**February 1990**
**Question** 4

When Bonnie was born in 1968, her Uncle Albert gave to Bonnie's parents, Max and Carol, a $1000 U.S. Savings Bond and 100 shares of stock of Delta Company, a small California corporation. He told them that he wanted to encourage Bonnie to get a good education and asked that it be used for this purpose. Albert endorsed both the bond and the stock "[t]o Max and/or Carol, for Bonnie." Max and Carol thanked him for the generous gift and subsequently put the bond and the stock in a safe deposit
box. Albert died in 1971.

In 1972, Max and Carol obtained a dissolution of their marriage. Bonnie continued to live with her mother Carol, who remarried in 1974. Carol retained control over the bond and the shares of stock. The bond matured in 1975 and Carol redeemed it for the face amount and placed this money in a joint non-interest bearing checking account which she owned with her new husband, Daniel. Carol told Daniel that the money was for Bonnie's education and he never inquired any further. The 100 shares of Delta stock increased in value and, in 1976, Carol exchanged these shares for shares of ABC Corp., worth $5000 at the time of the exchange. The value of the ABC Corp. shares has steadily declined and is now approximately $250.

Meanwhile, Bonnie developed an interest in music and studied piano privately for many years until she became quite proficient. She was eventually able to obtain a partial music scholarship to attend the state university upon her graduation from high school. It was at this time that she first learned, from her father, of the existence of the gift from her Uncle Albert. She asked her mother for the bond and the stock, but her request was refused. Carol told Bonnie that the gift had been used to pay for tile piano lessons.

What rights and remedies, if any, does Bonnie have against: 1. Carol?

Discuss.

2. Daniel? Discuss.

3. Max? Discuss.

<u>ANSWER A TO QUESTION 4</u>

## I. BONNIE v. CAROL

### A. Trust Creation

Albert's transfer of stocks and a bond to Carol and Max may have created an *inter vivos* private express trust for the benefit of Bonnie.

A trust requires a declaration of trust or transfer in trust to a trustee of a definite trust or transfer in trust to a trustee of a definite trust res for a lawful purpose with determinable duties to be exercised by the trustee on behalf of definite beneficiaries.

Here Albert transferred the bond and stocks to Max and Carol. He stated that they were to be used for her education, and the form of title reflected his intent that Bonnie be the beneficiary. By accepting the gift, expressing their thanks and exercising control over the corpus, Max and Carol evidenced their acceptance of the trust duties.

Carol may argue that Albert's words were merely precatory, and did not amount to a command, or that the trust purpose was indefinite. But the fact of the inclusion of the words, "for Bonnie," indicates more than a mere wish or suggestion on Albert's part, and "education" though vague, is a sufficient and indeed common trust purpose. The trustees will be deemed to have discretion in carrying out so vague a purpose, but it is not so vague as to negate trust intent.

### B. Duties of Carol

1. Duty of Care - A trustee has a duty in administering trust funds to act with due care. This standard has been variously defined as the care of a prudent person managing his own funds, or managing those of another, or merely of a prudent person exercising like functions.

Under any definition, the trustee must manage the corpus in a manner reasonably calculated to preserve and maximize income, and with due care that disbursements are properly directed toward the achievement of trust purposes.

2. Duty to Invest - Carol thus had a duty to invest the trust corpus prudently for maximum income. By selling the bond and placing the assets in a non-interest bearing account, Carol probably breached this duty. Though the sum was small, it was safe and earning interest where it was. Carol will be liable to Bonnie for the amount that could have been earned and was not, certainly to the extent of the interest the bond itself would have continued to earn.

3. Duty to Diversify - A trustee is under a duty to diversify trust assets to guard against loss, unless the trustor has manifested a contrary intent.

Here Carol can argue that Albert's choice of Delta stock implied an authorization to let the asset remain in this form. It probably did, especially since a small local entity was involved; in any case the stock appreciated reasonably so Carol has no liability for not selling it earlier.

However, once she sold the stock, she may have been under a duty not to put the entire amount in a single new stock. She will argue the amount was too small to diversify, but in that case stocks may have been inherently too risky a type of investment. Once she lost the protection of Albert's implied authorization to retain the Delta stock, investing in one new stock, and then taking no action as its value fell precipitously, probably breached either the duty to diversify or the general duty of due care. As a consequence, Bonnie should be able to recover from Carol at least the lost value of the stock asset, and probably also a reasonable return on the $5,000 which Carol carelessly invested.

It should be mentioned here that Carol is not being held strictly liable for loss, or even liable for negligent or erroneous business judgment in investing the funds, but rather on the basis that a reasonable person would not invest a small trust fund in a high risk stock. If Carol can show that ABC was a highly prudent investment, or reasonably appeared so at the time, she will not be liable for the loss of value of the stock.

4. Duty to Account - A trustee has a duty to account for any expenditures of trust assets to the beneficiaries.

Carol will argue that she spent the proceeds of the bond on piano lessons for Bonnie. Whether this comes within the ambit of Albert's trust purpose is a question of fact. Probably a parent trustee is granted broad discretion in administering a small trust fund for a generalized educational purpose, and Bonnie's musical education appears to have been serious and possibly expensive. However, if evidence shows Albert meant "college education," private piano lessons may not be deemed a valid trust expenditure.

Further, Carol must have actual records documenting that the funds were applied in this fashion. Absent such documentation, she will not be entitled to offset such expenditures against her liability to Bonnie.

5. Duty to Earmark/Segregate - In placing the trust res into her own joint checking account with her husband, Carol breached her duty to keep trust funds separate and protect them from unauthorized invasion. If Daniel's access to this fund resulted in loss to the trust, this resulted from Carol's violation of this duty and she will be liable for it.

## II. BONNIE v. DANIEL

Daniel never accepted the duty of a trustee, and had no reason to know more about the funds than what Carol told him. Therefore he is not liable to Bonnie for the breach of any fiduciary duty.

Nevertheless, if Bonnie can trace into his hands any of the funds deposited by Carol into the joint account, since he acquired them without consideration, he may be deemed a constructive trustee and required to reconvey them to Bonnie or to a properly appointed substitute trustee for Carol.

## III. BONNIE v. MAX

Max was probably a co-trustee since he equally accepted that duty from Albert. Although he clearly relied on Carol to perform the duties of the trust, a trustee cannot completely delegate his responsibility, and his failure to perform any type of supervision over her activities as trustee will probably subject him to joint liability for all losses occasioned by her breach of trust duties.

Max may argue that his divorce from Carol terminated his trust obligations. Ideally, he should have sought a court determination to that effect. If, however, as part of the dissolution proceedings the trust assets were specifically awarded to Carol, with or even without specific designation as being subject to the trust, the court may be willing to infer that the trust duties at that point devolved upon her exclusively as well. Max would be aided in this argument by the fact that Bonnie herself apparently remained in Carol's custody, though if custody was joint and Bonnie merely lived most or all of the time with Carol the argument would be less persuasive.

## ANSWER B TO QUESTION 4

### 1. BONNIE v. CAROL

CREATION OF AN INTERVIVOS TRUST

Uncle Albert created an intervivos trust for Bonnie when he transferred the $1,000 Savings Bond and 100 shares of Delta Company to Bonnie's parents.

The elements required for an intervivos trust are:

(1) Present manifestation of testamentary intent or an intent to presently create a trust - as evidenced by Uncle Albert's language when he delivered the property to Max and Carol asking that it be used for the purpose of Bonnie's education and also when he endorsed the property "to Max and/or Carol, for Bonnie" - both indicating an intent to create a trust for the benefit of Bonnie.

(2) Trust Res or Trust Property. This is the savings bond and the shares of Delta Stock which were transferred for the benefit of Bonnie.

(3) Ascertainable Beneficiary. The beneficiary must be clearly identifiable and ascertainable. In this instance it is clear that Uncle Albert wanted Bonnie to be the intended beneficiary of his gift.

(4) Delivery. The trust property must be delivered to the trustee while the Settlor (Uncle Albert) concurrently has the intent to create a trust - you need concurrent intent and delivery or act. Uncle Albert gave the bond and shares of stock to Max and Carol after endorsing them and stated his intended purpose for the use of the property at the time of the delivery.

(5) Trustee. While a trustee can be appointed by the court, it is generally thought of as a necessary element of creating an intervivos trust. The trustee in this instance was really two people, namely Bonnie's parents, Max and Carol. There is a question as to whether the settlor intended both of them to act jointly because of naming both of them or intended them to be able to act alone because of the and/or language.

Generally, when there is more than one trustee, they must act in concert for the benefit of the beneficiaries and never act individually. The and/or language could also be an indication of alternative trustees in case one was not able to complete performance.

Because both Carol and Max were named, and because they did in fact accept delivery of the trust property they must both act and carry out the required fiduciary duties of Trustee.

Carol and Max may claim that Uncle Albert did not intend to create an intervivos trust because of his precatory language. Generally, one must be very clear in the language creating a trust so that there is no question that creating of a trust was intended. Generally, this arises when a settlor uses language such as I wish, or I hope, or I would like it if...which indicates his wish but not a definite intent.

In this case, Max did state his wish that the property be used for Bonnie's education but from the totality of the circumstances surrounding the delivery of the property as well as the endorsement as being "for Bonnie", I think it is clear that a valid testamentary trust was intended and created.

Carol, as Trustee, had certain fiduciary duties which she owed to the trust as well as to

Bonnie. While all of the parties may have breached one or more of these duties, I will discuss the elements under Carol's section then under each of the other parties, I will discuss the duties applicable to them.

Co-Trustee's Duty to Act in Concert. As noted above, when there are more than one trustee, they must always act in concern, in unison and never individually. When one trustee acts alone, he or she will become personally liable for any losses to the trust resulting from the act. In this instance, it was not clear whether Uncle Albert intended Carol and Max to be joint trustees or individual alternate trustees. In light of the divorce, it might be foreseeable that they would be unable to act jointly or come to any mutual decisions about what to do with the property so the court may have approved Carol's acting alone in this situation.

If Carol was not to act alone, then Max would be personally liable for not following up on his duties as co-trustee as it is his duty to make sure he performs his duties as trustee. If necessary, it would be up to him to inform the court that the other trustee was not allowing him to be involved in the trust activities or take some other action to ensure his involvement. Otherwise, he will be personally liable for all losses occurring whether due to his own action/inaction or to the other trustee's action or inaction.

Duty of Due Care. A trustee has a duty of due care owing to the trust and the beneficiaries of the trust. The duty of due care at common law was the duty to act as a reasonably prudent person dealing with his own affairs. Modern law has expanded this duty to a reasonably prudent person dealing with another person's affairs. This is a more stringent duty and creates a higher standard of care.

Carol's duty was to act as a reasonably prudent person dealing with Bonnie's property and to take care that the property was protected and to attempt to increase its value.

Carol failed to do this when she allowed the bond to mature then placed it in a non-interest bearing checking account because it was loosing money each and every day. She had a duty to invest the money or at least place it in a safe interest bearing account.

Carol also failed her duty of due care when she exchanged the Delta stock for ABC stock and then allowed it to dwindle down to nothing. Reasonable investments are permissible, however, if the investment does not pan out, the trustee cannot throw up her hands and take a loss, rather, she must reinvest the stock or put it into something more secure and try to increase its value.

Carol would be liable for the decreased value of the ABC stock at least to the value it was at the time of investing in ABC and perhaps more looking to what the investment should have made over the applicable time period.

Carol breached her duty of due care owing to Bonnie when she allowed the money from the bond to sit in an account not drawing interest and to allow the stock to decrease in value substantially without reinvesting it or taking any other action.

Duty to Invest. The duty to invest is similar but not identical to the duty of due care. The duty to invest arises from the trustee's duty to maintain or protect the trust corpus and to increase its value. The duty to invest in some states, by statute is evidenced by a list of proper investments or safe investments. If the state does not have such a list, then the trustee must invest in safe and secure investments and not new businesses or high risk corporations. Generally government bonds and secured investments are acceptable as are mutual funds and more moderate investments which allow for a moderate income but little risk of loss.

There is no indication of the rating of the ABC corporation however, Carol had a duty to immediately sell the stock when she realized that the stock was rapidly decreasing in value and to purchase something else that would be more reliable. She also had a duty to keep an eye on the investments and not to just invest the money and leave it.

Further, Carol had a duty to invest the money from the Bond and at least to have it in an account that would bear interest.

Carol has breached her duty to invest and as such would be personally liable for all losses proximately arising from her breach of duty.

Duty to Segregate and Earmark. A trustee cannot commingle his funds with those of the trust. All trust property must be kept separately and must be earmarked as trust property. When Uncle Albert gave the property to Max and Carol, it was earmarked as being for Bonnie. All transactions when changed the form of the property should have also been properly earmarked.

When the bond and the shares were placed in the safety deposit box, they were properly earmarked and in a safe place. There was no breach of this duty at that time. However, when Carol sold the bond and placed the money in a joint account in her name and Daniel's, there was a definite breach of the duty to earmark and segregate and Carol will be held personally liable for any losses arising from this transaction. It is not clear whether other funds were in the account or whether they drew from this account however, all losses proximately arising from this breach of Carol's duty will be recoverable by Bonnie.

Duty to Diversify. A trustee must also diversify so as to limit possible losses. By having all the stock in the ABC corporation, when ABC corporation started decreasing in value, all of the stock was lost. Had Carol performed her duty to diversify then she may have only lost a small amount rather than substantially the entire amount.

Carol has breached her duty to diversify and will be personally liable for all losses arising from this breach.

Duty to Account. A trustee has a duty to account to the beneficiaries each and every year if not more frequently (semi-annually or quarterly depending on the extent of the trust) and to report all gains and losses as well as all major transactions. Carol has failed to do this and when Bonnie asked about the money was merely told that it had been spent but did not offer any accounting of what actually happened to the trust property. This duty was established to protect the trust and beneficiaries and to prevent unfair dealing by the trustee and to act as a check on the trustee.

Carol has breached this duty and the court can require her to account for all trust property over the lifetime of the trust.

Duty of Loyalty. A trustee has a duty of loyalty owing to the trust and to the beneficiaries. A trustee must put the interest of the trust and beneficiaries ahead of all others at all times. There must be no self dealing and a trustee must protect the trust property. In this case the placing of the money from the bond in a joint account for Carol and Daniel was a breach of the duty of loyalty as well as her actions in spending the money. While it is not clear what she did with the money are whether she actually did use it for Bonnie's piano lessons (without an accounting we don't know what she did with the money) any use by Carol of the trust property for her own benefit would be a breach of the duty of loyalty and all losses arising from such a breach are recoverable by Bonnie.

Finally, Carol had a duty to perform personally. It appears that Carol did do this however, the placing of the money in a joint account was opening it up for Daniel to act with the money/property of the trust which would be prohibited. A trustee cannot delegate trust duties to others.

In conclusion, Carol has breached many of her fiduciary duties arising from the trust for Bonnie and as such will be personally liable for all losses arising out of the breach of her duties. The court can place a constructive trust on the joint account (for the benefit of Bonnie) and Carol's only duty will be to turn the account over to Bonnie.

As for the losses the trust has suffered, Carol will be required to replace the stock with equally valuable stock at the time of the sale and purchase of ABC ($5000) or a reasonable time thereafter when Carol should have realized that it was a bad investment and taken some action. She will also be liable for the loss of interest that the money from the bond should have been earning while it was in the account as well as any expenditures from the account that Carol made that were not for the benefit of the trust or Bonnie's education.

2. <u>BONNIE v. DANIEL</u>

Daniel was not a trustee of the trust. It is unclear whether he actually had anything to do with the trust property or whether he was just made aware of the trust and that the property was for the benefit of Bonnie. If he knowingly spent that money knowing that it was trust property then he would be liable for all money taken and would be required to replace the money or the court could place a constructive trust on any purchases he made with the property. In all likelihood, the money is gone and the property will/may be untraceable and Bonnie may have to settle for return of the funds taken, if any.

Daniel did not have any real trustee duties as he was not a named trustee and his only duty was to not interfere or knowingly accept benefits or take property from the trust knowing that it was held for the benefit of Bonnie. A trustee cannot even borrow from the trust or hinder the trust property in any way even if there is an intent to repay.

Daniel will only be liable for any breaches of the trustee duties of which he was a knowing participant or of which he accepted the benefit of such breaches (such as by accepting or using the money from the trust).

3. <u>BONNIE V. MAX</u>

Max, as discussed above was a co-trustee and as such had all the trustee duties discussed above owing by Carol. If a trustee fails to perform, relying on the other trustee, he will still be personally liable for all losses arising from breach of the trustee duties as he was required by the trust to be there and perform personally. He could not delegate his duties to Carol and then rely on her actions. And just because he allowed Carol to act does not relieve him of any liability.

Max will be liable to the trust and to Bonnie to the same extent as Carol because cotrustees are joint and severally liable for all losses resulting from breach of trustee duties. While he may be able to seek indemnity from Carol, if Carol is unable to replace trust property, he will be liable to the full extent of the loss. Max breached his duties as trustee when he allowed Carol to perform individually.

Max's only defense would be in that as part of the divorce ruling Carol became the sole trustee which would be within the court's power to rule based on the fact that co-trustees that cannot get along while married probably cannot get along to manage a trust. However, there is no mention in the facts of such a ruling and unless the court relieved him of his duties as trustee, then he would remain completely liable for all fiduciary duties owing to the trust and to Bonnie.

Finally, it should be noted that the court in its own discretion or on the motion of Bonnie can relieve the trust of the present trustees, Max and Carol and appoint new trustees. The breach of the trustee duties is sufficient to warrant their replacement.

February 1996

## **Question** 4

Connie, who died in 1989, left a will which created a trust of which her son, Sam, was to be both trustee and life income beneficiary. On Sam's death, the successor trustee was to distribute the corpus outright to the then surviving issue of Connie's predeceased daughter, Deborah. The trust contained a standard clause regarding trustee's powers, including the power to "sell, invest, and manage" the trust property.

Common shares of Hercules Corp., a well-established, successful manufacturing company, made up 30% of the original trust corpus. For years, Hercules regularly paid generous cash dividends, all of which Sam, as trustee, allocated to income. In 1993, instead of paying a cash dividend, Hercules distributed a dividend of its own stock, which Sam also allocated to income.

In January 1994, Fabulon, Inc., a newly formed company, made an initial public offering of its common stock. The prospectus stated that Fabulon had created a new material similar to fiberglass, but which experimental testing had shown to be of superior durability, The prospectus further disclosed the company's intent to distribute most of its earnings as dividends.

After reading the Fabulon prospectus in February 1994, Sam sold the trust's Hercules stock to his wife at its current fair market value. The sale of stock produced a profit for the trust, and Sam allocated the capital gain portion to the income account. He used the balance of the proceeds to purchase Fabulon stock for the trust.

Hercules continued to prosper and its stock continued to appreciate. Fabulon's product failed and, in December 1995, Fabulon went bankrupt and its stock became worthless.

Has Sam breached his duties as trustee? Discuss.

ANSWER A TO QUESTION 4

A trust is a fiduciary relationship where one person (or people), the trustee, holds legal title and another has an equitable interest in the corpus. In this case the question assumes, as do I, that a trust has been created.

As explored more fully below, however, I note that naming Sam as both trustee and income beneficiary creates problems because any decision made by Sam that benefits himself as income beneficiary, even if legitimate, is subject to great scrutiny.

Among the duties that a trustee possesses are: (1) the duty to properly allocate incoming money (and property) between income and the corpus; (2) duty to garner a reasonable rate of return through prudent investment; and (3) duty of loyalty.

A trustee has all powers given expressly in the trust -- here, the power to "sell, invest and manage the property." In addition, a trustee possesses the powers given expressly by relevant state law and the implied powers necessary to carry out the trustee's responsibilities.

These powers, however, are limited and shaped by the trustee duties discussed above. Here, Sam breached several of his duties.

A trust will generate (hopefully) money and other income. The trustee must allocate each incoming asset correctly, assigning it to either income or corpus.

This is especially important in this case, because the income beneficiary (Sam) and the corpus beneficiary (Deborah's issue) are different.

1. The Dividends

Cash dividends from stock held by a trust are allocated to income. Therefore, Sam

properly allocated the cash dividends paid by Hercules Corp. to

A.

Allocation between Income and Corpus,

the income.

corpus.

By contrast, dividends paid by stock in lieu of cash are properly allocated to the

Here, Sam placed the stock dividend paid by Hercules into the income category, hence breaching his duty of proper allocation.

2. The Proceeds from the Hercules Stock Sale

When items from the corpus, such as property or stock are sold, any profit must be allocated to the corpus account.

Sam disregarded this rule when he sold the Hercules stock and allocated the profit to the income account. Hence, he breached his duty.

3. Breach of Loyalty in Connection with Allocation

As discussed more fully in part C, a trustee owes the trust and beneficiaries the utmost loyalty.

When Sam improperly allocated the trust's incoming assets, he benefited himself personally (as income beneficiary). This personal benefit was at the expense of Deborah's issue, who, when taking the trust outright at Sam's death, will get less than they should have had the allocation been done properly.

B. Duty to Garner a Reasonable Return

A trustee also owes the trust a duty of care. He or she must act with that degree of care, skill and prudence that a reasonably prudent person would exercise in managing his or her own property.

Moreover, the trustee must invest carefully, refraining from risky investments. Some states provide a list, by statute, of acceptable investments for a trustee. These lists include cautious investments such as government bonds.

Other states follow the prudent investor rule which requires a trustee to refrain from risky and speculative investments, in favor of careful ones.

stock.

Sam breached this duty both by buying Fabulon, Inc. stock and by selling the Hercules 1.

Fabulon.Inc.

A trustee following the prudent investor rule would not invest in an initial public offering ("IPO") of a newly formed company. Nor would such an investment be on the approved list on states providing for authorized investments.

Fabulon, Inc. was purchased by Sam through an IPO. An IPO of a new company, by its nature, is very risky because there is no "track record" to determine how the company has performed in the past.

Moreover, it was unclear, as revealed in the prospectus, whether the product would actually work, as only "experimental testing" had apparently been conducted.

Finally, Sam purchased the stock apparently after only reading the prospectus.

A prospectus, however, is drafted and circulated by the company in order to persuade purchasers to buy the stock offered.

It does not appear that Sam was a market analyst or otherwise possessed special skills relevant to his decision to buy Fabulon.

A trustee may not delegate his responsibilities, such as determining how to invest. The prudent investor, however, would consult an expert or do more investigation than merely reading the prospectus prior to purchasing a newly available stock.

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Thus, Sam breached his duties when buying Fabulon.

2. <u>Hercules Corporation Stock Sale</u>

Sam also breached his duty when he sold Hercules stock. That stock was part of the original trust corpus and consistently "paid generous cash dividends." It even paid a stock dividend in 1993, thus enabling more dividends to be paid in the future.

Although the sale of Hercules was profitable, it is unlikely that a prudent investor would sell a stock performing successfully.

Moreover, use of the proceeds from the Hercules stock to invest in a risky venture such as the Fabulon stock surely breached Sam's duty.

Finally, there is an issue as to whether Sam should even sell an income producing asset that was part of the original corpus, despite the broad grant of powers in the trust.

A trustee owes a duty of loyalty to the trust. This duty prohibits the trustee or his family members from dealing with the trust in an individual capacity. The only exception to this rule is when court approval is first obtained.

Whether a transaction that breaches this duty of loyalty is objectively fair to the trust is irrelevant.

The trustee has an absolute duty to refrain from, inter alia, lending or borrowing money to or from the trust, buying or selling property from or to the trust, and engaging in business with the trust.

Here, Sam sold the Hercules stock to his wife. He thus dealt with the trust on an individual basis through his wife.

As explained, because court approval was seemingly not attained, that the sale was at fair market value is irrelevant to the question of Sam's breach.

As a remedy for this breach, Deborah's issue (as beneficiary) can set aside, ratify or collect profit as a result of the interested transaction.

In this case, since Hercules has continued to prosper and Fabulon went bankrupt, Deborah's issue should set aside the sale of Hercules to Sam's wife and reclaim the profitable stock.

## ANSWER B TO QUESTION 4

### Sam's Breach of Trustee Duties

In a trust with standard delegations of power to the trustee, the trustee has the discretion to "sell, invest and manage" the corpus of the trust using his or her judgment. Inherent in the trusteeship are duties to the current and future beneficiaries of the trust. Sam

C.

Dutv of Loyalty -- Sale of Hercules Stock to Sam's Wife

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C.

Duty of Loyalty -- Sale of Hercules Stock to Sam's Wife

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appears to have breached some of those duties here by overstepping his powers as trustee.

### The Trust

The trust is made up of a trustee, a beneficiary, a corpus and the settlor's intent to create a trust. Here, Sam is both trustee and beneficiary for his lifetime. The corpus is the stock and other unnamed assets, and the settlor manifested his intent to create the trust in his will.

### Sam's Duties of the Trustee
### Duty of Loyalty

The trustee is in a fiduciary relationship to the trust and its beneficiaries. The trustee must deal in good faith for the profit of the trust rather than for self-profit. Where the trustee uses his position to benefit himself, even in good faith, he must disgorge those profits he earned by the self-dealing.

### Misallocation to Income

Here, Sam breached his duty of loyalty to the future beneficiaries of the trust by misallocating the Hercules stock dividends to income rather than to principle. Where stock dividends are issued in cash, they are to be allocated to the income so that it is disbursed to the current beneficiary, in this case Sam. For the dividends issued in cash, Sam was not in breach.

The 1993 dividend was paid in Hercules stock. Sam should have allocated this to the principle for the benefit of the trust corpus so that the future beneficiary of the corpus, Deborah, would receive the shares outright. Sam acted against the intent of the settlor and was in breach of his fiduciary relationship to Deborah by allocating the stock dividend to income so that he would personally profit as the current beneficiary.

## Sale of Hercules Stock to Wife

Sam's sale to his wife of the Hercules stock may also be construed as self-dealing since the stock was profitable and presumably Sam would personally realize the profits with his wife. Since the stock was originally part of the trust corpus, Sam has deprived the future beneficiary of a profitable asset and is personally profiting from the sale.

Even if Sam in good faith believed that the sale of Hercules stock in order to buy Fabulon stock was in the trust's best interest, as discussed above, good faith is no defense if the trustee makes a profit.

## Misallocation of Capital Gain

When Sam sold the Hercules stock, he produced capital gain for the trust. Capital gain is allocable to the corpus of the trust for the future beneficiary of the corpus. Here, Sam allocated the capital gain to income so that he personally gained as the current beneficiary. Thus, he breached his fiduciary duty to Deborah in this respect as well.

## Purchase of Fabulon Stock

By purchasing the Fabulon stock to replace Hercules, Sam assured larger income payments. Fabulon had announced that it would make all distributions in cash rather than in stock, while a stock issuance appears to have been Hercules' method in 1993. Sam may be found in breach of his duty of loyalty by purchasing a more risky company's stocks in order to increase the payments to himself.

## Duty of Care

The trustee also has a duty to protect the trust res and to exercise his best efforts to make it profitable. To determine whether Sam breached this duty, the courts will examine his actions under the prudent investor rule.

## Prudent Investor Rule

The prudent investor rule as applied to trustees requires that the trustee make investment decisions that would be considered reasonably prudent under the circumstances. Each investment is considered independently rather than the trustee's performance as a whole over all the assets in the trust. Here, the courts will examine Sam's decision to sell Hercules stock and buy Fabulon under the prudent investor rule to see if he breached his duty of care.

The trustee is required to make investments in established companies or government instruments that make a fair rate of return, but which are considered conservative investments. The Hercules stock appears to be such an investment - it is a "well-established, successful" company.

By contrast, the Fabulon stock is what is considered a "risky" investment. Fabulon is a newly formed company, with a novel product, making its first public offering. Thus, there is no background or track record upon which to base a wise, informed investment decision. Typically these types of risky investments are not within the power of the trustee to make, so Sam may be found to have breached his duty of care by making this investment, simply on the basis of its risky character.

## Failure to Properly Manage

Even if the court finds that his initial decision was not in breach because he had not been uninformed, Sam held on to the stock for two years until Fabulon went bankrupt.

Trustees also have the duty to supervise and to manage the investments he chooses to make with the trust res. Because Sam held on to the Fabulon stock instead of selling and repurchasing Hercules or some other profitable securities, he is also in breach of his duty to manage the trust.

## Failure to Diversify

The trustee must diversify the assets held in a trust so that unexpected losses in one type of investment will not destroy the corpus. Here, Sam took the 30% of Hercules stock and put it all in Fabulon without seeking to diversify the risky Fabulon with a safer and potentially off-setting investment. Thus, he has breached his duty of care to the trust in this respect as well.

July 1974

**QUESTION NO. 15**

*(Answer this question hi Book No. 15)*

Seth, by a written declaration of trust, transferred $100,000 to Tom, as trustee, to "invest the money, pay the income to Ben for 10 years, and then transfer the trust assets outright to Rex as remainder beneficiary." Tom was specifically empowered to resign prior to the termination of the trust.

Within a month after creation of the trust, Tom used the money to buy, for the trust, a parcel of remote desert land with proven zinc ore reserves. The grantee named in the deed was: "Tom as Trustee." Tom mined the land for zinc for nine years. The mining operations produced $20,000 cash income per year, after payment of operating expenses. Tom paid this $20,000 each year to Ben. Ben deposited the money in bank accounts and has made no use of it.

At the end of nine years the zinc ore was exhausted, and Tom resigned as trustee and left the area. Seth diligently looked for a successor trustee, and one month later appointed Walt as successor trustee. During the month following Tom's resignation, Granite Co, wrongfully removed $10,000 worth of gravel from the land. Rex discovered this and informed Tom. Tom did nothing in relation to the removal of the gravel.

The gravel deposits are exhausted and the land now has no market value. There is no applicable statute of limitations.

What are Rex's rights, if any, against Tom, against Ben, and against Granite Co.? Discuss.

Answer A to Question 15

1. <u>Rex's Rights Against Tom</u>

Clearly Seth created a valid express trust, naming Tom as trustee, with a res of $100,000, Ben as income beneficiary and Rex as remainder beneficiary. Therefore Rex's rights will be those of a trust beneficiary against his trustee, and the issues involved will be whether Tom as trustee, violated the duties he owed Rex as remainder beneficiary, in the purchase of the desert land, failing to amortize its cost against income, and doing nothing when Granite Co wrongfully removed the gravel from the trust property.

(a) <u>Toms purchase of the desert land</u>
As trustee Tom was obligated to follow Seth's instructions with regard to the trust. Here the problem is with what Seth meant when he instructed Tom to "invest" the money.

There are two general theories applied by courts to trust investments. Some states use a statutory list which expressly enumerates those investments considered proper for trust assets, generally including government securities, high grade corporate bonds and first trust deeds on stable property. The other method used to measure the propriety of trust investments is called "The Prudent Man Rule" and requires that the trustee exercise the prudence and caution of a reasonable man in managing his own affairs with respect to trust dealings. Although somewhat more flexible than the statutory list theory the prudent man rule basically recognizes the same types of investments as proper.

While courts may be split over the general propriety of investing directly in land as a trust asset there would he little? question that Tom's purchase of remote desert land would be improper. Even though Tom had a duty to make the trust productive he could have done so by making other investments which would have protected the trust corpus for the remainder beneficiary, as he had a duty to do.

By investing the trust corpus in the desert land, a "wasting asset" Tom violated his duty to protect Rex's interests.

Tom also violated his duty to segregate and earmark the trust assets by taking the property in his own name, as trustee, without specifying the trust he purported to represent.

(b) <u>Toms</u> <u>failure to amortize</u> the <u>cost</u> <u>of</u> the <u>desert</u> <u>land against</u>
<u>the trust income</u> from if Toms duty with respect to the management of the trust was to properly allocate the expenses created during the generation of trust income against the income and corpus accounts. Assuming for the purpose of this discussion that Tom's purchase of the desert land was proper it was his duty to ammortize its cost, which would have initially been charged against the corpus or capital account, against income over its useful. life as a "wasting asset".

Since the ore deposits on the la-id were exhausted in nine years Toms duty was to charge approximately $11,111.00 per year against the income. This he did not do, therefore he is liable to Rex for the amount he failed to return to the capital account plus is any interest it would have earned during the period.
(c) <u>Toms failure to take action on behalf of the trust against</u> <u>Granite Co.</u>

Although the trust instrument expressly authorized Tom's resignation courts would not permit him to do so without their approval. Therefore Tom's resignation was improper and ineffective and he had a duty to the trust to protect it from wrongdoers, which he breached. Since he breached his duty he should be liable to the trust for the loss of the $10,000 caused by Granite Co's removal of the gravel.

Conclusion: Because Tom breached his duties to the trust he is liable for the entire loss to it, $110,000 although he may be entitled to indemnity from Ben and Granite Co. for the respective amounts they gained through Tom's breach of duty

2. Rex's Rights against Ben

As remainder beneficiary Rex is entitled to compel the return of the income improperly paid to Ben by Toms failure to amortize the cost of the land against income in the amount of $100,000. This should present no problem for the court since Ben has not used any of the money generated by the trust. 3. Rex s Rights against Granite Co.

Rex would be entitled to have the court compel Tom to sue granite Co on behalf of the trust since Tom was trustee at the time of the breach but failed to do so. Or Rex could sue on his own behalf.

There may be a question with regard to how the $10,000 damages should be apportioned since what it amounts to is the sale of a trust asset. However since it was the trusts sole asset and was not producing income it should all go to Rex.

## Answer B to Question 15

The trust itself was valid; Seth clearly manifested an intention to separate the legal and equitable titles in his conveyance to Tom; the trust res was transferable property; and there was clearly a delivery. Hence Rex clearly may assert the rights of a trust beneficiary against any wrongdoers.

I. Rex v. Tom. Rex has a good claim against T for violating his fiduciary duty to the remainderman. In the first place, a Trustee is generally under a duty to invest as would "a prudent man in the exercise of his own affairs." As such, T is generally required to diversify his investments-since a prudent man would not put all his eggs in one basket, but would be expected to invest in a balanced portfolio to minimize the individual risks of loss. T has clearly failed to do this, and should be liable to the Remainderman to the extent that the property left for distribution at termination is worth less than that which would have been produced by prudent investment.

But Tom has committed an even more flagrant breach of his trustee's duties: although the terms of the trust clearly designate two beneficiaries--an income beneficiary and a remainderman, T has invested all the money in a wasting asset--thus producing maximum value to the income beneficiary at the expense of the other (in fact, R receives nothing at termination because of Granite Co's trespasses and conversions; but even if the land were still worth $10,000, T would clearly have breach his duty.) Unless the trust specifically gives T the discretion to favor the income beneficiary in such a manner, T must act in the best interests of both striving for a reasonable income for the beneficiary and a reasonable capital accumulation for the remainderman. Since T has clearly breached his fiduciary duty to the remainderman, he is personally liable for the amount of the losses caused by his acts.

Whether R has an action against T for T's failure to do anything about Granite Co. is more doubtful. By the terms of the instrument T had the power to resign before termination (this, of course, would not affect the existence of the trust itself) . And he might argue that the privilege of resignation was absolute--one which he could exercise at his discretion. In such a case, T would contend that he could not be liable for failure to prevent Granite Co's wrongful acts. R would argue in return, however, that the power to resign was not absolute, but carried with it an implied duty of either a) petitioning a court to appoint a new interim trustee, or b) finding a satisfactory new trustee himself before resigning; and c) in any event, a duty of not resigning without doing one of the above when the trust assets were threatened. It must be remembered that in the absence of express authority relieving T of his duties, T is bound to act with the standard of care required of a fiduciary, and since a prudent man would not ordinarily leave his own assets "unmanaged" for a period of a month, with no body to protect his interests, Rex will probably be able to persuade a court to read the above implied duties into the instrument, notwithstanding the power of resignation.

(It should also be noted that S cannot be said to have acquiesced in T's resignation; and even if he did this could not be used as a defense by T against R. At common law, unless otherwise stated, a transfer in trust such as this would be irrevocable; hence S would have no power to relieve T of liability to R because S would be totally without power to cut of R's interest)

If the court did so hold, T would be liable for the $10,000 damage which occurred after his resignation without making any effort to protect the property.

R v. Ben

R might have a claim against B. not because B was in any sense a wrongdoer himself, but simply because B has unjustly received the benefits of an act which constituted a breach of duty on the part of T. In these circumstances, (as, for example, where a valid contract to make a will is breached and the testator leaves his property to another), a court of equity will impose a constructive trust upon the legal owner for the benefit of the person who in justice ought to have received the property. In this case, Ben has received $180,000 from T as a result of T's wrongful acts, and a court of equity would probably compute what it considered to be B's rightful share (calculated, for example, as 8% of 100,000 for a period of 10 years) and direct B to hold the balance for the benefit of R.

If B would be harmed by this transaction, of course the remedy would be denied; however here there is no showing of prejudice to B (the money is all easily available in B's bank account); and, furthermore, there is no showing that R's delay in seeking his remedies has caused any harm. Thus a constructive trust seems a reasonable and appropriate remedy, and will probably be R's best chance of recovering a substantial share of his expected benefits, since Tom has "left the area".

III. R. v. Granit co.

The question here is whether R, as the holder of simply a beneficial remainder interest, may bring an action in his own name for damage to the land, or whether he must rely on the Trustee for protection. In general, it is the trustee who has the right to manage and the duty to defend the property;as legally entitled to ownership and possession, he may be said to be the "real party in interest" in regard to wrongs done by trespassers (just as the life tenant possesses the right and duty to recover for trespass & waste).

Here, however, it could be argued that to deny the remainderman to sue Granit Co. for its wrongs would leave the trust res unprotected, since T has absconded.

Nevertheless, Granite Co. could still argue that Walt, not Rex, is now the proper "real party in interest"-- And the objection would be reasonable. There is no showing that Walt is unable or unwilling to safeguard the rights of R: indeed, it is to be presumed that he will fulfill his duty and bring the proper actions for trespass and conversion against Granit Co. (to fail to do so would be a breach). Furthermore, although R's argument might have been strong, where there was in fact no trustee and it was necessary to take immediate action to prevent irreparable damage, this is not now the case. The wrong has already occurred; there is no longer any danger of further injury to the remainder; and there is no indication that the present trustee will not effectively pursue the remedies against Granite Co.

Therefore I conclude that R's individual claim against Granite Co. will probably fail.

**July 1979**

QUESTION NO. 15

Bank is sole trustee of a valid written inter vivos trust created by Davis, who died one year ago. The trust was originally revocable by Davis but became irrevocable at the time of his death. The trust assets consisted of $550,000 in cash delivered to Bank.

The trust, which was never amended or revoked, gives the trustee sole investment powers, governed by the prudent man standard and contains a spendthrift clause.

Under the trust, Bank was directed to set aside $50,000 as Trust 1 and within two years after Davis' death to distribute such sum, and any income to such of Davis' friends or other persons as Bank selects. Bank invested the $50,000 corpus of Trust 1 in United States Government obligations.

At Davis' insistence, Bank had invested the remaining $500,000 of the trust estate in the stock of a newly formed corporation which owned six restaurants. The investment had diminished in value to $400,000 at the time of Davis' death.

Upon Davis' death his adult daughter, Gloria, become entitled to income for life from all trust property not effectively passing to Trust 1 described above. When Bank consulted Gloria after Davis' death, she, with full knowledge of the nature of the investment and the loss in value during Davis's life, insisted upon retention of the restaurant corporation stock. At Gloria's death, one year after Davis' death, the stock had diminished in value to $350,000.

After Gloria's death, net income (from all the property not effectively passing to Trust 1 described above) is to be paid to Davis' son, John, until age 50, the trust is to terminate and the corpus is to be paid to his estate.

Bank has petitioned the appropriate court for instructions, giving notice to Davis' son, John, the sole surviving beneficiary.

John has demanded (a) that Bank restore the $150,000 diminution in value of the investment in the restaurant corporation stock; (b) that the corpus of Trust 1 be added to the residual trust for him; (c) that the residual trust be terminated immediately and distributed to him since he is an adult (age 32), otherwise competent, and is now the sole trust beneficiary.

Bank and John seek resolution of the following:

(1) Is Trust 1, providing for distribution to Davis' friends or others, valid? Discuss.
(2) Is Bank liable for any diminution in the value of the restaurant corporation stock, and, if so, to what extent? Discuss.
(3) Should the residual trust for John be terminated upon his demand? Discuss.

Answer A to Question 15 Validity of Trust I:

The elements of a valid trust include Trust res; Valid Trust purpose; Beneficiaries which are definite and a Trustee. It is clear from the hypothetical that three of the four are present under modern law -- at common law a non-person could not be a trustee because of the trustee's duty of non-delegation and personal supervision. Banks are permissirle Trustees under modern law however. The problem with Davis' Trust I is the lack of definite beneficiaries. The general rule is that a valid trust must pass both equitable title and legal title. The trustee takes legal title subject to enforceable, equitable rights in the beneficiary. If the beneficiary is indefinite their equitable title does not pass and a valid trust does not arise.

In Davis' Trust I, the beneficiaries are to be chosen from his "friends or other persons as Bank selects." WWhile courts have recognized trusts created for a class of persons, they have consistently required that the class named, if subject to Trustee discretion in selection, he sufficiently limited so as to entitle that class or member thereof to be able to enforce the rights created in at least requiring the Trustee to exercise his discretion. where as here no limited class is named, no one has standing to require the beneficiary to act and hence courts have traditionally been loathe to recognize a trust. Traditionally, the effect of a trust which fails for lack of ascertainable beneficiaries is a resulting trust in favor of the settlor's heirs or, if the settlor has given an alternative disposition in case of failure the courts will follow his intent. Under the traditional view, the trust I here, failing for want of definite beneficiaries would fall into the residuary as provided by Davis.

Modernly, some courts have held that in an uncertain beneficiary situation as here, there is created in the Trustee a power of appointment which may be exercised if Trustee wishes to do so -- much like an honorary trust situation. Should Bank be in a jurisdiction taking this view, they would be permitted to exercise the power created by Davis by selecting from among his friends and such exercise would be enforceable.

Any argument that was made that Davis intended a Charitable trust would fail because the language does not intend benefit or betterment of the public in general or an indefinite portion thereof. Charitable purposes usually recognized (education, public health, government, religion, etc.) do not include friends.

Liability For Restaurant Stock Loss:

A trustee owes to the beneficiaries equally, a duty to exercise skill, care and prudence in management of the trust corpus. Generally, Settlor's intent will prevail over general rules of Trustee conduct, if such instruction is mandatory. Clearly, while David was alive he had the power to dictate Bank's investments, because he retained power to revoke which implies power to modify. Here, Davis' instructions to Bank to invest in restaurant were properly within his power and hence Bank properly carried them out.

Upon Davis' death however, Bank was not under a clear mandate to retain the restaurant stock. Davis never instructed that Bank was not to sell the stock. Hence under the prudent investor standard prevailing in the jurisdiction, Bank was under a duty to act with care and skill and prudence relative to the Trust Corpus. By retaining the stock in the face of continuing loss, they violated that standard and hence are liable to the trust for losses suffered thereby.

Even though Gloria insisted upon retention of the stock, because Bank as trustee is under a duty of care equally to both beneficiaries, and since John apparently was not contacted in regard to the stock, Bank will not be able to raise the defense of Beneficiary Consent in an action brought by John.

For their breach of duty in relation to the stock Bank should be liable to the Trust for the diminution in value of the stock -- $50,000 plus loss of what the total normal income would have been on the $100,000 since Gloria's death.

Gloria's estate would not get reimbursed for loss of income during her beneficiary period because she consented to the Trustee malfeasance.

Bank is not liable for the full $150,000, because $100,000 of that loss occurred while under the direction of Davis and hence Bank was not in breach as to that loss.

Termination of Residual Trust:

The General Rule is that trusts may not be terminated until their purpose is accomplished or impossible or unless such power is reserved by the Settlor. Courts have recognized a right to terminate the trust when all beneficiaries consent thereto. Most jurisdictions require, in addition to unanimous beneficiary consent, that such termination would not be contrary to Settlor's purpose in creating the trust. Here, John has been restricted from taking the Principal until he reaches 50. Many courts would construe Settlor's intent under such a provision to be to protect the beneficiary from his own indiscretion and hence termination would violate the purpose.

Most courts also hold that the presence of a spendthrift clause in the trust precludes termination of the trust by beneficiary consent for the same reason. While it is not clear whether the spendthrift clause here applies to John's interests or even if it did whether it would be a valid restraint on John's interest (some cts do not recognize a spendthrift clause on a remainder interest but most do). If it did apply, John would clearly not be able to terminate.

Further, John could not terminate regardless of Settlor's purpose because his estate stands to take on his premature death and hence all beneficiaries would not be joining in the request to terminate.

## Answer B to Question 15

1) Validity of Trust I for Distribution to Davis' friends or others.

In order for a trust to be valid, there must be an ascertainable trust res, here $50,000 in Trust I would qualify. There must be a valid trust purpose to provide income for a certain period end or then to distribute the principal and income to certain designated beneficiaries is a valid purpose.

However where we run into difficult with this trust is that there are no ascertainable beneficiaries. There is a requirement that in all trusts, except charitable trusts that meet the Common Law requirements of the purposes of alleviating poverty, aiding education or governmental functions, providing health care services or aiding religion or other similar benefits, there must be a definite beneficiary. Children has been held to be an acceptable designation of beneficiaries but "friends" has been held to be too vague and not possible for the court to construe.

The Bank could argue that the alternative "or other persons as Bank selects" gives Bank a power of appointment. That, however, seems to be a weak argument. While a person could argue that he could appoint himself, it seems unlikely that the Bank could appropriate this trust to itself without a breach of its fiduciary duty.

In addition in order for a trust to be valid, there must be a beneficiary capable of enforcing the trust. Obviously under the wording of Trust I, there is no one who can enforce.

Who are Davis' friends?

The language relative to the Banks' "solution" is very similar to that in the Bishop of Durham case where the court held that the trust must fail.

Therefore, I conclude that Trust I must fail and the $50,000 plus income should pour over into the remaining trust estate and be held for the named beneficiaries.

2) Bank liability for diminution of value of restraint stock.

From the facts, it appears that Davis, the settlor retained some measure of control over the trust until his death as it was revocable during his life.

Davis directed the investment of the $500,000 of the trust estate to the restaurant stock. Since Davis had the power to revoke the trust, the Bank should not be held liable for the $100,000 loss of principal and interest at the date of Davis' death.

However, upon the death of Davis, the trustee has a fiduciary duty to treat the principal as a prudent business person would treat his own funds.

Gloria was only entitled to a life income interest she had no interest in the principal.

It was Bank as sole trustee that had the obligation to conserve the principal. Gloria's advice will not excuse the Bank for the loss of the $50,000 in principal from the date of Davis' death until Gloria's death.

The Bank is not obligated to provide a reasonable rate of return on the principal as that was to be paid to Gloria for her life and she can be presumed to have waived her right to any income.

Therefore, I conclude the Bank would have to pay $50,000 to the trust principal. There would be no offset permitted from the $50,000 from Trust I as they are separate transactions.

3) Termination of the trust,

Usually when all of the beneficiaries of a trust are before the court, a trust may be terminated and the residuary amount paid to the beneficiaries. In this problem, Trust I was invalid so there are no outstanding beneficiaries to contend with, Gloria's interest was limited to income for her life no heir's rights are involved and John is an adult with no mention of any rights in John's heirs. Therefore, there are no rights that could be prejudiced by dissolving the trust. The only exception is where a dissolution would defeat the purpose of the trust.

This trust has a spendthrift clause and provides that until John is 50 he is only entitled to the income from the trust.

Since it would appear that the main purpose of the trust was to prevent spendthrift John from hypothecating or squandering the trusts assets, it would defeat the trustor's intent to dissolve the trust at this time.

So I conclude that John must wait until he reaches his 50th year to obtain the corpus of the trust. He may continue to enjoy the income from the principal. The spendthrift provision would keep his principal amount free of his creditors attachments.

**Fall 1978**

QUESTION NO. 15

By a written trust instrument[. Kirk transferred 200 shares of Capco stock to Burr. as trustee, to pay the income to Sue for tier life with the remainder to Pack. The trust instrument also gave Burr a power of sale over the trust property. Thereafter the shares were registered by Capco in the name: "Burr, trustee for Sue and Park." Kirk reserved no power to revoke or modify the trust.

Later. Kirk desired to regain control over the 200 shares but wanted to conceal his acquisition of control from other Capco shareholders Kirk directed Rob, a business associate who owed Kirk 550.000. to pay this amount to Burr in return for the transfer of the shares to Rob.

Burr sold the stock for the S50.000 to Rob because Burr knew Kirk wanted control of the stock and was settlor of the trust, although Burr was also aware that $50,000 represented only half the value of the stock.

At Burr's direction, Capco registered the stock in the name of Rob_ Kirk then informed Rob by letter that Rob was to hold the stock upon a secret trust for Kirk. In reply to Kirk. Rob stated that he was a bona fide purchaser for value and the beneficial owner of the stock. When Sue learned of the transfer she complained to Burr. To keep her quiet, Burr turned over to Sue the S50.000 received from Rob.

Pack learned of the transfer of the Capco stock and the payment to Sue. and seeks your advice.

To what relief, if any, is Pack entitled:

( I ) Against Kirk? Discuss.

(') Against Burr' Discuss.

(3) Against Sue'? Discuss.

Answer A to Question 15

Pack vs. Kirk

Pack, as the beneficiary of the remainder interest in the Capco stock trust, has a cause of action against Kirk, the settler, because Kirk induced the trustee, Burr, to violate his fiduciary duties to Pack.

Kirk put the Capco stock into trust with no power of revocation or modification, for the benefit of Sue and Pack. Sue and Pack therefore became the equitable title holders of those 200 shares of Capco stock.

Then Kirk induced the trustee, Burr, to sell the stock for one half its value. Burr violated his fiduciary duties as trustee for due care and loyalty, but Kirk, as a knowing participant in Burr's fraudulent acts thereby became liable to the beneficiaries also. Had Kirk been an innocent donee, he would merely be forced to return the property to the trust res. As a knowing participant, however, Kirk is liable to the beneficiaries for any gain he realizes from inducing Burr to violate the trust, and for any loss the trust realizes due to the transactions.

Here, the stock was worth $100,000 and Burr sold it for $50,000. Therefore, Kirk, as a knowing participant of the trust fraud is jointly and severally liable with Burr for the remaining $50,000.

At Kirk's direction, Burr sold the stock to Rob to hold in secret trust for Kirk. If Rob correctly asserts that he is a bona fide purchaser, taking without notice of Burr's fraud, then his equities outweigh Pack's as a beneficiary and Pack may not compel re-transfer of the stock to the trust. If Rob is a knowing participant also, then he will be liable to the trust as is Kirk and Pack may compel a transfer of the stock back through Kirk from Rob to the trust.

Without Rob's notice, however, Kirk is still liable to the trust as a knowing participant for Pack's equitable vested remainder interest in the trust. Pack vs. Burr

Burr, as trustee, had the power expressed in the trust to sell the Capco stock. However, in making the decision to sell, Burr violates his fiduciary duty to the trust if he delegates the decision to sell to someone else. Here, he allowed the settler, Kirk, to make the decision to sell the stock to Rob.

Burr violated his duty of due care to the trust beneficiaries also by accepting 1/2 the value of the stock. This is not a business decision that the "prudent investor", using his own money would make. This prudent investor standard is the standard for measuring the trustee's duty of due care. Some states provide acceptable lists of investments that outline a trustee's prudent investments, but in almost all jurisdictions, a sale for 1/2 value is a violation of the trustee's duty of due care.

Pack therefore has a cause of action against Burr for violating the trust. When Sue complained of Burr's improper dealings, he gave her the $50,000 paid by Rob. This is another violation of Pack's remainder interest. The trust agreement provided income to Sue for life but the trust corpus was vested in Pack as a remainderman. By conveying the corpus to Sue, Burr violated the duty of loyalty that he owes to all beneficiaries equally. Pack therefore has a cause of action against Burr to reimburse the entire $100,000 trust res.

Pack vs. Sue

Burr gave the life estate holder, Sue, who had only a right to income, the entire trust corpus. Pack has a cause of action against Sue for a constructive trust of the $50,000 given her by Burr.

A constructive trust is an equitable remedy. Ordinarily a constructive trust only arises in cases of fraud or other mis-dealings in which title to property is improperly conveyed. Sue does not have the title to the Capco stock, but she has the money paid for the stock, acquired in a fraudulent transaction. If the court has difficulty with the equitable remedy of constructive trust because no title is involved, it may impose an equitable lien on the $50,000.

Since Sue had only a right to lifetime income her retention of the entire trust corpus is improper.

Pack has standing to sue Kirk, Burr and Sue because he is a beneficiary with a vested remainder. A beneficiary may sue to enforce a trust against the b.

Answer B to Question 15

(1) Kirk will have to return either 50,000 and the value of any increase in Capco stock or, under a constructive trust theory, the Capco stock, to the trust.

(2) Burr will have to return 100,000 and the value of any increase in Capco stock to the trust. Alternatively, a constructive trust over the shares held by Bob may be available.

(3) Sue will have to return the 50,000 to the trust_

Kirk established a valid trust

Burr, a trustee, had a fiduciary relationship over a trust res, i.e., 200 shares of Capco, to manage it for the benefit of two beneficiaries. Sue was the income beneficiary and Pack had a remainder interest. Pack would receive the principal after Sue's death. Establishment of a trust to create a flow of money for 2 people is a valid trust purpose.

Kirk retained no power to revoke or modify. In most states, a trust, in the absence of specific designation, is presumed to be irrevocable. A minority of jurisdictions, including California, presume a trust to be revocable in the absence of any specific designation.

On a trust, legal title is held by the trustee. Equitable title is held by the beneficiaries.

(1) Pack v Kirk

Kirk, the original settlor, of the trust caused Burr, the trustee, to sell the stock at half its value. This was an inducement to the trustee to breach a fiduciary duty. I discuss Burr's breach in part 2.

Equitable interest in the property belonged to Sue and Pack. Pack had equitable title to a principal worth 100,000. As a result of Kirk's actions, Pack's principal was cut to 50,000. It is clear that Kirk stole 50,000 of property from the trust and therefore from Pack.

The proper label for Kirk's offense is a bit unclear to me. It probably comes closest to being conversion, whereby someone deals with the property of another with an intent to deprive them of that property permanently. Kirk wrongfully acquires title through a fraud as to the purchase of stock.

In states that presume trusts to be irrevocable, Kirk has no possible defense to re-taking the trust property. Even in states that presume a trust to be revocable, the settlor must revoke the trust. He cannot recapture the trust property secretly or by fraud.

Nor can Kirk find any support in his actions for the modern trend which allows the settlor to retain a great deal of control over the trustee's actions. That control must be explicitly retained and exercised in an above board manner. Does Pack have standing to sue Kirk?

Normally, beneficiaries cannot bring suit directly against third parties who defraud the trust. An exception, however, is where the trustee is involved in the fraud as in the instant case. What remedy could Pack get from Kirk?

Pack probably has two options. First, he can sue Kirk for 50,000 of damages and any accretion in the value of the principal that occurred for the time that Pack was without the 50,000 worth of stock.

Second, he can probably establish a constructive trust over the shares now held by Bob. Bob's claim to be a BFP is without merit because be didn't purchase for consideration and took title to the stock with notice of its origins.

Pack could establish that Bob held the property in trust for Kirk or Pack could simply directly establish a constructive trust for himself.

(A) Purchase Money Trust:

Kirk gave Rob the money to purchase the stock. Even though Rob acquired title, he furnished no consideration for the sale. Unless Rob can prove it was a gift, a vaulting trust would be imposed on Rob for Kirk.

Since this is a resulting trust, Rob's duties would be to transfer the res to the settlor. Then, Pack could claim that a constructive trust should be established with Kirk as trustee and Pack as beneficiary in order to prevent unjust enrichment of Pack. A constructive trust is also a dry trust and Kirk's obligations would be to convey the property back to the original trust.

(B) A court could probably, due to the equities involved, through a one-step process establish a constructive trust with Bob as trustee. If Bob were not a party to the suit and only Kirk was, this might be difficult.

Note: When the court orders Kirk to turn over the trust res, the court will appoint a trustor to replace Burr and the res will be returned to the trust. (2) Pack v Burr

A trustor has a fiduciary relationship to manage the trust for the equal benefit of the beneficiaries. The paramount standard in a prudent person standard. The trustee must act as a reasonably prudent investor would act, with an eye both toward maximizing income and conserving the principal. The trustee should act with the same care a reasonably prudent person would act in managing his/her own affairs. Burr clearly breached this duty to Park,

1. Burr breached the duty by selling the stock for the reasons why he did.

He sold the stock not to maximize the income from the trust property, but to benefit Kirk.

This is a violation of the prudent investor standard and also a violation of the trust instructions.

2. Burr breached his fiduciary duty by selling the stock for half its value; a reasonable investor certainly wouldn't do that.

3. Burr breached his fiduciary duty by giving 50,000 to Sue. That violated the terms of the trust - Sue was to receive the income, not the principal, and
a trustee owes a duty not to favor one beneficiary over another. And it certainly a prudent investment.

4. Burr breached his duty by ordering the fraudulent recording of Bob as the true owner since he was aware of the circumstances surrounding Bob's purchase.

4. There is an argument that Burr breached his fiduciary duty by not diversifying. He only had one kind of stock and he had the power to sell. More would have to be known about the terms of the trust.

Remedy:

There is no problem with standing. A beneficiary may sue a trustee for breach.

Pack is personally liable for 100,000 in principal to Pack. Packs remedy would be reestablishment of a trust with the court appointing a new trustor. If damages were awarded, Burr would have to give, above the 100,000, any reasonable accretion in the principal. In a suit against Burr, Pack could probably also get a constructive trust established over the Capco shares because Bob's not a BFP and because of Burr's role in ordering the stock transferred to Bob.

(3) Pack v. Sue

Sue wrongfully accepted the 50,000 which belonged to the trust res. A court would establish a constructive trust over the 50,000 and Sue's obligation would be to turn the money over to the original trust.

One might argue that Sue's unclean hands should prevent her from receiving the trust income. This, however, is a civil suit and return of the property to the trust makes Pack whole.

Spring 1978
QUESTION NO. 8

Smith, single and childless, spent much of his income from his real estate transactions supporting his disabled half-brother, Jones.

In January 1977, Smith, while competent, signed a written declaration of trust stating, in part:

"I, as trustee, am holding in trust:

"(1) my promissory note, payable to myself as trustee, in the amount of $10,000, and

"(2) all profits to be earned from my real estate transactions during the period July 1 through December 31, 1977."

The trust instrument further provided that all income from the trust was to be paid to Jones for life and upon Jones' death, the income and corpus were to go to Brown. The trust instrument contained a spendthrift provision declaring that creditors could not reach either income or principal in the hands of the trustee. The declaration finally stated that if Smith ever became incompetent, then Bank was to be appointed trustee and one-half of Smith's then existing property not within the trust would be added to the trust.

On April 1, 1977, while competent, Smith revoked the declaration of trust. On May 1, 1977, Smith sustained a serious brain injury. He was thereafter declared legally incompetent and ceased all business activities.

In 1978, Adams recovered a judgment in a tort action against Jones and Brown. The judgment is unsatisfied and Jones and Brown have no assets other than their interests, if any, in the trust. The conservator of Smith's estate asserts that there is no trust and that all assets of Smith are free of any trust.

What are Adam's rights, if any, with respect to any assets now held by Smith's conservator? Discuss.

Answer A to Question 8

A) <u>Was there a valid trust created in January?</u>
Creation of a trust requires an intent to create the trust (and a manifestation thereof) beneficiaries who are ascertained, a res, and a trustee.

There is no problem here with respect to the intent to create that trust or the manifestation of such intent. A settlor may declare a trust and act as trustee, which is precisely what Smith did. There are also clearly ascertained beneficiaries (Brown and Jones). The problem arises with the res. There does not seem to be one. Smith's promissory note payable to himself is illusory. He cannot be trustee over his own promise to pay. The result might be contra, however, if he actually segregated and held some of the proceeds of the note. But here where he was promisor and promisee, there is no enforceable promise. Similarly, all profits to be earned from Smith's real estate transaction is not a property right -- it is the quintessence of a mere expectancy. A weak argument might be made that since Smith was involved in real estate, he was conveying to the trust a future interest in his real property, which is a sufficient res. Such argument cannot withstand scrutiny, however. The final possibility for a res is the direction to the bank to add one half of his property to the Trust at the time of his incompetency. This is not, however, an interest in property; it too is merely an expectancy. With respect to both this and his real property, an argument can be made that the future earnings to be contributed should be considered property for a res. This argument should fail.

B) <u>Assuming a Trust had been created, is Smith's revocation effective?</u>

Yes. Although the rule is diametrically opposed in many common law jurisdictions, in California unless an inter vivos trust is expressly irrevocable, it may be revoked at any time by the settlor. Smith's revocation was effective.

C) <u>Assuming there was a valid trust created, what is the effect of the spendthrift provision?</u>

None. To be effective a spendthrift provision must preclude both voluntary and involuntary transfer of the beneficiaries rights. Here, although the facts are a bit ambiguous, it appears that Smith only limited involuntary transfers of the beneficiaries' interests. This is generally ineffective to create a spendthrift provision. Accordingly Adams can reach the interests of Jones or Brown. However, if a valid spendthrift provision was created, it is quite possible it is effective only as to Jones. At Common Law such provisions could only operate for the benefit of income beneficiaries, although many states do now recognize them in favor of remaindermen, as well. Finally, many states have limited the operability of spendthrift provisions as applied to certain classes of creditors. Creditors with personal injury judgements qualify under some statutes and not others. If the applicable statute puts such judgement
creditors into the preferred category with dependents etc., then Adams will be able to attach

Smith's and possibly Brown's interests in the trust. In any event he will be able to reach only such interests and not the assets in the trust itself, which are presently held by the conservator.

D) Adams Rights

Finally, regardless of any of the contingencies discussed above, Adams has no rights to Smith's assets. At best he has a very weak claim to the beneficiaries interests in those assets.

## Answer B to Question 8

A trust is an interest in property which separates the legal and equitable title, placing in the hands of a trustee property that the trustee is empowered to manage and distribute (including income) to named beneficiaries. By choosing this form, a settlor (the creator of a trust) puts into more capable and responsible hands the duty to invest and manage trust assets so that the beneficiaries of the trust are protected and assured of receiving income. In this case we have an attempt to create a private, inter vivos, declaration of trust (one in which the Settlor is the Trustee).

Certain elements are necessary for the creation of a valid trust. There must be intent to create a trust, a trustee, identifiable beneficiaries, and the conveyance of presently existing property to serve as the trust res or corpus. In this instance, all these elements are satisfied with the exception of the res.

The trust res represents the property conveyed to the trustee for management and distribution. In order to ensure that the settlor in fact intended to create a trust and to be certain that there is something for the trustee to maintain, it is required that a presently existing interest in the property conveyed be present. Here, the items which S has attempted to declare in trust are his future real estate earnings and a promissory note.

Future earnings.

Future earnings do not represent a transferable property interest nor is it a presently existing interest. Rather, it is no more than a mere expectancy which is improper as an attempted trust res. However, some courts hold an attempted creation of a trust of an expectancy to be the promise to create a trust when the expectancy is received. However, where this promise is not supported by consideration (as here), a trust will arise upon the receipt of the expectancy only if the settlor reaffirms when it is received. Some very few jurisdictions require no reaffirmation of a gratuitous trust when the beneficiaries of the "promised" trust are issue of the settlor. In any case, while these concepts may be relevant as to the promissory note or other property, it is doubtful that the expectancy will materialize at any rate. The earnings of July 1- December 31 are rendered unlikely by Smith's incompetency.

The promissory note:

The question of whether a debt can be held in trust is at issue only if there is a real debt owed. Here, the note is really a promise to pay oneself as trustee. In this sense, it is an attempted transfer of non-existent property in trust and is valid, where no consideration was paid, upon the reaffirmation when the expectancy (a real debt) arises. However, reaffirmation must
be of an interest which can be placed in trust, Ordinarily, a debt cannot be placed in trust or can serve as a res if and. only if it is the debt of a third party which is presently payable.

Here, the enforceability of the promise to pay is doubtful at any rate given the absence of consideration) and with the general reluctance to let a debt serve as a trust res, the trust has no property to be managed.

Delivery

In addition, even if either item were acceptable interests for the res, the fact that S declared himself trustee raises issues of delivery. Did S notify the beneficiaries or earmark the trust corpus? It is not likely that he did the latter and we are at least doubtful as to the notification.

Revocability

Even if a trust was created, was S's attempted revocation valid? Most jurisdictions presume the irrevocability of trusts but a substantial minority presume that trusts are revocable. If the trust is revocable but the beneficiaries have changed position reasonably in reliance on the trust, then the beneficiaries must concur for the trust to be validly terminated. Thus, if this is a jurisdiction presuming the irrevocability of trusts or one where revocability is presumed but needs the concurrence of relying beneficiaries, the trust, if any, still stands.

The "pour-over" provision on incompetency.

Given that no valid trust of the note or the earnings existed, can a trust have sprung into existence upon the happening of the incompetency condition? At least at this time there would be some property to be held in trust. However, the intent of the settlor must accompany the conveyance of property or be inferable from the circumstances of the case. Here, S had attempted to revoke the trust; in no way can he be said to "reaffirm" his promise to create a trust upon the happening of the expectancy. Thus, the notion of "pour over" which although usually applied to wills is arguably relevant here, the necessary element of intent is lacking. Because no trust was created, J and B have no interest in S's assets and A may not recover from S's conservator even if he otherwise might.

Presuming, however, the existence of a trust; A would still be unable to recover. Spendthrift provisions are upheld in the vast majority of jurisdictions. A spendthrift clause is one designed to insulate the interest of the beneficiary from the claims of creditors and his own foolhardiness. Some courts have interpreted this general policy to limit the application of spendthrift provisions to an amount necessary for the support of the beneficiary. Others have allowed "higher" creditor claims, such as a tort claim, to prevail even in the face of a spendthrift provision. Still others allow such a clause to protect only income beneficiaries, such as J.

The majority, however, would allow the conservator, even if there was a trust, to apply the spendthrift clause to J, and as it would defeat the purpose of the clause to allow A to recover from B's interest at the expense of J, then B's interest is also protected.

Spring 1983

QUESTION 4

In 1972, Agatha loaned $300,000 to her brother George. George died in 1975. His will provided that if Agatha forgave the $300,000 debt, a $300,000 trust would be created for her under his will (Trust #1). Agatha forgave this debt in exchange for the trust interest. Under this trust, Agatha receives the income for life, and upon her death the corpus is to be distributed to Betty, Agatha's daughter.

George's residuary estate passed into Trust #2 for the benefit of five named beneficiaries. Agatha was not named as a beneficiary of this trust.

Each of the trusts created by George's will contained a spendthrift provision stating that creditors could not reach income in the trustee's hands. Nancy, George's accountant, was designated trustee of Trust #1, and Agatha was designated trustee of Trust #2. Each trustee was authorized to sell trust assets.

In 1978, Agatha defaulted on a $10,000 loan from John made in 1971. She relied on the spendthrift clause to shield her income interest in Trust #1 from John's claim for the debt. However, to discharge her debt, she offered to sell John 100 shares of T stock from the corpus of Trust #2 for $10,000 less than its fair market value. John agreed and purchased the stock from Trust #2 on the offered terms.

In 1979, John gave the T stock to his nephew Larry as a wedding present. Tarry had no notice of the prior transactions and still has possession of the T stock.

What are the rights and liabilit**ies** of John, Agatha, and Larry? Discuss.

ANSWER A TO QUESTION 4

I. THE TRUSTS - AGATHA A. DEFINITION

A trust is a device whereby the legal and equitable interests in property or money are separated. The trustee has tit'e, or the legal interest in the property, and the beneficiary has the equitable interest. A trust is created by a present transfer of property (the res) by the trustor with an intent of creating a trust. No particular written formalities are required for a declaration of trust on chattel. There do not seem to be any problems in formation of the two trusts created by George's will, so they are, subject to the limitations discussed infra, enforceable as valid testamentary trusts.

B. THE SPENDTHRIFT CLAUSE

A spendthrift clause is a term of a trust which limits the ability of the beneficiary to alienate his equitable interest in the trust res. *Most states recog*nize some form of a spendthrift clause. Some forms prevent only voluntary alienations by the beneficiary (i.e., he cannot assign his rights to distributions) , others bar involuntary assignments (i.e., creditors cannot levy execution on the instrument) .

The provision in the trusts created by the will is of the type which, if enforceable, limit creditors' ability to get trust assets from the trustee, but permit creditors to reach the assets once they are distributed to the beneficiaries. Since Agatha receives only the income from Trust #1, John would have been limited to collecting from the income as it was distributed to Agatha, if the spendthrift clause had been valid.

While most jurisdictions do recognize spendthrift clauses in general, it is well established that a person cannot put his or her assets beyond the reach of creditors by this device. The rationale for spendthrift clauses is that the trustor was under no obligation to create the trust. As a result, the creditors of the protected beneficiary cannot be heard to complain about being deprived of that to which they are not entitled.

The foregoing rationale is clearly inapplicable where the creditor could have reached assets and the beneficiary puts them beyond reach. Here, Agatha had an asset of $300,000. She "forgave" the debt, thereby extinguishing the assets, in return for a promise which revived it in a very useable form, but protected from creditors. It is unlikely that a court would allow Agatha to do indirectly what she cannot do directly. She clearly could not have created a trust; Nancy trustee, Agatha the life income beneficiary.

Moreover, John is precisely the type of creditor which self spendthrifting would be most damaging to. He lent her money in 1971; later, in 1972, Agatha attempted the spendthrift trust. It is very likely that John lent her the funds in reliance on her having the assets to satisfy the loan if she fail(-.d to repay. In sum, Agatha's interest in Trust #1 is not beyond anyone's reach besides her own.

C. FIDUCIARY DUTY

A trustee of a trust is a fiduciary and must account to the beneficiaries for the management of the trust assets. A basic duty of the trustee is to make the trust res profitable by exercising such care as would a reasonably prudent person in his own investments. More importantly, with respect to Agatha's conduct, the trustee must not engage in self dealing. The trustee has a duty of loyalty.

Here, a reasonably prudent person would not sell his own assets at $10,000 below market, so that prudent management duty is clearly breached. More importantly, Agatha did it to discharge a debt of her own. There is no real difference between her conduct and a simple embezzlement of the stock to pay her debt. This latter breach is significant in that it will increase the scope of her liabilities to the trustee. Had her breach been innocent, she would have been liable only for the trust's actual loss. A willful breach subjects her to liability for whatever the stocks she sold would have made (or for their appreciation). Accordingly, Agatha owes the beneficiaries of Trust #2 the value of ,the stock, the dividends not received after the sale, and the amount of appreciation.

II. JOHN

The liabilities of one who takes from a trustee who in delivering is breaching his duty, turns upon the knowledge of the transferee. A transferee for value without notice of the breach takes free of the claims of the beneficiaries. One who takes with notice will be said to have taken in constructive trust, with a duty to convey to the beneficiaries on demand. Where, as here, the trust assets are no longer in the possession of the transferee, he may be liable for the value of the assets formerly received on the theory of conversion.

Notice, for the purpose of the foregoing rules, does not consist of mere knowledge that there was a trust, or that the transferee was taking from a trustee. The notice must be such that the transferee knew or should have known that the asset received was transferred in violation of the trustee's fiduciary duty.

We are not told enough to reach a conclusion on whether John took with notice, but it seems likely that he did. He purchased at $10,000 under market, and we are told that the stock was in the trust. While it is not necessarily registered in the trust's name, it may well have been. That, coupled with the severe underpayment, would have been enough to put John on notice. If he had such notice, he is liable to the beneficiaries (to the extent that they cannot recover from Larry or Agatha) for the $10,000.

III. LARRY

A donee of trust assets does not take free of the equitable claims of aggrieved beneficiaries, regardless of notice. Where the misappropriated assets come to rest in the hands of a donee, the court will impose a constructive trust in favor of the beneficiaries, who can then compel redelivery to the trust. Accordingly, Larry must give back the stock.

## ANSWER B TO QUESTION 4

Rights and Liabilities of John

Before discussing any of the rights and liabilities of the parties who took property or performed under the trust, it is necessary to discuss the validity of the trusts created.

Was there a valid Trust #1?

A valid testamentary trust can be created when the terms of it are included in a will or the trust is already in existence and is incorporated by reference in the win.

Here, George created two trusts under his will. As a condition in his will to Agatha taking under Trust #1, she was required to forgive a debt owed by G to A. Such a condition in a will is valid. However, by so doing, it makes A a
co-settlor of Trust #1. A co-settlor is one who participated in the formation of a trust.

The other requirements of the trust are that it have a trustee, definite beneficiaries, a trust res, intent by the settler to make a trust, and a proper trust purpose.

Here, Trust #1 had A and G as settlors. N was the trustee and was given the power to sell trust assets. The beneficiaries were A as to the income for

life, and B as to the corpus. The trust intent is clear on its face in the will and the purpose was to repay A in return for her forgiving the indebtedness, which is proper.

Was there a valid Trust #2?

The settlor of this trust is George alone, A is trustee, and five beneficiaries are named. The intent and purpose appear proper from the fact that they were a disposition of G's residuary estate under the will. Since A was not a beneficiary here, she was not a co-settlor but merely a trustee.

Did John have a right to collect from Trust #1?

A spendthriftt clause in a trust can prevent the creditors of a trust from encumbering the trust res prior to its receipt by the beneficiary. However, where a co-settlor is also a beneficiary, he may not use such a clause as a shield against creditors. Here, A was a co-settlor because her compliance with the condition of forgiving G's debt meant she helped in bringing the trust into existence. She provided consideration for the trust. As such, she may not shield herself from the creditors under the spendthrift clause of Trust #1.

Therefore, John had a right to force the trustee, Nancy, to turn over to John before distributing to A any of the trust income for life, in satisfaction of the debt incurred by A in 1971.

What are John's liabilities under Trust #2?

John did not claim under Trust # 1, but accepted A's offer to buy stock under Trust #2. This poses the question of misconduct by a trustee.

A trustee is a fiduciary for the beneficiaries and as such has a duty to avoid self dealing and also to follow instructions and, under many statutory rifles, may only invest or sell trust assets under a prescribed scheme. A trustee will be held accountable for any misconduct in his dealings with the trust res.

Here, A was authorized under the trust to sell stock. However, implicit in such authority is that she sell it at the fair market value and avoid conflict of interest in such sales.

Here, A sold the stock from Trust #2 as trustee to John for $10, 000 less than the fair market value. A will be liable for that amount.

John as a purchaser of the stock will- be liable to the trust beneficiaries to return the stock or its value plus increase in value unless he was a bona fide purchaser (for value and without notice) . The fact that he received the stock for $10,000 less than its value impliedly puts John on notice that A was acting in violation of her fiduciary duties. Normally, a trustee may not sell stock for less than fair market value. He wilt then be liable to the beneficiaries for $10,000 and perhaps the value of the increase. He may, however, still proceed against A under Trust #1.

What are the rights and liabilities of A?

As noted above, A violated her duty under Trust #2 and is liable to the beneficiaries for $10,000 (difference of fair market value - amount received).

A is also liable to J for the debt incurred in 1971 and as a co-settlor, may not shield herself therefrom. Under Trust #1 Nancy, as trustee, may be forced to pay J directly any income A is due to receive under that trust.

What are the rights and liabilities of L?

Larry received the stock as a gift from J. Although he had no notice, he failed to give value which is required of a bona fide purchaser. As such, he is not allowed to keep the stock and must return it to the equitable owners, the beneficiaries, and the legal owner, the trustee. As such, the stock will be put in an equitable constructive trust. A constructive trust occurs where one holds property wrongfully as against rightful owners. The courts impose this type of trust in order to protect rightful owners. Here, the five named beneficiaries will be protected and may enforce the return of the stock. If it is returned, then L and J will not be further liable. L, however, will have no claim against J because it was a gift.

However, if L has changed positions as a result of reliance on the gift of stock, he may have some claim against J. However, this is unlikely because L gave no value.

July 1985
QUESTION 3

Bill, a widower, had one child, his daughter June. Bill purchased a $100,000 farm (Blackacre), bought a single payment life insurance policy on his own life (face amount $50,000), and maintained a large balance in a checking account (usually $100,000). Titles to the farm and the account were always in Bill's name only. June was named originally as beneficiary of the insurance policy, but Bill reserved the power to change the designation of his beneficiary.

A few years before his death, Bill requested the insurance company to make Joe, his neighbor, sole policy beneficiary. After the company informed Bill the change had been made, Bill wrote Joe: "I have named you my insurance beneficiary--yo« are to collect the proceeds and divide them three ways. You are one; the others I shall name later." Joe replied: "Sure, I'll do what you want."

In June 1980, Bill executed a deed conveying Blackacre to an old friend, Pete. The day of this execution, Bill mailed a signed letter to Pete directing him to "rent my farm, pay the net income to June yearly, and when she dies, convey the farm to my church." Pete received and read the letter. A few days later, Bill attempted to deliver the deed to Pete but found out from Pete's housekeeper that Pete was on a three-month sailing trip in the South Pacific. Bill gave the housekeeper the deed and told her to give it to Pete when he returned.

In July 1980, Bill suffered a heart attack and while hospitalized, executed a valid will which left "all property I own to my daughter, June, and I recommend that she look out after my 90-year-old Aunt Selma, as long as she lives, making such gifts and provisions for her as she, June, thinks best."

The day after executing this will, Bill wrote the. following on a separate piece of paper: "To Joe: the other two beneficiaries are Tom Allen and his wife."

Bill died the following day. Two days after Bill's death, Pete's housekeeper handed Pete the deed.

Who is entitled to the assets and why? Discuss.

ANSWER A TO QUESTION 3

PROCEEDS OF THE INSURANCE POLICY

Insurance proceeds pass free of probate, so June as Bill's devisee under the will would not take the insurance policy proceeds.

Although Joe is the sole named beneficiary under the policy, Joe agreed with Bill to collect the proceeds and divide them three ways. Bill wrote this information to Joe and Joe replied, "I'll do what you want." Because he made this agreement, he may be the trustee of the proceeds for himself and Tom and his wife.

By writing this letter to Joe, Bill made the proper declaration of trust, or it shows he intended Joe to be the trustee of the proceeds.

Joe is trustee, and the fact that he is one of the beneficiaries is not fatal to the creation of the trust, since there are other beneficiaries (see below) and therefore someone to enforce the fiduciary relationship.

Although at earlier common law the proceeds of an insurance policy on Bill's life might not have been a sufficiently present trust res, such trusts are now almost uniformly held valid.

The trust is not for any obvious illegal purpose.

Thus the proceeds are the trust res and Joe holds them in trust. Since no realty is involved, an oral trust would be enforced. Here Bill made his intention known in writing, and Joe "replied", so probably the writing requirement is satisfied anyway. The fact that testamentary formalities were not complied with is irrelevant, since as stated above, insurance proceeds are not deemed testamentary.

The final requirement for a valid trust is that it have ascertainable beneficiaries. (A private trust, as this is.) The problem here is that Bill said he would "name them later." However, contingent beneficiaries have been held to be sufficient to support a valid trust, as long as there is an ascertainable standard by which to determine them and the beneficiaries are ascertainable at the time that their interest comes into possession. Since Bill wrote the names of the beneficiaries on a paper the day after executing his will, this may be sufficient.

If a valid trust is not created because of lack of ascertainable beneficiaries, then Joe keeps the insurance proceeds outright.

However, there may be another theory if the express trust fails, and that is to impose a constructive trust on Joe for the benefit of Allen and his wife if Joe were to refuse to deliver the 2/3 of the proceeds. Most courts would impose such a constructive trust to prevent unjust enrichment of Joe, since he could otherwise be said to be guilty of fraud if he promised at the time to do as Bill requested and then later backed out.

Holographic Will Theory

The note written by Bill naming Tom and his wife as beneficiaries could not be probated as a valid holographic will. It is not signed. It is not clear if it is in his handwriting. It is not clearly disposing of property, but is giving instructions.

Incorporation by Reference

The note cannot really be said to be incorporated by reference into Bill's will either since it was written after the will, and at any rate the will does not apparently refer to any other document or identify such a piece of paper. The most important requirement, however, is that such a document be in existence at the time of the will, and this note was written the day after. For the same reason, the note could not be integrated into the will.

Conclusion: Insurance Proceeds

Joe should get the insurance proceeds, to hold as trustee for himself, Tom Allen and his wife, divided three ways. This is an inter vivos trust and the beneficiaries are ascertained by the written note.

BLACKACRE

There are two important questions with respect to the disposition of Blackacre: first, is there a valid trust created, and second, was there a valid delivery of the deed?

Delivery of the Deed

To be an effective conveyance, a deed must be delivered, which is more a question of the grantor's intent than it is a question of physical transfer of the piece of paper.

Here Bill clearly intended an inter vivos transfer -- a present transfer of interest to Pete. He attempted to deliver the deed to Pete but had to leave it with Pete's housekeeper. This shows his present intent to transfer. If he meant to transfer interest only after his death, he would probably have kept the deed for the 3 months that Pete was on his sailing trip. Instead, he gave it to his housekeeper. The housekeeper is Pete's agent, and when there is physical delivery or transfer of a deed to the grantee's agent, this raises a presumption of present delivery. So Bill's delivery to the housekeeper as agent for Pete, coupled with what can be inferred from that act, would likely make this a valid inter vivos transfer.

If, however, the deed were held not to be validly delivered during Bill's life, then it would fail as a testamentary transfer, since it was not completed with the necessary formalities -- execution in the presence of witnesses who also sign.

Valid Trust

Assuming Pete is the valid legal title holder of Blackacre, as argued above, it must be determined if Bill's letter to Pete directing him to pay the income to June for life and remainder to the Church is a valid and enforceable trust.

A trust must have a res, a transfer of present interest, a trustee, a valid purpose, and ascertainable beneficiaries to be valid. Since this involves the transfer of land, the statute of frauds also requires a writing. Here Bill wrote his trust instructions to Pete, and the deed was transferred. Thus all the requirements of a valid trust would seem to be met.

Conclusion: Blackacre

Pete holds Blackacre in trust for June for life, and then to Bill's church. (Bill only states "my church": as long as he only has one church, there is no problem with ambiguity.)

However, if the deed is held not to be validly delivered, it would fail as a testamentary devise and would then go to June under Bill's will. (See below).

CHECKING ACCOUNT: BILL'S WILL

Bill executed a valid will leaving everything to his daughter June. Thus June would get the $100,000 in the checking account and Blackacre if it failed as a deed. The question here is whether the words in Bill's will, recommending that June "look out" for Aunt Selma, are sufficient to create an enforceable interest in Aunt Selma.

The words seem to be precatory, in which case June would be title owner of Bill's money and would be under only a moral obligation to take care of Aunt Selma. Bill only "recommends" looking after Selma. He says to make only such gifts as June "thinks best." These words do not seem sufficient to create a fiduciary obligation in June, to hold this money in a discretionary trust for Selma.

However, sometimes precatory words will support the creation of a trust or will be found to be sufficient evidence of a trust intention if, for example, there are detailed instructions, or extrinsic evidence shows that the settlor supported the intended beneficiary, or the intended trustee and intended beneficiary are already in a fiduciary relationship.

Although there is not much detail here, Bill does speak of "gifts and provisions" for as long as Selma lives. Since Selma is 90, it is very possible that Bill was taking care of her. And Selma and June are in a family relationship. Although it seems a close case, a court might find under these facts that Bill created a valid testamentary trust, with June as trustee for Selma, to "look out for" or "support" her in her (June's) discretion.

The problem with such a solution is that it does not seem to carry out Bill's intent, because June would then own all the property left under Bill's will as trustee for Selma. June would not own any of it for herself, at least until Selma died, and then June would take the trust as a resulting trust back in the settlor -- June would then take the resulting trust res as Bill's intestate heir. However, since Bill did attempt to provide yearly income to June through the trust he attempted to set up with Blackacre, this may have been his intent.

## ANSWER B TO QUESTION 3

Distribution of Bill's assets through his will would go mainly to his daughter June. However, the transactions occurring prior to Bill's death may influence what assets will be available for distribution at Bill's death through the will.

Any property which was given away or placed in an inter vivos trust prior to Bill's death will not be included for testamentary disposition. For ease of analysis, I will discuss each asset individually.

1. INSURANCE POLICY

Bill changed the beneficiary of the policy from June his daughter to Joe the neighbor. Upon informing Joe of the change, he also gave Joe directions on distribution of the proceeds.

It is possible that B was attempting to create an inter vivos trust. A trust is essentially a division of legal and equitable title. In order to do so, there must be: 1) a trustee; 2) a beneficiary; 3) compliance with formalities; 4) a proper trust purpose; and 5) delivery of trust property (res).

Here Joe was named as trustee and he agreed. Although he was also a beneficiary, he is not the sole beneficiary since B had told him that the other beneficiaries will be named later. If Joe were the sole beneficiary and sole trustee of an irrevocable trust, there would be no trust since creation of valid trust requires that there be enforceable duties. If Joe were both trustee and sole beneficiary, he could not enforce the trust against himself.

B has designated the life insurance policy as the trust property. In order to be valid, the trust must contain existing rights and not future expectancies. Life insurance policies have been held to be valid trust property and not mere expectancies. Although Bill reserved the power to change beneficiaries (thus making the trust revocable), the trust res will be created if there was a trust intent of B. Although the facts do not specify if the policy (or a copy) was delivered to Joe, failure of delivery is not fatal if there was an intent by Bill to transfer title to Joe. Clearly there was since Bill had the insurance company change the policy.

The fact that Bill has left open other beneficiaries to be named in the future will not destroy the trust so long as one definite beneficiary was named. In this case, Joe was named.

A settlor of a trust may reserve some powers as long as he has given up dominion and control. Here Bill only reserved the power to name beneficiaries, so this should not be construed as control.

Since no charitable purpose was stipulated, this would be a private trust.

A problem arises since Bill did not name the other 2 beneficiaries of the insurance trust until just before he died and after executing his will. The final disposition deprives June of any of the insurance proceeds (amounting to $100,000).

June may try to argue that her father had just had a heart attack the day before and thus may have lacked capacity to dispose of his estate. Further, it is not clear that Joe ever got notice of the other two beneficiaries.

June may also try to argue that the entire transfer failed for lack of delivery of the policy to Joe. However, the alteration of the policy itself will probably be sufficient since the trust res was already in place. Joe was the trustee of a valid trust and also entitled to 1/3 of the policy. Since the other beneficiaries were named during B's life, they can receive the other 2/3 (assuming no fraud or duress).

Note that Bill could not give 2/3 after his death (by his will) since it was an inter vivos trust. June may try to argue that the gifts (2/3) to Tom Allen were after B's death, but she will probably lose since delivery occurred when Joe was named beneficiary, not when the others were added.

2. <u>BLACKACRE</u>

Again B has attempted an inter vivos disposition of his property. B has attempted to set up a trust with life income to June and remainder to B's church. If the deed stated to "Pete as trustee", a trust clearly would have been created. However, B appears to have transferred title to Pete outright. Any transfer of real property must be in writing to satisfy the statute of frauds. Here, B's letter (signed) to Pete specifies that the deed is transferred pursuant to a trust for the benefit of June. Thus the lack of restriction on the deed should not be a problem.

There is a problem with the trustee's assent to being responsible for the trust. B gave the deed to Pete's housekeeper, who did not give the deed to Pete until after B's death. In order for this trust to be valid, the trust must be executed (formed) prior to B's death, or attempted trust will fail and the property will pass under the will to June. Here the difference is significant since under the will June would get the entire property outright, and under the trust she gets only a life interest.

Here since B actually delivered the deed to Pete, there should not be a problem. Even though the maid had custody of the deed, she held it as agent for Pete. Thus delivery should be accomplished.

3. THE WILL

Any property remaining at B's death will pass under the will. Since B's will is stated to be validly executed", all formalities have been met. However, B must have had testamentary capacity at the time of making the will. This may be a problem due to his suffering a heart attack that same day. Assuming he had capacity, the residue of estate will go to June.

The provision for the 90-year-old Aunt Selma gives June absolute discretion in making gifts to Selma. This could be construed as an expression of testamentary trust, naming June trustee for Aunt Selma. It could also be construed as precatory language of desire which June should follow. The difference is that as a trustee, June would have a duty of good faith and due care enforceable by Selma. As precatory words of hope or desire, June's duties would not be mandatory. Since B has "recommended" rather than required, it is doubtful that a trust would arise here.

Any property remaining in B's estate, thus, would go to June. This includes whatever is left in the checking account. It also could include any of B's inter vivos dispositions which may have failed.

## February 2005
## Question 6

In 2003, Sam executed a valid testamentary trust, naming Tom as trustee. The terms of the trust state:

(a) All net income is to be paid to Bill, Sam's nephew, for life;
(b) Tom may invade principal for Bill in such amounts as Tom, in his sole and absolute discretion, determines;
(c) The trust terminates on Bill's death and any remaining principal is to be distributed to Alma Mater University;
(d) The interests of the beneficiaries are inalienable and not subject to the claims of creditors.

In 2004, Sam died.

In 2005, Lender obtained a judgment against Bill for an unpaid credit card bill that includes charges for tuition, groceries, and stereo equipment. Lender now requests a court order directing Tom to pay all future installments of trust income to it rather than Bill until the judgment is satisfied.

Bill is delinquent in making child support payments to Kate, his former spouse, for their child. Kate now requests a court order directing Tom to pay all future installments of trust income to her rather than Bill until the arrearages are eliminated.

Bill wants Tom to invade the trust principal so Bill can promote a newly-formed rock band, but Tom has refused. Bill now requests a court order directing Tom to invade the trust principal.

Because of Tom's refusal to invade the trust principal, and because Alma Mater is concerned over Bill's debt difficulties, Bill and Alma Mater wish to terminate the trust in order to divide the trust principal, but Tom has refused. Both Bill and Alma Mater now request a court order terminating the trust.

How should the court rule on the requests made by Lender, Kate, Bill, and Alma Mater? Discuss.

## Answer A to Question 6

A trustee is a fiduciary relationship with respect to property where a settlor transfers property to a trustee who holds the property for the benefit of named beneficiaries, for a valid trust purpose. On the facts, Sam executed a valid express testamentary trust naming Tom as the trustee and Sam and Alma Mater University as beneficiaries. Sam has a life interest in the trust and Alma Mater has a remainder interest.

(1) Request by Lender

The express trust created creates a spendthrift clause under (d). As a general rule, a beneficiary's interest is both voluntarily and involuntarily alienable as a property right. Involuntary alienation allows a creditor to attach to the beneficiary's rights to future payments by obtaining a judgment.

A spendthrift clause is designed to protect the beneficiary from their spendthrift ways by prohibiting both voluntary and involuntary alienation of the beneficiary's right to future payments. Thus the spendthrift clause created in (d) prohibits Lender from attaching to Bill's future payments of income. The provision explicitly state's [sic] that the beneficiaries' interest is inalienable and not subject to creditor's claims.

However, the courts recognize exceptions to the protection provided by spendthrift provisions including where a creditor has provided necessaries to the beneficiary. Necessaries include items such as food, clothing, shelter and medical care.

On the facts, Lender provided Bill with tuition[,] groceries[,] and stereo equipment. A court would likely find that only the groceries were necessaries and would order that Lender be entitled to payment for the groceries from the income of the trust. Thus a court would likely grant Lender's requested order for payment of Bill's grocery debt.

With respect to the stereo and tuition, Lender could seek recovery based on surplus. The concept of surplus is recognized in some jurisdictions and allows a creditor to attach to future payments to the beneficiary despite a spendthrift clause where the income to be paid exceeds the beneficiaries['] station in life, thus resulting in a surplus. On the facts it is unclear what income is produced in relation to Bill's station in life. In making the determination as to whether surplus exists the court will only consider Bill's reasonable expenses. If Lender can establish surplus, a court would likely grant his requested order and direct Tom as trustee to pay future installments of surplus to Lender to satisfy Bill's debt.

(2) <u>Request by Kate:</u> Preferred Creditor

In addition to the two exceptions noted in relation to Lender, the courts have also recognized an exception for preferred creditors.

A court will disregard a spendthrift clause and allow a preferred creditor to attach to the beneficiary's future income payments from the trust. Preferred creditors include government debt and outstanding child and spousal support and alimony payments.

On the facts, the beneficiary Bill has failed to make child support payments to his former spouse Kate for the support of his child. Thus Kate is a preferred creditor and is entitled to attach to Bill's right to future income from the trust to satisfy the delinquent child support.

Therefore, a court would likely grant Kate's request and order Tom to pay trust income to Kate in satisfaction of Bill's outstanding child support obligation until the arrearages are eliminated.

(I Request by Bill - Discretionary Trust Provision

Under the terms of the will, Tom has sole and absolute discretion to determine whether or not to invade the trust principle [sic] for Bill's benefit. Tom as trustee has all express powers as set out in the trust and all implied powers required to exercise the express powers. As a fiduciary, Tom has an obligation to exercise his discretion in good faith. On the facts, there is no indication that Tom's refusal to invade the trust principal to allow Bill to promote the rock band was made in bad faith.

Therefore, based on the facts, the court would not interfere with Tom's discretion as explicitly set out in the trust and would deny Bill's request. The court would not therefore order Tom to invade the trust principal.

® Request by Alma Mater & Bill - Termination

A court will not order a termination of a trust even with the consent of all beneficiaries where such termination would be in violation of the trust purposes and would be contrary to the testator's intent.

The trust established by Sam evidences a clear intent to provide for Bill during his lifetime. This is a valid trust purpose which continues until Bill's death. On the facts, Bill is still alive and thus the trust purpose is ongoing. As well, the termination of the trust would destroy Sam's intent to provide for Bill throughout Bill's life.

In addition, the trust has not become passive as Tom, the trustee, still has active duties in maintaining and managing the trust. Nor have circumstances changed such that the doctrine of changed circumstances would apply to modify the trust terms.

Therefore, the court would uphold Tom's refusal to terminate the trust and would deny Bill and Alma Mater's request since termination would destroy the settler/testator (Sam's) intent.

## Answer B to Question 6

Trust actions are governed by the trust document. Valid

Trust

A valid inter vivos trust was created since Sam (S), the settlor, had an immediate intent to create a trust for a legal purpose, and delivered a presently existing res, title property interest, to Tom (T), the trustee, for the purposes of management for the benefit of the beneficiaries Bill (B) and Alma Mater (AM).

Type of Trust

Income

B has a life interest in the income of the trust, subject to its provisions.

Mandatory Distributions (Provision A)

The trust sets out mandatory distributions of income to B by T. T must then distribute the income to B.

Spendthrift Provision (Provision D)

All distributions, both income and principal, are subject to a spendthrift provision. This prevents creditors from attaching and beneficiaries from voluntary [sic] assigning their rights. This is held as valid restraint. B & AM may not alienate nor may creditors attach. There are, however, exceptions to the creditor[']s rule discussed below.

Principal

Discretionary to Bell (Provision B)

T is given discretionary power to distribute principal to B. T is thus not required to distribute any principal and may distribute as he feels is necessary) [sic][.]

AM (Provision C)

AM has a right to all of the principal remaining at B's death subject to the spendthrift limitation.

T's Fiduciary Duty

Trustees are subject to fiduciary duties. T is thus bound to follow the provision set out by the trust. As such, his actions below with the individuals are governed by the document provisions discu[s]sed above.

Parties' Requests Lender

As explained, as a spendthrift trust, creditors may not normally attach and T cannot be required to pay off the court order. Exceptions for creditors are made for the following creditors: government creditors, tort judgments, spousal or child support, alimony, necessities and surplus above station.

Here, Lender seeks reimbursement for groceries, a necessity. Since courts want beneficiaries to be able to obtain necessities based on credit, this exception exists and reimbursement may be made. Lender may also argue tuition is a necessity but this is likely to fail[.]

The right to collect for the stereo equipment and education may come under the surplus exception. Creditors may attach to the income a beneficiary receives beyond that which is necessary to maintain their station in life.

It is unclear here what amount B receives and what amount his past lifestyle dictates is necessary for maintenance[.] Lender may have an argument and thus gain attachment. T will then be required to make payments to Lender[.]

Kate

Again, the income to B is subject to the spendthrift provisions. Kate, however, has a claim under the exception for child support payments, since this is a creditor that courts have felt should not, in equity and public policy, be excluded. Kate may attach and require T to make payments to her. Her order ought to be granted.

Bill's order will fail. The trustee[']s fiduciary duties to the trust are governed by the document and T is granted discretion in his allocation of principal to B. T's decision not to support B's rock band plans, especially in light of B's other monetary problems, is reasonable. T appears to be using his discretion to fulfill his duty of care, acting as a reasonably prudent person managing other people's money, under the circumstances.

Further, in using his discretionary powers, T must also adhere to his duty of loyalty to all beneficiaries. While AM only has a right to the leftover, he may also consider that all parties', including B's, best interests may be served investing the principal. B's order should be denied.

Alma Mater

B&AM have both requested that the trust be terminated. A trust may be terminated where all the beneficiaries, including unborn beneficiaries represented by legal counsel, petition the court for determination. The court must also find that all of the purposes of the trust have been fulfilled.

While all the beneficiaries (present & future) are currently petitioning, B&AM, the court is likely to find that the trust's purposes have not been fulfilled. S created a trust that granted B a lifetime right in the income of the trust subject to a spendthrift clause[.]

It appears from the terms that S was attempting to insure for the provision of income to B, despite his issues with spending wisely. To prematurely cancel the trust would leave B without the protections that S intended. Cancellation would be directly at odds with this purpose.

Though it may fulfil the purpose of AM's gaining some of the principal, their express right in the trust is only to the remaining principal and not the most principal they can receive. Further, this purpose of S is best protected by T's discretionary power over the principal. B&AM's order to terminate should thus be denied.

Additionally, AM's concerns over the debts fail since B's right to the principal, AM[']s interest, is subject to T's discretion. Even if the creditors could attach under an exception, attached creditors to a discretionary interest only have a right to collect when T chooses to pay out. Only in that scenario is T required to pay the creditor. AM's interest is thus further protected and S's purposes are better furthered through the continuation of the trust and the order ought to be denied.