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Pitfalls in the Administration of Estates

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PITFALLS IN THE ADMINISTRATION OF ESTATES

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EDITOR'S NOTE: *The following is an address made at a meeting of the Denver Bar Association on March 2, 1953.*

I am going to talk about some problems which arise in the administration of estates and trusts. Actually these problems constitute pitfalls, or traps, into which the unwary, inexperienced, or ill-advised fiduciary* may fall.

I speak of pitfalls, but bear in mind that what may be a pitfall for the fiduciary may be a windfall for the beneficiary or for a third person who has a claim against the estate. This being true, some of you may be interested in these problems from the fiduciary's point of view, some from the point of view of an attorney representing a beneficiary, and some from the point of view of an attorney suing on behalf of a third person.

We are going to deal with problems affecting executors, administrators and trustees. Generally, however, when I speak of one of these officers it includes, so far as liability is concerned, the others. All are fiduciaries, all administer property for the benefit of others, all act as principals not as agents, and all are held to a high degree of responsibility. Certainly no one should accept any of these offices, and no attorney should assume the responsibility of giving advice with respect thereto, unless he knows a great deal about this subject. Most of the pitfalls, or traps, which a trustee may encounter result from the numerous duties he owes to the beneficiaries, and the fact that a violation of any of these duties constitutes a breach of trust. There is, for example, the duty of loyalty, the duty not to delegate authority, the duty to exercise reasonable care and skill in the administration of the trust, the duty to preserve the trust property, and the duty to enforce claims. Additional dangers arise from the fact that trustees are often regarded as the owners of property, and also from the fact that many people, including too many lawyers, think of a trustee, or an executor, or an administrator, as an agent for someone. They think of him as acting in a representative capacity whereas he is not an agent. He acts as an individual and, as a rule, his liabilities are the same as an individual acting for his own benefit.

Here are some of the traps. To some of you they may be new; to others they will only serve as reminders that danger exists.

The first of these traps or problems is based on the rule of law that a trustee is personally liable to third persons for torts

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* The word "fiduciary" is here used generically to include executors, administrators and trustees.

committed in the administration of the trust to the same extent that he would be liable if he owned the property in his own right. This is true whether the fiduciary committed the tort intentionally, or negligently, or without fault, and whether or not he acted in accordance with the terms of the instrument creating the relationship.

Here is an illustration. A owned a garage that was managed by B. A died and his will authorized his executor, D (afterwards defendants), to continue the garage business with said B as manager. The State law also authorized an executor to carry on a decedent's business. During the administration of the estate P (plaintiff) drove his car into the garage and as he did so the sliding door came down and cut off the end of P's nose.

After the estate was closed, D the executor, discharged, and the assets of the estate distributed to T, a trustee, P, the injured person, brought suit for damages against D the former executor, individually and as executor. He also joined T, the trustee to whom the assets had been distributed.

T, the distributee, demurred. The demurrer was sustained. D was left as the sole defendant. Then, despite the fact that D had acted within his powers in continuing the operation of the garage, that he was not personally at fault, and that he was no longer executor, a verdict for $87,000.00 was rendered against him personally and individually.

The case then went to the Supreme Court of California. There it was held that the executor was personally liable for torts committed by the employees of the business operated by the executor, even though the will and the State statute authorized him to continue the business. This was under the doctrine of respondeat superior. The Court said that an estate is not a legal person or entity and after distribution and discharge it no longer exists; that an executor or trustee is not like an officer of a corporation, free from liability if not at fault. It is the executor or trustee, individually and personally, who acts or fails to act. The Court added that usually there is a right of reimbursement; that is, that this unfortunate D after being compelled to pay the $87,000.00, might be able to get it back from T, who now had the trust assets, but said the answer to that question depended upon whether or not the executor was at fault, or whether the distributee had so changed his position since distribution that it would be inequitable to charge him. It was not decided in the California case that D could recover from the trust estate. He was held liable individually for the $87,000.00.[1]

Here is trap number two. It is the duty of a fiduciary to procure such insurance on the trust property as is customarily taken out by prudent men with respect to their own property.

Refer again to the garage case. We found that the injured person could recover $87,000.00 from D, the former executor,

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[1] Johnston v. Long, 181 P (2d) 645 (1947).

individually. We also found that D, if not at fault, might be able to obtain reimbursement from the assets which he had distributed to T the testamentary trustee. But was D not at fault in failing to take out liability insurance? It would appear—although this is hypothetical, it is not in the decided case—that his failure to take out adequate liability insurance to cover the garage constituted a breach of trust and that, therefore, he was at fault and would not be able to recover from T, the trustee to whom the estate was distributed.

One of the first duties of an attorney representing a fiduciary should be to advise the fiduciary of the importance of adequate insurance (liability and fire).

Trap number three is another dangerous situation. It is a well established rule that a trustee is personally liable upon contracts made by him in the administration of the trust, unless the contract expressly stipulates that he shall not be so liable.

Take the garage case again. This is hypothetical, but as I have given the facts once I will use them to illustrate. Assume the following facts:

(1) T, the distributee, is now acting as testamentary trustee under the will.

(2) T was authorized to continue and did continue the operation of the garage.

(3) T decided to enlarge and build an addition to the garage.

(4) T made a contract which he signed, "T, as trustee under the last will and testament of A, deceased", and by which he agreed to pay the contractor $70,000.00 for the construction of the addition to the garage.

(5) While the addition was being built business turned bad, the trust estate went into debt, and there were no longer any substantial assets in the trust estate.

(6) The contractor presents his $70,000.00 bill to T, the trustee.

T is liable individually, just as if he had contracted on his own behalf. The fact that he signed the contract as trustee does not free him from liability. He may, or may not, be able to reimburse himself from the trust estate.

That a trustee is personally liable on his contracts is well established. It is so stated in Section 262 of the Restatement of Trusts. He is personally liable for his contracts for all purchases and services, including legal services. He is probably personally liable on notes signed by him in behalf of the estate, even though he borrows money with full authority.

The leading American case is *Taylor v. Davis, as Administrator,*[2] and followed in scores of cases. In that case the Supreme Court summed up the rule as follows:

[2] 110 U. S. 330 (1883).

> A trustee is not an agent. An agent represents and acts for his principal. . . . When an agent contracts in the name of his principal, the principal contracts and is bound, but the agent is not. When a trustee contracts as such, unless he is bound no one is bound, for he has no principal. The trust estate cannot promise; the contract is therefore the personal undertaking of the trustee.

And the same is true of executors and administrators. Even if an executor signs a contract pursuant to an order of court he still is personally bound. He may or may not be able to obtain exoneration from the estate. But any right to exoneration or payment from the estate is derivative and arises only from the relationship between the fiduciary who is personally liable, and the assets of the trust estate.

For similar reasons title should never be taken in the name of the *estate* of anybody. Corporate stock should never be registered in the name of an estate. An estate is not a legal entity. Some of you may question some of these statements but I think there is ample authority throughout the United States for all these propositions.

There is, however, a conflict of authority as to the personal liability of a trustee who signs a negotiable instrument in such a way as to disclose the fact that he is trustee for a designated estate, as for example, "John Doe, as trustee under the will of Richard Roe, deceased." Section 20 of the Negotiable Instruments Law was intended to relieve trustees disclosing the trust from such liability, but the wording is ambiguous.

Some of the courts interpret the Negotiable Instrument Act as freeing him from personal liability. Others say that he is personally liable. So far as I know there has been no decision in Colorado but it is well to assume that there is responsibility.

Now is there any way in which you can protect the trustee against personal liability on contracts and notes? There is a way. Put in your contract or on your note, "It is expressly stipulated and agreed that the trustee shall not be personally liable upon this undertaking and that the other contracting party shall look solely to the assets of the trust estate which may from time to time be in the hands of the trustee," or have him sign it as trustee and then add the words, "But not individually". At any rate, use language clearly indicating that he is *not* binding himself individually but *only* as a fiduciary.

Trap number four is a particularly mean one. It is best illustrated by the leading Minnesota case of *McLaughlin v. Minnesota Loan and Trust Company*.[3] The facts were that Minnesota real estate was leased for a 100 years, with covenants, running with the land, calling for payment of rents, taxes, assessments, etc. In 1926 one Short owned the leasehold. After his death the leasehold

[3] 255 N. W. 839 (1934).

passed by will to the trust company as testamentary trustee, and was accepted. It then turned out that the trust estate was insolvent and the reversioner (the owner of the land subject to the lease) brought suit to enforce the covenants against the trust company in its individual corporate capacity. It was held that the trust company was liable, the court saying that at law a trustee is regarded as the owner with all the rights and subject to all the liabilities of ownership. The trustee is liable or no one is liable. The trust estate itself cannot be liable to suit, and is but the fund out of which the trustee may reimburse himself for proper expenditures.

An administrator, also, is the owner of the personal property of his intestate and is subject to the liabilities incident to ownership. It makes no difference whether the property is a horse, a watch, an automobile, or a dog, as was strikingly illustrated when an administrator, who by virtue of his office became the owner of intestate's dog, was held liable for damages occasioned when the dog bit a ten year old boy.[4]

Trap number five may arise because of situations created by the Rule Against Perpetuities.

Here is what you might call the "discretionary authority trap." There are a great many trusts in which the trustee is given discretionary authority to use income, or income and principal, for the support, maintenance, and education of children, or members of a family, of a person creating a trust.

Suppose I create an irevocable living trust with the X Bank. I create it today. I have two children and I authorize the trustee to use as much of the income or principal, or both, as the trustee deems necessary for the education and support of my children now living or *hereafter born until the youngest reaches the age of twenty-five* and then to distribute the balance of the trust estate to my Uncle Joe, we will say, or to the children.

The trustee, in the exercise of his discretion, uses the income and principal for the benefit of my children, and finally exhausts the estate. Then I die and then *my creditors* or *Uncle Joe* come in and demand of the trustee the entire trust estate, including all of the income earned during the administration of the trust.

It appears that the trustee would be liable for the entire principal and income. Why? Because the trust violated the Rule against Perpetuities. The rule is that a discretionary power, such as I have just mentioned, is void, as violating the Rule against Perpetuities, if it can be exercised at a time beyond the period of the rule. When I created the irrevocable living trust for my children now living or hereafter born and permitted the discretionary power to continue until afterborn children, if any, reach twenty-five, it violated the rule and was bad in its entirety.

In drafting wills for your clients, or in administering a trust, look out for that discretionary authority, because in any case

[4] Adams v. Star, 49 A. 897 (1901).

where it may be exercised in favor of persons not yet born it is very likely that it violates the Rule against Perpetuities.

There are a number of other traps which are related to the Rule against Perpetuities and arise from dangerous misconceptions. For instance, there is a common belief that if title is vested in anyone, a trustee for example, the rule isn't violated. The Colorado Supreme Court said so on one occasion. But that is not true. It doesn't avoid the Rule against Perpetuities to have the title vested in a trustee. The beneficial interests must vest within the period or they are bad.

There is another belief that the Rule against Perpetuities has to do only with restraints against alienation, and if there are existing persons who can convey absolute and indefeasible title the rule is not violated. But that also is not true. For example, suppose that you convey Blackacre to John Doe and his heirs with a proviso that if liquor is ever sold on the premises the property shall go to Richard Roe and his heirs. Although John and Richard, by joining in a conveyance, can give an absolute and indefeasible title, the interest of Richard violates the Rule against Perpetuities and John has a fee simple absolute. Richard's interest does not vest until liquor is sold on the premises and this may not be until a time later than lives in being plus twenty-one years.

In that general connection, but not with respect to estates, I might mention another situation. A man sold real estate, and reserved an option to repurchase the property at any time within 25 years upon the payment of $10,000. The option is void. It violates the Rule against Perpetuities because it may be exercised at a time beyond lives and twenty-one years.

Here is another dangerous situation. Ordinarily a trustee may not deviate from the terms of the trust. That is, if a trust instrument says that he shall retain the stock of American Telephone Company he has to retain it and if he sells is liable for a loss. But suppose that X is administering a trust under the terms of an agreement which provides that the trustee shall keep the trust fund invested in good municipal bonds yielding not less than 4%, and suppose that no such bonds are available. There is another rule which says that the trustee is not under a duty to the beneficiary to comply with the terms of the trust requiring him to do something which is impossible. Here is the trap. Under circumstances where it is impossible to comply with the terms of the trust; for instance, where it is impossible to buy 4% municipals, the court will permit or direct the trustee to deviate from the specific terms of the trust in order that the general purposes of the trust may be carried out, and the trustee *may be personally liable* if he neglects to apply to the court for permission to deviate.

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It has been said that the invention and development of the trust is the most important and distinctive achievement of Anglo-

Saxon law. That statement might be questioned when we think of such institutions as the jury, but the importance of the trust in American life cannot be denied. Property of the value of sixty billions or perhaps more is now held in trust. The administration of trusts, and that includes decedent's estates, is as hazardous as it is important, as I have attempted to demonstrate, and always is accompanied by the element of contingent liability. Every lawyer who deals with trusts or trustees, executors, or administrators, should be aware of the dangers, and the collateral opportunities, which pertain to the law of trusts.

SUPREME COURT AMENDS RULES ON ADMISSION

IN THE SUPREME COURT:

AMENDMENT TO RULE 202

Insert after paragraph B of Rule 202:

Provided, that if the jurisdiction from which an applicant in Class A or B applies, imposes by any law, rule or regulation; limitations, restrictions or conditions upon the admission of members of the bar of the State of Colorado seeking admission to the bar of such jurisdiction, this Court may impose like restrictions, limitations or conditions upon any such applicant seeking admission to the bar of this state.

Adopted by the Court en banc May 8, 1953.

AMENDMENT TO RULE 226

Rule 226 is amended to read as follows:

226. Any attorney and counselor at law in good standing from any other jurisdiction in the United States, may in the discretion of any court of record in this state, be permitted to participate before such court in the trial or argument of any particular cause in which, for the time being, he is employed. Provided, that a member in good standing of the bar of this court is associated in such cause at all stages thereof.

Neither disbarred attorneys nor persons whose applications for examination or admission have been rejected for failure to show good character will be permitted to practice before any justice of the peace of this state.

Adopted by the Court en banc May 14, 1953.