

## TRUSTEE LIABILITY PROVISIONS

The following article is a brief outline of the extent of the liability, or lack thereof, for independent trustees in the event a common-law contract 1041 trust is sued by a would-be judgment creditor.

NOTE: It must be explained that the Internal Revenue Service claims the following nine (9) common warning signs **may reveal** an unscrupulous trust promotion:

1. A promise to reduce or eliminate income and self-employment tax (*i.e.; If you are a W-2 wage earner from the trust . . . you are not self-employed . . . no self employment tax.*).
2. Deductions for personal expenses paid by the trust (*A definite “no no”!*).
3. Depreciation deductions on an owner's personal residence and furnishings (*Again, never ever do this!*).
4. High fees for trust packages, to be offset by promised tax benefits (*A typical trust usually cost between \$1800 ~ \$3000.*).
5. Use of backdated documents (*You’ve got to be totally stupid to use this gimmick.*).
6. Unjustified replacement of the trustee (*Replacement without cause is legal but you need to be able to justify “Why”.*).
7. Lack of an independent trustee (*A person not related by blood, marriage, or employment to the Beneficiaries.*).
8. Use of post office boxes for trust addresses (*Again, this is legal but not advisable.*).
9. Use of terms such as pure trust, constitutional trust, sovereign trust or unincorporated business organization (*For some strange reason the IRS does not like patriotic or religious terms in describing a trust arrangement.*).

# Trusteeship is an important role!

## Having an Effective Trust

*make sure there is good paperwork and the trustees are independent*

For a trust to work properly, there should be an independent trustee and the paperwork must be kept in good order. Make sure your trust is not held to be a 'sham' by the IRS and therefore become ineffective.

For a trust to fulfil its objectives and work effectively, it must be administered by its trustees independently of the settlors. The settlors are the people who initially set up the trust or transfer assets to it.

The settlors must not exercise the effective control over a trust's assets, otherwise it could be held by a court to be a sham. A sham would be an attempt by the settlors to mislead third parties such as the settlor's creditors or a court into believing a trust was being established when the settlors in fact did not really intend to create a trust, but instead meant to form a structure to, say, evade tax.

So, trustees should be clearly seen as being independent of the settlors, either by appointing another person who is not a beneficiary as a co-trustee, or using some other trustee arrangement.

To be seen to be making decisions independently of the settlors; all the trustees should:

Observe the terms of the trust deed.

Keep full records of all decisions made, usually by passing trustee resolutions and lodging them in a minute book.

Act honestly and in good faith in relation to the trust property for the benefit of its beneficiaries.

Ensure that all trustees take part in every decision, unless otherwise permitted by statute or the terms of the trust deed.

Consider whether the trustees' discretion to do something should in fact be exercised, eg: trustees should not put trust assets into risky investments.

Treat all beneficiaries equally and impartially, although many trusts allow trustees to have some freedom in allocating income to discretionary beneficiaries.

An independent trustee should not simply "rubber-stamp" the settlors' decisions; otherwise a court might hold there was never intention to create a trust and that the structure is a sham.

### **Consequences**

If a trust is found to be a sham, assets that were thought to be trust property would remain subject to the rights and obligations of the property as it was held before the trust was set up.

For example, a debtor's home would still be vulnerable to a creditor, or a settlor's would automatically be available for claims against his or her estate.

The tax consequences of a sham trust could be extremely serious. The Internal Revenue Department could demand tax penalties once "a sham" was revealed.

### **Liability**

An independent trustee should ensure that he or she never becomes personally liable for actions they undertake on behalf of a trust.

The trust deed should contain an indemnity out of the assets of a trust in favor of the trustees. Other legal documents creating obligations for the trustees should have express written exclusions of liability for independent trustees so they do not become personally involved. Examples are where the trustees buy, sell or lease property or where they borrow money from a bank.

### **Do it right**

Creating a trust can be an excellent way to minimize risk. Make sure you are doing it for the right reasons, and be certain your practices and procedures are well documented.

## California Probate Code and Independent Trustees

The independent trustee brings a wealth of relevant specialist knowledge and experience to your trustee board. In a relatively short amount of time, they will be able to add enormous value to your trustee body.

The first source of law to review in regard to the liability of trustees is the California Probate Code. Let's therefore consider Probate Code Sections 15001 and 15002, which state:

15001. Except as otherwise provided by statute:

(a) This division applies to all trusts regardless of whether they were created before, on, or after July 1, 1987.

15002. Except to the extent that the common-law rules governing trusts are modified by statute, the common-law as to trusts is the law of this State.

The common-law is the case law of a State as opposed to its statutory law counterpart. As is evident from Section 15002; case law will apply except to the extent it has been modified in any way by a statute. There are a few other statutes which have modified case law, or which will be applicable in all circumstances; the first of which is Probate Code section 16011 which basically says that the trustees have a duty to take reasonable steps to defend actions that may result in a loss to the trust. This is fairly self explanatory, and doesn't really connect to trustee liability, but it does specify that the trustees have a duty to defend any such actions that may result in a loss to the trust.

There are other specific code sections which do touch on the liability of trustees to third persons. The first is Section 18000 of the Probate Code:

18000. Personal liability of trustee to third persons on contracts.

(a) Unless otherwise provided in the contract or in this chapter, a trustee is not personally liable on a contract property entered into in a trustee's fiduciary capacity in the course of administration of the trust unless the trustee fails to reveal the trustee's representative capacity or identify the trust in the contract.

The trustees avoid any possibility of liability by making sure that when in enters into any contract, actual or implied, it, the trust, specifies that the trust is a party to the contract and the trustees are acting in their fiduciary capacity as trustees on behalf of the trust. For background information, this changes the prior case law in California, which stated a trustee was personally liable on a contract unless the contract stipulated that the trustee was not liable. The cases in California setting forth this prior law are Hall v Jameson, 151 Cal. 606, 611-612 (1907), Duncan v Dormer, 94 Cal. App. 218, 221, (1928), cf. Purdy v Bank of America, 2 Cal. 2d 298, 301-302, (1935) [*trust estate also liable when properly bound by acts of trustees*].

With all of the foregoing in mind, it is important to also be aware of sub-paragraph (b) of Section 18000 of Probate Code which states:

(b) The personal liability of a trustee on a contract entered into before July 1, 1987, is governed by prior law and not by this section.

Thus, the case-law rule governing a trustee's personal liability for pre-operative date contracts has been preserved by Probate Code Section 18000(b); so for any contract entered into by a trust before July 1, 1987, the case law is applicable, and the trustees will be personally liable on a contract unless the contract stipulates that the trustees were not liable.

To reinforce the foregoing is a quote from Section 25.01 of Trust Administration & Taxation, Nossarnan & Wyatt:

25.01 As a general rule under the common law of trusts, the trustee is personally liable on contracts made on behalf of the trust. This rule has been revised in California by its Trust Law (effective July 1, 1987), providing now that a trustee is not personally liable under a contract properly entered into in the fiduciary capacity of trustee in the course of administering the trust unless the trustee fails to either reveal representative capacity or identify the trust in the contract.

The next code section we want to consider is California Probate Code Section 18001, which states:

18001 Personal liability of trustee arising from ownership or control of trust estate. A trustee is personally liable for obligations arising from ownership or control of trust property only if the trustee is personally at fault.

A trustee is "personally at fault" when the trustee, either intentionally or negligently, acts or fails to act.

Let's briefly look at California Probate Code Section 18002:

18002: Personal liability of trustee for torts. A trustee is personally liable for torts committed in the course of administration of the estate only if the trustee is personally at fault.

In this particular area of the law, a trustee is "personally at fault" when the trustee commits a tort either intentionally or negligently. Cf. Johnston v Long, 30 Cal. 2d 54, 62-63, (1947):

Section 18004 of the California Probate Code indicates that any kind of an action against the trust has to be brought against the trustee in the trustee's capacity as trustee, for this section reads as follows.

18004. Assertion of claims against trust. A claim based on a contract entered into by a trustee in the trustee's representative capacity, on an obligation arising from ownership or control of trust property, or on a tort committed in the course of administration of the trust may be asserted against the trust by proceeding against the trustee in the trustee's representative capacity, whether or not the trustee is personally liable on the claim.

Other Code Sections which have some relevancy to this issue of trustee liability are:

- ◆ California Probate Code Section 15685, which provides that the trustee has an equitable lien on all trust property as against the beneficiary ... for liabilities sustained in the administration of the trust, or because of ownership or control of any trust property, and
- ◆ California Probate Code Section 16011, which basically specifies that the trustee has a duty to take reasonable steps to defend actions that may result in a loss to the trust.

To Summarize the Foregoing:

The trustee is the real party in interest with respect to the trust. Hence, litigation against the trust necessarily involves naming the trustee as a party.

The trustee may be subject to liability for contracts on behalf of the trust.

- ◆ When a contract was entered into before July 1, 1987, unless it is stated in the contract, there is to be no personal liability of the trustee;
- ◆ When a contract is entered into, on or after July 1, 1987, if the contract fails to specify the trust is a party, or the contract fails to reveal the trustee's representative capacity ... cf Zimmer Construction Co v White, 8 Cal. App. 3d 672

Regarding the tort situation, as was set forth in California Probate Code Section 18002; the trustee is generally liable for torts committed by himself, or herself. Probate Code Section 18001 states a trustee can be subjected to liability when he or she is the holder of title to trust property, but only when the trustee is personally at fault for the injury or damages.

A case in California specifies that a trustee who held mere title was not liable for negligence in maintenance of the building where the beneficiary controlled "operation and maintenance of the trust property"; Cf. Richman v Green, 143 Cal App. 2d 470, (1956).

The foregoing is only a brief summary of the various liability provisions in California law regarding the liability of trustees.

## **Appendix A. Definition of Independent Trustee**

Independent trustee means a trustee who:

- ✓ has not been employed by the trust in an executive capacity within the last five years;
- ✓ is not, and is not affiliated with a company that is, an adviser or consultant to the trust or a member of the trust's senior management;
- ✓ is not affiliated with a significant customer or supplier of the trust;
- ✓ has no personal services contract(s) with the trust, or a member of the trust's senior management;
- ✓ is not affiliated with a not-for-profit entity that receives significant contributions from the trust;
- ✓ within the last five years, has not had any business relationship with the trust (other than service as a trustee);
- ✓ has not had any of the relationships described above with any affiliate of the trust; and
- ✓ is not a member of the immediate family of any person described above.

## **Appendix B. Definition of Other Positions Associated with a Board of Trustees**

Following is a guide to terms used for assessment of *Trust Position* in the Application Form. The terms are not definitive but are simply a guide to assist in understanding the various titles:

### ADVISORY TRUSTEE

Trustee appointed in an advisory capacity for specific expertise, more often for a set period.

### BOARD MEMBER

Board member of an incorporated society; A board member of a statutory trust, also commonly referred to as a trustee.

### BOARD OF TRUSTEES

A minimum of 4 trustees with an elected chairman.

### CHAIRMAN

The elected presiding trustee, often with a casting vote.

### EMERITUS TRUSTEE

An honorary position for considerable past contribution, normally non-active.

### EXECUTIVE TRUSTEE

Trustee with an executive position (eg. executive officer, school principal).

### INDEPENDENT TRUSTEE

A person or entity acting as trustee, having no commercial or family ties with settlors or beneficiaries (who may also be trustees) that may make independent decisions for the trust without influence or prejudice. An Independent Trustee is more often a Professional Trustee, with affiliation to a professional trustee body.

### LAY TRUSTEE

Trustee without professional qualification with less than 7 years experience.

### NOMINEE TRUSTEE

Usually a corporate body, appointed to oversee the administration of group schemes, unit trusts, etc.

NOMINAL TRUSTEE

A trustee remunerated by a nominal per meeting amount.

PASSIVE TRUSTEE

Trustee who has very little involvement with the running of the trust except where circumstances demand.

PRINCIPAL TRUSTEE

A presiding trustee where there is no chairman or board (eg. estates, family trusts).

PROFESSIONAL TRUSTEE

A professional with affiliation to a professional trustee body, with a minimum of 5 trusteeships.

RESPONSIBLE TRUSTEE

A trustee with administration responsibilities, usually remunerated in that capacity.

SENIOR TRUSTEE

A trustee with a minimum of 7 years experience.

TRUST PRACTITIONER

A professional specializing in advising on trust administration and compliance, usually with affiliation to a professional trustee body.