

PREVENTING AND LITIGATING TRUST DISPUTES

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I. INTRODUCTION

Two of the main purposes in establishing a trust are the creation of an orderly disposition of assets and the reduction or prevention of costly litigation. A carefully planned and drafted trust can provide peace of mind to settlors and their legal counsel, administrative ease to the trustee, and effective disposition of wealth to the intended beneficiaries. Adherence to the fiduciary requirements of the trust during its administration can effectively prevent and/or eliminate unnecessary trust disputes and related litigation.

II. POTENTIAL AREAS OF TRUSTEE LIABILITY

The fiduciary nature of trusteeship arises from the fact that the trustee “holds legal title to property that is held in trust for the benefit of another.”¹ A trustee has the duty to “administer the trust, diligently and in good faith, in accordance with the terms of the trust and applicable law.”² The provisions of the trust instrument generally set forth the powers, obligations, and duties of the trustee; however, because of the fiduciary relationship between trustees and beneficiaries, the law imposes stricter requirements upon the trustee which are greater than those imposed under the ordinary morals of the marketplace.³ In fulfilling his or her duties, the trustee must focus upon the needs of the beneficiaries, always keeping in mind the purposes and goals of the trust, and must otherwise act for the benefit of those over whom he or she has a fiduciary duty. Where a trustee fails in his or her fiduciary duties, the beneficiaries are not left to simply suffer the consequences of the fiduciary’s poor decisions or management. Instead, they may seek restitution from the trustee personally.

A. The Trustee’s Fiduciary Duties

The fiduciary duties of a trustee are divided into eight categories, which categories themselves encompass additional duties. Those categories are: (1) the duty to administer the trust in accordance with its terms and applicable law;⁴ (2) the duty of prudence;⁵ (3) the duty to act personally, and the related duties with respect to delegation;⁶ (4) the duty of loyalty;⁷ (5) the duty of impartiality;⁸ (6) the duty to furnish information to beneficiaries;⁹ (7) the duty to keep

¹ EDWARD F. KOREN, ESTATE AND PERSONAL FINANCIAL PLANNING § 30:07 (1998).

² RESTATEMENT (THIRD) OF TRUSTS § 76 (2007).

³ *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (“Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”)

⁴ RESTATEMENT (THIRD) OF TRUSTS § 76 (2007).

⁵ *Id.* § 77.

⁶ *Id.* § 80.

⁷ *Id.* § 78.

⁸ *Id.* § 79.

⁹ *Id.* § 82.

records and provide reports;¹⁰ and (8) the duty to segregate and identify trust property.¹¹ These duties are not mutually exclusive, and overlap with each other so as to strengthen the individual responsibilities each trustee owes to the estate beneficiaries.

1. *Duties in Administering the Trust*

The trustee's general responsibilities in administering a trust include, but are not limited to, the following: "(a) ascertaining the duties and powers of the trusteeship, and the beneficiaries and purposes of the trust; (b) collecting and protecting trust property; (c) managing the trust estate to provide returns or other benefits from trust property; and (d) applying or distributing trust income and principal during the administration of the trust and upon its termination."¹² Other duties encompassed within the scope of these broader duties are: (1) creating an inventory of the settlor's estate; (2) filing and providing the beneficiaries with annual and final inventories; (3) keeping accurate records; (4) filing estate and final income taxes; and (5) distributing trust assets to beneficiaries and creditors of the settlor's estate.¹³

Although a trustee can be held liable for failure to comply with any one of these duties, the overriding duties with which a trustee must comport are managing and administering the trust with care and skill and ensuring that he or she remains loyal to the trust beneficiaries in acting for their benefit.

2. *Duty of Prudence*

In administering a trust, the trustee has a duty to act as a prudent person, in light of the circumstances, purposes, and terms of the trust.¹⁴ Prudence means that the trustee must exercise reasonable care, skill, and caution in administering the affairs of the trust.¹⁵ However, where the trustee has advanced skills as compared to an ordinary trustee, the trustee must utilize those skills in the exercise of his or her fiduciary role.¹⁶

The care and skill requirements of the trustee are not onerous; thus, they do not disqualify most settlors' friends and family members from acting as trustee. The care requirement requires that the trustee exercise reasonable effort and diligence in performing the functions of the trustee, always keeping in mind the objectives of the trust and the interests of the beneficiaries.¹⁷ As to the trustee's skill, the trustee must maintain the skills of a person of ordinary intelligence.¹⁸ In addition to care and skill, the trustee must exercise caution in administering the trust over which

¹⁰ *Id.* § 83.

¹¹ *Id.* § 84.

¹² *Id.*

¹³ See generally Layne T. Rushforth, *Your Duties as Trustee for a Living Settlor: Guidelines for Trust Administration*, March 22, 2008, <http://rushforth.net/pdf/trustee.incapacity.pdf>.

¹⁴ RESTATEMENT (THIRD) OF TRUSTS § 77 (2007).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* § 77 cmt. b.

¹⁸ *Id.*

he or she is a fiduciary. Although the trustee is not required to avoid all risks, he or she must exercise caution reasonably appropriate to the circumstances of the trust.¹⁹

3. *Duties with Respect to Delegation*

Although the care and skill requirements do not prevent most individuals from serving as trustee, certain aspects of trust administration require more skill and expertise than the average person possesses. The Restatement (Third) of Trusts points out that maintaining the necessary skills to administer a trust, and providing the proper level of care to the beneficiaries and the trust or estate generally, often requires advice and assistance from outside sources;²⁰ but, it must be remembered that a trustee is generally prohibited from delegating the balance of his or her responsibilities.²¹ For example, the California Probate Code states: “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.”²² Where, however, the administration of a trust requires additional skills beyond those possessed by the average person, such as in the areas of investing and/or maintaining the corpus of the trust, or where there is an express provision within the trust instrument providing for delegation, a trustee may delegate his or her functions in the same manner as a prudent person²³ of comparable skill might delegate his or her duties.²⁴

In selecting an agent to whom duties are to be delegated, the trustee must exercise his or her “fiduciary or prudent discretion,” along with reasonable care and skill, to ensure that the individual or individuals chosen possess the requisite skill and experience necessary to satisfy the fiduciary demands of a trustee.²⁵ Although the trustee may delegate certain ministerial duties, the trustee does not thereby dissolve his or her duties of acting with care and skill, duties which he or she owes to the trust beneficiaries or to the trust generally. Instead, by his or her act

¹⁹ *Id.*

²⁰ *Id.*

²¹ See *Meck v. Behrens*, 252 P. 91, 94-96 (Wash. 1927) (“It is a general rule that a trustee in whom there is vested discretionary powers involving personal confidence cannot delegate his powers and shift his responsibility to other persons . . .” (quoting 39 Cyc. at 304)); see also RESTATEMENT (THIRD) OF TRUSTS § 80(1) (2007) (“A trustee has a duty to perform the responsibilities of the trusteeship personally”).

²² CAL PROB. CODE § 16012 (Deering 2008).

²³ R.F.V. HEUSTON, SALMOND ON THE LAW OF TORTS 56 (17th ed. 1977) (“The reasonable man connotes a person whose notions and standards of behavior and responsibility correspond with those generally obtained among ordinary people in our society at the present time, who seldom allows his emotions to overbear his reason and whose habits are moderate and whose disposition is equable. He is not necessarily the same as the average man—a term which implies an amalgamation of the counterbalancing extremes.”).

²⁴ See, e.g., NEV. REV. STAT. § 164.770(1) (2007) (“A trustee may delegate functions of investment and management that a prudent trustee of comparable skills could properly delegate under the circumstances.”); RESTATEMENT (THIRD) OF TRUSTS § 80(1) (“A trustee has a duty to perform . . . except as a prudent person of comparable skill might delegate those responsibilities to others.”); *Estate of Vail v. First of Am. Trust Co.*, 722 N.E.2d 248, 252 (4th Dist. 1999) (Corporate fiduciaries are required to keep all funds, both principal and income, which are awaiting investment or distribution, to be invested for the beneficiaries “at a rate of return commensurate with that available in trust quality investments.”).

²⁵ NEV. REV. STAT. § 164.770(1); RESTATEMENT (THIRD) OF TRUSTS § 80(2).

of delegation, the trustee acquires the additional responsibility of supervising the agents he or she chooses to assist him or her in fulfilling the fiduciary role.²⁶

In addition to seeking out agents to whom duties may be delegated, it may also frequently become necessary to seek legal advice or representation in the administration of a trust. In retaining such counsel, the trustee does not absolve him or herself of liability for any breach of trust or failures to otherwise preserve and maintain the trust assets. The trustee remains liable for his or her actions regardless of whether counsel has been retained.²⁷ Exercising competence in selecting counsel, however, and following that advice prudently and in good faith, will generally be indicative of the trustee having exercised prudence in administering the affairs of the trust.²⁸

4. *Duty of Loyalty*

In addition to the duties of care and skill, the trustee owes the beneficiaries a strict duty of loyalty. The trustee must remember that the management and investment of trust property is always to be done “solely in the interest of the beneficiaries.”²⁹ The duty of loyalty prevents the trustee from self-dealing or placing his or her interests above those of the beneficiaries.³⁰ In fact, the laws of many states even prohibit the settlor of a trust from including within the instrument any provision for decreasing or eliminating the liability of a trustee for his or her actions, including deriving profit from the trust.³¹

One potential for litigation due to a breach of the duty of loyalty arises where the trustee is also a beneficiary of the trust. The trustee chosen could be a close friend, family member, or business partner of the settlor. In these cases, it is wise to counsel the settlor regarding potential conflicts that could arise between the trustee and the beneficiaries.³² If a settlor names a business partner to serve as a trustee of a trust that owns as its primary asset, the stock or membership interests in the company for which the business partner is employed, provisions concerning compensation should be addressed to delineate between overlapping duties of the trustee and those of the employee. This delineation may prevent wasting of trust assets in the form of overcompensation of the business partner for duties that he would normally be required to render

²⁶ See, e.g., NEV. REV. STAT. § 164.770(1) (The trustee must establish the scope and terms of the delegation, and must also periodically review the agent’s performance.); RESTATEMENT (THIRD) OF TRUSTS § 80(2) (The trustee must exercise fiduciary discretion and act as a prudent person would in supervising and monitoring agents to whom duties have been delegated.).

²⁷ RESTATEMENT (THIRD) OF TRUSTS § 77 cmt. b(2).

²⁸ *Id.*

²⁹ NEV. REV. STAT. § 164.715 (2007). See CAL. PROB. CODE § 16002(a) (2008) (“The trustee has a duty to administer the trust solely in the interest of the beneficiaries.”); N.Y. EST. POWERS & TRUSTS LAW § 11-2.1 (Consol. 2008) (“A trust shall be administered with due regard to the respective interests of income beneficiaries and remaindermen.”); see also UNIF. TRUST CODE § 802 (amended 2005) (“A trustee shall administer the trust solely in the interests of the beneficiaries.”).

³⁰ NEV. REV. STAT. § 163.160 (2007); RESTATEMENT (THIRD) OF TRUSTS § 78(2); see also *Meinhard*, 164 N.E. at 547 (“A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”).

³¹ See, e.g., CAL. PROB. CODE § 16461(b) (Deering 2008); NEV. REV. STAT. § 163.160(3)(b) (2007).

³² UNIF. TRUST CODE § 802 cmt. (amended 2005).

as a fiduciary of the company. An overlapping duty may include the requirement of the business partner as chief executive officer to create an annual accounting to the owners of the company and the beneficiaries of the trust, which are the same persons in this example.

The settlor(s) of a trust should be counseled to carefully consider their choice for trustee, keeping in mind the inherent risk that that a beneficiary acting as trustee may betray the trust placed in them. The California Court of Appeals has held,

[A] trustee cannot purchase or deal with the subject of the trust nor place himself in an attitude antagonistic to the trust. It is against public policy to permit persons occupying fiduciary relations to be placed in such a position that the influence of selfish motives may be a temptation so great as to overpower their duty and lead to a betrayal of their trust. This rule is unyielding . . . Courts will not permit an investigation into the fairness or unfairness of such a transaction or allow the trustee to show that the dealing was for the best interest of the beneficiaries. It is a trustee's duty in all things to first consider and always to act for the best interests of the trust.³³

A proper trust document in which a beneficiary also serves as the trustee for the trust should include provisions addressing such potential conflicts.³⁴ Thereafter, a trustee should do everything in his power to avoid a conflict of interest.³⁵

5. *Duty of Impartiality*

The trustee must also administer the trust in a way that is impartial to the various beneficiaries of the trust.³⁶ This duty includes requirements that the trustee invest, protect, and distribute assets of the trust in an impartial manner, and also that the trustee communicate and consult with all beneficiaries equally.³⁷ Not only must the trustee act with loyalty to all beneficiaries and balance their interests equally, he or she must also act with recognition of the needs of any future beneficiaries as well.³⁸

In Nevada, the trustee is required to impartially invest and manage the trust property, “taking into account any differing interests of the beneficiaries.”³⁹ This duty of impartiality in the administration and distribution of the trust is mandatory in absence of a trust provision to the contrary.⁴⁰

³³ *Cagnolatti v. Guinn*, 189 Cal. Rptr. 151, 156 (Cal. Ct. App. 1983) (quoting *Toedter v. Bradshaw*, 330 P.2d 688, 693 (Cal. 1958). See *Estate of McLellan*, 5463 P.2d 1120 (Cal. 1936).

³⁴ UNIF. TRUST CODE § 802 cmt. (amended 2005).

³⁵ *Riley v. Rockwell*, 103 Nev. 698, 701 (1987).

³⁶ NEV. REV. STAT. § 164.720 (2007); RESTATEMENT (THIRD) OF TRUSTS § 79(1) (2007); UNIF. TRUST CODE § 803 (amended 2005) (“If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries’ respective interests.”).

³⁷ RESTATEMENT (THIRD) OF TRUSTS § 79(1) (2007).

³⁸ *Id.* § 79(2).

³⁹ NEV. REV. STAT. § 164.720(1).

⁴⁰ *Id.* § 164.720(2).

6. *Duty to Furnish Information to the Beneficiaries*

Closely related to the duty of loyalty is the duty to communicate with beneficiaries and to inform them of all material facts with which the trustee has or should have knowledge.⁴¹ Specifically, trustees are charged with keeping beneficiaries informed of changes in the trust, or trusteeship, and with promptly responding to any beneficiary requests for information.⁴² In general, the duty to inform means that the trustee must “inform the beneficiaries fully of all facts which would aid them in protecting their interests.”⁴³ This includes “all material facts in connection with a nonroutine transaction which significantly affects the trust estate and the interests of the beneficiaries.”⁴⁴ A common example of information that should be provided by the trustee includes the issuance of an annual schedule K-1 (IRS Form 1040) to each beneficiary receiving distributions from a trust,⁴⁵ and annual trust accountings.

7. *Duty to Keep Records and Provide Reports*

The duty to keep beneficiaries informed of the status and proceedings of estate administration includes the requirement that the fiduciary keep accurate records and provide accountings to the beneficiaries of the trusts over which they serve as fiduciaries.⁴⁶ For example, trustees must generally submit an intermediate accounting for each year in which the trust is active. This annual accounting is usually filed after the end of each calendar year and must inform the beneficiaries of the status of the trust, including additions, deductions, accountings for investments, and the values of assets, among other requirements.⁴⁷

In Nevada, an individual trustee must file an inventory of all property of which he or she has come into possession within seventy-five days after obtaining possession of that property.⁴⁸ Moreover, the trustee must file an annual inventory within sixty days after the end of each calendar year in which the trust is active.⁴⁹ This accounting must make reference to:

⁴¹ RESTATEMENT (THIRD) OF TRUSTS § 78(3) (2007).

⁴² *Id.* § 82.

⁴³ Allard v. Pac. Nat’l Bank, 663 P.2d 104, 110 (Wash. 1983) (citing Esmieu v. Schrag, 563 P.2d 203 (1977)).

⁴⁴ *Id.*

⁴⁵ Schedule K-1 (Form 1041) provides the beneficiaries’ summarized reporting information for beneficiaries who file Form 1040. Generally, the beneficiary must report items shown on his or her Schedule K-1 (and any attached schedules) the same way that the estate or trust treated the items on its return. If the treatment on the beneficiary’s original or amended return is inconsistent with the estate’s or trust’s treatment, or if the estate or trust was required to but has not filed a return, the beneficiary must file Form 8082—Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)—with the beneficiary’s original or amended return to identify and explain any inconsistency (or to note that an estate or trust return has not been filed). If the beneficiary is required to file Form 8082 but fails to do so, the beneficiary may be subject to an accuracy-related penalty. This penalty is in addition to any tax that results from making the beneficiary’s amount or treatment of the item consistent with that shown on the estate’s or trust’s return. Any deficiency that results from making the amounts consistent may be assessed immediately. *See* Schedule K-1 (Form 1041) 2006 Instructions for Beneficiary Filing Form 1040 at <http://www.irs.gov>.

⁴⁶ RESTATEMENT (THIRD) OF TRUSTS § 83 (2007).

⁴⁷ *See, e.g.*, CAL. PROB. CODE § 16062 (Deering 2008) (“[T]he trustee shall account at least annually, at the termination of the trust, and upon a change of trustee, to each beneficiary to whom income or principal is required or authorized in the trustee’s discretion to be currently distributed”); NEV. REV. STAT. § 165.040 (2007).

⁴⁸ NEV. REV. STAT. § 165.030 (2007).

⁴⁹ *Id.* § 165.040(1).

- (a) The period to which the account applies;
- (b) The names and addresses of any living or other potential beneficiaries known to the trustee;
- (c) Additions to, investments of, and deductions from the trust principal during the accounting period with the dates and sources of such acquisitions, investments, and deductions;
- (d) A description of the trust income and distributions for the accounting period;
- (f) A statement of unpaid claims, including a statement as to whether any taxes have become due with regard to the trust property;
- (g) A brief summary of the account; and
- (h) Such other facts as the courts may require.⁵⁰

A trustee's failure to provide an accurate accounting of the trust assets to the beneficiaries may result in multiple breaches of a trustee's fiduciary duty, due to the trustee's numerous informational and record keeping requirements.

8. *Duty to Segregate and Identify Trust Property*

The duty to segregate trust property includes the duty to keep trust property completely separate from the trustee's own property, as well as from other property not subject to the trust.⁵¹ The duty to keep trust property separate from other property means that, for purposes of money, stock, and other liquid assets, the trustee must maintain separate accounts or physically keep the assets separated. For example, a fiduciary may not place money from the trust in his or her own personal bank account, even if the trustee keeps accurate records and makes an effort to ensure that the funds are kept separate on paper.⁵² This prohibition against commingling also applies to property held in separate trusts. Thus, a trustee that administers multiple trusts is prohibited from commingling the property of the individual trusts.⁵³

Part of the trustee's duty of loyalty is the duty to ensure that trust property is designated or identified as trust property.⁵⁴ The fiduciary must take control of the assets of the trust upon the settlor's death, and must make a diligent effort thereafter to create an inventory of the trust property.⁵⁵ Trustees must also ensure that trust property is properly designated as an asset of the trust to eliminate any confusion concerning ownership issues.⁵⁶

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.* comment b.

⁵³ *Id.* comment c.

⁵⁴ RESTATEMENT (THIRD) OF TRUSTS § 84 (2007).

⁵⁵ UNIF. PROB. CODE § 3-706 (amended 2006).

⁵⁶ RESTATEMENT (THIRD) OF TRUSTS § 84 comment d.

B. Trustee Liability

With all the duties required of individual trustees, liability arising from neglect of those duties is an ever-present concern. Where the trustee has or threatens to commit a breach of trust,⁵⁷ the beneficiaries or co-trustees may initiate an action against the trustee seeking any number of remedies. These remedies could include: (1) compelling the trustee to perform his or her duties; (2) enjoining the trustee from committing the breach; (3) compelling the trustee to redress the breach through the payment of money;⁵⁸ (4) appointing a receiver or temporary trustee over the trust; (5) removing the trustee; (6) setting aside the trustee's objectionable actions; (7) reducing the trustee's compensation, or denying it all together; (8) imposing equitable liens or constructive trusts upon the trust property; or (9) tracing and recovering trust property for which there have been wrongful dispositions.⁵⁹

In addition to the remedies mentioned above, the trustee may be sued in a civil action, and collection may be had from the trust property, under certain circumstances. Generally, the measure of damages for a breach of trust by a fiduciary is "the greater of: (1) the amount required to restore the value of the trust property and trust distributions to what they would have been had the breach not occurred; or (2) the profit the trustee made by reason of the breach."⁶⁰ Under some statutes, where the trustee was engaged in legitimate business activity, or where the loss to the trust was the result of the trustee's personal fault, the beneficiaries of the trust may recover the full amount of damage to the trust.⁶¹ Where the trustee's tort resulted simply in an increase in value to the trust, the beneficiaries may recover only that portion of the increase in value to the trust.⁶²

The settlor of a trust may also seek a remedy against the trustee of an inter-vivos trust for the trustee's breach of his or her duties. The settlor's options include: relieving the trustee from any or all duties, altering or denying any privilege or power conferred upon the trustee, or adding duties, restrictions, or liabilities to those imposed or granted by statute.⁶³ Interestingly, the settlor may relieve the trustee of liability for breaches of trust through provisions in the trust instrument. However, the settlor may not relieve the trustee for those liabilities listed above or for breaches of trust "committed intentionally, with gross negligence, in bad faith, or with

⁵⁷ *Chicago Title & Trust Co. v. Chief Wash Co.*, 13 N.E.2d 153, 156 (Ill. 1938) ("The term 'breach of trust' is sufficiently comprehensive to include every violation by a trustee of a duty which equity lays upon him, whether willful and fraudulent, or done through negligence, or arising through mere oversight or forgetfulness. Included is every omission or commission which violates in any manner the three major obligations of carrying out a trust according to its terms, of care and diligence in protecting and investing the trust property, and of using perfect good faith." (citing Pomeroy's Eq. J. § 1079 (4th ed.))).

⁵⁸ *Stuart v. Continental Ill. Nat'l Bank & Trust Co.*, 369 N.E.2d 1262, 1272 (Ill. 1977) ("A trustee is personally liable for any loss occasioned by a violation of his duties as trustee") (citations omitted); RESTATEMENT (SECOND) OF TRUSTS, §207 (1959) (The trustee is chargeable with interest at the legal rate).

⁵⁹ NEV. REV. STAT. § 163.115(1) (2007).

⁶⁰ UNIF. TRUST CODE § 1002 (amended 2005).

⁶¹ NEV. REV. STAT. § 163.140(1) (2007). See *Herget Nat'l Bank of Pekin v. Lampitt*, 478 N.E. 2d 904, 906 (Ill. Ct. App. 1985) (Any waste or other damage that the trustee may do to the *res* would be considered a breach of fiduciary duty, for which the common law give the beneficiary a remedy against the trustee.).

⁶² *Id.*

⁶³ *Id.* § 163.160(1).

reckless indifference to the interests of a beneficiary,” nor may the trustee be relieved from liability for deriving profit from his or her breach of trust.⁶⁴

In addition to the settlor’s power to relieve a trustee from liability, any beneficiary of full legal capacity, or the court on its own initiative, may relieve the trustees of his or her obligations.⁶⁵ Beneficiaries may also provide relief to a fiduciary who has neglected or otherwise violated one of his or her duties. For example, Nevada law provides that any beneficiary with statutory authority may release trustees from liability for past violations of any provision of the statutes.⁶⁶

One final area of potential liability for a trustee is claiming ignorance of trust provisions or duties. The Restatement (Third) of Trusts is very clear that ignorance will not absolve a trustee from liability.⁶⁷ The trustee has the duty to become familiar with the terms and purposes of the trust and to act so as to preserve the settlor’s intent.

In the end, the common themes running through the statutes, case law, and commentaries when the issue is trustee liability are that the fiduciary must act with appropriate care and skill and must also act with loyalty so as to maintain and preserve assets for the benefit of present and future beneficiaries.

III. TRUSTEE LIABILITY INSURANCE

Legislation and regulations regarding trustee liability continually become more complex, and because there are so many areas in which a trustee may be held liable for breach of the fiduciary capacity, attempts are often made to reduce or completely eliminate the personal liability of a trustee. One means of creating this shield is through the use of exculpatory provisions within the trust instrument itself. Exculpatory provisions can be effective, and often provide additional protection for nonprofessional trustees. However, an unscrupulous trustee can often use these same provisions to harm the beneficiaries. Liability insurance has arisen as an alternative remedy to ameliorate the tension between trustee liability and potential harm to the beneficiaries.

Trustee liability insurance provides the trust beneficiaries with a monetary remedy for loss that may result from improper acts of a trustee.⁶⁸ It is a form of professional liability insurance, and the coverage and pricing depends greatly on the type of trust, the nature of the trust assets, and the trust agreement itself, along with the structure of the services the trustee is

⁶⁴ *Id.* § 163.160(3).

⁶⁵ *Id.* §§ 163.170, .180.

⁶⁶ *Id.* § 163.170.

⁶⁷ *Id.* § 77 cmt. (c).

⁶⁸ See discussion *supra* Section II.B.

required to provide under the terms of the trust.⁶⁹ Often, trustee liability insurance is purchased to cover negligent acts, errors, and omissions in pension and employee benefit plans.⁷⁰

When searching for a plan, it is advisable to find a policy that covers the “trust itself; past, present, alternate and future trustees (and their heirs, estates and legal representatives); [and] plan employees” and those who are acting as the fiduciaries of the plan (in the case of employee benefit plans).⁷¹ Coverage is almost always provided on a claims-made basis, which means that the policy will cover claims reported during the policy period.⁷² Other policies are occurrence policies, that cover acts during the policy period but which are not necessarily reported during the policy period.⁷³ The premiums for trustee liability insurance policies are paid by the trust, and care should be used to ensure that the trustee does not personally carry his or her own liability insurance, as this could decrease the financial effectiveness of the trust’s trustee liability policy.⁷⁴

IV. REPRESENTING BENEFICIARIES IN COURT

Beneficiaries enter into trust litigation for a variety of reasons, which among others, results in petitioning the court for removal of a trustee, challenging the actions of a trustee, and/or challenging specific clauses within trust documents. When representing beneficiaries in court, attorneys should be aware of potential areas of conflict that are unique to the litigation of trusts and other probate disputes.

A. No Contest Clauses

One area of concern is the validity and effect of no contest clauses in trusts and wills. The general rule is that courts will construe trusts “in a manner effecting the apparent intent of the settlor.”⁷⁵ When a settlor places a no-contest clause in his or her will or trust, he or she hopes to prevent future litigation concerning the instrument. He or she also hopes that the court with jurisdiction over the probate of the will or trust will consider the no-contest clause a manifestation of his or her intent, and consequently abide by that intent. The validity of no-contest clauses has, however, been the subject of legislation and judicial opinion. Individuals who elect to place no-contest clauses in their wills are often denied the effect thereof.

This does not mean that no-contest clauses are wholly ineffective. The Restatement (Third) of Property states “[a] provision in a donative document purporting to rescind a donative

⁶⁹ Acadia Specialty Ins. Agency, Inc., *Trustee Liability Insurance*, <http://www.acadiaspecialty.com/trustee.htm> (last visited December 9, 2008).

⁷⁰ Int’l Found. of Employee Benefit Plans, *Buying Fiduciary Liability Insurance – A Short List of Questions*, IN FOCUS, 3rd Quarter 2001, <http://www.ifebp.org/Resources/News/TopicsInDepth/Trustee+Resource+Center/fiduciaryins.htm>.

⁷¹ *Id.*

⁷² Acadia Specialty, *supra* note 69; Int’l Found. of Employee Benefit Plans, *supra* note 70.

⁷³ Int’l Found. of Employee Benefit Plans, *supra* note 70.

⁷⁴ Phillip M. Lyon & John Mrsan, *Legal: Do You Need Fiduciary Liability Insurance?*, DETROITER, Mar. 1, 2005.

⁷⁵ *Hannam v. Brown*, 956 P.2d 794, 798 (Nev. 1998) (citations omitted). See *Gardenhire v. Superior Court*, 26 Cal. Rptr. 3d 143, 147 (Cal. Ct. App. 2005) (“In construing trust instruments, as in the construction and interpretation of all documents, the duty of the court is to first ascertain and then, if possible, give effect to the intent of the maker.” (quoting *In re Estate of Gump*, 107 P.2d 17 (Cal. 1940))).

transfer to, or a fiduciary appointment of, any person who institutes a proceeding challenging the validity of all or part of the donative document is enforceable unless probable cause existed for instituting the proceeding.”⁷⁶ Therefore, if the beneficiary has good (probable) cause for bringing an action challenging the validity of a provision in a will or trust, the court will generally ignore the no-contest clause. This same principle has been adopted by the courts of various jurisdictions including Nevada,⁷⁷ as well as by the legislatures of several states.⁷⁸ The underlying idea is that a no-contest clause will generally be upheld—thereby supporting the testator or settlor’s intent—unless the beneficiary’s challenge shows good or probable cause as to why the clause should be set aside.

B. Attorney Malpractice

Malpractice litigation in the estate, probate, and trusts area has increased substantially during the past two decades.⁷⁹ Although much of the litigation stems from faulty or negligent drafting, attorneys are increasingly being held liable for incompetent representation as well. This increase in liability stems partially from the fact that many jurisdictions now grant trust beneficiaries standing to sue attorneys for their incompetence.

1. *Two Alternate Theories of Liability*

Malpractice actions against estate-planning attorneys generally proceed upon two general theories of liability.⁸⁰ The first is that an attorney owes his or her clients the duty to use such care and skill as would a prudent person in the profession.⁸¹ Where the attorney fails to exercise such care and skill, and where the attorney’s neglect is the proximate cause of damages to the client, an action in negligence is appropriate. The second area of liability arises from the contractual nature of the lawyer-client relationship.⁸² Because attorneys contract to use reasonable care, skill and diligence in fulfilling their services, clients may sue for negligence where an attorney fails to use the implied care and skill in fulfilling the contract.⁸³

2. *The Attorney’s Duty*

Generally, an attorney is only liable in malpractice to the persons with whom he or she has a lawyer-client relationship—*i.e.*, those individuals with whom he or she is in privity.⁸⁴ Under Nevada law, in order for a plaintiff to maintain a malpractice action against an attorney,

⁷⁶ RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS § 8.5 (2003).

⁷⁷ *Hannam*, 956 P.2d at 798 (“[P]ublic policy favors recognition of the implied exception to no-contest clauses for good faith challenges based on probable cause . . .”).

⁷⁸ *See, e.g.*, CAL. PROB. CODE §§ 21303–21306 (Deering 2008).

⁷⁹ John D. Valentine & Aaron L. Pawlitz, *Malpractice in Estate Planning*, in 8TH ANNUAL ST. LOUIS ESTATE PLANNING INTERNSHIP PROGRAM (UMKC/CLE 2001) (citing Martin D. Begleiter, *First Let’s Sue All the Lawyers—What Will We Get: Damages for Estate Planning Malpractice*, 51 *Hasting L.J.* 325, 330 (2000)).

⁸⁰ Roy. M. Adams, *The Ongoing March of Negligence Claims – How to Protect Against Them*, Address at the Cannon Financial Institute, Inc. and Sonnenschein Nath & Rosenthal LLP 2003 Estate Planning Teleconference Series 2 (July 15, 2003).

⁸¹ *See* discussion *supra* at Part II.A.1.

⁸² Adams, *supra* note 80, at 2 (citing *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961)).

⁸³ *Id.*

⁸⁴ *Kahn v. Morse & Mowbray*, 117 P.3d 227, 236 n.16 (Nev. 2005).

that individual must establish: “(1) the existence of ‘an attorney-client relationship, (2) a duty owed to the client by the attorney, (3) breach of that duty, and (4) the breach [is the actual and] proximate cause of the client’s damages.”⁸⁵ In the trust administration context, the client is usually the settlor or the fiduciary, and the attorney-client relationship is easy to establish. Over the years, however, many courts have extended the lawyer-client relationship to the beneficiaries of trusts and wills, thereby expanding the scope of malpractice liability.

a. Drafting Attorney’s Liability to Third-Party Beneficiaries

In the leading case of *Lucas v. Hamm*, the California Supreme Court held that an attorney was liable to the beneficiaries of a will drafted by that attorney.⁸⁶ Although ultimately holding that the attorney there had not been negligent, the court used the opportunity to establish that a drafting attorney can be held liable not only to the person for whom he or she has a direct attorney-client relationship, but also to the client’s beneficiaries, if the actions of the attorney ultimately affect those individuals’ bequests in a negative manner. The court’s reasoning was that estate-planning attorneys are ultimately hired to draft documents that are meant to benefit the client’s beneficiaries. As the court stated,

the determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant’s conduct and the injury, and the policy of preventing future harm.⁸⁷

The California court’s ruling recognized that individuals with whom an attorney has not contracted for his or her services (*i.e.*, those with whom the attorney is *not* in privity) can still recover from the drafting attorney as intended third-party beneficiaries of the attorney’s services. Third-party beneficiary status is not sufficient alone, however, in that the requirements of a legal malpractice action—duty, breach, causation, and damages—must still be met.

b. Liability of the attorney retained by the fiduciary to third-party beneficiaries

Liability to third-party beneficiaries can also extend to the lawyer for a fiduciary in his or her representative capacity. Although some jurisdictions hold that an attorney is only liable to those with whom he or she is in privity, those jurisdictions are few in number.⁸⁸ Courts not adhering to the strict privity doctrine generally utilize two tests for determining whether an attorney owes duties to third-party beneficiaries. Those two tests are the multi-factor balancing test and the third-party beneficiary test.⁸⁹ Under the multi-factor balancing test, a court will examine the following six factors when determining whether to extend liability:

⁸⁵ *Id.* (citing *Allyn v. McDonald*, 910 P.2d 263, 266 (1996) (quoting *Semenza v. Nevada Med. Liability Ins. Co.*, 765 P.2d 184, 185 (1988)) (alteration in original) (punctuation stylized for readability)).

⁸⁶ *Lucas*, 364 P.2d at 689.

⁸⁷ *Id.* at 688 (citing *Biakanja v. Irving*, 320 P.2d 16,18-19 (Cal. 1958)).

⁸⁸ These states include Maryland, Nebraska, New York, Ohio, Iowa, Virginia, Alabama, and Texas. *Adams*, *supra* note 80, at 5.

⁸⁹ *Goldberg v. Frye*, 266 Cal. Rptr. 483 (Cal Ct. App. 1990); *Neal v. Baker*, 551 N.E.2d 704 (Ill. App. Ct. 1990).

(1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to the plaintiff; (3) the degree of certainty that the plaintiff suffered injury; (4) the closeness of the connection between the defendant's conduct and the injury; (5) the policy of preventing future harm; and (6) whether recognition of liability under the circumstances would impose an undue burden on the profession.⁹⁰

In contrast, under the third-party beneficiary test, the court examines whether or not the third-party beneficiaries were meant to benefit from the relationship the attorney has with the fiduciary. Thus, the beneficiary “must prove that the primary purpose and intent of the attorney-client relationship [was] to benefit or influence the third party.”⁹¹

Courts in Nevada have adopted the reasoning of the California courts, and recognize that an attorney for the fiduciary can be held liable to the beneficiaries of an estate or trust in negligence.⁹² In *Charleston v. Hardesty*, the Nevada Supreme Court made reference to California case law in which the beneficiaries of a trust had been allowed to sue the trustee's attorney for legal malpractice. The Nevada court stated, “[w]hen an attorney represents a trustee in his or her capacity as trustee, that attorney assumes a duty of care and fiduciary duties toward the beneficiaries as a matter of law.”⁹³

Most courts hold that these duties arise primarily because of the joint, derivative, or secondary attorney-client relationship which courts perceive to exist between the attorney and the third-party beneficiaries.⁹⁴ Generally, the duties include those of impartiality, good faith, and fair dealing.⁹⁵ They also include the affirmative duty of ensuring that the trustee does not take actions that would negatively affect the interests of the beneficiaries, such as misappropriating trust property or other acts of self-dealing.⁹⁶ However, the duties owed to beneficiaries may be limited by the scope of the attorney's representation of the fiduciary.⁹⁷ For example, if the attorney represents the fiduciary in the fiduciary's personal capacity only, and not in matters related to the administration of the trust, the attorney's duties are greatly diminished.⁹⁸ These duties may also be limited further by the ethical or statutorily imposed duties to maintain confidentiality and protect the attorney-client relationship.⁹⁹

⁹⁰ *Goldberg*, 266 Cal. Rptr. at 489 (citing 1 *Mallen & Smith, Legal Malpractice* § 7.11 (3d ed. 1989)).

⁹¹ *Neal*, 551 N.E.2d at 706 (alteration in original) (citing *Pelham v. Griesheimer*, 440 N.E.2d 96, 100 (Ill. 1982)).

⁹² *Charleston v. Hardesty*, 839 P.2d 1303, 1306 (Nev. 1992) (“[W]hether an attorney owes . . . a duty [to a third person not in privity] is a question of law and depends on a judicial weighing of the policy considerations for and against the imposition of liability under the circumstances.” (quoting *Morales v. Field*, 160 Cal. Rptr. 239, 243 (Cal. Ct. App. 1979))).

⁹³ *Id.* at 1307-08 (quoting *Schick v. Bach*, 238 Cal. Rptr. 902, 908 (Cal. Ct. App. 1987)).

⁹⁴ Am. Coll. of Tr. and Est. Counsel Found., *Commentaries on the Model Rules of Professional Conduct* 2 (4th ed. 2006) [hereinafter *ACTEC*].

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ See discussion *infra* Parts IV.C. and V.

In the end, attorneys for fiduciaries should contemplate potential malpractice liability when drafting documents and providing trustees with counsel and advice in trust administration. Moreover, attorneys for trust beneficiaries should ensure that the attorneys retained by the fiduciary to assist in the administration of the fiduciary estate provide the beneficiaries with proper information and otherwise manage the trust assets properly.

C. Conflicts of Interest

The potential for conflicts of interest that often arise during the administration of a trust present an additional hurdle to estate-planning attorneys. For example, estate planners often represent multiple members of the same family, and these individuals may also have different roles within the family (*i.e.*, some members are beneficiaries, while other persons serve as trustee or trustees). They often have different goals as well. Furthermore, under some circumstances, the attorney representing a fiduciary or beneficiaries may have been the attorney who originally wrote the trust or other testamentary documents involved. Regardless of the role the beneficiary plays in the administration of a trust, the attorney who represents beneficiaries must take steps to ensure that his or her liability due to a conflict of interest is properly addressed.

The primary means by which an attorney can find protection is through full and complete disclosure at the outset of representation. In this way, the attorney can ensure that confidentiality issues will be handled in a manner most favorable to the attorney. A fully disclosed and thorough engagement agreement, in which the attorney sets forth the scope of his or her representation, is a very effective means of accomplishing the goal of diminished potential liability.¹⁰⁰ If an attorney represents both the beneficiary(ies) and the fiduciary, the attorney might elect to meet with each party individually. During these meetings, the attorney can question each individual in hopes of discovering potential problems or conflicts that may have gone undetected during a meeting with all of the clients together.¹⁰¹

The Model Rules of Professional Conduct further allow an attorney to limit the scope of his or her representation, and even permit representation when a potential conflict of interest is present.¹⁰² The somewhat relaxed nature of multiple client representation in the estate-planning context is likely due to the non-adversarial nature of estate planning.¹⁰³ However, even though representation can proceed in the face of a potential conflict of interest, several conditions must be met, one of which is informed consent by the client in writing.¹⁰⁴ In addition, full disclosure and the opportunity for each represented party to provide input on the attorney's scope of representation will further assure the attorney that he or she has diminished his or her potential for liability.¹⁰⁵

¹⁰⁰ See ACTEC, *supra* note 94, at 4 (discussing the anticipation and avoidance of conflicts of interest); see also Anthony L. Barney, *Maintaining an Ethical Practice*, in NAT'L BUS. INST., ESTATE PLANNING TOOLBOX: FLPs AND FLLCS DONE RIGHT (Nov. 2008).

¹⁰¹ See *id.* at 32-33.

¹⁰² See NEV. RULES PROF'L CONDUCT R. 1.2, 1.7 (2006) [hereinafter NRPC]; see also ACTEC, *supra* note 94, at 32 (commentary on ABA Model Rule 1.2).

¹⁰³ ACTEC, *supra* note 94, at 91.

¹⁰⁴ NRPC R. 1.7(b)(4) (2006).

¹⁰⁵ See generally ACTEC, *supra* note 94, at 91 (comment to Model Rule 1.7 ("Conflict of Interest: Current Clients")).

Although the fiduciary's attorney often provides advice and counsel to the beneficiaries of an estate or trust, it is prudent for an attorney to encourage the beneficiaries to seek their own independent counsel. In this manner, the beneficiaries can seek appropriate advice from an attorney who is focused solely on their welfare.¹⁰⁶ Some jurisdictions have raised the conflict of interest that arises by allowing the beneficiaries of an estate or trust to bring actions against the attorney for the fiduciary. For example, the Supreme Court of Washington noted that there is an "unresolvable conflict of interest [that] an estate lawyer encounters in deciding to represent the Personal Representative, the estate, or the estate heirs [that] unduly burdens the legal profession."¹⁰⁷ Although some courts have recognized this potential for conflicts of interest, thereby prohibiting suit by third-party beneficiaries,¹⁰⁸ these conflicts have not as yet driven the majority of courts to rule that third-party beneficiaries may not bring actions against estate-planning attorneys for legal malpractice. Nevada courts have yet to comment on this issue.

V. ATTORNEY-FIDUCIARY PRIVILEGE ISSUES

The attorney-client privilege is a complex and sensitive area of the law. The relationships between the fiduciary, the beneficiaries, and the attorney retained to represent a trust and/or the trustee seem only to intensify the complexity. Part of the difficulty in this area arises from the fundamental question of who the attorney represents—*i.e.*, who is the attorney's client? Even after the client question is resolved, there still remain questions surrounding the scope of the privilege and whether it should extend to the beneficiaries of the trust.

Unfortunately, there is no nationwide consensus on the scope of the attorney-fiduciary relationship.¹⁰⁹ Some states hold that an attorney retained by the trustee to assist him or her in the administration of a trust is the attorney for the entire trust,¹¹⁰ including the beneficiaries, while other states hold that the attorney is merely counsel for the fiduciary.¹¹¹ Regardless of the state, the trend seems to be that of diluting the attorney-client privilege and allowing beneficiaries to have access to communications between the attorney and the fiduciary. Notwithstanding this lack of consensus, the current majority view is that the fiduciary is the attorney's only client.¹¹² The underlying rationale for this view is that the trustee hires an

¹⁰⁶ *Id.* at 33.

¹⁰⁷ *Trask v. Butler*, 872 P.2d 1080, 1085 (Wash. 1994).

¹⁰⁸ *Goldberger v. Kaplan, Strangis, & Kaplan, P.A.*, 534 N.W.2d 734, 739 (Minn. Ct. App. 1995) ("It is the potential for conflict that makes direct suit by the beneficiary unacceptable; the fact that the interests of the Personal Representative and the beneficiary may be aligned in a particular case does not render the suit acceptable." (citing *Spinner v. Nutt*, 631 N.E.2d 542, 545 (Mass. 1994))).

¹⁰⁹ *Id.* at 2 ("The lawyer who represents a fiduciary generally is not usually considered also to represent the beneficiaries. However, most courts have concluded that the lawyer owes some duties to them.").

¹¹⁰ *See Steinway v. Bolden*, 460 N.W.2d 306, 307 (Mich. Ct. App. 1990) ("The personal representative is a fiduciary of the estate who is charged with settling and distributing the estate.").

¹¹¹ *See Wells Fargo Bank v. Superior Court*, 990 P.2d 591, 595 (Cal. 2000) ("[T]he attorney for the trustee of a trust is not, by virtue of [his or her advisory] relationship, also the attorney for the beneficiaries of the trust. The attorney represents only the trustee." (alterations added) (quoting *Fletcher v. Superior Court*, 52 Cal. Rptr. 2d 65, 67 (Cal. Ct. App. 1996))).

¹¹² Steven K. Mignogna, *The Erosion of the Attorney-Client Privilege in Trust and Estate Litigation 2* (2005), available at http://www.abanet.org/rppt/meetings_cle/2005/spring/pt/DevelopingTrends/MIGNOGNA_hand.pdf. *See* ACTEC, *supra* note 94, at 2 ("Under the majority view, a lawyer who represents a fiduciary generally with

attorney to provide assistance and advice in administering the trust, and any communications between the attorney and the fiduciary (client) should be protected.¹¹³

As litigation concerning trusts and their administration has increased over the past few decades, courts have increasingly been inclined to erode the attorney-client privilege, thereby extending the designation of “client” to the beneficiaries of trusts.¹¹⁴ Under this minority view, the attorney’s liability stems from the notion that the fiduciary is obligated to disclose to the beneficiaries all information necessary for the administration of the trust, and from the idea that the fiduciary and the beneficiaries are joint clients of the attorney.¹¹⁵

In addition to the jurisdiction-specific legal and/or legislative positions concerning the attorney-client privilege in estate and trust planning and litigation, attorneys should all be aware of the fiduciary’s duty to furnish information to the beneficiaries of a trust; the law of agency and the attorney’s principal-agent relationship with the fiduciary; ethical considerations regarding privileged communications; and the evidentiary attorney-client privilege and work product rules.¹¹⁶

A. Statutory Authority

Under the statutes of most states, trustees and personal representatives have a duty to keep and render accounts and to supply beneficiaries with information necessary to protect their interests in the trust or estate.¹¹⁷ This relationship has been recognized as the catalyst for allowing access to communications between lawyers and fiduciaries that would normally be privileged under different circumstances. In *Riggs National Bank v. Zimmer*, the court held that

[a]s a representative for the beneficiaries of the trust which he is administering, the trustee is not the real client in the sense that he is personally being served. And, the beneficiaries are not simply incidental beneficiaries who chance to gain from the professional services rendered. The very intention of the communication is to aid the beneficiaries. The trustees . . . cannot subordinate the fiduciary obligations owed to the beneficiaries to their private interest under the guise of attorney-client privilege. The policy of preserving the full disclosure necessary in the trustee-beneficiary relationship is . . . ultimately more important than the protection of the trustee’s confidence in the attorney for the trust.¹¹⁸

respect to a fiduciary estate stands in a lawyer-client relationship with the fiduciary and not with respect to the fiduciary estate or the beneficiaries.”)

¹¹³ See *Wells Fargo Bank*, 990 P.2d at 598 (“[T]he trustee, rather than the beneficiary, is the client of an attorney who gives legal advice to the trustee, whether on the subject of trust administration . . . or of the trustee’s own potential liability) (citations omitted)); *Spinner*, 631 N.E.2d at 542 (refusing to impute the attorney-client relationship between attorneys for the trustee and the plaintiff beneficiaries).

¹¹⁴ See Rust E. Reid et al, *Privilege and Confidentiality Issues When a Lawyer Represents a Fiduciary*, 30 REAL PROP. PROB. & TR. J. 541 (1996).

¹¹⁵ *Id.* at 5-6; ACTEC, *supra* note 94, at 2.

¹¹⁶ See generally Reid, *supra* note 114.

¹¹⁷ See, e.g., NEV. REV. STAT. §§ 165.010–165.240 (2007); see also *Allard v. Pac. Nat’l Bank*, 663 P.2d 104, 110 (Wash. 1983).

¹¹⁸ *Riggs Nat’l Bank v. Zimmer*, 355 A.2d 709, 713-14 (Del. Ch. 1976).

In *Hoopes v. Carota*, the New York Court of Appeals reached a similar conclusion, and allowed the beneficiaries of a trust to discover communications between the trustee and the lawyer retained to assist the trustee in administering the trust.¹¹⁹ The court reasoned that the attorney-client privilege only applies to confidential communications made between the attorney and the fiduciary with regard to personal legal advice.¹²⁰ The holding in *Hoopes*, however, remains the minority view.

The majority of courts hold, in the absence of any exception, that communications between lawyer and fiduciary are privileged, even in the face of the statutory duty to furnish information. In fact, it has been stated that the “[b]reach of a trustee’s duty to the trust beneficiaries is probably not sufficient to justify counsel’s breach of the duties of loyalty and confidentiality owed to the fiduciary client in most jurisdictions.”¹²¹ This was the holding in *Wells Fargo Bank v. Superior Court*, wherein the California Supreme Court stated that it would not restrict the evidentiary attorney-client privilege, one that was statutorily created, based solely “on notions of policy or ad hoc justification.”¹²²

From these authorities it is clear that, although there is no consensus on whether beneficiaries will be allowed access to privileged and confidential communications, with respect to attorney-fiduciary relationships in the majority of jurisdictions, the statutorily created attorney-client privilege has survived.

In addition to the attorney-client privilege, the work-product doctrine, as established by the Supreme Court in *Hickman v. Taylor*, also acts to shield many documents and notes prepared by the attorney in preparation for litigation.¹²³

B. The Principal-Agent Problem and the Scope of Representation

The issue of the attorney-client privilege leads to the question of whom the attorney represents, and in what capacity—which is the determinative factor for a number of jurisdictions. Where the attorney is retained to represent the fiduciary in matters related to trust administration, and where the communication in question concerns the administration of the trust, the beneficiaries may be entitled to the communication because it represents necessary information to be furnished to the beneficiaries. The underlying belief is that the beneficiaries are the true clients of the attorney retained by the fiduciary or that the attorney jointly represents the fiduciary and the beneficiaries in his or her capacity.¹²⁴

¹¹⁹ *Hoopes v. Carota*, 543 N.E.2d 73 (N.Y. 1989).

¹²⁰ *Id.* at 73.

¹²¹ Mignogna, *supra* note 112, at 4 (citing Robert F. Phelps, Representing Trusts and Trustees – Who Is the Client and Do Notions of Privacy Protect the Client Relationship?, 66 Conn. B.J. 211, 221-22 (1992)).

¹²² *Wells Fargo Bank*, 990 P.2d at 596. See NEV. REV. STAT. § 49.095 (2007) (“A client has a privilege to refuse to disclose, and to prevent any other person from disclosing, confidential communications: 1. Between himself or his representative and his lawyer or his lawyer’s representative. 2. Between his lawyer and the lawyer’s representative. 3. Made for the purpose of facilitating the rendition of professional legal services to the client, by him or his lawyer to a lawyer representing another in a matter of common interest.”)

¹²³ *Hickman v. Taylor*, 329 U.S. 495, 510 (1947)

¹²⁴ Reid, *supra* note 114.

In contrast, an early English case on the subject, *Talbot v. Marshfield*, held that where the advice sought relates to the trustee's liability in his or her personal capacity, the communication is privileged, as it is not necessary to protect the interest of the beneficiaries.¹²⁵ Therefore, according to this rationale, disclosure does not depend as much upon the status of the parties, but upon the purpose for which the advice was sought, *i.e.*, the scope of the attorney's representation. The California Supreme Court in *Wells Fargo* strengthened this argument by holding that "the attorney client privilege 'applies not only to communications made in anticipation of litigation, but also to legal advice when no litigation is threatened.'"¹²⁶ Therefore, the fundamental issues are the purpose of the representation and the nature of the advice and counsel received.

C. Ethical Considerations

In addition to the statutory attorney-client privilege, attorneys are also subject to the ethical rules imposed by their respective jurisdictions. First and foremost, attorneys must keep confidential all communications relating to their representation of the client absent the informed consent of the client.¹²⁷ In addition, lawyers are charged with openly and timely communicating with their clients,¹²⁸ and with ensuring that conflicts of interest do not arise.¹²⁹

These rules present additional conflicts for attorneys retained to represent fiduciaries in their administrative role. Naturally, one would assume that the fiduciary would take his or her charge to keep the beneficiaries informed seriously, and would provide the beneficiaries with all relevant information obtained from the attorney. However, the commentaries to the Model Rules of Professional Conduct created by the American College of Trust and Estate Counsel (ACTEC) point out that not all fiduciaries fulfill their duties, suggesting that the attorney may contact beneficiaries directly to inform them of any necessary "non privileged" information and should encourage the fiduciary to relay any relevant information in a timely manner.¹³⁰ Furthermore, with respect to conflicts of interest, attorneys should be cautious when representing fiduciaries that are also beneficiaries of the trust.

In addition, an attorney should take precautions when representing fiduciaries generally, so as to ensure that the scope of representation is fully understood by each party. This can be accomplished through a written document in which the beneficiaries affirm that they have been informed of the scope of the attorney's representation, or through a retention letter specifically tailored to inform all parties of the scope of the attorney's representation.¹³¹ Informing beneficiaries of the scope of representation can often be accomplished at the outset of the attorney's representation of the clients, through a meeting with all parties in which the attorney explains the nature and scope of his or her representation.¹³² In this way, the attorney can

¹²⁵ See *Talbot v. Marshfield*, (Ch. 1865) 62 Eng. Rep. 728; see also *Wells Fargo Bank*, 990 P.2d at 596-97 (explaining *Talbot's* application in that case).

¹²⁶ *Wells Fargo Bank*, 990 P.2d at 596 (citations omitted).

¹²⁷ See, e.g., NRPC R. 1.6 (2006).

¹²⁸ *Id.* R. 1.4.

¹²⁹ *Id.* R. 1.7.

¹³⁰ ACTEC, *supra* note 94, at 2, 57 (commentary on relationship with fiduciaries generally and specific commentary on Model Rule 1.4).

¹³¹ Mignogna, *supra* note 112, at 2.

¹³² ACTEC, *supra* note 94, at 33 (comment on Model Rule 1.2).

specifically explain the confidences he or she will be obligated to keep, and can let the parties know what communications he or she may disclose. Establishing these guidelines at the outset of representation is the best way to address the issue of potential future disclosure.

VI. TAX CONTROVERSIES IN ESTATE PLANNING

A well-written trust will contain proper provisions relating to the appropriate allocation and distribution of trust monies for local, state, and federal tax obligations. Controversies may arise, or become complicated further, by poor draftsmanship and/or improper actions by the fiduciary of the trust.

A. Fiduciary for Purposes of Federal Taxation

A fiduciary, for purposes of the Internal Revenue Service, is any “guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.”¹³³ The Treasury regulations define fiduciaries further as “persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another, as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary.”¹³⁴

Although persons acting on behalf of another constitute fiduciaries, the principal-agent relationship does not by itself constitute a fiduciary relationship for federal tax purposes. The regulations indicate

[a]n agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the Internal Revenue Code.¹³⁵

Therefore, absent this duty to and confidential relationship with the beneficiary or the principal, an agent is not always a fiduciary for an individual for whom he or she acts, or over whose property he or she has responsibility.

B. Statutory Duties of the Fiduciary with Respect to Death Taxes

Under the Nevada Revised Statutes, in the absence of a court appointed personal representative, the trustee has the responsibility of paying the debts of the decedent, including any tax liabilities, as well as all other costs in connection with the settlement of the decedent’s estate.¹³⁶ These distributions must be made from the principal of the trust.¹³⁷ Other costs and

¹³³ I.R.C. § 7701(a)(6) (2006).

¹³⁴ Treas. Reg. § 301.7701-6(b)(1) (2009).

¹³⁵ *Id.* § 301.7701-6(b)(2).

¹³⁶ NEV. REV. STAT. § 164.800(2)(c) (2007) (The trustee must pay “from principal all other disbursements made or incurred in connection with the settlement of a decedent’s estate or the winding up of a terminating income interest,

fees, such as attorney's fees and interest on taxes, may be paid from either the principal or income of the trust.¹³⁸ These other costs may be paid from income earned on property passing to a marital deduction trust if the payment of these taxes does not cause the income beneficiary of the trust to which the property is passing to lose the benefits of the deduction.¹³⁹

The trustee must also pay out of the income of the trust any taxes on receipts allocated to income.¹⁴⁰ Likewise, taxes on receipts allocated to principal must be paid from principal.¹⁴¹ Where the tax is on the trust's share of an entity's taxable income, the trustee must pay the tax proportionately, based upon whether the tax is allocated to income or principal.¹⁴² Finally, any receipts allocated to the trust's principal or income must be reduced by the amount that was distributed to the beneficiaries for which the trust receives a deduction.¹⁴³

The trustee is also authorized to transfer money between principal and income where the tax benefits between the remainder beneficiaries and the income beneficiaries are adjusted as a result of elections by the trustee, income taxes imposed upon the fiduciary or the beneficiary which are the result of a distribution, or where the estate or trust has an ownership interest in an entity whose taxable income is includible in the taxable income of the estate, trust, or beneficiary.¹⁴⁴

The trustee also has a duty to ensure that any decisions related to trust administration, management and investment of trust assets, and the allocation of principal and income are made after considering the potential tax consequences of those decisions.¹⁴⁵ Furthermore, under Nevada law, a trustee may not make any adjustment to principal or income

(a) That diminishes the income interest in a trust that requires all the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;

(b) That reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law.”).

¹³⁷ *Id.*; *Id.* § 164.905(1)(f) (2007) (“A trustee shall make the following disbursements from principal: . . . (f) Estate, inheritance and other transfer taxes, including penalties, apportioned to the trust.”).

¹³⁸ *Id.* § 164.800(2)(b).

¹³⁹ *Id.*

¹⁴⁰ *Id.* § 164.920(1) (2007).

¹⁴¹ *Id.* § 164.920(2).

¹⁴² *Id.* § 164.920(3).

¹⁴³ *Id.* § 164.920(4).

¹⁴⁴ *Id.* § 164.925(1) (2007).

¹⁴⁵ See NEV. REV. STAT. § 164.745 (2007) (stating that the trustee must evaluate the potential tax consequences of his or her decisions in the management and investment of trust assets); § 164.795 (2007) (establishing that the trustee must consider the potential tax consequences of any decision to adjust principal and income).

(c) That changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

...

(e) If possessing or exercising the power to make an adjustment causes a natural person to be treated as the owner of all or part of the trust for income tax purposes, and the natural person would not be treated as the owner if the trustee did not possess the power to make an adjustment; [or]

(f) If possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of a natural person who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the natural person if the trustee did not possess the power to make an adjustment.¹⁴⁶

Thus, under Nevada law, a trustee must evaluate the potential tax consequences of his or her decisions in the management and investment of trust assets. and consider the potential tax consequences of any decision to adjust principal and income in accordance with statute.

C. *Marital Deduction Election: Transfers Between Spouses*

1. *I.R.C. Section 2056(b)(7)—Qualified Terminable Interest Property*

In 1981, Congress enacted legislation that has the effect of significantly decreasing the estate tax burden on the first of two spouses to die. This legislation, Internal Revenue Code Section 2056(b)(7), permits the executor of a decedent's estate to postpone payment of the estate tax by electing to have that burden pass on to the future estate of the surviving spouse.¹⁴⁷ Under 2056(b)(7), any tax on qualified terminable interest (QTIP) property transferred to the surviving spouse upon the decedent's death, if remaining at the surviving spouse's death, is allocated to the surviving spouse's gross estate.

Several restrictions must be met, however, before this election can be made. First, the surviving spouse must be entitled to all of the income from the property. Second, no person may have the power to appoint the trust property to anyone other than the surviving spouse during the surviving spouse's lifetime. Finally, the executor of the decedent's estate must make the "marital deduction" election to pass the tax on to the surviving spouse's death.¹⁴⁸ Once these requirements are met, Section 2044 operates to include within the gross estate of the surviving spouse the value of any QTIP property that passed to the surviving spouse under Section 2056(b)(7).¹⁴⁹

¹⁴⁶ *Id.* § 164.795.

¹⁴⁷ I.R.C. § 2056(b)(7) (2006).

¹⁴⁸ *Id.* § 2056(b)(7)(B)(ii), (v).

¹⁴⁹ *Id.* § 2044 (2006).

The advantages of tax deferral under Section 2056(b)(7) are commonly employed in many trust instruments. For example, a married couple can create a trust that is designed to become two subtrusts upon the death of either of them. At the death of the first spouse, one of the subtrusts (*i.e.*, the tax exempt trust) receives the unified credit of the predeceasing spouse, while the other subtrust receives the remaining property of the marital estate. From the remaining property of the marital estate, the surviving spouse receives all of the net annual income. Upon the death of the surviving spouse, the principal is distributed to the beneficiaries. In this manner, the predeceasing spouse's estate does not have to pay an immediate estate tax, but instead receives a tax deferral until the death of the surviving spouse.

2. *Federal Right of Recovery*

Once the surviving spouse dies, the Internal Revenue Code provides protection for the surviving spouse's estate. Under Section 2207A, if the surviving spouse's gross estate includes QTIP property upon his or her death, that person's estate shall be entitled to reimbursement from the remainder persons for the amount by which the estate tax paid exceeds the tax that would have been payable by the estate had the QTIP property not been included in the surviving spouse's gross estate.¹⁵⁰

Returning to the previous example, the estate of the surviving spouse is entitled to seek reimbursement from the beneficiaries of the trust estate if he or she is required to make payment for estate tax that arises from inclusion of the predeceasing spouse's estate under Section 2056(b)(7) in the gross taxable estate of the surviving spouse. In order to understand the federal right of recover, consider the concept explained by the following example:

D died in 1994. D's will created a trust funded with certain income producing assets included in D's gross estate at \$1,000,000. The trust provides that all the income is payable to D's wife, S, for life, remainder to be divided equally among their four children. In computing D's taxable estate, D's executor deducted, pursuant to Section 2056(b)(7), \$1,000,000. Assume that S received no other property from D and that S died in 1996. Assume further that S made no section 2519 disposition of the property, that the property was included in S's gross estate at a value of \$1,080,000, and that S's will contained no provision regarding Section 2207A(a). The tax attributable to the property is equal to the amount by which the total Federal estate tax (including penalties and interest) paid by S's estate exceeds the Federal estate tax (including penalties and interest) that would have been paid if S's gross estate had been reduced by \$1,080,000. That amount of tax may be recovered by S's estate from the trust. If, at the time S's estate seeks reimbursement, the trust has been distributed to the four children, S's estate is also entitled to recover the tax from the children.¹⁵¹

In order to avoid unnecessary malpractice exposure, the drafting attorney should include terms in the trust that properly allocate responsibility for payment of any estate tax that arises from an election under Section 2056(b)(7) in the taxable estate of the predeceasing spouse. A

¹⁵⁰ *Id.* § 2207A(a).

¹⁵¹ T.D. 8522, 59 FR 9654, Mar. 1, 1994, as amended by T.D. 9077, 68 FR 42594, July 18, 2003.

well-drafted trust should define the respective tax liabilities for each beneficiary, rather than rely upon the federal right of recovery.

3. *Failure to Exercise Federal Right of Recovery*

The surviving spouse's failure to exercise the right of recovery under Section 2207A(a) can create unintended gift tax consequences. The amount not recovered by the surviving spouse is deemed a gift from the surviving spouse to those from whom the tax would have been recovered, but was not.¹⁵²

4. *Federal Estate Tax Apportionment Law*

In most jurisdictions including Nevada, apportionment laws have been passed at the state level that deal with the inequities arising from the federal marital deduction, and that equitably prorate payment of the federal estate tax due from those persons interested in the trust estate who are subject to that tax.¹⁵³

¹⁵² Treas. Reg. § 20.2207A-1 (2009).

¹⁵³ NEV. REV. STAT. §§ 150.290–150.380 (2007). *See also* *Boryan v. United States*, 690 F. Supp. 459, 463 (D. Va. 1988); *Commissioner v. Stern*, 357 U.S. 39, 44-45 (1958); *Mayors v. Commissioner*, 785 F.2d 757, 759-60 (9th Cir. 1986); *American Equitable Assurance Co. of New York v. Helvering*, 68 F.2d 46, 48 (2d Cir. 1933) (It is well settled that federal tax liability can be created under state apportionment statutes as well as by contract.).