Trustee Defenses

Statute of Limitations, Laches, Self-Executing Accounting Release Provisions, and Exculpatory Clauses

By Kevin J. Parker

This article addresses certain defenses available to trustees against claims brought by trust beneficiaries and focuses on timeliness defenses (statute of limitations, laches, and self-executing accounting release provisions) and exculpatory clauses. At the end of the article, certain practice tips are provided.

Statute of Limitations and Laches

The law on the time limits for a beneficiary to bring an action against a trustee has evolved over time. In early cases, the courts were pro-beneficiary, rejecting time limit defenses on various grounds, including that the cause of action was not time barred unless and until a certain period of time had elapsed after termination of the trust or resignation of the trustee, or that statutes of limitation were tolled until full disclosure had been made by the trustee. Some courts held that statutes of limitation did not apply at all, on the theory that claims against trustees were equitable claims and therefore only equitable timeliness defenses (laches, for example) were available to the trustee. The modern rules are more pro-trustee.

Most states follow one of three systems: the Restatement system, the Uniform Trust Code (UTC) system, or the Uniform Probate Code (UPC) system. The Restatement system is essentially a laches system. The Uniform Trust Code system is primarily a statute of limitations system. The Uniform Probate Code system is primarily a final accounting release system, with a statute of limitations component.

The Restatement (Second) of Trusts § 219 provides as follows:

> (1) The beneficiary cannot hold the trustee liable for a breach of trust if he fails to sue the trustee for the breach of trust for so long a time and under such circumstances that it would be inequitable to permit him to hold the trustee liable.
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> (2) The beneficiary is not barred merely by lapse of time from enforcing the trust, but if the trustee repudiates the trust to the knowledge of the beneficiary, the beneficiary may be barred by laches from enforcing the trust.

The Restatement comments identify certain factors that the court will consider, including (1) the length of time that has elapsed between the breach of trust and the bringing of suit, (2) whether the beneficiary knew or had reason to know of the breach, (3) whether the beneficiary was under an incapacity, (4) whether the beneficiary's interest was presently enjoyable or enjoyable in the future, (5) whether and when the beneficiary had complained of the breach, (6) the reasons for the delay in the beneficiary suing, (7) any change of position by the trustee, including loss of rights against third parties, (8) the death of a witness or parties, (9) hardship to the beneficiary if relief is not given, and (10) hardship to the trustee if relief is given.

Although section 219 speaks in terms of "laches" rather than statute of limitations, comment (b) references the "analogous" statute of limitations as impacting the analysis: "The length of time necessary to bar the beneficiary from holding the trustee

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liable for breach of trust depends upon the circumstances. In the absence of special circumstances the beneficiary is barred if the period of the Statute of Limitations applicable to actions at law in analogous situations has run."

A question often arises whether time deadlines for bringing a claim can start to run against a beneficiary whose interest is not presently enjoyable. Comment (e) answers that question in the affirmative. Comment (e) to the Restatement (Second) of Trusts § 219 provides that a beneficiary who has an interest enjoyable only in the future may still be guilty of laches by reason of failure to sue even before his interest becomes presently enjoyable.

For states that traditionally follow the Restatement, one issue that will need to be addressed in the near future is whether the courts will follow the Restatement (Second) or the Restatement (Third). If adopted in the form of the Tentative Draft, the Restatement (Third) of Trusts § 98 would provide as follows: "A beneficiary may not maintain a suit against a trustee for breach of trust if the beneficiary is barred from doing so by the doctrine of laches or by a statutory period of limitation."

Notably, the Tentative Draft specifically recognizes the applicability of statutes of limitation, not simply laches principles.

In contrast to the Restatement, the Uniform Trust Code provides specific deadlines for most claims. Uniform Trust Code § 1005 provides as follows:

> (a) A beneficiary may not commence a proceeding against a trustee for breach of trust more than *one year* after the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding.
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> (b) A report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.
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> (c) If subsection (a) does not apply, a judicial proceeding by a beneficiary against a trustee for breach of trust must be commenced within *five years* after the first to occur of:
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> > (1) the removal, resignation, or death of the trustee;
> >
> > (2) the termination of the beneficiary's interest in the trust; or
> >
> > (3) the termination of the trust.

UTC § 1005 (emphasis added).

The Uniform Trust Code puts the onus on the trustee to make disclosures to the beneficiary to take advantage of the shorter one-year statute of limitations. It remains to be seen how the courts will interpret and apply the requirement that the report to the beneficiary "adequately discloses" the existence of a potential claim for breach of trust. In particular, it is uncertain whether a standard annual accounting will satisfy the courts. Most likely, that will depend on the nature of the claimed breach.

The Uniform Probate Code provides an entirely different claims-bar mechanism. Uniform Probate Code § 7-307 provides as follows:

> Unless previously barred by adjudication, consent or limitation, any claim against a trustee for breach of trust is barred as to any beneficiary who has received a final account or other statement fully disclosing the matter and showing termination of the trust relationship between the trustee and the beneficiary unless a proceeding to assert the claim is commenced within [6 months] after receipt of the final account or statement. In any event and notwithstanding lack of full disclosure a trustee who has issued a final account or statement received by the beneficiary and has informed the beneficiary of the location and availability of records for his examination is protected after 3 years. A beneficiary is deemed to have received a final account or statement if, being an adult, it is received by him personally or if, being a minor or disabled person, it is received by his representative as described in Section 1-403(1) and (2).

Section 7-307 is primarily an accounting-release provision. But the introductory clause ("Unless previously barred by adjudication, consent or limitation") makes clear that the accounting-release concept is in addition to, rather than in lieu of, other claim bars. See, e.g., *Harris Trust Bank of Arizona v. Superior Court*, 933 P.2d 1227, 1231 (Ariz. Ct. App. 1996) (holding that statute of limitations defenses were viable and that the accounting-release provisions of the UPC constituted additional defenses).

An issue often arises as to whether claims of certain beneficiaries are barred "by representation." For example, if claims of income beneficiaries are barred, does that mean that claims of remainder beneficiaries are barred as well?

The Uniform Trust Code contains provisions relating to virtual representation whereby notice to one person may bind another. See UTC §§ 301–305.

The Uniform Probate Code also contains virtual representation provisions, but such provisions are restricted to court proceedings. See UPC § 1-403.

A related issue is the appropriate calculation and measure of damages for breach of trust when claims by some beneficiaries are barred but others are not. Restatement (Second) of Trusts § 219, comment (e), addresses the circumstance in which the claims of a life beneficiary are barred, but claims by the remainderman are not. In that instance, comment (e) provides: "[T]he trustee owes a duty to the remainderman to pay into the trust the amount of the loss, but the trustee is entitled to take the income during the life of the life beneficiary on the amount so repaid."

Self-Executing Accounting Release Provisions

Many trusts include a provision whereby the trustee is purportedly released from liability for the period covered by a particular accounting if the trustee sends the accounting to a designated group of beneficiaries and no beneficiary objects within a certain time frame.

Other trust instruments include a provision that approval of the accounting by a certain beneficiary or class of beneficiaries carries the same weight as court approval. Both the Restatement (Second) and Restatement (Third) (via comments) endorse this basic procedure and deem it effective. But there is some case law to the contrary.

Restatement (Second) of Trusts § 172 provides as follows: "The trustee is under a duty to the beneficiary to keep and render clear and accurate accounts with respect to the administration of the trust." Although this provision does not speak to the accounting-release concept, that concept is addressed in the comments. Comment (d) provides, in pertinent part:

> By the terms of the trust it may be provided that the trustee shall submit an accounting to a particular person, for example one of the beneficiaries of the trust, and that the approval of the account by that person shall discharge the trustee. Such a provision is effective, provided that the third person acts in good faith in giving his approval and provided that the trustee made a proper disclosure in his accounting of his conduct in the administration of the trust.

Restatement (Third) § 83 provides as follows: "A trustee has a duty to maintain clear, complete, and accurate books and records regarding the trust property and the administration of the trust, and, at reasonable intervals on request, to provide beneficiaries with reports or accountings." As with the Restatement (Second), the Restatement (Third) does not address the accounting-release concept in the specific provision but does so in the comments. Comment (d) provides, in pertinent part:

> The terms of trusts sometimes provide that the trustee need only account or submit reports to a designated person, for example, to one of the beneficiaries of the trust (or to the settlor of an irrevocable inter vivos trust), and that the approval of the trustee's account or report by that person shall discharge the trustee from liability. A provision of this type is effective, provided (i) the other person in giving approval acts neither in bad faith nor in casual disregard of the interests or rights of the nonassenting beneficiaries and (ii) the accounting appropriately discloses material issues about the trustee's conduct. (The provision does not eliminate a beneficiary's right to information under § 82.) The designated person's approval, however, is subject to court review for abuse, with particular attention (see (i) above) to neglect or to the possible effects of a conflict of interests between that person and a beneficiary (or even to a settlor's disregard of beneficiary rights that the settlor has no power to modify). This review is available to a beneficiary regardless of a trust provision to the contrary, such as one purporting to make the trustee's discharge final or conclusive upon the designated persons' approval (cf. § 87). The beneficiary's right of review, however, is subject to the doctrine of laches or an applicable period of limitation (see § 98).

Although case law is sparse on the topic, the recent Illinois case of *Vena v. Vena,* 899 N.E.2d 522 (Ill. App. Ct. 2008), is notable. In that case, the Illinois Court of Appeals held that an accounting-release provision was unenforceable as being against public policy. The Illinois court did, however, explicitly note that it was not making any determination regarding whether a provision as described in the Restatement (Third) § 83, comment (d), would be upheld under Illinois law:

> We have no reason to decide here whether the trust provisions that section 83, comment *d*, describes are in fact permissible under Illinois law. The provision here, as the parties agree, goes beyond what comment *d* endorses; without deciding whether a provision strictly modeled on comment *d* would be enforceable under Illinois law, we hold that the provision in Harry's trust is contrary to public policy because of the limitations it places on redress for serious trustee misconduct.

899 N.E.2d at 526. The particular trust provision rejected by the Illinois Court of Appeals in *Vena* provided that approval by a majority of the income beneficiaries would release the trustee the same as if the trustee's accounts had been approved by the court. The Illinois court held that such a provision "too thoroughly deprives an individual beneficiary of the ability to enforce his or her rights and too thoroughly insulates the trustee from accounting to a court." Id. at 528.

Even if the self-executing accounting release provision is not strictly enforceable, it may be beneficial for the trustee. It may have a chilling effect on claims; and it would be an important point in the trustee's favor for a laches defense.

Exculpatory Clauses

Many trusts include a provision that purports to immunize the trustee from liability to the beneficiaries absent something beyond "ordinary" negligence or breach of fiduciary duty, such as fraud or intentional misconduct.

In the early days, such clauses were held unenforceable as against public policy. The modern rule (reflected in the Restatement and uniform statutes) provides for enforceability of such clauses, with certain limitations, although some state statutes still invalidate such clauses.

Most states deal with exculpatory clauses in trust instruments in one of three ways. Some states follow the Restatement principles. Some states have adopted the Uniform Trust Code. Some states have, by statute, nullified exculpatory clauses as being against public policy.

The Restatement and Uniform Trust Code provisions are similar. Both provide that exculpatory clauses are generally enforceable. Both provide that such clauses are to be strictly construed. Both establish substantive limitations, providing that the exculpatory clause does not relieve the trustee from bad faith, intentional misconduct, or reckless indifference. Both the Restatement and Uniform Trust Code also provide that an exculpatory clause will be unenforceable if insertion of the clause into the trust instrument was itself a breach of fiduciary duty.

The Restatement (Second) of Trusts § 222 provides as follows:

> (1) Except as stated in Subsections (2) and (3), the trustee, by provisions in the terms of the trust, can be relieved of liability for breach of trust.
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> (2) A provision in the trust instrument is not effective to relieve the trustee of liability for breach of trust committed in *bad faith* or *intentionally* or with *reckless indifference* to the interest of the beneficiary, *or of liability for any profit which the trustee has derived from a breach of trust*.
>
> (3) To the extent to which a provision relieving the trustee of liability for breaches of trust is inserted in the trust instrument as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor, such provision is ineffective.

Restatement (Second) of Trusts § 222 (emphasis added).

This Restatement provision is similar to the Uniform Trust Code provision on exculpatory clauses, with two significant differences. First, under this Restatement provision, a trustee who is relieved of liability for a breach of trust by virtue of the protections of an exculpatory clause must still disgorge profits derived from such breach of trust. In contrast, the corollary in the Uniform Trust Code, discussed infra, would not require a trustee to disgorge profits if the trustee's actions—even if constituting a breach of trust—were protected from liability by virtue of the exculpatory clause.

Second, the Restatement and Uniform Trust Code differ over defining and addressing the circumstance in which the exculpatory clause is inserted in the trust instrument as the result of abuse by the trustee of a fiduciary or confidential relationship to the settlor. Both the Restatement and the UTC have similar clauses, but the UTC takes it one step further. UTC § 1008, discussed infra, contains an additional clause placing the burden on a trustee who drafted or caused the exculpatory clause to be drafted to "prove[ ] that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor." In the comments, the UTC clarifies that the trustee's burden is satisfied if the settlor was represented by independent counsel, even if the settlor's attorney used the trustee's form.

On trustee profits derived from actions that would constitute "ordinary" negligence but would be protected from liability under an exculpatory clause, the Restatement (Second) of Trusts § 243 provides, in pertinent part, as follows:

> If the trustee commits a breach of trust, the court may in its discretion deny him all compensation or allow him a reduced compensation or allow him full compensation.
>
> . . .
>
> g. *Exculpatory provisions.* A trustee may be denied compensation, wholly or partially, on account of a breach of trust committed by him, even though he does not incur a liability for the breach of trust because of an exculpatory provision in the trust instrument. See § 222.

Subsection (g) dovetails into section 222 quoted above, reiterating that the trustee may be denied compensation in the event of a breach of trust, even if the trustee does not incur liability for such breach of trust because of an exculpatory clause.

Tentative Draft No. 5 of the Restatement (Third) § 96 provides as follows:

> (1) A provision in the terms of a trust that relieves a trustee of liability for breach of trust, and that was not included in the instrument as a result of the trustee's abuse of a fiduciary or confidential relationship, is enforceable except to the extent that it purports to relieve the trustee
>
> > (a) of liability for a breach of trust committed in bad faith or with indifference to the fiduciary duties of the trustee, the terms or purposes of the trust, or the interests of the beneficiaries, or
> >
> > (b) of accountability for profits derived from a breach of trust.
>
> (2) A no-contest clause may not be enforced to the extent that doing so would interfere with the enforcement of proper administration of the trust.

This provision is a substantial backtracking from the Restatement (Second). As noted above, the Restatement (Second) of Trusts § 222 provides that the exculpatory clause is ineffective to relieve the trustee of liability for breach of trust committed in bad faith, intentionally, or with *reckless* indifference to the interests of the beneficiary. The Tentative Draft of the Restatement (Third) removes the word "reckless" and broadens the unenforceability to "indifference to the fiduciary duties of the trustee, the terms or purposes of the trust, or the interest of the beneficiaries." Under this Tentative Draft, therefore, the exculpatory clause will be a much less effective tool for the trustee.

The Uniform Trust Code provision on exculpatory clauses is similar to the Restatement (Second). Uniform Trust Code § 1008 provides as follows:

> (a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it:
>
> > (1) relieves the trustee of liability for breach of trust committed in *bad faith* or with *reckless indifference* to the purposes of the trust or the interests of the beneficiaries; or
> >
> > (2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.
>
> (b) An exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or

> confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor.

UTC § 1008 (emphasis added).

As noted above in discussion of the Restatement (Second) of Trusts § 222, this UTC section, in contrast to the corollary Restatement section, would allow a trustee to retain a profit that the trustee made from the trust even though the profit was derived from a breach of trust, as long as such breach did not arise to the level of one of the exceptions (bad faith or reckless indifference).

Certain states, such as New York, have by statute declared exculpatory clauses to be ineffective as against public policy. See N.Y. Est. Powers & Trusts Law § 11-1.7 (limitations on powers and immunities of executors and testamentary trustees).

Practice Tips

For the trustee's benefit, the trust instrument should include a self-executing accounting-release provision. A simple clause would state that the trustee may send periodic accountings to the current beneficiaries, and, in that event, the trustee's accounting is deemed approved and the trustee is released from liability for the period of such accounting just as if the court had approved the accounting, unless the receiving beneficiary objects in writing within a certain time after receipt of such accounting.

From the trustee's perspective, there is no harm in having an exculpatory clause in the trust. Any exculpatory clause is better than none at all.

The drafting process should also anticipate a possible beneficiary argument that the exculpatory clause was allegedly inserted into the trust without the settlor's knowledge (in boilerplate, for example) or as a result of improper influence by the trustee. So the drafter should make sure the clause is explained to the settlor.

The trustee should send periodic accountings to the beneficiaries. The broader the distribution (current and remainder beneficiaries, for example) and the fuller the disclosure, the better laches and statute of limitations arguments later.

The trustee also should anticipate and proactively address standard beneficiary arguments. These arguments include the following: the accounting is incomplete; the accounting deliberately withheld or misportrayed information; the accounting did not alert the beneficiary to a potential claim; the beneficiary never received the accounting; or the beneficiary was a minor and/or incapacitated.

In addition, the trustee should anticipate beneficiary arguments to try to get around the exculpatory clause: bad faith or reckless disregard. Trustees should have a written record to explain and support significant discretionary decisions.

Trustees also need to be aware that e-mail is discoverable to the same extent as other correspondence. In the litigation discovery process, the beneficiary will be looking for some offhand remark in the e-mail chatter to try to establish bad faith to get around the exculpatory clause.

The trustee's administrative staff also must know what is a privileged communication. Simply copying in-house counsel on an e-mail does not necessarily make the communication privileged. Moreover, even a direct communication with counsel is not necessarily privileged from beneficiaries or a successor trustee in all instances. Courts are very inconsistent in decisions on such privilege issues. See, e.g., *Moeller v. Superior Court*, 947 P.2d 279 (Cal. 1997); *Wells Fargo Bank, N.A. v. Superior Court*, 990 P.2d 591 (Cal. 2000). It can be expected that a beneficiary will attempt to discover seemingly privileged communications to try to establish bad faith.

The trustee may want to be proactive by filing a petition with the court for approval of an accounting. For controversial and significant discretionary decisions, the trustee may want to petition the court for advance approval.

In some circumstances, the trustee will want to ask the court to appoint a guardian ad litem to represent minor, incapacitated, and/or unborn beneficiaries.

When sued by a beneficiary, the trustee should raise the affirmative defenses of statute of limitations and laches. The trustee should raise the exculpatory clause defense as both a ground for denial of liability and as an affirmative defense. There is some debate whether that defense is an affirmative defense. See, e.g., *Siegemund v. Shapland*, 324 F. Supp. 2d 176, 183–85 (D. Me. 2004).

The exculpatory clause does not solve all problems. Even if the exculpatory clause protects the trustee from liability, the beneficiary may argue that she still is entitled to some equitable relief, including reimbursement or forfeiture of trustee fees and/or removal of the trustee.

In the circumstance in which a trustee has resigned or been removed, and a successor trustee has been appointed, the successor trustee may have to consider whether to bring an action against the predecessor trustee. Regardless of whether the successor trustee wants to bring the action, the beneficiaries may make a demand on the successor trustee to do so. In such cases, the exculpatory clause comes into play on two levels. First, the exculpatory clause protects the *predecessor* trustee, so the successor trustee needs to take that clause into account in evaluating the viability of a claim against the predecessor trustee. Second, whatever decision the successor trustee makes, the exculpatory clause protects the *successor* trustee from complaints by the beneficiaries who disagree with the successor trustee's decision. The exculpatory clause provides an additional level of protection to the successor trustee in its discretionary decision whether to bring an action against the predecessor trustee. ■