

February 2002
Question 4

Richard, a resident of California, created a revocable, inter vivos trust in 1998 at the urging of his wife, Alicia, who was also his attorney. Alicia drafted the trust instrument.

Richard conveyed all of his separate property to the trust. The trust instrument named Alicia as trustee with full authority to manage the trust and invest its assets. By the terms of the trust, Richard was to receive all of the income during his life. Upon his death, his child by a former marriage, Brian, and Alicia's daughter by a former marriage, Celia, would receive for their lives whatever amounts the trustee in her discretion thought appropriate, whether from income or principal. Whatever remained of the principal on the death of the last income beneficiary was to be divided equally among the then-living heirs of Brian and Celia. Celia was included as a trust beneficiary only after Alicia convinced Richard that this was necessary to avoid a possible legal action by Celia, although Alicia knew there was no legal basis for any claim by Celia.

Celia had lived with Alicia and Richard from her 10th birthday until she graduated from college at age 21 in 1990. Although Richard had once expressed an interest in adopting her, he was unable to do so because her natural father refused to consent. After Celia's college graduation, however, she rarely communicated with either Richard or Alicia.

After creation of the trust, and while Richard was still alive, Alicia invested one-half of the trust assets in a newly-formed genetic engineering company, Genco. She lent the other one-half of the trust's assets at the prevailing market rate of interest to the law firm of which she was a partner.

Richard died in 2000, survived by Alicia, Brian and Celia. Brian, upset with the way Alicia has handled the trust assets, seeks to have the trust declared invalid or, in the alternative, to have Alicia removed as trustee and require her to indemnify the trust for any losses.

1. What grounds, if any, under California law can Brian assert for invalidating the trust, and what is the likelihood Brian will succeed? Discuss.

2. What grounds, if any, under California law can Brian assert for removing Alicia as trustee and requiring her to indemnify the trust, and what is the likelihood Brian will succeed? Discuss.

3. As an attorney, independent of her capacity as trustee, has Alicia violated any rules of professional responsibility? Discuss.

ANSWER A TO ESSAY QUESTION 4

Part 1. Grounds Under California Law Which Brian ("B") Can Assert for Invalidating the Trust and Likelihood of Success

The issue is whether B can assert that the trust created by Richard ("R") pursuant to California law suffered legal defects in its creation so as to invalidate the trust. In order for a trust to be validly created, the settlor must deliver trust assets (res) to a Trustee for the benefit of certain beneficiaries for a valid legal purpose. According to the facts a trust instrument was executed, which satisfies any statute of fraud issues, whereby R, the Settlor, conveyed its separate property to the trust. Thus, the res requirement has been met. A California court will not invalidate a trust for lack of a trustee, but where there is only one trustee and such trustee is also the only beneficiary. Here, R named Alicia ("A") as Trustee, and the beneficiaries are initially, R, then B and Cecilia ("C"), and then others. The last legal hurdle is that the trust must have a valid legal purpose. In the instant case, the purpose is valid, since it does not restrict actions frowned upon by the law, such as prohibition of marriage.

According to the facts, R's trust was validly created. B's best argument for invalidating the trust is that R lacked the testamentary capacity and intent to create the trust because of (1) undue influence and (2) fraud. B is likely to succeed on this basis. With respect to undue influence, B will point to extrinsic evidence that A, an attorney, drafted the trust instrument and urged R to create the trust. Pursuant to common law, beneficiaries of a trust or will is (sic) prohibited from drafting the trust, unless they are related and live in the same house. This exception is met, since A is R's wife and lives with R, though A should have sought outside counsel to review the instrument. For B to succeed on a claim of undue influence, B would have to show that but for a strong

influence, R would not have entered into a trust and made the specific distributions outlined therein. Given the facts, it would be difficult for B to succeed in proving undue influence.

B's other cause of action, which is much stronger, is fraud in creation of the trust. For a claim of fraud, B would have to prove that A intentionally made a misrepresentation of fact to induce R to enter into the trust, and that R relied on such representations. These requirements are met in this case. The facts show that C was included as a trust beneficiary only after A convinced R that this was necessary to avoid a possible legal action by C, although A knew there was no legal basis for such a claim. A clearly misrepresented law and had the necessary scienter to induce R to include C, a stepdaughter that (sic) was not formally adopted or acknowledged as a daughter by R, as a beneficiary to the trust. Because the requirements for fraud are met, B would likely succeed in invalidating the trust or at least the provision in the trust benefiting C.

Part 2. Grounds under California Law B can assert for removing Alicia ("A") as Trustee and Requiring A to indemnify the Trust; and Its Likelihood of Success

A's powers as a trustee can be expressly granted in the trust instrument or implied. In addition, A as the trustee has fiduciary duties, mainly a duty of care and a duty of loyalty. Because the trust does not specifically discuss A's powers, we must look to A's duties of care and loyalty. A's duty of care, which has been described as the prudent investor rule, requires that A exercise the degree of care, skill and prudence of a reasonable investor investing his or her own property. The prudent investor rule requires the trustee to, among other things, diversify trust assets and avoid risky investments while keeping the income production potential of the trust.

In the present case, A violated her duty of care to R and the other beneficiaries, including R. A invested 50% of trust assets in a newly-formed genetic engineering company, Genco, and the other 50% in the form of debt at the prevailing market rate of interest to the law firm of which she was partner. Both of these investment decisions are not decisions that prudent investor would decide upon. First, A did not diversify the trust's assets as exemplified by the 50% and 50% investments. Second, the investment in a (sic) Genco a newly-formed company without publicly disclosed operating results for a period of time is a very risky investment. Most financial institutions and prudent investors would advise investors to avoid shares of new companies because they lack operating results and many years of public reporting of financial results. A violated this basic rule in investing 50% of the corpus into a newly-formed genetic engineering company. The facts do not indicate that Genco is a public company, which compounds the riskiness of this investment since private companies are not subject to many of the accounting and financial restrictions and disclosures that are intended to protect investors. Lastly, A invested the remaining 50% of the funds as debt to a law firm at prevailing interest rates. All things equal, this investment is more risky than placing the funds at a bank which is generating the same amount of interest. If the latter option is available, A also breached A's duty of care by not investing R's separate property into a less risky investment.

B can also claim that A violated her duty of loyalty. The duty of loyalty requires that the Trustee has undivided loyalty to the trust and may not enter into transactions with the trust that will detriment the beneficiaries. In the instant case, A made a loan of trust assets to the law firm where A is a partner. As discussed in the previous paragraph, this is to the detriment of the beneficiaries since safer investments and possible more profitable investments existed.

Because A violated her duties of care and loyalty, B has a strong claim for removing A as trustee and requiring her to indemnify the trust. Where a trustee has violated these duties, not only may the trustee be removed, the beneficiaries can see (1) to ratify the transactions made by the trustee, (2) impose a surcharge on the trustee (i.e., indemnify the beneficiaries for losses) or (3) trace trust assets and recover such asset. Because we do not know the results of A's investments in Genco and in the loan to her law firm, we cannot recommend a specific course of action to B; however, since B seeks to have A indemnify the trust for losses, B will clearly have such option at his disposal. In addition, the court will not hesitate to remove A as trustee for lack of another trustee specified in the trust instrument, since the Court has power to appoint another trustee.

Part 3. Possible Violations by A of the Rules of Professional Responsibility

As an attorney, independent of her capacity as trustee, A has violated many rules of professional responsibility. First, A has a duty of loyalty to R, which means that A should act in the best interest of R, her client, and her own personal interests should not adversely affect her representation. If such personal or other interest affects her representation, A can only represent R if she reasonably believes that her personal and possible conflicts of interest will not adversely affect her representation of R and R is advised of the situation with consultation and consents. Pursuant to California Law, such consent should be written. According to the facts of this case, A had a potential conflict, since A was named a trustee and A's daughter was a beneficiary. This was not a potential conflict, but an actual conflict. In addition, A did not seek R's consent or advise him of the conflict. In fact, A was well aware of the conflict and intentionally lied to R so that R would include C as a beneficiary and continued to draft the trust instrument. When

apprised of such a conflict, A should have withdrawn or asked R to seek another attorney for representation (or at least an outside attorney's opinion on the trust instrument). Because of this conflict of interest, A has violated her duty of loyalty to R.

A also violated her duty of competence. A lawyer should have the legal knowledge, skill, preparedness and thoroughness necessary to protect his or her client's interest. In this case, A did not possess such knowledge as reflected by her advice to R. A should have withdrawn as R's attorney given the conflict of interest and not have advised R as to the legal consequences of not including C.

Lastly, A committed misconduct since A has duty not to lie and defraud clients. As an officer of the court, A should not have intentionally abused her role [as] a lawyer to R by telling him that it was necessary to include C in the trust. This intentional misrepresentation of the law is misconduct that is violative of the rules of professional responsibility.

Because of these violations of the rules of professional responsibility, A should be censured for her actions.

ANSWER B TO ESSAY QUESTION 4

1. Brian's Grounds to Invalidate the Trust

At his wife's urging, Richard created an express inter vivos trust of his separate property,

which allowed him the income from the property for the remainder of his life, and at his death to go to his children. Brian can argue (1) that the trust was not validly formed, (2) that Alicia exerted undue influence over Richard and overcame his will in his disposing of his separate property in the trust at his death, (3) that the trust is voidable because of Alicia's misrepresentation to Richard regarding Celia.

Trust Requirements

Brian could first attempt to argue that the inter vivos trust was not validly created.

Under California law, a valid inter vivos trust requires (1) intent to create a trust, (2) delivery of the res (including constructive delivery), (3) a res (property to be placed in the trust -trust assets), (4) named ascertainable beneficiaries, (5) a trustee, and (6) a valid lawful purpose.

In the present case, it appears that the requirements for a valid trust have been met. Although Richard created the trust at the urging of his wife, it appears that he did in fact intend to create the trust. Additionally, his separate property was transferred to the trust as the res, Brian and Celia and their heirs were named ascertainable beneficiaries, Alicia was named as the trustee, and the trust purpose (providing for Richard's children) is a lawful one. Therefore, the trust appears to have facially met the requirements for a valid trust.

Undue Influence

However, Brian will assert that the trust is void because Alicia exerted undue influence (1) by urging Richard to create the trust of his separate property, and (2) by convincing him against his will to leave trust property to his stepdaughter Celia.

Under California law, a testamentary disposition is void if it was the result of undue

influence. In order to prove undue influence, Brian has the burden of showing (1) that Alicia exerted influence over Richard, (2) that Richard's will was "overborne" by Alicia's influence, and (3) that but for the influence, the disposition would have been different. However, proof that a party had the ability to influence the testator, as well as the motive, is not sufficient in and of itself to demonstrate undue influence.

In the present case, Alicia urged Richard to create the trust of his separate property. This fact demonstrates that she did attempt to exert influence over him, but there are no facts indicating that Richard's will was overborne by this urging, or that he did not already desire to create the trust of his own will.

Additionally, Richard did not want to include Celia in the trust, but Alicia convinced him to do so because he might be sued if he did not. This is a much closer call, because in this case, Alicia exerted influence by giving faulty legal advice to Richard, he changed his mind based solely on the influence, and but for Alicia's self-serving advice, he would not have included Celia in the trust. If the Court or finder of fact believes that Alicia exerted undue influence, then the inclusion of Celia in the trust would be void, and the trust may potentially be declared invalid.

Misrepresentation

Brian will also argue that Alicia's misrepresentation regarding Celia was fraud in inducing Richard to create the trust and include Celia in it.

In order to demonstrate that the trust was based on misrepresentation, Brian must show (1) that Alicia made a material misrepresentation to Richard, (2) that Alicia knew the information was false, (3) Richard in fact relied on the misrepresentation, (4) that Richard's reliance was justifiable, and (5) damages.

In the present case, Alicia knew that Celia did not have grounds for a legal action

against Richard, and yet she still told Richard that he should include her in the trust to avoid a lawsuit. Richard relied on this advice because he did in fact include Celia in the trust, and his reliance was justifiable given that his wife was an attorney and he was not, so he reasonably trusted her legal advice. The damages in this case result from the fact that Celia was wrongfully added to the trust.

Based on this misrepresentation, it will be a close call whether the entire trust will be found void, or whether the provision regarding Celia will be declared invalid. It appears that Richard intended to create a trust for the benefit of Brian and his heirs, and that he originally intended to create a trust before the misrepresentation. Therefore, the gift to Celia would likely be declared void based on the misrepresentation, but the trust itself would likely not be revoked.

2. Removal of Alicia as Trustee and Indemnification

Alicia invested half the trust assets in a new biotech company and loaned the other half of the trust assets to her law firm. Based on her actions as trustee, Brian has several arguments that she should be removed and that she should be forced to indemnify the trust.

Powers of Trustee

Under the common law, a trustee was entitled to buy or sell trust assets, but was not entitled to borrow for the trust or loan funds from the trust. However, under the modern trend, the trustee is entitled to loan or borrow funds for the benefit of the trust under certain circumstances.

Brian could argue that Alicia exceeded her duties as trustee because she was not empowered to loan trust assets, but nonetheless loaned funds to her own law firm.

However, because under the modern trend a trustee is entitled to loan trust assets, Brian will likely lose this argument. (However, see discussion below regarding self-dealing/duty of loyalty regarding loan to Alicia's law firm.)

Duty to Diversify Trust Assets

Brian would also argue that Alicia violated her duty as trustee to diversify the trust assets. A trustee has an obligation to diversify the trust assets to keep them from being depleted.

In the present case, Alicia invested half of the trust assets in one risky company, and loaned the other half to her own law firm. In doing so, she failed to properly diversify the trust assets, and ran the risk that if one of the two investments lost money, the trust assets would be depleted. Therefore, Alicia violated this duty.

Duty to Avoid Speculation

Brian will also argue Alicia violated her duty to avoid speculation and risky investments of the trust assets. A trustee has an obligation to avoid speculating the trust assets or placing the assets in risky investments that might jeopardize losing the trust assets. Under the prudent investor rule, a trustee must act as a reasonably prudent person would do in managing their own business assets.

In the present case, Alicia invested half the trust assets in a speculative new biotech company. Regardless of whether Alicia actually believed that this was a good company, new and untested biotech companies are inherently risk investments. In investing half the trust funds in this company, Alicia did not act as a reasonably prudent investor would do, and she violated her duty to avoid speculation.

Duty to Keep Trust Assets Productive

A trustee also has a duty to keep trust assets productive. In this case, Alicia loaned half the trust assets to her own law firm. There is no indication what kind of rate of return this loan will receive, but if it is not substantial, or if it is below what it would otherwise receive from being properly invested, Alicia has violated her duty to keep the trust assets productive.

Duty of Fairness

A trustee also has a duty of fairness not to favor one beneficiary over the other. In the present case, Celia is Alicia's daughter, and Brian is Richard's son from a previous marriage.

Therefore, Alicia cannot favor Celia over Brian. Additionally, Alicia cannot attempt to invest in risky investments in order to benefit the trust assets during the lifetime of Celia (who has a lifetime interest in trust income), at the risk of jeopardizing the trust assets for future beneficiaries. By investing in risky investments for quick-profit (the biotech firm) it appears that Alicia is violating this duty.

Duty of Loyalty of Trustee

The main duty that Alicia violated is the duty of loyalty. A trustee has a duty not to self-deal trust assets or commingle trust assets with her own. In the present case, Alicia loaned half the trust assets to her own law firm, where she is a partner. Therefore, because she loaned money to an entity which she is an equity owner, she violated her duty to avoid commingling or self-dealing.

Damages

Brian has several options in receiving damages for Alicia's breaches of her duties as

trustee. First, for any investment that Alicia made that benefited the trust and were profitable, he can ratify those actions, and keep the proceeds. For any deals that Alicia made that lost money, Brian can surcharge the trustee, and she will be required to indemnify the trust for the losses. Finally, for any self-dealing, such as the loan to her law firm, Brian can trace the funds, and have them given back to the trust.

3. Alicia's Violation of the Rules of Professional Responsibility

Alicia violated several rules of professional responsibility.

Duty of Loyalty

First, an attorney has a duty of loyalty to the client to avoid conflicts of interest. A conflict of interest arises where an obligation or interest of the attorney, to a third party, or to another client is materially adverse or directly adverse to the client. If there is a potential conflict of interest, the attorney can represent the client in that matter only (1) if the lawyer reasonably believes she can give the client effective representation, (2) the attorney informs the client of the nature of the conflict, (3) the client consents, and (4) the consent is reasonable.

In the present case, Alicia had a conflict of interest in serving as the trustee and in drafting the trust document for Richard because her own interest in providing for her daughter may affect her representation. (This was in fact demonstrated by the fact that she misinformed Richard of the law to include Celia in the will). Although there was a conflict, Alicia did not inform Richard of the conflict, Richard did not consent, and on the facts given, any consent he gave would have been unreasonable.

An attorney can also not create an instrument for the client that gives the attorney or close relative of the attorney a gift or devise. Alicia may have violated this duty by writing

the testamentary trust that gave Celia, Alicia's daughter, an interest in the trust. Although there is an exception where the attorney is a relative of the client, this exception may not apply given Alicia's fraud and the devise to her daughter.

Duty of Competence

An attorney also has a duty of competence to the client to act vigorously and competently to advance that client's interests. Under this duty the attorney has an obligation to give competent legal advice, vigorously advance the client's interests, and not take a case if they will violate an ethical rule. Alicia did not advance Richard's interests, and should have refused to draft the instrument because of her conflict of interest (discussed above).

Duty of Dignity and Decorum

Under the duty of dignity and decorum, an attorney has an obligation not to present false or misleading legal advice. Alicia violated this duty when she told Richard falsely that Celia would have a legal claim if she were not included in the will. This may also constitute tortious misrepresentation (see above).