2d 29 (Iowa Ct. App. 1993).

227. *Id.* at 33.

228. *Id.* at 34.

deceased father and was for the lifetime benefit of the trustee's mother, remainder to the decedent's children.²²⁹ After seven years of administering the trust and running the companies, it was discovered that the deceased father had another daughter by a previous marriage.²³⁰ That daughter, qualifying as a remainder beneficiary, then challenged the trustee's actions.²³¹

The extent of a trustee's duty of loyalty when dealing with closely-held business assets is an evolving issue. The UTC provision gives statutory clarification to some basic considerations, but, as case law develops in this area, there may be future opportunities for more extensive statutory coverage.

In summary, the UTC takes a rather restrained approach to refining the duty of loyalty. It softens the harsh edges of the doctrine but stops short of creating true safe harbors except for rather mundane transactions. The method used to soften application of the no further inquiry rule is significant. The rule applies conclusively to outright self-dealing, *i.e.*, transactions between the trustee and the trust. It also applies conclusively where the trustee takes an opportunity that should have been given to the trust.

However, transactions between the trust and a relative or affiliate of the trustee create only a rebuttable presumption of voidability. The trustee can rebut the presumption by proving that the transaction was not affected by the conflict. The questions under the case law center around whether the fiduciary's relationship with the other party to the transaction is close enough. A trustee who is a majority stockholder in a corporation could not sell trust assets to the corporation under common law,²³² but, under the Code, that trustee may be able to rebut the presumption by showing a lack of influence. The closeness of the relationship certainly would be relevant in showing a lack of influence, but that question would not decide the issue as it has under case law. Also, reasonableness of the terms of the transaction would be a factor in showing lack of influence, but it would not be the ultimate question. Under common law, either the nature of the relationship would preclude further inquiry, or, if found to be not sufficiently close to cause a conflict, the transaction would be judged as other actions of the trustee, whether or not it was fair and reasonable. The Code provision that creates the rebuttable presumption is sufficiently broad to include situations like *Rothko* and other situations in which there is an incidental benefit to the trustee. Thus, in *Rothko*, the questions would not be whether there was self-dealing and, if not self-dealing, whether the transaction was fair. Instead, the transaction would be presumptively voidable, unless the fiduciaries could prove that their judgment was not affected by the conflict.

229. *Id.* at 31.

230. *Id.*

231. *Id.* at 31-32.

232. SCOTT & FRATCHER, *supra* note 14, § 170.10.

The Code selects a list of routine transactions that can be challenged if unfair but are otherwise permissible. This approach follows the lead of other codifications of the duty of loyalty but clarifies that the trustee still must act fairly toward the beneficiary. In other words, the trustee is allowed to be tempted in these circumstances because these transactions are deemed necessary for efficient operation of modern trusts. It also should be noted that any transgressions by the trustee involving these transactions (such as compensation or loans from the trustee for the protection of the trust) may be easier to spot in most cases than other breaches of loyalty. Nevertheless, giving into the temptation is still forbidden. Also, transactions between the trustee and a beneficiary that do not involve trust property are acceptable if the trustee can prove fairness. The burden does not shift to the trustee, however, unless the trustee has obtained an advantage in the transaction that would not have been available in an arm's length transaction.

The Code further clarifies a trustee's ability to invest in mutual funds, again authorizing transactions that are beneficial to modern trusts while setting limits on the trustee to protect the beneficiaries. The Code takes a mild approach to management of corporate interests held by trusts. It indicates that the stricter standards of trust duty apply in this area, rather than corporate law, and it does not expressly forbid or authorize trustees serving as corporate managers but, rather, establishes the best interests of the beneficiaries as the standard against which to judge the trustee's actions.

V. CONCLUSION

The UTC's definition of the trustee's duty of loyalty preserves, yet subtly realigns, the common law definition. Under the common law approach, the trustee is presumed to be disloyal in transactions between the trust and the trustee, which is the same result under the UTC formulation. However, for less direct conflicts, the common law first will judge the significance of the trustee's interest to determine whether the presumption of a breach of duty applies. If the interest is deemed too incidental to trigger the presumption, then the transaction is judged on reasonableness. The UTC asks different questions. If the conflict is not direct, the question is whether the trustee actually gave into temptation, and it is the trustee's burden to prove that she did not. Even where the interest of the trustee is significant, she has the opportunity to rebut the presumption that her judgment was affected. She would not have that opportunity under common law. On the other end of the spectrum, where the interest of the trustee was less significant, the beneficiary fairs better than under common law. The test in those circumstances shifts under the Code from the common law test of reasonableness (which can encompass a broad range) to whether the trustee's judgment was actually affected, and the fairness of the terms is just one factor. A beneficiary still could void a transaction that was otherwise arguably "fair" if it could be

shown that the trustee's personal interests affected her actions as trustee. This rephrasing of the relevant questions should not increase litigation because the common law tests are also fact-sensitive, and it is an appropriate shift because it focuses on what should be the real issue, whether the trustee was in fact disloyal. The other provisions of the UTC's duty of loyalty provide appropriate safe harbors for necessary and low-risk conflicts of interest without giving the trustee carte blanche to serve two masters.

