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Successor Trustee Liability

What you must know before accepting a fiduciary appointment



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In recent years, as the economy has faltered and banks have failed, merged and re-emerged, the fiduciary business with its annuity revenue stream seems more attractive than ever. But is it, really? The fact is that the fiduciary business can be a bit of a minefield. Issues that could destroy profits (and peace of mind) include surcharges, loss of fiduciary commissions resulting from a predecessor's errors, plus additional risk management costs.

What's a successor trustee to do? There are some practical preventatives and solutions—ranging from exculpatory and indemnification clauses to decanting and alternative dispute resolution procedures. Here are the general rules of the road.

Legal Backdrop

As a general principle of fiduciary law, successor trustees are not liable to beneficiaries for breaches committed by predecessor trustees unless, as the *Restatement (Second) of Trusts* puts it, the successor trustee either "(a) knows or should know of a situation constituting a breach of trust committed by his predecessor and he improperly permits it to continue; or (b) neglects to take proper steps to compel the predecessor to deliver the trust property to him; or (c) neglects to take proper steps to redress a breach of trust committed by the

predecessor."¹

Presumably successors "should know" of a breach if they've vetted the prior trust accounting thoroughly. The courts generally treat layperson trustees more leniently with respect to what they should know. Still, all successors must take proper steps to redress any breaches of trust committed by predecessors. At minimum, such steps will include disclosing the potential problems calmly and clearly to both the trust beneficiaries and the predecessor. This disclosure may take place in an informal setting or such formal settings as negotiations, mediations, arbitrations or litigations. The goal is to work with the beneficiaries to correct any unintended errors as quickly and calmly as possible. If beneficiaries are included in the process and any errors and remedies are explained fully, there is a far greater likelihood of peaceful resolution to the breach.

A successor trustee's guideposts vary from state to state and are more clearly articulated in some jurisdictions than others. At one end of the spectrum we have, for example, Massachusetts and Louisiana with a very strict approach: Successor trustees have a duty to investigate and correct a predecessor trustee's breach of fiduciary duty. At the other end of the spectrum lie states like Illinois and

Pennsylvania, where there is no such duty.

More specifically: under Massachusetts law, a successor trustee has both the right and the duty to collect against a breaching previous trustee on behalf of trust beneficiaries. In the 2006 case of *Zoppo v. Zoppo*, a court held that a successor trustee did in fact bring a proper action seeking redress of a former trustee's breach.² In *Zoppo*, however, the trust was a special Massachusetts "nominee trust"—more akin to an agency relationship rather than a "true trust."

In 2008's much-publicized case of *O'Connor v. Redstone*, the Supreme Judicial Court of Massachusetts reviewed the obligation of the successor trustee to closely scrutinize the actions of a predecessor trustee.³ In that case, beneficiaries brought suit against media mogul Sumner M. Redstone, one of America's wealthiest men, and his brother, Edward Redstone, for allegedly breaching their fiduciary duties to both men's children in connection with the redemption of stock in a family business that both men held in trust for their respective children.

The beneficiaries brought suit in 2006 objecting to redemptions of the family business stock that had occurred back in 1972 and 1984. Relevant to the

issue of whether the beneficiaries' claims were time-barred or instead were tolled due to a conflict of interest on the part of the successor trustee, the Massachusetts high court observed: "When taking over the administration of a trust, the successor should obtain an accounting from or review the records of the predecessor trustee. The [successor] trustee ordinarily has the associated responsibility of taking reasonable steps to uncover and redress any breach of duty committed by a predecessor fiduciary. If a successor trustee fails to take reasonable steps to fulfill his duty in those regards, he is liable for his own breach."⁴

The Massachusetts cases are noteworthy in that the state has a tradition of attorneys acting as fiduciaries with their law partners acting as alternates and successors. This affirmative duty to redress prior breaches under Massachusetts law is often anathema given the discomfort many attorneys feel about questioning, much less taking action against, a professional colleague.

Louisiana law is similar to Massachusetts on this score. In the 1989 case of *Matter of Donald E. Bradford Trust*, a Louisiana appeals court held the successor trustees liable to the beneficiaries for failing to take action to redress their predecessor's breach.⁵ In that case, a series of attorney trustees had diverted funds to, or for the settlor's benefit. Such lax and informal administration led to the successor trustees' liability and the trust ultimately was transferred to a bank trust company for proper administration.

Illinois and Pennsylvania take the opposite view—one that is protective of successor trustees. Illinois law provides that successor trustees are under no duty to inquire into acts or

doings of predecessor trustees and that successors are not liable for any act or failure to act by predecessors.⁶ Pennsylvania law also adopts this approach.⁷

Despite the diverse landscape, there are some general, practical steps successor trustees should take.

Estate Planning Stage

Drafters of trust documents should consider.

- **Exculpatory language** — Utilize exculpatory language or add it in the successor trustee appointment instrument.⁸ There may be public policy limitations under applicable state law on one's ability to limit successor trustee liability through exculpatory provisions. For example, under New York law, successor executors and testamentary trustees may not be exonerated from liability for failure to exercise reasonable care, diligence and prudence.⁹

Therefore, note carefully that the extent to which exculpatory language can be effective will vary with the jurisdiction and depend upon whether the appointment is to serve as a testamentary trustee under a will, or as a successor trustee under an inter vivos trust.

Note, too, that exculpatory clauses are generally construed narrowly by the courts. Even if exculpatory clauses are clearly drafted in the trust instrument, courts may impose a surcharge upon the trustee if there has been a breach.¹⁰

- **Corporate co-trustees** — Sloppy administration by an individual trustee can result in fiduciary liability. If you are considering acting as a fiduciary, consider appointing a corporate co-trustee to act with you to ensure

that a safety net is established with respect to accountings, investments, tax filings and other administrative matters.

Administrative Stage

Successor trustees can:

- **Review and Disclose** — Institute a systematic review of the prior trust accountings, income tax returns and relevant estate and gift tax returns with a view toward the future of the trust. Any problems found in the course of such review could be addressed by the exiting and entering trustee jointly in the spirit of corrective action and collaboration. Beneficiaries should be made fully aware of the problems and proposed solutions along the way. Beneficiaries are generally less likely to sue a predecessor or pressure a current trustee to sue if they feel fully informed and respected in the trust administration process.

- **Obtain indemnification agreements** — It may be possible for the successor trustee to enter into an indemnification agreement with the appointing party with respect to the successor's obligation to obtain redress against the predecessor trustee. Public policy limitations on exonerated provisions under applicable state law could limit the extent of the relief available. But such agreements could provide some additional comfort to the successor fiduciary, somewhat like a fiduciary liability insurance policy.

- **Purchase fiduciary liability insurance policies** — An added precaution would be for a trustee to buy an actual fiduciary liability insurance policy from an insurer who routinely covers similar policies, such as director and officer liability policies. These fiduciary policies

cover negligence but not intentional breach, such as embezzlement. Attorney fiduciaries also may include fiduciary liability coverage in their legal malpractice policies. Corporate fiduciaries can obtain bankers professional liability insurance (also known as BPL insurance). No matter what the type of insurance, underwriters will look closely at the trust instrument and underlying holdings (for example, closely held business interests, real estate and stock concentrations) to determine the risk and appropriate premium charges.¹¹

■ **Get detailed accountings** — Before undertaking a trusteeship, successor trustees should insist that their predecessors render a full and comprehensive accounting. The accounting can be informal, if circumstances permit. But a judicial accounting proceeding may be needed if any of the interested parties are unwilling to sign off on the predecessor trustee's accounting, or if some of the interested parties are minors or are otherwise under a disability. Also note that extra due diligence is warranted with any real property holdings that may carry environmental or other liabilities.

■ **Consider decanting** — Many modern trusts provide for decanting as a way to reform trusts that have problematic or outdated provisions. The new trust to which property in the old trust is decanted presumably could break the chain between predecessor trustee and successor trustee—bearing in mind, however, that this area of the law is highly undeveloped, so the public policy limitations we've noted on the exoneration of successor trustees still might apply. Even if a provision authorizing a trustee to decant trust property to another trust does not exist in the governing instrument, it

may be possible to decant to a new trust pursuant to state decanting statutes. Decanting statutes exist in Alaska, Delaware, Florida, New York, Tennessee, and South Dakota, among other jurisdictions.¹²

Dispute Resolution Stage

Once a dispute has arisen between successor and predecessor trustees, there are options, including:

■ **Mediation** — Should the trustees or beneficiaries reach an impasse, they could retain an independent mediator to work out a private settlement. This effort may include waiving trustee commissions or other quiet redress that could keep the dispute private and out of public court records. Most individual and corporate trustees value their reputation and would welcome finding private solutions to a breach when there has been no malice or fraud. But there may be substantial limitations upon mediation's effectiveness, particularly when some beneficiaries are minors, under a disability or otherwise incapable of releasing their rights under applicable state law without a formal judicial determination. So, if the stakes are high enough and fiduciary liability poses a major concern, a judicial accounting resolving all claims against the predecessor trustee generally will be warranted. Still, mediation could assist the represented parties to better understand each others' positions and potentially reduce resentments, grudges and misunderstandings.

■ **Arbitration** — Any further impasse might be handled by binding arbitration in which the parties are entitled to some discovery and a panel of arbitrators—as opposed to a single judge in litigation. An increasing number of states,

including Florida, are relying on arbitration to settle fiduciary disputes. But, as with mediation, even when there's an entry of an arbitration award, there could be a continuing significant liability risk to successor trustees when beneficiaries are disabled in the legal sense (minors and incapacitated persons). Keep that exposure in mind when evaluating the advantages and disadvantages of arbitration as a possible solution to limit fiduciary liability.

You've Been Warned

The successor fiduciary business can be viable and profitable for those successor trustees that engage in a thorough review of their predecessor's conduct. Should any problems arise, trustees who make open and comprehensive disclosures to their beneficiaries and take appropriate steps to rectify matters quickly will be better positioned to gain the trust of otherwise wary beneficiaries. But, fair warning: successor trustees who turn a blind eye to predecessors' errors will surely pay the price down the road and find the courts profoundly unforgiving.

Endnotes

- 1 *Restatement (Second) of Trusts*, Section 223.
- 2 *Zoppo v. Zoppo*, 453 F. Supp.2d 232 (D. Mass. 2006).
- 3 *O'Connor v. Redstone*, 452 Mass. 537 (Mass. 2008).
- 4 *Ibid*, at pps. 552-53 (internal citations and quotations omitted). In *O'Connor*, a successor trustee had been appointed in the 1980s. The defendant predecessor trustee contended that the successor trustee's knowledge of the facts forming the basis for the beneficiaries' claims commenced at the time of the running of the statute of limitations and thereby caused the beneficiaries' claims against them to become stale. The court held that the analysis of the defendants' contention boiled down to whether the successor trustee was truly independent of the predecessor trustee. The court proclaimed that, ordinarily, the statute of limitations for a claim against a former trustee for breach of fiduciary duty begins to run when the successor trustee knows, or through reasonable diligence should know, of the breach. But, to the extent that the successor trustee himself participated in

the alleged breach of trust by the predecessor trustees, the statute of limitations was tolled. Applying these standards, some of the beneficiaries' claims had expired, while others had been tolled.

5 *In Matter of Donald E. Bradford Trust*, 524 So.2d 1213 (La. Ct. of App. 1989).

6 Illinois S.H.A. Ch. 17, Paragraph 1684(2).

7 20 Pennsylvania Cons. Stat. Section 7770 provides that "a successor trustee shall not be personally liable for the acts or omissions of the trustee's predecessor and shall have no duty to investigate the acts or omissions of the predecessor."

8 *In Steph v. Scott*, 840 F.2d 267 (5th Cir. 1988), the successor trustees were exonerated from failure to seek redress for breach by prior trustees based on the following language of the trust instrument: "Insofar as shall be permitted by law, my Executors and/or Trustees shall not be liable for any act or omission in connection with the administration of my estate or the respective trusts, nor for any loss or injury to the property held in my estate or the respective trusts, except only for actual fraud."
9 N.Y.E.P.T.L. 11-1.7.

10 Also, attorney trustees who draft the trust instrument in question may find the exculpatory language totally ineffective against later claims by beneficiaries because inserting such a clause presents a classic conflict of interest. See American College of Trust and Estate Counsel (ACTEC) commentaries to Model Rule of Professional Conduct 1.7, Conflict of Interest: General Rule.

11 For a more detailed discussion of fiduciary liability insurance, see Charles E. Rounds, Jr., and Charles E. Rounds, III, *Loring A Trustee's Handbook*, Section 3.5.4.2 (2008 Edition).

12 The criteria to invoke these statutes can vary quite significantly. For example, under the New York decanting statute, the ability to decant to another trust is limited to when the trustee possesses absolute discretion to invade trust principal for the benefit of one or more of the trust's beneficiaries. In contrast, Alaska's decanting statute may be invoked even if the authority to invade principal is limited by an ascertainable standard for health, education, maintenance and support.

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