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SELF-DEALING TRUSTEES AND THE EXONERATION CLAUSE: CAN TRUSTEES EVER PROFIT FROM TRANSACTIONS INVOLVING TRUST PROPERTY?

CHARLES BRYAN BARON, ESQ.*

INTRODUCTION

In the landmark New York Court of Appeals case of *Meinhard v. Salmon*,¹ Chief Judge Benjamin Cardozo set forth the trustee's creed:

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.²

The sale or purchase of trust property by a trustee, commonly referred to as self-dealing, is one such proscribed behavior.³ Justice Kent outlined the underlying rationale for the rule

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¹ *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) (holding that joint venturers owe each other a duty of the finest loyalty because of their fiduciary relationship).

² *Id.* at 546.

³ See *In re Noonan's Estate*, 63 A.2d 80, 83 (Pa. 1949) (holding the executor liable for self-dealing in selling the trust property where he had a personal interest in the transaction that might affect his judgment); RESTATEMENT (SECOND) OF TRUSTS § 170(1) cmt. b. (1959) [hereinafter RESTATEMENT] ("A trustee with power to sell trust property is under a duty not to sell to himself ... [even if he] acts in good faith ... [and] pays a fair consideration."). But see *In re Scarborough Properties Corp.*, 255

against self dealing:

[The purpose of the rule] is to bar the more effectually every avenue to fraud. Such a purchase[] [of trust property by a trustee], though it may not originate in any purpose to defraud, is a constructive fraud, because the natural tendency is mischievous and harmful. The rule is founded in the highest wisdom. It recognizes the infirmity of human nature, and interposes a barrier against the operation of selfishness and greed. It discourages fraud by taking away motive for its perpetration. It tends to insure fidelity on the part of the trustee, and operates as a protection to a large class of persons whose estates, by reason of infancy, infirmity, or other causes, are intrusted to the management of others.⁴

This Article will analyze the question of whether a trustee, acting in an individual capacity, is permitted to profit personally from transactions involving trust property. The analysis will include an examination of the rule against self-dealing, as well as the rationale for the rule's existence. Part I examines various forms of self-dealing transactions, followed by a discussion of the consequences of self-dealing upon the transaction itself. In these contexts, beneficiaries have frequently invoked the "no further inquiry" rule so that a court may set aside a self-dealing transaction without considering the trustee's good faith or benefit to the estate in implementing the transaction.⁵

Part II examines the exoneration clause as perhaps the only method available to circumvent the harshness of the "no further inquiry" rule and rescue an otherwise voidable self-dealing transaction so as to give meaning to the terms of the trust instrument and uphold the intent of the testator. Yet, even so, a close reading of the relevant case law reveals that the language

N.E.2d 761, 764 (N.Y. 1969) (rejecting the application of the rule against self-dealing where the trustee purchased the trust property after obtaining court approval) (citations omitted).

⁴ *In re Ryan's Will*, 52 N.E.2d 909, 923-24 (N.Y. 1943) (quoting Justice Kent in *Bergen v. Bennett*, 1 Caines, Cas., 19).

⁵ See *Interfirst Bank Dallas v. Risser*, 739 S.W.2d 882, 898 (Tex. Ct. App. 1987) (explaining that the "no further inquiry" rule invalidated self-dealing transactions despite the consideration of good faith and fairness); *Manchester v. Cleveland Trust Co.*, 168 N.E.2d 745, 752 (Ohio Ct. App. 1960) (stating that the "no further inquiry" rule applies to set aside the self-dealing transaction on the basis that there may be fraud once a breach of trust has been established). But see *In re Estate of Rothko*, 372 N.E.2d 291, 296 (N.Y. 1977) (holding that the lower court properly considered the issue of fairness regarding the trustee's transactions instead of merely applying the "no further inquiry" rule).

contained in an exoneration clause permitting self-dealing transactions must be explicit, clear, and unmistakable. A naked grant of managerial authority is insufficient to sustain the self-dealing transaction. Furthermore, even where trust language is narrowly drawn, profits accruing to a trustee from the self-dealing transaction may only be "normal" and "reasonable" profits such as those made by a third party in an arm's length transaction, and not those realized through the sale of trust property to a trustee at a fraction of market value.

Part III will consider the efforts made in the Restatement (Second) on Trusts to ensure that a trustee remains loyal to his trust, while at the same time allowing a settlor to provide, by the explicit terms of the trust, that a trustee may profit from self-dealing.⁶ The analysis will reveal that the Restatement inadequately addresses the interplay between a trustee's duty to act in good faith towards the trust and the settlor's power to authorize self-dealing. This inadequacy may have led to a contradiction between sections 170 and 222 of the Restatement, with the former authorizing exoneration clauses permitting trustees to profit from self-dealing, and the latter prohibiting such exoneration clauses as violative of public policy. Finally, Part IV proposes several solutions in order to resolve the contradiction.

I. SELF-DEALING TRANSACTIONS

The Restatement (Second) of Trusts provides that the trustee has a duty to administer the trust solely in the interests of the beneficiary.⁷ Accordingly, a trustee may not lend trust funds to himself.⁸ In *In re Estate of Stowell*,⁹ the executor of the estate, Rand, was both the trustee of a testamentary trust as well as the president and shareholder of a closely held corporation whose shares constituted the entire corpus of the trust.¹⁰ Rand, as executor,¹¹ lent himself and the corporation estate funds.¹² The

⁶ See RESTATEMENT, *supra* note 3, § 170 cmt. a ("A trustee ... is under a duty not to profit at the expense of the beneficiary ... unless authorized to do so by the terms of the trust").

⁷ See *id.* § 170(1).

⁸ See *id.* § 170 cmt. 1. ("The trustee violates his duty to the beneficiary ... where he uses the trust property for his own purposes. Thus, he cannot properly use trust money in his business, or lend trust money to himself").

⁹ 595 A.2d 1022 (Me. 1991).

¹⁰ See *id.* at 1023-24.

¹¹ Rand was a "personal representative" under Maine law. See ME. REV. STAT.

court found no express authority in the trust instrument that allowed for personal loans or loans to the corporation. Furthermore, Rand had failed to obtain the consent of, or give notice to, the beneficiaries for either of the loan transactions. Rand eventually repaid the loans to the estate.¹³

The Maine Supreme Judicial Court held that Rand's self-dealing was a breach of his fiduciary duty as a matter of law because "[t]he record disclose[d] neither an authorization by the will, trust instrument, or the court, nor a voluntary consent by the beneficiaries to a conflict of interest transaction."¹⁴ With regard to the loan transaction between Rand as personal representative and Rand *pro se*, the court reasoned that the transaction created the conflict of interest envisaged in the Maine Probate Code,¹⁵ as well as section 170(1) of the Restatement (Second) of Trusts.¹⁶ As far as the loan transaction with the company was concerned, the court observed that Rand held 19% of the company stock and was president of the company. His duty as president, which called for minimizing costs by obtaining loans at a low interest rate, conflicted with his duty to the estate to maximize the return on such loans by charging the company

ANN. tit. 18-A, § 1-201(30) (West 1964). The statute's definition of "personal representative" includes the executor of the estate. *Id.*

¹² See *In re Estate of Stowell*, 595 A.2d at 1024.

¹³ See *id.*

¹⁴ *Id.* at 1025 (referring to title 18-A, sections 3-713 and 7-404 of the Maine Probate Code).

¹⁵ See ME. REV. STAT. ANN. tit. 18-A, § 3-713 (West 1964). The code states, in pertinent part:

Any sale or encumbrance to the personal representative, ... 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, unless

(1) The will or a contract entered into by the decedent *expressly* authorized the transaction; or

(2) The transaction is approved by the court after notice to interested persons.

Id. (emphasis added).

¹⁶ See RESTATEMENT, *supra* note 3 at . The transaction arguably contravened the provisions of section 170(2) of the Restatement (Second) of Trusts, which provides: "The trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know." *Id.* The *Stowell* court relied solely upon section 170(1) of the Restatement (Second) of Trusts in its decision without considering section 170(2). See *In re Estate of Stowell*, 595 A.2d at 1025.

higher rates of interest.¹⁷ Accordingly, the court remanded the case to the Probate Court to determine the extent of the surcharge that Rand would be required to reimburse to the estate.¹⁸

The prohibition against self-dealing also encompasses situations in which a trustee's interests are in competition with those of the trust beneficiary.¹⁹ Two egregious examples of this are illustrated by the case of *Hanson v. First State Bank and Trust Co.*²⁰ In *Hanson*, a bank was appointed testamentary trustee. The testatrix's brother, Haley, was chairman of the board of the bank and controlled most of its stock.²¹ The testatrix had owned stock in another company which in turn owned all of the stock of a cable company. After the testatrix's death, the FCC ordered the company, of which Haley was also a director, to distribute the cable company stock to its shareholders. The bank, as trustee, received calls from brokers offering to purchase the cable company stock at \$1.39 per share, but Haley separately negotiated the sale of his own shares in the cable company to Storer Communications for \$5 per share.²²

In a second transaction, the bank, as trustee, leased a vacant lot to an auto company. The vacant lot was owned by the trust, Haley, and other family members. Haley was also the principal owner and officer of the auto company.²³ The Georgia Supreme Court held that Haley had so dominated the bank that the conflicts between his individual interests and the interests of the trust were attributable to the bank.²⁴ The court characterized the series of transactions as "a case of prohibited 'self-dealing' by Haley, who, because of his control over the bank, [was] the virtual or *de facto*, trustee, and, at the same time, ha[d] engaged in extensive dealings on his own account with the

¹⁷ See *id.* In *Stowell* the court found that Rand's loans from the decedent's estate created a conflict of interest violating his duty of undivided loyalty. *Id.*

¹⁸ See *id.* at 1026.

¹⁹ See RESTATEMENT, *supra* note 3, § 170 cmt. p (stating that entering into substantial competition with the beneficiary's interest is a violation of the trustee's duty to the beneficiary).

²⁰ 385 S.E.2d 266 (Ga. 1989).

²¹ See *id.* at 266-67.

²² See *id.* at 270.

²³ See *id.* Haley wore not two, but three hats simultaneously. He was the co-owner of the leased premises with the trust (as lessor), the substantial owner of the lessee auto company, and through the instrumentality of the bank, purported to act as trustee as well. See *id.* at 270-71.

²⁴ See *id.* at 268.

trust."²⁵ Consequently, the court remanded for a determination of the conflicts between Haley's interests and those of the beneficiaries.²⁶

The New York case of *In re Estate of Rothko*²⁷ is an additional, yet no less egregious, illustration of fiduciaries who have allowed their interests to compete with those of the trust beneficiaries. Mark Rothko was a renowned expressionist painter who died in 1970.²⁸ His will was admitted to probate without objection.²⁹ The will had nominated three executors, Reis (the will's draftsman), Stamos, and Levine.³⁰ Within three weeks after the will had been admitted to probate, the Rothko estate entered into two contracts for the sale and disposition of 798 of Rothko's paintings.³¹ In the first contract, the estate agreed to sell one hundred paintings to Marlborough A.G. ("MAG"), a Liechtenstein Corporation.³² In the second contract, the estate agreed to consign 698 Rothko paintings to Marlborough Gallery ("MNY"), a New York corporation and an affiliate of MAG.³³

At the time that negotiations were taking place for the sale and consignment of the Rothko paintings to MNY and MAG, co-executor Reis was also serving as a director of MNY.³⁴ Notwithstanding the fact that Reis purportedly refused to participate in the negotiations themselves, he reserved the right to ratify or veto the actions of the co-executors regarding the consignment of the Rothko paintings to MNY.³⁵ Ultimately, the Surrogate held that Reis's dual status "imposed upon him an extraordinary head-on conflict. His primary duty as an estate fiduciary was to obtain terms the most advantageous for the estate in its dealings and negotiations with MNY His conflicting duty as a director of MNY was to bargain precisely in opposition."³⁶ Because Reis had essentially acted as consignor and consignee of the paint-

²⁵ *Id.*

²⁶ *See id.* at 270.

²⁷ 379 N.Y.S.2d 923 (Sur. Ct. N.Y. County 1975), *modified on other grounds*, 392 N.Y.S.2d 870 (App. Div.), *aff'd.*, 372 N.E.2d 291 (N.Y. 1977).

²⁸ *See id.* at 932.

²⁹ *See id.* at 934.

³⁰ *See id.* at 933.

³¹ *See In re Estate of Rothko*, 372 N.E.2d 291, 293 (N.Y. 1977).

³² *See id.*

³³ *See id.*

³⁴ *See Rothko*, 379 N.Y.S.2d at 935.

³⁵ *See id.* at 936.

³⁶ *Id.*

ings, the Surrogate held that he had "benefit[ted] himself indirectly at the expense of the estate," and as a result, had breached his duty of loyalty, amounting to "the equivalent of self-dealing."³⁷

A second conflict of interest arose regarding co-executor Stamos. Stamos, an artist himself, entered into an individual contract with MNY to market his own paintings while the consignment of the Rothko estate paintings to MNY was still pending.³⁸ The court noted that the personal contract was more advantageous to Stamos individually than the consignment contracts were to the Rothko estate, since the commission rate due MNY for Stamos's personal contract was lower than that of the estate paintings.³⁹ Furthermore, the court observed that Stamos was allowed, under his own contract with MNY, to fix a minimum selling price for his paintings. The estate consignment contracts with MNY contained no such provision.⁴⁰ Clearly, then, Stamos was self-dealing by competing with the estate for the most favorable terms of sale for his own paintings to MNY, and the Surrogate found that he engaged in a "self-serving breach of loyalty."⁴¹

The "classic"⁴² example of a self-dealing trustee, however, involves a trustee's purchase of trust property in his individual capacity. A trustee may not sell trust property to himself (or his spouse)⁴³ privately or by auction, even if the sale is made in good

³⁷ *Id.* at 940. ("[Reis's] conduct does not amount to self-dealing in the sense of buying or selling assets directly to or from the estate for his own personal account"). For a similar expansive definition of self-dealing which was put forward in the construction of an exoneration clause, see *Interfirst Bank Dallas v. Risser*, 739 S.W.2d 882, 899 (Tex. Ct. App. 1987) ("[A]ny conduct by the trustee which violates fiduciary duty by taking advantage of the trustee's position as trustee to benefit the trustee ... can constitute self-dealing.").

³⁸ See *Rothko*, 379 N.Y.S.2d at 940.

³⁹ See *id.*

⁴⁰ See *id.*

⁴¹ *Id.* at 941. The Appellate Division unanimously affirmed the finding of the Surrogate that both co-executors, Reis and Stamos, had a conflict of interest and divided loyalty because of their connections to MAG and MNY corporations. *Will of Rothko*, 392 N.Y.S.2d 870, 872 (App. Div.), *aff'd*, 372 N.E.2d 291 (1977).

⁴² In *Rothko*, the Surrogate seemed to implicitly agree with this categorization of the classic self-dealing trustee by referring to Reis's breach of the duty of loyalty as the "equivalent" of self-dealing, rather than self-dealing itself. *Rothko*, 379 N.Y.S.2d at 940; see also text accompanying note 37.

⁴³ See RESTATEMENT, *supra* note 3, § 170(1) cmt. e (stating that a sale of trust property by the trustee to his spouse is voidable by the beneficiary because such a sale is considered to be the equivalent of a sale made by the trustee to himself); see

faith and for adequate consideration.⁴⁴ Arguably, the participation of a trustee at an auction of the trust corpus involves an inherent conflict of interest, since the trustee is forced to "wear two hats." As a fiduciary acting on behalf of the trust, the trustee's duty of loyalty mandates that he obtain the highest possible price for the trust asset being auctioned. However, the trustee in his individual capacity represents an opposite, competing interest: securing the trust property at the lowest possible price. The incompatibility of these two roles and the competition subsumed within the auction process would likely cause the trustee not only to contravene the principle embodied in section 170(1) of the Restatement (Second) of Trusts, comment b (sale of trust property to trustee individually),⁴⁵ but also to run afoul of the principle contained in comment p (competition with the beneficiary).⁴⁶

Similarly, an individual or corporate trustee may not sell to the trust property which is being held by the trustee in an individual capacity, or property "in which he has a personal interest of such a substantial nature that it might affect his judgment."⁴⁷

also *In re Minch's Will*, 71 N.E.2d 144, 146 (Ohio Ct. App. 1946) (stating that a presumption of self-dealing arises from a sale of trust property by a trustee to his wife or father). But see UNIF. TRUSTS ACT § 5, 7B U.L.A. 774 (1985) ("No trustee shall directly or indirectly buy or sell any property for the trust from or to itself or an affiliate; or from or to a director, officer, or employee of such trustee or of an affiliate; or from or to a relative, employer, partner, or other business associate.").

⁴⁴ See RESTATEMENT, *supra* note 3, § 170(1) cmt. b.; see also *In re Downing's Estate*, 57 A.2d 710, 712 (Pa. Super. Ct. 1948) ("The prohibition against self-dealing is absolute; where the trustee violates it, good faith or payment of a fair consideration is not material."); *In re Bradley's Estate*, 143 N.Y.S.2d 264, 266 (Sur. Ct. 1955) (holding that "it is immaterial that the trustee acts in good faith in purchasing trust property for himself, and that he pays a fair consideration").

⁴⁵ RESTATEMENT, *supra* note 3, § 170(1) cmt. b; accord A. SCOTT & W. FRATCHER, *THE LAW OF TRUSTS* § 170.4 (4th ed. 1988) [hereinafter SCOTT & FRATCHER, *LAW ON TRUSTS*].

[A] trustee ... cannot sell to himself at a public auction. The duty of the trustee in conducting the sale is to obtain as high a price as possible, but if he is allowed to purchase for himself at the sale it would be to his interest to have the property sold at the lowest possible price. The trustee is in a position where he can depreciate the sale, either by discouraging the attendance of bidders or by discouraging their bids. In view of the dangers resulting from this conflict of duty and interest, the sale will be set aside even though in fact it appears that the trustee did his best to sell at the highest price.

Id.

⁴⁶ See RESTATEMENT, *supra* note 3, § 170(1) cmt. p.

⁴⁷ *Id.* § 170(1), cmt. h.

In *In re Downing's Estate*,⁴⁸ a commercial bank assigned its interest in a mortgage to a trust for which it was serving as corporate trustee.⁴⁹ The mortgagor subsequently defaulted, causing the estate to suffer a loss.⁵⁰ Upholding the decision of the orphans' court to surcharge the corporate trustee for the losses incurred by the estate, the Pennsylvania Superior Court held that "[a] bank acting as trustee violates its duty to the beneficiary or trust estate and the rule forbidding self-dealing where it purchases mortgages for the trust which it formerly held in its commercial department."⁵¹

The court reasoned that the self-dealing rule, which prohibits a trustee from purchasing his own property on behalf of the trust, is not limited to property which the trustee owns individually.⁵² A trustee's purchase of property from an entity in which he has substantial ownership or control will also contravene the rule against self-dealing.⁵³ The *Downing* court included within the ambit of "substantial interest" both proprietary rights less than full ownership, such as the interest of a mortgagee or pledgee in the pledged⁵⁴ or mortgaged property,⁵⁵ as well as a controlling or substantial interest of the trustee in the corporation which owned the property.⁵⁶ Moreover, the court opined that "[t]he question is not whether the trustee's substantial interest [in the property sold] did affect his judgment, but whether this interest is of such a substantial nature that it *might* affect his judgment."⁵⁷

⁴⁸ 57 A.2d 710 (Pa. Super. Ct. 1948).

⁴⁹ See *id.* at 711.

⁵⁰ See *id.* at 712.

⁵¹ *Id.*

⁵² See *id.*

⁵³ See *id.* See generally RESTATEMENT, *supra* note 3, §170(1) cmt. h (discussing the possibility that the judgment of the trustee would be clouded by self-dealing in individual property where the trustee has a substantial personal interest).

⁵⁴ See *Coster v. Crookham*, 468 N.W.2d 802, 807 (Iowa 1991) (holding that under Iowa statute prohibiting self-dealing, a pledge of collateral is a constructive sale of the collateral "even though no foreclosure occurred") (citing *Securities Investor Protection Corp. v. Vigman*, 803 F. 2d 1513, 1518 (9th Cir. 1986)).

⁵⁵ See *Downing*, 57 A.2d at 712.

⁵⁶ See *id.*; see also RESTATEMENT, *supra* note 3, § 170(1) cmt. h (contending a violation of duty when a trustee self-deals in property owned by a corporation where the trustee has a substantial interest).

⁵⁷ *Downing*, 57 A.2d at 713 (emphasis added). For an especially strident denunciation of this aspect of the self-dealing rule, see Louis C. Haggerty, *Conflicting Interests of Estate Fiduciaries in New York and the "No Further Inquiry" Rule*, 18 FORDHAM L. REV. 1, 4 (1949) ("[A] fiduciary who sells or buys from any relative by

Subsumed within this dialectic between the phrases "might affect" and "did affect" is the *ratio leges* of the rule against self-dealing by a trustee. The rule against self-dealing is a deterrent and prophylactic rule. Its application is not dependent upon the trustee's unjust enrichment,⁵⁸ nor will a trustee escape liability by contending that the self-serving transaction was carried out in good faith.⁵⁹ As stated, "[t]he principal object of the administration of the rule is preventative, to make the disobedience of the trustee to the rule so prejudicial to him that he and all other trustees will be induced to avoid disloyal transactions in the future."⁶⁰ Consequently, if a corporate trustee purchased for the trust shares of stock owned by the corporation's commercial department, it would contravene the self-dealing rule since "there would be a temptation to consider ... [the corporation's] advantage in making the [purchase] and not ... solely the ... [interests of] the beneficiaries"⁶¹ By engaging in such self-dealing, the corporate trustee places itself in a position wherein its interests were, or might be, in conflict with those of the beneficiary.⁶²

blood or marriage or any business associate is asking for trouble.").

⁵⁸ See GEORGE G. BOGERT & GEORGE T. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 543, at 247 (2d ed. 1993).

⁵⁹ See *id.*

⁶⁰ *Id.* at 246-47.

⁶¹ RESTATEMENT, *supra* note 3, § 170(1) cmt. i, illus. 3, at 368; see also UNIF. TRUSTS ACT § 7, 7B U.L.A. 778 (1985) (stating that "[n]o corporate trustee shall purchase for a trust shares of its own stock, or its bonds or other securities, or the stock, bonds or other securities of an affiliate").

⁶² See *In re Ryan's Will*, 52 N.E.2d 909, 922 (N.Y. 1943). The rule proscribing a corporate trustee's purchase of property owned by the corporation, and policy considerations in support of this rule are also applicable to transactions made by a corporate trustee with its affiliate or subsidiary. See RESTATEMENT, *supra* note 3, § 170(1) cmt. i, illus. 4 & 5. In *Ryan*, a trust company owned certain mortgages, and sought to invest trust funds in those mortgages by assigning the mortgages to an affiliate who would immediately reassign the mortgages back to the trust company as trustee, all as part of one transaction. *Ryan*, 52 N.E.2d at 915. There was no evidence that the affiliate ever had ownership of the mortgages. See *id.* at 922. The court held that the assignment and subsequent reassignment of the mortgage between the trust company and the affiliate on the same day as part of the same transaction, coupled with the fact that title to the mortgage was never transferred to the affiliate, constituted a self-dealing transaction made between the trust company *pro se* and the trust company as trustee. See *id.* Self-dealing by a trustee is absolutely proscribed to "avoid the possibility of fraud and to avoid the temptation of self-interest." *Id.* at 923. The court further held that this rule against self-dealing may not be circumvented by conducting transactions through an affiliate. See *id.*

A. *The Voidable Self-Dealing Transaction. What can a Beneficiary do?*

Having set forth the predominant variations of self-dealing transactions, a second question remains as to the effect of a trustee's self-dealing upon the underlying transaction.

1. The "No Further Inquiry" Rule.

Historically, courts had employed the "no further inquiry" rule to manifest their unequivocal condemnation⁶³ of a trustee's breach of loyalty. In *In re Kilmer's Will*,⁶⁴ the executors, in accordance with their powers set forth in the testator's will, offered certain estate premises for sale in order to finance the payment of taxes.⁶⁵ Though the executors had received a bid on the property, one of the executors attempted to solicit a different buyer and offered to match the purchase price if his new prospect did not materialize.⁶⁶ The executor's prospective buyer did not materialize, and the executor eventually purchased the estate property in his individual capacity.⁶⁷

In voiding the transaction as being a sale of property by the executors to "one of their own," the Surrogate observed that through the "no further inquiry" rule, the law implements a

⁶³ See Haggerty, *supra* note 57, at 19. The author argues against the implementation of the "no further inquiry" rule:

The "no further inquiry" rule is of a different character. The proclamation in the *Munson* case that the court will not inquire into considerations of abstract justice in a case involving a transaction between a fiduciary and himself is pietistic rather than morally sound A feeling of self-righteousness and a glow of self-satisfaction, not too far removed from smugness, are apt to accompany the denunciation of ill-advised conduct on the part of others

....

It is by its own nature, an acknowledgment of weakness, as it is based on the fear of an inability to determine the true rights of the parties involved. This fear of course, may have been justified in 1886 when the *Munson* opinion was written But today [1949], with all the books and records which must be kept and with all the powers of examination and of inspection which may be invoked [sic], neither the courts nor the parties are helpless There is no reason why the abstract justice of a case should not at least be inquired into ... when the good faith of a fiduciary is established.

Id.

⁶⁴ 61 N.Y.S.2d 51 (Sur. Ct. Broome County 1946).

⁶⁵ *Id.* at 53.

⁶⁶ See *id.* at 53-54.

⁶⁷ See *id.* at 54.

principle prohibiting fiduciary self-dealing by granting to the beneficiary the option to set aside any transfer by the fiduciary to himself.⁶⁸ The court reasoned that in such a case:

The law 'does not stop to inquire whether the contract of transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without undertaking to deal with the question of abstract justice in the particular case.'⁶⁹

The court went on to note that even though the "no further inquiry" rule invalidates self-dealing transactions at the beneficiary's option, the transaction itself is not void, but only voidable.⁷⁰ In addition, the beneficiary's right to set aside the transaction is subject to the equitable defenses of laches, ratification, and consent.⁷¹ Furthermore, the settlor's authorization of the otherwise proscribed self-dealing transaction can take the form of an express exculpatory clause in the trust instrument.⁷²

2. Liability Of Trustee To Beneficiary For Self-Dealing Transaction; Measure Of Damages

An aggrieved beneficiary is not only entitled to petition a court to avoid a self-dealing transaction, but may also move to have a trustee surcharged for any loss to the estate resulting from the self-dealing transaction. In *In re Tannenbaum's Will*,⁷³

⁶⁸ *Id.* at 55 (noting that injection of the fiduciary's self-interest is prevented by "granting to the party to whom the fiduciary duty is owed an approximately unqualified option to avoid any transfer by the fiduciary to himself").

⁶⁹ *Id.* at 56 (quoting *Wendt v. Fisher*, 154 N.E. 303, 304 (N.Y. 1926)).

⁷⁰ *Id.* at 57 (noting that even if the sale is voidable, it is only voidable upon the election of objecting respondents). In *In re Estate of Rothko*, 372 N.E.2d 291 (N.Y. 1977), the court of appeals differentiated between a void and voidable transaction:

Where a contract is voidable on both sides, [because of a trustee's self-dealing] ... the transaction is not wholly void, since in order to prevent the contract from having its normal operation the claim or defense must in some manner be asserted and also since the contract is capable of ratification, such a contract affects from the outset the legal relations of the parties.

Id. (citing 1 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 15, at 28-29 (Walter H.E. Jaeger, ed., 3d ed. 1959)).

⁷¹ See *Kilmer's Will*, 61 N.Y.S.2d at 57 (discussing circumstances where it would be inequitable to deem a sales transaction void).

⁷² See *infra* notes 82-83 and accompanying text.

⁷³ 219 N.Y.S.2d 149 (Sur. Ct. N.Y. County 1961), *modified sub nom.*, *In re Estate of Tannenbaum*, 248 N.Y.S.2d 749 (App. Div. 1964), *aff'd*, 205 N.E.2d 866 (N.Y. 1965).

the testator's will directed his executors, including his widow, to liquidate his clothing business as soon as practicable after testator's death.⁷⁴ Notwithstanding this provision of the will, the testator's widow and co-executrix of his estate continued the business in her individual capacity and also purchased shares in the business from the other executors.⁷⁵ The Surrogate held that the co-executrix widow's acquisition of the business and her purchase of the shares from the other co-executors were improper self-dealing and surcharged the executors for the value of the goodwill of the business and for the profits earned by the widow-executrix in continuing the testator's business.⁷⁶ The Surrogate reasoned that:

When certain action would be for the best interests of the estate, but possibly involve personal gain or technical conflict of interest, the fiduciary must not proceed without prior authority from the Court upon a proper showing. Good faith will not absolve him from the consequences of a violation of his duty The consequences [to the trustee] are that any resulting loss to the estate must fall upon his shoulders though his motives be innocent, and any profit derived from the action will inure to the benefit of the estate without any compensation for his fruitful efforts, subjecting him to surcharge in either case.⁷⁷

The guiding principle by which the court fixes damages in the event of a trustee's self-dealing transaction is "the rule that the beneficiaries are entitled to be put in the position which they would have occupied if no breach of duty had been committed."⁷⁸ Thus, a beneficiary has three alternative remedies against a self-dealing trustee. First, the trustee is charged with any loss to the trust estate. Second, the trustee is charged with any profit actually made by the trustee through the breach of trust. Third, the beneficiary may recover from the trustee any lost profits which would have accrued to the estate had there been no such breach of trust.⁷⁹

⁷⁴ See *id.* at 151 (noting that the will directed the executors "to liquidate, as soon as may be practicable after my demise, my business now ... or any other business of which I may be the individual owner at the time of my death").

⁷⁵ See *id.* at 154 (discussing the decision of the testator's widow to continue the business because of her determination that the business had no goodwill).

⁷⁶ See *id.* at 156.

⁷⁷ *Id.* at 153.

⁷⁸ *In re Estate of Rothko*, 379 N.Y.S.2d at 965. (citing 3 AUSTIN WAKEMAN SCOTT, *THE LAW OF TRUSTS* § 205 (3d ed. 1967)) [hereinafter SCOTT ON TRUSTS].

⁷⁹ See RESTATEMENT, *supra* note 3, §§ 205, 206; see also RESTATEMENT (THIRD)

Furthermore, if a self-dealing trustee has transferred trust property to a third person, a beneficiary has the right to follow, or "trace," the property into the hands of such third person, unless such third person is a bona fide purchaser.⁸⁰ Moreover, if the trustee has reinvested the trust proceeds into a new,

ON TRUSTS § 205 cmt. a (1992) (incorporating the provisions of the Prudent Investor Rule); see, e.g., *In re Estate of Janes*, 681 N.E.2d 332, 339 (N.Y. 1997) (noting that the "lost profits" or "market index" measure of damages is applicable to a case of "deliberate self-dealing and faithless transfers of trust property").

⁸⁰ See *Rothko*, 379 N.Y.S.2d at 965 (citation omitted). New York Estates, Powers and Trusts Law ("EPTL"), section 7-3.2 provides, in pertinent part:

7-3.2. Bona fide purchasers and creditors protected.

An express trust not declared in the disposition to the trustee or an implied or resulting trust does not defeat the title of a purchaser from the trustee for value and without notice of the trust, or the rights of a creditor who extended credit to the trustee in reliance upon his apparent ownership of the trust property.

N.Y. EST. POWERS & TRUSTS LAW § 7-3.2 (McKinney 1992); see also *Kirsch v. Tozier*, 38 N.E. 375, 376 (N.Y. 1894) (noting that in New York, a person dealing with a trustee needs to inquire as to the scope of the trustee's authority). If the instrument creating the transaction refers to the trust, and the transaction is ultra vires of the trust provisions, the transaction is void. See N.Y. EST. POWERS & TRUSTS LAW § 7-2.4 (McKinney 1992). Accordingly, a third party cannot be absolved of liability when it is dealing with a patently self-dealing trustee. See *In re Pepi*, N.Y. L.J., June 19, 1996, at 30 (Sur. Ct. Nassau County 1996) (holding that a credit company dealing with a trustee is chargeable with knowledge of all of the trust provisions including the duty to hold and manage the property for the benefit of the beneficiaries). If the trust instrument grants the trustee broad powers it still "cannot absolve a third party transacting business with ... [a blatantly self-dealing] trustee." *Id.* In such a case, where the bona fide purchaser rule is inapplicable because the transaction is void *ab initio*, the beneficiary's remedy should be tracing the property in kind. See *United States v. Dunn*, 268 U.S. 121, 132 (1925) (holding that a "beneficiary of a trust may ... follow the trust *res* fraudulently diverted until it reaches the hands of an innocent purchaser"). In contradiction to the EPTL's "objective" position regarding the duty of a third party to inquire as to the trustee's powers, section 7 of the Uniform Trustees' Powers Act has no such duty of inquiry. UNIF. TRUSTEES' POWERS ACT, § 7, 7B U.L.A. 758 provides, in pertinent part:

With respect to a third person dealing with a trustee or assisting a trustee in the conduct of a transaction, the existence of trust power and their proper exercise by the trustee may be assumed without inquiry. The third person is not bound to inquire whether the trustee has power to act or is properly exercising the power; and a third person, without actual knowledge that the trustee is exceeding his powers or improperly exercising them, is fully protected in dealing with the trustee as if the trustee possessed and properly exercised the powers he purports to exercise.

Id.

Clearly, the position of the Uniform Trustees' Powers Act is predicated solely on the subjective knowledge of the third party. If the Uniform Trustees' Powers Act subjective standard was to be applied to the facts of the *Pepi* case, the credit company could have been considered a bona fide lender because it did not have actual knowledge that the transaction involved a trustee's self-dealing.

“traceable” investment, the beneficiary has the option to follow such proceeds into the new investment or to hold the trustee personally liable for the proceeds.⁸¹

II. THE EXISTENCE AND VALIDITY OF EXCULPATORY CLAUSES

A. Construction of Exculpatory Clauses Permitting Self-Dealing

A settlor may specifically authorize a trustee's otherwise avoidable self-dealing transaction.⁸² This explicit authorization for self-dealing may be accomplished by careful drafting of a so-called exculpatory or exoneration clause. Whereas a court applying the “no further inquiry” rule will set aside a self-dealing transaction at the behest of the beneficiary—without weighing the merits or good faith of the individual transaction—an exculpatory clause will reduce the standard of a trustee's duty from utmost loyalty to good faith, thereby permitting a court to inquire into the propriety of the individual transaction.⁸³

In the case of *Renz v. Beeman*,⁸⁴ three members of the Pruyn family made an agreement in 1954 to create three inter vivos trusts in a single instrument.⁸⁵ Together, the three trusts held a majority of the 8,000 voting preferred shares of Finch-Pruyn, a closely held corporation.⁸⁶ The defendant, Mrs. Beeman, acted as co-trustee and beneficiary of the trusts together with her husband, who also served as president of Finch-Pruyn.⁸⁷ In 1958, a Finch family member died and bequeathed 2,000 shares of voting preferred and 6,300 shares of non-voting common stock of Finch-Pruyn to the Metropolitan Museum of Art in New York City.⁸⁸ The museum's agent contacted the president of Finch-Pruyn to negotiate a sale of the stock.⁸⁹ Thereafter, in 1962, the corpora-

⁸¹ See *Rothko*, 379 N.Y.S.2d at 965 (“If the fiduciary has invested the property or its proceeds into any other property into which it can be distinctly traced, the beneficiary also has an election, either to follow the same into the new investment, or to hold the fiduciary personally liable for the breach.”).

⁸² See RESTATEMENT *supra* note 3, § 170(1) cmt. a.

⁸³ See, e.g., *Renz v. Beeman*, 589 F.2d 735, 744-45 (2d Cir. 1978).

⁸⁴ *Id.*

⁸⁵ See *id.* at 741.

⁸⁶ See *id.* (noting that the new trust held “a majority of the outstanding shares.”) (emphasis omitted).

⁸⁷ See *id.* at 740-43.

⁸⁸ See *id.* at 741-42.

⁸⁹ See *id.* at 742 (noting that the district court characterized an exchange of a series of letters as the “initial steps toward negotiating the purchase of the ...

tion purchased the non-voting common stock and Mrs. Beeman purchased the 2,000 voting preferred shares individually, not adding them to the 1954 trusts.⁹⁰

In 1969, Mrs. Beeman created a trust with her brother and deposited into the trust 2,360 shares of voting preferred shares she held individually (including the 2,000 shares from the 1962 purchase) and her brother contributed 888.8 shares of voting preferred shares.⁹¹ Mrs. Beeman also agreed to exercise her testamentary power of appointment under the 1954 trust to transfer her beneficial interest in 777.8 shares of voting stock to the new trust.⁹² This act in effect shifted control from the 1954 trust to the new trust because the new trust then held a majority of the 8,000 voting shares of Finch-Pruyn.⁹³ A beneficiary of the 1954 trust sued to impose a constructive trust on the 2,000 voting shares purchased by Mrs. Beeman in her individual capacity, so as to restore the balance of ownership of the Finch-Pruyn stock in the 1954 trust.⁹⁴

The district court held, *inter alia*, that the purchase of stock by a co-trustee individually was within the discretion afforded to the trustees by the exculpatory language in the trust agreements.⁹⁵ Accordingly, in dismissing the beneficiary's complaint, the court applied a good faith standard to the trustee's purchase of the stock instead of the undivided duty of loyalty standard usually applied to self-dealing transactions.⁹⁶

The Second Circuit vacated the dismissal of the complaint, holding, in part, that the district court utilized the wrong standard to evaluate the trustees' self-dealing purchase of voting preferred shares.⁹⁷ The court examined the terms of the trust to ascertain whether the instrument authorized the self-dealing stock purchase.⁹⁸ The trust agreement was found to have granted wide managerial powers to the trustees, including powers "to vote the stock, to retain or sell trust property, to enter into various busi-

stock.'").

⁹⁰ See *id.*

⁹¹ See *id.* at 742-43.

⁹² See *id.* at 743.

⁹³ See *id.* at 743.

⁹⁴ See *id.* at 739 (holding that a good faith standard should be employed because of the exculpatory provision in the 1954 trust agreement).

⁹⁵ See *id.* at 743.

⁹⁶ See *id.* at 744.

⁹⁷ See *id.* at 745.

⁹⁸ See *id.* at 743-44.

ness arrangements with others ... and generally 'to do all such acts, take all such proceedings, and exercise all such rights and privileges ... as if [he were] the absolute owner thereof.'"⁹⁹ The exculpatory clause stated:

[T]he decision of the Trustees with respect to the exercise or non-exercise by them of any discretionary power hereunder, or the time or manner of the exercise thereof, made in good faith, shall fully protect them and shall be conclusive and binding upon all persons interested in the trust estate.¹⁰⁰

The Second Circuit observed that an exculpatory clause can reduce a trustee's duty of utmost loyalty to that of good faith, a standard which would enable a court to examine the merits of a particular transaction.¹⁰¹ Nevertheless, the court emphasized that an exculpatory provision must be drafted with explicit language in order to lower the standard, and that courts may not broadly construe the language "lest they unwittingly permit erosion of the fiduciary duty itself."¹⁰² Therefore, because there was no such provision in the trust agreement explicitly granting the trustees the right to engage in a self-interested transaction, the trustee was not protected by the exculpatory clause. Conse-

⁹⁹ *Id.* at 741 (quoting the trust agreement).

¹⁰⁰ *Id.* (quoting the exculpatory clause in the trust agreement).

¹⁰¹ See *id.* at 744-45; cf. *In re Estate of Rothko*, 372 N.E.2d 291, 295 (N.Y. 1977) (determining the proper legal standard in voiding an estate contract). In *Rothko*, the court rejected appellants' contention that the surrogate's court and the appellate division incorrectly applied the "no further inquiry" rule to a non-self-dealing transaction, and that the courts should have examined the fairness of the transaction to determine whether a breach of fiduciary duty occurred. *Id.* The court found that the appellate division and the Surrogate did not rely exclusively on the "no further inquiry" rule, and that there was "more than an adequate basis to conclude" that the transactions were unfair. See *id.* at 296. However, the court of appeals made no reference to the Surrogate's characterization of the Reis transactions as "equivalent to self-dealing." Hence, the court did not squarely address the question of whether the "no further inquiry" rule is applicable only to self-dealing transactions. Arguably, the court of appeals merely noted the utilization of both the "good faith" and "no further inquiry" standards in the lower courts' decisions, but made no attempt to identify the proscribed fiduciary conduct to which either standard might be applied.

¹⁰² *Renz*, 589 F.2d at 745; see *In re Will of Heidenreich*, 378 N.Y.S.2d 982, 985 (Sur. Ct. Nassau County 1976). In *Heidenreich*, the court held that the trust agreement specifically authorized trustees to engage in self-dealing transactions. *Id.* The court stated that as long as trustees did not act in bad faith—which they did not—they were absolved from liability with respect to the transaction. See *id.*; see also *Public Serv. Co. of Colorado v. Chase Manhattan Bank, N.A.*, 577 F. Supp. 92, 102 (S.D.N.Y. 1983) (stating that "[t]he [c]ourt will not strain the language of the [trust] agreement to find an exculpatory provision neither fairly implied by the language nor consistent with the relationship between the parties").

quently, the higher duty of undivided loyalty, and not the good faith standard, applied to the transaction,¹⁰³ and the trustee violated this higher duty when she purchased the stock individually rather than offering it for sale to the trust or its beneficiaries.¹⁰⁴

Similarly, in *In re Durston's Will*,¹⁰⁵ shares of the corporate trustee formed part of the testator's estate. The trustees retained these shares of their own trust company and purchased additional shares with estate funds.¹⁰⁶ The New York Court of Appeals held that such retention and purchase of the Syracuse Trust Company's own shares, without a clause in the will specifically authorizing such actions, constituted self-dealing.¹⁰⁷ The trustees' argument that an exculpatory clause in the will had authorized these transactions was rejected by the court:

We may not infer from broad grants of power "to hold, care for, manage and control" the trust estate; "to sell and convert into money any part or all thereof ..., to invest or reinvest the same, or portions thereof, in such interest bearing or income producing securities or property as to the said trustees, in the exercise of their discretion may seem best," that such authority was to be exercised without regard to the fundamental duties and loyalties imposed upon all trustees¹⁰⁸

If the testator had intended to authorize self-dealing transactions and thereby waive the undivided loyalty rule as applied to such fiduciary relationship, "the authority should have been stated."¹⁰⁹ The court further held that a power, however broad,

¹⁰³ See *Renz*, 589 F.2d at 745.

¹⁰⁴ See *id.* at 748. The court emphasized how the trustee, in her role as a fiduciary, should have put the interests of the trust ahead of her personal interests. See *id.* The court stated that "[a]n opportunity for purchase that comes to [her] while in a fiduciary capacity compels the trustee to give a right of first refusal to [her] trust estate if the opportunity fits the purpose of the trust." *Id.* at 746 (citing *Wootten v. Wootten*, 151 F.2d 147, 150 (10th Cir. 1945)).

¹⁰⁵ 74 N.E.2d 310 (N.Y. 1947).

¹⁰⁶ See *id.* at 312.

¹⁰⁷ See *id.* at 313.

¹⁰⁸ *Id.* Although broad discretionary powers were granted to the trustees in their administration of the trust, the clause did not explicitly grant authority to engage in transactions involving competing interests of the trust and the personal interests of the trustees. See *id.*; see also *Benedict v. Amaducci*, No. 92 Civ. 5239 (KMW) 1993 WL 87937, at *10 (S.D.N.Y. 1993) (stating that even if trustees granted broad discretionary powers in the administration of trusts, the rule of undivided loyalty is neither lessened nor abolished).

¹⁰⁹ *Durston's Will*, 74 N.E.2d at 313; see also *Kinney v. Lindgren*, 26 N.E.2d 471, 474 (Ill. 1940) (holding that officers of a trust company who were also trustees of the trust fund that originally held the shares of the trust company were not given ex-

that is conferred upon a trustee, must not be exercised in such a manner so as to violate the duty to the beneficiaries.¹¹⁰

Paralleling the decision of the New York courts, the Minnesota Supreme Court in *In re Anneke's Trust*¹¹¹ construed a trust instrument as not having explicitly authorized self-dealing by the trustee-bank.¹¹² During the administration of the Anneke trust, the trustee-bank purchased, with trust money, securities owned by its own trust department, which resulted in a profit to the bank.¹¹³ The court addressed the issue of whether in establishing the terms of the trust, the settlor had authorized the bank to purchase securities from itself.¹¹⁴

The relevant trust provision provided that the trustee "in case of an investment under the provisions hereof *in securities held by it*, shall be entitled to the regular commission or underwriting profits of its Bond Department on the sale of such securities."¹¹⁵ The trustee argued that the words "held by it" meant "owned by it" and that the section, when read together with the rest of the trust instrument, evinced an intent by the settlor to authorize the self-dealing transaction.¹¹⁶ The court held that it would not "read into the instrument, by implication, a waiver of a rule ... so well established and so strictly applied as ... [the rule] against self-dealing by a fiduciary."¹¹⁷ If the attorney-draftsman of the instrument had intended to authorize self-

press authority to purchase more shares of the trust company with funds, and therefore breached the fiduciary duty owed to the beneficiary); *In re Estate of McCredy*, 470 A.2d 585, 600-01 (Pa. Super. Ct. 1983) (holding that although the trustee engaged in self-dealing, the terms of the exoneration clause combined with testatrix's knowledge of the trustee's conflict of interest constituted a waiver of the application of the rule of undivided loyalty). In *Kinney*, because the trustee purchased trust company bonds at face value knowing that their actual value was substantially lower, the decision could also have been predicated upon the trustee's bad faith and not solely on the terms of the trust agreement. See *Ledbetter v. First State Bank and Trust Co.*, 85 F.3d 1537, 1544 (11th Cir. 1996) (stating that if a trustee is given authority to retain stock received from the trustor as investment in the trust, trustee must act in good faith and not abuse his discretion) (quoting SCOTT ON TRUSTS § 187, *supra* note 78).

¹¹⁰ See *Durston's*, 74 N.E.2d at 313 (citing *Carrier v. Carrier*, 123 N.E. 135, 139 (N.Y. 1919) and RESTATEMENT OF THE LAW OF TRUSTS § 186 cmt. f (1935)).

¹¹¹ 38 N.W.2d 177 (Minn. 1949).

¹¹² See *id.* at 183.

¹¹³ See *id.* at 179.

¹¹⁴ See *id.* at 179.

¹¹⁵ *Id.* at 180 (alteration in original) (quoting trust agreement).

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 183.

dealing, he would have done so in "clear and unmistakable language."¹¹⁸ Since there was no such clear and unmistakable language in the trust agreement, the court was compelled to "construe the contract strictly against a meaning that will read into the instrument, by implication, an intention to grant such authority."¹¹⁹

What is the "clear and unmistakable" language that the *Anneke* court required? A later Minnesota case, *In re Kemske*,¹²⁰ which cited and followed *Anneke*, seemed to illustrate the "clear and unmistakable" language necessary for a valid exoneration clause. In *Kemske*, the settlor created a trust initially funded with shares of stock in a mutual fund which had been administered by the trustee-bank's parent company.¹²¹ The trust was drafted by a Mr. Somsen, an attorney and friend of the settlor and also a director and shareholder in the parent company.¹²² At the trustee-bank's insistence, Somsen had inserted an exoneration clause relieving the trustee-bank from liability for self-dealing.¹²³ The settlor had invested in the mutual fund until his death.¹²⁴ Thereafter, the trustee-bank continued to invest trust funds in its parent company's mutual fund.¹²⁵

The beneficiaries of the trust petitioned the court to surcharge the trustee-bank for self-dealing.¹²⁶ The Minnesota Supreme Court, in affirming the district court's order denying the surcharges, held that the exoneration provision had authorized the trustee-bank to deal in the mutual fund shares of the parent company.¹²⁷ The court reasoned that a settlor may waive the law's protection against self-dealing in clear and unmistakable language and the exoneration provision was found to contain

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ 305 N.W.2d 755 (Minn. 1981).

¹²¹ *See id.* at 757-58.

¹²² *See id.*

¹²³ *See id.* at 758.

¹²⁴ *See id.* at 758.

¹²⁵ *See id.*

¹²⁶ *See id.* at 757.

¹²⁷ *See id.* at 760. The exoneration clause provided, *inter alia*, that:

Trustor is aware that trustee is presently owned by State Bond and Mortgage Company and power to invest in it or in stocks of corporations owned or managed by it or in which it may have any interest whatever is given expressly for the purpose of averting and waiving any prohibitions upon such investment which might exist in the absence of such power.

Id. at 758.

such language as required by the *Anneke* court.¹²⁸

Several problematic aspects to the *Kemske* decision seem to have been overlooked by the majority's decision. For example, a dissenting opinion argued that the exoneration clause did not go far enough in meeting the clear and unmistakable language standard articulated by the *Anneke* court. The minority would have required that:

[T]he trustee draft an instrument that clearly explains the nature and extent of the conflict and the financial benefit that may accrue to the trustee as a result of the conflict. In this case, it would have been possible, even by separate letter signed and acknowledged by the settlor, to identify briefly and clearly the potential conflicts, to give an indication of how the trustee would benefit from investments with affiliated entities, and to indicate the anticipated extent to which trust funds would be invested with affiliated entities.¹²⁹

In addition, neither the majority nor the dissenting opinions addressed the issue of the conduct of Mr. Somsen, Kemske's attorney. Somsen was the draftsman of the trust agreement, which incorporated an exoneration clause relieving the trustee-bank of liability for self-dealing.¹³⁰ This clause was inserted, at the co-trustee-bank's request, by an attorney who himself was encumbered by a conflict of interest. When Somsen accepted the attorney's fee for drafting the trust, he was Kemske's counsel and had a fiduciary duty to draft the trust in Kemske's best interest. However, Somsen inserted an exoneration clause that was in the best interest of the trustee-bank and parent corporation, of which Somsen was a director and shareholder. There was no indication in either the majority or dissenting opinions that Kemske was informed of the conflict, although Kemske signed the trust. Clearly, the attorney wore two hats in this transaction and violated the fiduciary duty that he owed to his client.¹³¹

¹²⁸ See *id.* at 760.

¹²⁹ *Id.* at 764 (Yetka, J., concurring in part, dissenting in part).

¹³⁰ See *id.* at 757.

¹³¹ See, e.g., N.Y. CODE OF PROFESSIONAL RESPONSIBILITY, EC 5-3 (McKinney Supp. 1997). Ethical Consideration 5-3 provides, in pertinent part:

EC 5-3. Even if the property interests of a lawyer do not presently interfere with the exercise of independent judgment, but the likelihood of interference can be reasonably foreseen by the lawyer, a lawyer should explain the situation to the client and should decline employment or withdraw unless the client consents to the continuance of the relationship after full disclo-

The minority's position in *Kemske* seems to provide a solution to the attorney's conflict of interest as well as the parent corporation's self-dealing. Perhaps, to apply the principle embodied in the minority's opinion, the settlor's attorney should have drafted, and had the settlor execute, a disclosure document analogous to that required by the New York Surrogate's Court Procedure Act, section 2307-a.¹³² Absent the disclosure requirements suggested by the minority position and as set forth in N.Y. S.C.P.A. 2307-a, the attorney in this case appears to have engaged in a more egregious and insidious act of self-dealing than that alleged to have been committed by the corporation itself. In fact, the Minnesota Supreme Court has disbarred attorneys who have engaged in self-dealing transactions while representing clients.¹³³

sure.

Id.

¹³² N.Y. SURR. CT. PROC. ACT § 2307-a (McKinney 1997). Section 2307-a of the Act provides, in pertinent part:

§2307-a. Commissions of an attorney-executor

1. Disclosure. When an attorney prepares a will to be proved in the courts of this state and such attorney or a then affiliated attorney is therein an executor-designee, the testator shall be informed prior to the execution of the will that:

(a) subject to limited statutory exceptions, any person, including an attorney, is eligible to serve as an executor;

(b) absent an agreement to the contrary, any person, including an attorney, who serves as an executor is entitled to receive an executor's statutory commissions; and

(c) if such attorney or an affiliated attorney renders legal services in connection with the executor's official duties, such attorney or a then affiliated attorney is entitled to receive just and reasonable compensation for such legal services, in addition to the executor's statutory commissions.

2. Testator's written acknowledgment of disclosure. An acknowledgment by the testator of the disclosure required by subdivision 1 of this section must be set forth in a writing executed by the testator in the presence of at least one witness other than the executor-designee. Such writing may be executed prior to, concurrently with or subsequently to a will in which an attorney or a then affiliated attorney is an executor-designee and must be filed in the proceeding for the issuance of letters testamentary to the executor-designee.

Id.

¹³³ See, e.g., *In re Perry*, 494 N.W.2d 290, 292 (Minn. 1992) (disbarring attorney for "failing to inform his [client] of the conflict of interest that resulted from acting as her fiduciary and trustee of the ... trust while appropriating substantial trust funds for his own benefit"); *In re Olson*, 358 N.W.2d 662, 663 (Minn. 1984) (disbarring attorney for self-dealing and conversion of assets, as well as other acts); *In re Franke*, 345 N.W.2d 224 (Minn. 1984) (disbarring attorney for, among other

III. GOOD FAITH EXERCISE OF POWER IN INSTRUMENT PERMITTING SELF-DEALING

Even if the trust instrument contains a clear, unmistakable, and explicit exculpatory clause granting the trustee power to self-deal, that power must be exercised in good faith. In *O'Hayer v. de St. Aubin*,¹³⁴ the trust instrument contained an express exculpatory clause authorizing the trustee to purchase stock from the trust corpus as well as explicitly exonerating the trustee from any liability for self-dealing.¹³⁵ The beneficiary sued the trustee's executors to set aside a sale of shares held by the trust to the trustee.¹³⁶ In affirming the judgment of the Westchester County Supreme Court, the Appellate Division, Second Department held that the language in the exoneration clause permitted self-dealing of the trust corpus by the trustee.¹³⁷ Nevertheless, the court recognized that the existence of an exoneration clause "[does not] say that the settlor's directions allow the trustee free rein to deal with the trust; the law interposes to require that the trustee always exercise good faith in his administration."¹³⁸ In support of this reasoning, the court cited section 222.3 of *Scott on Trusts*: "No matter how broad the [exoneration] provision may be, the trustee is liable if he commits a breach of trust in bad faith or intentionally or with reckless indifference to the interests of the beneficiaries, or if he has personally profited through a breach of trust."¹³⁹

Despite the court's ostensible reliance upon section 222.3 of *Scott on Trusts*, the court nonetheless held that "[t]he settlor in express language provided that the general rule prohibiting individual profit by the trustee should not apply"¹⁴⁰ The court predicated its holding upon section 170.9 of *Scott on Trusts*, which it cited approvingly in the very same paragraph where it had set forth section 222.3.¹⁴¹ It is submitted that the court erred in relying on section 222.3, which prohibits exoneration clauses

things, self-dealing and stating that the attorney "engaged in the most egregious conduct by drafting documents for his self-interest.").

¹³⁴ 293 N.Y.S.2d 147 (App. Div. 1968).

¹³⁵ See *id.* at 151, 158.

¹³⁶ See *id.* at 149.

¹³⁷ See *id.* at 151-52.

¹³⁸ *Id.* at 151.

¹³⁹ *Id.* (quoting SCOTT ON TRUSTS, *supra* note 78, § 222.3).

¹⁴⁰ *Id.*

¹⁴¹ See *id.*

authorizing self-dealing transactions, and instead should have relied exclusively upon section 170.9 of Scott's treatise, which sanctions clauses expressly permitting trustees to profit from self-dealing transactions.¹⁴² If the court did not err in its quoting of both sections of *Scott on Trusts*, then the court's holding is seemingly inconsistent with its reasoning. It is further submitted that sections 170.9 and 222.3 of *Scott on Trusts* are contradictory, since both sections provide opposing views of whether a settlor, by the terms of the trust, can explicitly authorize a trustee to profit from a self-dealing transaction.

A. Contradiction Between Restatement (Second) Of Trusts Sections 170 and 222

Arguably, the source of the problem regarding the propriety of an exoneration clause permitting self-dealing, and personal profiting by a trustee, is neither the *O'Hayer* decision, nor the two inconsistent sections of Scott on Trusts, but rather the text and comment of the Restatement (Second) of Trusts itself. The Restatement (Second) of Trusts, section 170(1), comment a, expressly provides that "as to matters within the scope of the [fiduciary] relation ... [a trustee] is under a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so by the terms of the trust"¹⁴³ Similarly, in comment t to section 170(1), the Restatement (Second) of Trusts expressly permits clauses authorizing self-dealing transactions:

t. Terms of the trust. By the terms of the trust the trustee may be permitted to sell trust property to himself individually, or as trustee to purchase property from himself individually, or to lend to himself money held by him in trust, or otherwise to deal with the trust property on his own account. The trustee violates his duty to the beneficiary, however, if he acts in bad faith, no matter how broad may be the provisions of the terms of the trust in conferring power upon him to deal with the trust property on his own account.¹⁴⁴

Notwithstanding the position set forth in section 170(1)

¹⁴² See SCOTT ON TRUSTS, *supra* note 78, § 170.9 ("By the terms of the trust the trustee may be permitted to do what in the absence of such a provision in the trust instrument would be a violation of his duty of loyalty.").

¹⁴³ RESTATEMENT, *supra* note 3, § 170(1) cmt. a.

¹⁴⁴ *Id.* §170(1) cmt. t.

authorizing clauses for self-dealing transactions, section 222(2) of the Restatement (Second) of Trusts, and comment b thereto, expressly proscribe exculpatory clauses:

§ 222. Exculpatory Provisions

(1) Except as stated in Subsections (2) and (3), the trustee, by provisions in the terms of the trust, can be relieved of liability for breach of trust.

(2) A provision in the trust instrument is not effective to relieve the trustee of liability for breach of trust committed in bad faith or intentionally or with reckless indifference to the interest of the beneficiary, or of liability for any profit which the trustee has derived from a breach of trust.¹⁴⁵

Comment b on Subsection (2), provides, in pertinent part:

b. Extent to which exculpatory provisions against public policy.

No provision in the terms of the trust is effective to relieve the trustee who derives a profit from a breach of trust from liability to the extent of the profit. Such provisions as these are invalid on the ground that it would be contrary to public policy to give effect to them.¹⁴⁶

It would seem that the correct rule of law is contained in section 170(1) comments a and t of the Restatement (Second) of Trusts, and that the rule incorporated in the contradictory section 222(2) and comment b reflects a position adopted by a minority of jurisdictions such as Texas,¹⁴⁷ which have incorporated

¹⁴⁵ See *id.* § 222(1), (2).

¹⁴⁶ RESTATEMENT, *supra* note 3, § 222(2) cmt. b; see also *id.* § 222(2) cmt. c. Comment c to section 222(2) of the Restatement provides, in pertinent part:

c. Distinction between exculpatory provisions and those limiting trustee's duties. If by the terms of the trust it is provided that the trustee shall not be under any duty to do or to refrain from doing an act which but for such provision it would be the duty of the trustee to do or refrain from doing, the trustee does not commit a breach of trust in doing or failing to do the act, unless such provision is ineffective as contrary to public policy. If, however, the trustee is not relieved of such a duty either because there is no provision to that effect in the terms of the trust or because such provision is ineffective as against public policy, a provision in the terms of the trust that the trustee shall not be liable for breach of trust is against public policy to the extent stated in Comment b.

As to the effect of the terms of the trust upon the standard of care and skill required of a trustee, see § 174, Comment d.

As to the effect of the terms of the trust upon the extent of discretion given to trustees in the exercise of powers conferred upon them, see § 187.

Id. (emphasis omitted).

¹⁴⁷ See TEX. PROP. CODE ANN. § 113.059 (West 1995) (prohibiting a trustor from

section 17 of the Uniform Trusts Act.¹⁴⁸ Despite the rationale posited for the rules contained in section 222, the two contradictory provisions of sections 170 and 222 still exist side by side. The contradiction was not addressed in *Scott on Trusts* (which itself contains the contradiction), *Bogert on Trusts and Trustees*,¹⁴⁹ or *O'Hayer*.

IV. RESOLVING THE CONTRADICTION: HEYMAN, TRIGGS, AND SELF-DEALING IN GOOD FAITH

Notwithstanding the Restatement's apparent internal contradiction regarding the propriety of exoneration clauses authorizing a trustee's self-dealing, courts may have resolved this contradiction by requiring trustees authorized to self-deal to do so in good faith. In the case of *Heyman v. Heyman*,¹⁵⁰ a husband and wife established a trust for the benefit of their infant son.¹⁵¹ A trust provision permitted the purchase or sale of securities by or for the trust through the trustee Heyman, or any corporation controlled by him.¹⁵² This provision authorized the trustee to deal with his own firm and make a profit.¹⁵³ The court held that an exoneration clause authorizing a trustee to self-deal and thereby earn a "normal profit" does not necessarily contradict the existence of a trust relationship.¹⁵⁴ However, a trustee's exercise of such power to self-deal would be subject to the principles of equity.¹⁵⁵ A "normal profit," according to the court, would constitute "such reasonable profit or commission as any

relieving a trustee from liability for self-dealing transactions); see also *Corpus Christi Nat'l Bank v. Gerdes*, 551 S.W.2d 521, 524 (Tex. Civ. App. 1977, writ ref'd n.r.e.) (holding that public policy prohibited only exculpatory clauses that authorized self-dealing; a trustee may otherwise be relieved of "duties, restrictions, and liabilities imposed by law").

¹⁴⁸ See J.D. Perovich, Annotation, *Validity and Construction of Trust Provision Authorizing Trustee to Purchase Trust Property*, 39 A.L.R.3d 836, 839 n.11 (1971); see also UNIF. TRUSTS ACT § 17, 7B U.L.A. 788 (1985). Section 17 provides, in pertinent part: "no act of the settlor shall relieve a trustee from the duties, restrictions, and liabilities imposed upon him by Sections 3, 4 and 5 of this Act." *Id.* Sections 3 and 4 of the Uniform Trusts Act prohibit loans made by a trustee to himself, with certain exceptions, whereas section 5 prohibits a trustee from selling trust property to himself. See *id.* at §§ 3-5.

¹⁴⁹ BOGERT & BOGERT, *supra* note 58.

¹⁵⁰ 33 N.Y.S.2d 235 (N.Y. Sup. Ct. 1942).

¹⁵¹ See *id.* at 237.

¹⁵² See *id.* at 240-41.

¹⁵³ See *id.* at 240.

¹⁵⁴ See *id.* at 241.

¹⁵⁵ See *id.*

banking or brokerage firm might make in dealing with a prudent trustee in the normal course of business.”¹⁵⁶

Accordingly, the court held that when a trust instrument, by its terms, relaxes the absolute rule proscribing self-dealing by a trustee and grants to the trustee power to deal with himself, in his individual capacity, this power must be exercised “in the best of faith and to evince the highest degree of disinterestedness, loyalty and honor.”¹⁵⁷ A court of equity will not give effect to exculpatory provisions permitting self-dealing so that a trustee could loot the corpus and revest it in himself.¹⁵⁸ The court reasoned that a trustee’s profiting to the extent of the entire trust corpus would transcend the justification of good faith, holding that “public policy ... will not permit gross negligence or bad faith in the administration of a trust.”¹⁵⁹

Although the court held that the trustee may earn reasonable profits in dealing with the trust securities, the trustee could not purchase assets from the trust at below market value.¹⁶⁰ Similarly, the trustee was prohibited from selling his own property to the trust at above its market value.¹⁶¹

The *Heyman* court thus “resolved” the contradiction between sections 170 and 222 of the Restatement (Second) of Trusts in a very simple manner. The provisions of section 222(2) were virtually grafted onto the provisions of section 170(1), so that exculpatory clauses for self-dealing transactions would be permitted, provided the self-dealing trustee did not exceed the boundaries of good faith. Essentially, the “no further inquiry” standard of undivided loyalty would, in the case of an exoneration clause specifically authorizing self-dealing, be replaced by a good faith standard as applied to each individual transaction.¹⁶²

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*; see also RESTATEMENT, *supra* note 3, §170(1) cmt. s (forbidding a trustee from disclosing privileged information to third parties).

¹⁵⁸ See *Heyman*, 33 N.Y.S.2d at 242.

¹⁵⁹ *Id.* at 243; see also RESTATEMENT, *supra* note 3, § 222(2) (making ineffective any provision relieving liability for breaches of trust “committed in bad faith, intentionally, or with reckless indifference to the interest of the beneficiary”).

¹⁶⁰ See *Heyman*, 33 N.Y.S.2d at 243.

¹⁶¹ See *id.*

¹⁶² See *Renz v. Beeman*, 589 F.2d 735, 744 (2d Cir. 1978) (recognizing that an exculpatory clause reduces a trustee’s duty from utmost loyalty to one of good faith); see also *Morris v. The Broadview, Inc.*, 65 N.E.2d 605, 609-10 (Ill. App. Ct. 1946) (upholding a trust provision granting a corporation’s trustee the right to participate in ownership, so long as such participation did not amount to an abuse of power).

A Massachusetts case, *New England Trust Co. v. Triggs*,¹⁶³ similarly intertwined sections 170 and 222 of the Restatement (Second) of Trusts. In *Triggs*, a trust company sold securities which comprised the corpus of a testamentary trust and deposited the proceeds of such sale into its own commercial department, pursuant to a statute which authorized such deposits.¹⁶⁴ The bank allowed the sale proceeds to remain uninvested pending distribution of such proceeds to the beneficiaries of the trust.¹⁶⁵ In addition, an exculpatory clause in the will provided that "[e]ach of my trustees ... shall be liable for his own receipts, payments and wilful defaults and for nothing else"¹⁶⁶

The Supreme Judicial Court of Massachusetts reversed the decree of the probate court and surcharged the trustees for the profits realized through the lending of the uninvested trust funds.¹⁶⁷ In reaching its decision, the court first noted that the Massachusetts statute specifically permitted a trust company to deposit trust funds into its own commercial department, provided appropriate security was deposited.¹⁶⁸ Notwithstanding this statutory authorization for a trustee-bank to self-deal, however, the court reasoned that the mere fact that a statute permitted a trustee-bank to deposit undistributed funds into its commercial department did not nullify the policy arguments supporting the contrary rule (prohibiting self-dealing by a trustee-bank).¹⁶⁹ A trustee-bank holding the uninvested funds in its commercial department might be "tempt[ed] to leave the money on deposit for an unnecessarily long time, since the bank is making a profit by lending the money at a greater rate of inter-

¹⁶³ 135 N.E.2d 541 (Mass. 1956).

¹⁶⁴ See *id.* at 547. The Massachusetts statute provided, in pertinent part: [F]unds held in the trust department of any trust company, whether or not incorporated as such, awaiting investment or distribution may be deposited in its commercial department if such corporation shall first transfer to its trust department to be held as security therefor bonds, notes, bills and certificates of indebtedness of the United States or of this commonwealth, or any of them, of an aggregate value of not less in amount than funds so deposited, and shall at all times maintain the value of such security at such amount.

Id. at 547 n.1 (quoting MASS. GEN. LAWS ANN. ch. 172, § 54A (West 1958) (current version at ch. 167G, § 8 (1994))).

¹⁶⁵ See *Triggs*, 135 N.E.2d at 544.

¹⁶⁶ *Id.* at 545.

¹⁶⁷ See *id.* at 551-52.

¹⁶⁸ See *id.* at 547.

¹⁶⁹ See *id.* at 548.

est than it pays on the account, if indeed any interest at all is paid on such accounts."¹⁷⁰

However, by surcharging the trustee-bank for the interest earned on the uninvested funds, the court did not ignore the provisions of the exoneration clause in determining the extent of the surcharge.¹⁷¹ While the court was not prepared, in the absence of express and clear exculpatory language, to allow the trustee-bank to retain the actual profits realized from its use of the trust funds, it declined to extend the surcharge to the principal and legal rate of interest in the event the trust sustained a loss.¹⁷² The court reasoned that the exoneration clause precluded the imposition of such liability upon the trustee-bank.¹⁷³

In the wake of *Triggs* several questions remain as to the scope of the rule against self-dealing transactions and the exoneration clauses which authorize such transactions. First, the court surcharged profits realized from an unreasonably long withholding from investment. While this "unreasonable withholding" standard might reconcile sections 170 and 222, the court failed to rule that unreasonable withholding could constitute "bad faith" for the purposes of section 222.¹⁷⁴ Furthermore, the court held that the language of the exculpatory clause did not "excuse the trustee from accounting for profits which accrue to it ... in the absence of express and clear language which would in effect make the trustee ... a beneficiary of the trust."¹⁷⁵ This holding implicitly contradicts section 222(2) of the Restatement (Second) of Trusts, which prohibits a self-dealing trustee from profiting from a breach of trust, even if an exoneration clause authorized such "breach of trust."¹⁷⁶ Conversely, this portion of the *Triggs* holding would be in implicit accord with section

¹⁷⁰ *Id.* (quoting SCOTT ON TRUSTS, *supra* note 78, § 170.18).

¹⁷¹ *See id.* at 551.

¹⁷² *See id.*

¹⁷³ *See id.*

¹⁷⁴ *Id.* at 548. The court concluded that:

there was not at any time conscious intent to have the bank profit through overlong withholding of cash from investment ... therefore, ... there was not either the bad faith or intentional and reckless indifference to the rights of beneficiaries which would be the basis for sustaining in the main, the surcharges imposed below.

Id.

¹⁷⁵ *Id.* at 551.

¹⁷⁶ RESTATEMENT, *supra* note 3, § 222(2).

170(1) of the Restatement (Second) of Trusts.¹⁷⁷ As such, *Triggs* arguably lies between the positions of Section 170(1) and 222(2) of the Restatement (Second) of Trusts. Unlike *Heyman*, section 222's good faith requirement was not simply grafted onto the permissive provisions of Restatement (Second) of Trusts section 170(1). Instead, the court's holding seems to borrow individual elements of sections 170(1) and 222(2).

A. Status of the Exoneration Clause Where a Statute Prohibits Self-Dealing Though Not Explicitly Invalidating Exoneration Clauses

What would be the effect of an exoneration clause in a trust instrument which specifically authorizes self-dealing if the governing statute itself prohibits self-dealing? In *In re Krause's Estate*,¹⁷⁸ a charitable trust instrument authorized the trustees to purchase at book value "all or any" of the capital stock of the Wolverine Tanning Corporation, a trust asset.¹⁷⁹ The probate court approved the subsequent purchase of over 47,000 shares by the trustees, and the circuit court dismissed the Attorney General's challenge to the transaction.¹⁸⁰ The Michigan Court of Appeals, in affirming the dismissal, held that a statutory prohibition against self-dealing¹⁸¹ is superseded by an exoneration clause authorizing such self-dealing because the statutory prohibition was merely a restatement of the common law rule against self-dealing.¹⁸² Accordingly, the trustees were permitted to purchase the shares at a profit.¹⁸³

On the other hand, the Ohio Court of Appeals adopted a dif-

¹⁷⁷ See *id.* § 170(1).

¹⁷⁸ 172 N.W.2d 468 (Mich. Ct. App. 1969).

¹⁷⁹ *Id.* at 469.

¹⁸⁰ See *id.* at 470.

¹⁸¹ The applicable statute provided that:

Except with the written approval of the probate court, a fiduciary in his personal capacity shall not engage in any transaction whatsoever with the estate which he represents, nor shall he invest estate funds in any company, corporation or association with which he is affiliated, other than as a bondholder or minority stockholder. A fiduciary in his personal capacity shall not personally derive any profit from the purchase, sale or transfer of any property of said estate.

Id. at 471 (quoting MICH. COMP. LAWS ANN. § 704.37 (1948) (current version at § 700.561 (West 1995))).

¹⁸² See *Krause*, 172 N.W.2d at 471-72.

¹⁸³ See *id.* at 473.

ferent position with regard to the interaction between the statutory proscription of self-dealing and trust provisions authorizing such self-dealing. In *Walters v. Wannemacher*,¹⁸⁴ the testator provided in his will that the nominated executor, testator's tenant and personal friend, would be granted a right to purchase, in his individual capacity, a certain tract of land from the estate.¹⁸⁵ The governing Ohio statute which regulated fiduciary self-dealing provided that:

[f]iduciaries shall not buy from or sell to themselves nor shall they in their individual capacities have any dealings with the estate, except as expressly authorized by the instrument creating the trust and then only to the extent expressly permitted ... by [statute] or with the approval of the probate court in each instance.¹⁸⁶

The Ohio Court of Appeals held that statutory prohibition of self-dealing is expressive of the common law, and any self-dealing made contrary to the statutory exception is at least voidable.¹⁸⁷ Accordingly, the court held that as long as the beneficiary of a right to purchase estate property is an executor, regardless of the will's provision regarding price or the formula to determine such a price, self-dealing purchases by executors will require court approval.¹⁸⁸

B. The Status of an Exoneration Clause Where the Statute Prohibits Both Self-Dealing and Exoneration Clauses Permitting Self-Dealing

If a statute established both a prohibition against self-dealing and a prohibition against exoneration clauses authorizing self-dealing, then exoneration clauses authorizing such self-dealing would be held ineffective as against public policy. This is

¹⁸⁴ 217 N.E.2d 695 (Ohio Ct. App. 1964).

¹⁸⁵ See *id.* at 696.

¹⁸⁶ OHIO REV. CODE ANN. § 2109.44 (Anderson 1994).

¹⁸⁷ See *Walters*, 217 N.E.2d at 698-99 (citing *Magee v. Troutwine*, 143 N.E.2d 581 (Ohio 1957)).

¹⁸⁸ See *id.* at 698. But see *Huntington Nat'l Bank v. Wolfe*, 651 N.E.2d 458 (Ohio Ct. App. 1994), wherein the court noted that "R.C. 2109.44, which prohibits self-dealing, makes an exception with respect to an individual fiduciary acting in his individual capacity if expressly authorized by the instrument creating the trust." *Id.* at 466-67. The court's dictum, which purportedly interpreted R.S. 2109.44, ignored the requirement of probate court approval. See *id.* Hence, the case arguably should not constitute authority for the ostensible proposition that Ohio relaxed its rule regarding the propriety of exoneration clauses permitting fiduciary self-dealing.

the rule in jurisdictions such as Texas¹⁸⁹ and Oklahoma,¹⁹⁰ which have adopted the provisions of section 17 of the Uniform Trusts Act: "[n]o act of the settlor shall relieve a trustee from the duties, restrictions, and liabilities imposed upon him by Sections 3, 4 and 5 of this Act."¹⁹¹

The case of *Interfirst Bank Dallas, N.A. v. Risser*¹⁹² demonstrates how a Texas court, even in the face of a statute proscribing self-dealing, fused the concepts of self-dealing and good faith while analyzing a given transaction. In *Interfirst Bank*, a testator set up two testamentary trusts wherein the nominated trustees were the testator's brother and Interfirst Bank.¹⁹³ Pursuant to the provisions of the will, 968.5 shares of Southwest Pump Company stock were to be split between the two trusts.¹⁹⁴ Following the death of the testator's brother, Interfirst Bank became the sole trustee.¹⁹⁵

Interfirst Bank in its capacity as trustee sold the 968.5 shares back to Southwest Pump Company for \$500,000,¹⁹⁶ which the jury found to be equal to one-third of the fair market value.¹⁹⁷ Without notifying the trust beneficiaries, Interfirst Bank sold the shares without making an attempt to solicit higher offers for the purchase of the shares or to arrange for competitive bidding.¹⁹⁸ In addition, Interfirst Bank had a long-standing banking

¹⁸⁹ See TEX. PROP. CODE ANN. § 113.059(b) (West 1995) (providing that "[a] settlor may not relieve a corporate trustee from the duties, restrictions, or liabilities of Section 113.052 [prohibiting trustee from loaning trust funds to himself] or [Section] 113.053 [prohibiting the purchase or sale of trust property by trustee to himself] of this Act."). The prohibition on the use of exoneration clauses extends to all trustees. See *id.*; see also *Langford v. Shamburger*, 417 S.W.2d 438, 444 (Tex. Civ. App. 1967) (holding that it would be contrary to public policy to permit the language of a trust instrument to authorize self-dealing by a trustee).

¹⁹⁰ See OKLA. STAT. ANN. tit. 60, § 175.21 (West 1994), which provides that "no act of the trustor shall relieve a corporate trustee from the duties, restrictions, and liabilities imposed upon it by Sections 9 [prohibiting a trustee from lending trust funds to itself], 10, and 11 [prohibiting a trustee from buying or selling trust property to himself] of this act."

¹⁹¹ UNIF. TRUSTS ACT § 17, 7B U.L.A. 787, 788 (1985). Section 3 of the Act prohibits a trustee from lending trust funds to itself. *Id.* § 3, at 771. Section 5 prohibits a trustee from buying or selling trust property from or to itself. *Id.* § 5, at 774.

¹⁹² 739 S.W.2d 882 (Tex. App. 1987).

¹⁹³ See *id.* at 886.

¹⁹⁴ See *id.*

¹⁹⁵ See *id.* at 886-87.

¹⁹⁶ See *id.* at 887.

¹⁹⁷ See *id.*

¹⁹⁸ See *id.* at 891.

relationship with Southwest which, at the time, included outstanding loans.¹⁹⁹ Interfirst Bank had also served as trustee for the company's deferred compensation plan.²⁰⁰ Furthermore, a loan officer of Interfirst Bank testified that the bank was interested in maintaining the then-existing management structure of Southwest as well as ensuring that its loans would be repaid.²⁰¹ The sale of the stock to Southwest allowed the company to resell it to its controlling shareholder,²⁰² a transaction which in fact secured the continued existence of the current management.²⁰³ Finally, incorporated within the trust instrument was a section providing that "[t]he Trustee shall never be liable for any action or any failure to act hereunder in the absence of proof of bad faith."²⁰⁴

The Texas Court of Appeals affirmed a lower court decision and held that Interfirst Bank had breached its fiduciary duty to the beneficiaries through self-dealing in the sale of the stock to Southwest Pump Company.²⁰⁵ The court noted that in Texas, a trust instrument may, in fact, relieve a trustee of certain duties and obligations.²⁰⁶ However, the language of such a trust agreement may not authorize self-dealing, as it is violative of Texas public policy.²⁰⁷ Likewise, the court observed that an exculpatory provision cannot "relieve the trustee of liability for action taken in bad faith or for acting intentionally adverse or with reckless indifference to the interests of the beneficiary."²⁰⁸

The trustee's duty of loyalty requires that it seek the best price for the trust property and secure competitive bidding to sell such property at the greatest advantage to the trust.²⁰⁹ The court noted that a trustee's sale of trust property for a price slightly

¹⁹⁹ See *id.* at 904.

²⁰⁰ See *id.* at 896.

²⁰¹ See *id.*

²⁰² See *id.* at 887.

²⁰³ See *id.* at 896.

²⁰⁴ *Id.* at 888 (quoting the trust instrument).

²⁰⁵ See *id.* at 905 (explaining that the lack of effort to obtain the best price for the stock, the failure to notify the beneficiaries of the sale and to get an outside appraisal, combined with Interfirst's own interest as a lender to Southwest, established ample evidence of self-dealing).

²⁰⁶ See *id.* at 888; see also TEX. REV. CIV. STAT. ANN. art. 7425b-22 (repealed 1984), TEX. PROP. CODE ANN. § 113.059 (West 1995).

²⁰⁷ See *Interfirst Bank*, 739 S.W.2d at 888 (citing *Langford v. Shamburger*, 417 S.W.2d 438 (Tex. Civ. App. 1967)).

²⁰⁸ *Id.* (citing RESTATEMENT, *supra* note 3, § 222(2)).

²⁰⁹ See *id.* at 891 (citing BOGERT & BOGERT, *supra* note 58, §749).

less than the fair market value would not, in and of itself, constitute self-dealing.²¹⁰ However, the court reasoned that an excessive variation between market value and sales price is some evidence of bad faith.²¹¹ The *Interfirst* jury found that the sale was made at one-third the fair market value and done without publicizing the sale, soliciting offers, or obtaining an appraisal.²¹² The court held that these three factors, when considered in the aggregate, constituted evidence of bad faith and self-dealing.²¹³ Furthermore, the court noted that the sale of stock to the Company was done to enable it to repay its loans to Interfirst Bank and ensure that the corporate management structure remained intact.²¹⁴ Therefore, the court found that trustee-bank's reason for the sale constituted a self-serving motive, and held that the sale was a self-dealing transaction.²¹⁵ As a result, the court removed Interfirst Bank as trustee, ordered it to account for the difference between the sale price and the fair market value of the stock at the time of the sale, and ordered it to pay other exemplary damages.²¹⁶

In *Interfirst Bank*, the Texas Court of Appeals admittedly expanded the definition of "self-dealing" beyond that provided for in the Texas Property Code.²¹⁷ Whereas the Code prohibited a transaction by a trustee to itself or to a corporate entity controlled by such trustee,²¹⁸ the *Interfirst Bank* court set forth its

²¹⁰ See *id.* at 895.

²¹¹ See *id.* at 905. "The price of one-third of the market value is a fact from which inferences of bad faith and self-dealing can be drawn." *Id.*

²¹² See *id.*

²¹³ See *id.*

²¹⁴ See *id.*

²¹⁵ See *id.* "[T]he jury had a basis from which to conclude that the trustee acquired a gain by reason of its trusteeship. Under these circumstances, we find sufficient evidence ... to uphold the jury's finding on both bad faith and self-dealing." *Id.*

²¹⁶ See *id.* at 909.

²¹⁷ *Id.* at 899

²¹⁸ See TEX. PROP. CODE ANN. § 113.053 (West 1995). Section 113.053 provides, in pertinent part:

§ 113.053. Purchase or Sale of Trust Property by Trustee (a) Except as provided ... a trustee shall not directly or indirectly buy or sell trust property from or to:

- (1) the trustee or an affiliate;
- (2) a director, officer, or employee of the trustee or an affiliate;
- (3) a relative of the trustee; or
- (4) the trustee's employer, partner, or other business associate.

Id.; see also TEX. PROP. CODE ANN. § 113.052 (West 1995) (providing that a trustee may not lend trust funds to a trustee or an affiliate).

own definition that "any conduct by the trustee which violates fiduciary duty by taking advantage of the trustee's position as trustee to benefit the trustee or some third person which the trustee desires to be benefited, can constitute self-dealing."²¹⁹

The transaction made by the trustee-bank in *Interfirst Bank* was admittedly not to itself or to a corporation controlled by it.²²⁰ The court refused to categorize the transaction between Interfirst Bank and Southwest Pump as one between "business associates," which categorization would have triggered the self-dealing statute.²²¹ The court pointed out that if Interfirst Bank was not in a position to gain an advantage for itself as a lender an improper motive could not be inferred. But because it was in such position, and it did not make a diligent effort to obtain the best price possible for the shares, these factors supported a finding of bad faith *and* self-dealing.²²² Arguably, the transactions between Interfirst Bank and Southwest did have an improper motive, which the court noted as an essential element of bad faith. However, the court need not have engaged in an expansive definition of self-dealing as it could have held that the Interfirst transaction would be set aside because of bad faith alone, since self-dealing *strictu sensu* was admittedly not established.²²³

CONCLUSION

The rule prohibiting self-dealing by a fiduciary has been invoked to avoid a myriad of transactions made between trusts and trustees as individuals or corporate entities over which trustees enjoy substantial influence. The purpose of the self-dealing rule is to ensure compliance with a trustee's "punctilio of an honor the most sensitive."²²⁴ As one English court pointedly observed,

²¹⁹ *Interfirst Bank*, 739 S.W.2d at 899.

²²⁰ *See id.* at 900.

²²¹ *See id.* at 896. The court interpreted the term business associate as including "a relationship which is generally confidential in nature, ... it should be more than just a party with whom a contract is made and more than just a relationship of a business to a customer. An example of a business associate includable under the act is a joint venturer." *Id.*

²²² *See id.* at 905.

²²³ *See id.* at 899 (concluding that "there was no statutory self-dealing"); *cf. In re Estate of Rothko*, 379 N.Y.S.2d 923, 940 (Sur. Ct. 1975) (using a more expansive definition of self-dealing), *modified on other grounds*, 392 N.Y.S.2d 870 (App. Div.), *aff'd*, 372 N.E.2d 291 (N.Y. 1977).

²²⁴ *Meinhard v. Salmon*, 164 N.E. 545 546 (N.Y. 1928).

"the shepherd must not become a wolf."²²⁵

In most non-Uniform Trust Act jurisdictions, exoneration clauses have been employed to circumvent the harshness of the "no further inquiry" rule's *a priori* avoidance of the self-dealing transaction. These clauses, however, must be sufficiently explicit to enable a court to elicit the settlor's clear intent to exculpate a self-dealing trustee; a mere grant of wide managerial authority in the trust instrument will not suffice.

In its zeal to prevent a self-dealing trustee from becoming a virtual self-aggrandizing wolf by the exploitation of generous exoneration clauses, the Restatement (Second) of Trusts sets forth standards according to which a trustee could *never* profit from a self-dealing transaction. Unfortunately, the standards dealing with exoneration clauses contradict those which expressly sanction trust provisions allowing self-dealing transactions and the concomitant profit inuring to the trustee. As this Article has discussed, both the *Heyman* and *Triggs* decisions provide possible solutions to the contradiction.

The Restatement (Third) of Trusts should squarely address the contradiction between sections 170 and 222 of the Restatement (Second) of Trusts, either by adopting the majority approach of section 170(1) or by incorporating the Texas-UTA approach embodied in section 222(2). If the Restatement (Third) of Trusts fails to adopt a clear position regarding the contradiction, the *Heyman* court's "self-dealing in good faith" approach should be adopted, as that solution is arguably closest to effectively resolving the problem.

Additionally, should an attorney-draftsman of a trust be both counsel for the settlor and a director of the corporate trustee, and should the corporate trustee request the attorney to insert into the trust an exoneration clause permitting self-dealing, a written disclosure form should be executed by the attorney and the settlor which would set forth the various roles the attorney would be fulfilling, the conflicts inherent in the simultaneous "wearing of many hats," and the plain meaning of the exoneration clause at issue.

Exoneration clauses have at times conflicted with express statutory prohibitions of self-dealing. Most jurisdictions allow probate courts to give advance authorization to otherwise pro-

²²⁵ *Tito v. Waddell* (No 2), [1977] Ch. 106, 241 (Eng.).

scribed self-dealing transactions.²²⁶ Nevertheless, the courts are divided as to whether or not the statutes prohibiting self-dealing are merely declarative of the common law so as to permit exoneration clauses authorizing self-dealing transactions.

The Texas-UTA approach to the self-dealing transaction and exoneration clauses is seemingly clear-cut. The Texas-UTA approach, echoing Restatement (Second) of Trusts section 222(2), defines the self-dealing transaction in a statute which proscribes self-dealing in any form. Accordingly, any exoneration clause which purported to permit such statutory self-dealing transactions would be struck down as violative of public policy. The Texas-UTA approach is concededly the minority approach with respect to the propriety of exoneration clauses permitting self-dealing and ostensibly seems to be an express safeguard against the existence of self-dealing transactions. Yet, the approach's weakness lies in its very specificity. Whereas those self-dealing transactions which are specifically set forth in the Texas statute will be struck down as violative of public policy, other transactions, whose categorization is not as obvious as that of a trustee selling trust property to himself, will not be struck down as statutory self-dealing.

The case of *Interfirst Bank* shows how a court can give an expansive interpretation to the term self-dealing and by so doing, render the term superfluous and meaningless. *Interfirst* involved a stock transaction which did not constitute "statutory" self-dealing; as such, the court could not have invalidated the transaction and the exoneration clause permitting such a transaction as violative of the express statutory proscription against exoneration clauses permitting self-dealing. Instead, the court examined whether the transaction itself was undertaken in good faith, concluded that (non-statutory) self-dealing was bad faith as a matter of law, and invalidated the transaction as one undertaken in bad faith. Thus, the court transcended the draconian Texas-UTA prohibition of statutory self-dealing and transformed the analysis of non-statutory self-dealing into a befuddled good-faith analysis as opposed to a self-dealing analysis.

From a policy standpoint, the question is whether upholding the express terms of a trust and the concomitant wishes of the settlor/testator is preferable and "more efficient" in terms of ju-

²²⁶ See *In re Estate of Rothko*, 379 N.Y.S.2d at 938.

dicial resources than upholding and enforcing a statute prohibiting self-dealing. While a superficial examination might lead the unsuspecting jurist to prefer a blanket prohibition against both self-dealing and exoneration clauses permitting such transactions, a more thorough examination of the *Heyman* and *Triggs* cases, on the one hand, and the *Interfirst Bank* case, on the other hand, conclusively demonstrates that the upholding of the express terms of the trust, tempered by the superimposed general principles of equity applicable to all fiduciaries, more effectively conserves judicial resources and is thus the more "efficient" approach. Conversely, it is the *Interfirst Bank* case and its "statutory" approach which wastes judicial resources by forcing courts to address the fairness of "non-statutory" self-dealing transactions.

It is submitted that the *Heyman*-Restatement section 170 approach of grafting a good faith requirement onto the exoneration clause permitting a trustee to personally profit from self-dealing, is preferable to the statutory self-dealing position espoused by Texas and the UTA. The *Heyman* approach would thus uphold the settlor's intent set forth in the terms of the trust, while subjecting the trust provisions to the superimposed equitable principles of good faith and fiduciary integrity, so as not to allow the trustee-shepherd to degenerate into a self-aggrandizing wolf.