PROTECTING YOURSELF WHEN PLANNING IN UNSETTLED WATERS: A CASE STUDY ON HOW TO STRUCTURE YOUR CLIENT RELATIONSHIP TO PROTECT YOURSELF FROM MALPRACTICE CLAIMS AND ETHICAL ISSUES

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Protecting Yourself When Planning in Unsettled Waters: A Case Study on How to Structure Your Client Relationship to Protect Yourself From Malpractice Claims and Ethical Issues

As professionals, we sometimes do some of our best, brightest and most valuable work at the periphery of the established rules. Some may call it pushing the limits. Others may call it taking educated risks. While still others may even call it brilliant planning in unsettled waters. Whatever it may be called, and no matter what professional and geographical area we practice in, there will always be a degree of risk in the professional activities that we undertake for clients. The purpose of this presentation is to raise awareness of the potential risks and liabilities that we take, knowingly or unknowingly, in every client representation that is undertaken, and to provide various steps that practitioners may take before a representation is begun, during the course of a representation when things begin to go south, and finally a discussion of some of the arguments that can be made in defense of a well-executed plan that may not have performed in the manner that was once hoped. This presentation is a little ditty about Jack and Diane, two American "Kids" asking their attorney to do the best he can.

Attorney Heck – A Case Study in Planning

Attorney Heck has practiced as a Partner in a mid-sized firm for many years. Heck manages a small group of estate planning attorneys in his firm and holds himself out in the community as exclusively working in the estate planning field. Heck maintains his professional competency by attending various continuing education seminars and by reading law and case updates when available. Heck, by all counts, is considered an ethical, competent, and well liked attorney by his peers and clients.

One sunny summer day, Heck meets with the patriarch and matriarch of the Smith family, Jack and Diane. Heck has worked with Jack and Diane for years, helping them implement various estate planning documents, structure their business holdings and business succession plans, and assisting them with both state and federal tax planning. Jack and Diane are very close with their three children, and intend to leave them a significant inheritance that will greatly exceed Jack and Diane's estate exemption amounts. Knowing that not only will the kids someday inherit the wealth (including the family business) and need their own planning, but also that they will someday be in charge of administering Jack and Diane's estates, Heck has always been very keen to develop working relationships with the kids and even recently the grandkids. Heck would love nothing more than to be the Smith's "Family Attorney".

On that sunny summer day, Jack and Diane express their desire to accelerate the tax planning that Heck has been providing to the family over the prior few years. Anxious about future political uncertainties, the potential for changing tax laws, and the ballooning value of the family business, Jack and Diane ask Heck to begin to aggressively shift some of their wealth to the kids. They also believe it's finally time to begin turning over the controls of the family business to one or more of the kids so that they can enjoy life in their remaining golden years. "Challenge Accepted!" says Heck, and he's off to do some of the most challenging and exciting planning that he has ever participated in.

Part I: PRE-PLANNING AND THE ENGAGEMENT LETTER

A. "Know Your Client" Checks

How many times have you put in time and effort for a client to later ask yourself, "Why did I ever take on that client in the first place?" Back when Heck first started his practice (a few short decades ago), if something seemed a little fishy and he really needed to find relevant information about a client and their background, he might have hired a private investigator to do a background check on the potential client. It was an expensive and labor intensive process, but he knew that developing and initiating a new client relationship could be an expensive endeavor and that pre-screening certain clients was necessary, or at least preferred. If the new client turned out to be other than what he expected, the lost billable time, practice focus, and administrative costs, not to mention potential heightened malpractice litigation risks, would not be worth the expected financial rewards from the new client. Luckily for Heck, times have changed. Today, there are countless online databases, background check sites, and investigative information services that professionals have at our disposal to assist with screening potential clients. A quick Google search for "Client Background Check" lists over 4.5 million web hits, as well as many websites dedicated to helping professionals develop an efficient and comprehensive client screening process. These services can be lumped into a few generic categories, which may include the following:

1. **Examples of Free Self-Help Search Tools:**

    (a) Search Engines like Google
    (b) Local/ county public records databases
    (c) State corporate registration databases
    (d) CorporationWiki
    (e) Credit reports
    (f) FINRA
    (g) SEC Registrations
    (h) State Licensing and Regulatory Agencies
    (i) Interpol

2. **Examples of Consolidated Search Tools**

    (a) Accurint by LexisNexis
    (b) Westlaw
    (c) TLO
    (d) KnowX
    (e) State Criminal Records Services

3. **Examples of Third Party References**

    (a) Having discussions with the referral sources that have worked with the client in the past.
    (b) Reference letters from other professionals that have worked with the client in their business.
    (c) Determine why the client left their prior professional relationship and request permission to contact the prior service provider if needed. If nothing else, the client's response to this request may indicate not only the quality of the client's relationship with the prior service provider, but also how they deal with professional service advisors (such as yourself) in general.
    (d) Obtain copies of driver's licenses, marriage certificates, IRS transcripts, or any other documents necessary to validate key characteristics of the client.

While this list of tools is in no way a complete list, a professional can tailor their tools to the type of information that is relevant. Information relevant to a financial professional may be very different than the information relevant to an accountant or attorney. Even more importantly, different types of representations may require more or less due diligence. This is often referred to as "*Risk Based Client Due Diligence*" where the level of due diligence scales up or down depending on the perceived risks involving the client. A very good discussion of Risk Based Client Due Diligence can be found as part of the ABA's Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing can be found at:

http://www.americanbar.org/content/dam/aba/publishing/criminal_justice_section_newsletter/crimjust_taskforce_gtfgoodpracticesguidance.authcheckdam.pdf

However, regardless of the perceived risk of the client, it is prudent to at least take the steps necessary to validate the identity of the client.

While running background checks on a client seems like a pretty innocuous idea, it does come with some risk, especially when a professional enters the realm of consolidated search tools. In order to minimize the risk to the professional, both legally and in the eyes of potential clients, the following is a general list of best practices that should be considered:

1. Have a written policy outlining the types of information that may be obtained in conjunction with the client screening process.

2. Let clients know the company's client screening policy and that part of initial engagement process will be to perform a background check or through the use of other screening process. Often this can be included as part of the initial engagement letter.

3. Obtain written consent from the client to perform the background checks or screening process. Often this can be included as part of the initial engagement letter.

4. Develop a written policy for maintaining the privacy of the relevant information obtained, as well as the subsequent destruction of any personal information not relevant to the representation.

B. Engagement Letters

Heck's firm has two governing philosophies – *"Get the Client!"* and, even more importantly, *"Get the Retainer!"* Unfortunately for Heck, that doesn't always mean he takes the time to get a signed engagement letter. He knows better, but the time and effort, not to mention the possibility of losing the client in the time period between the meeting and the delivery of the engagement letter, just isn't worth the trouble. With Jack and Diane, he knows them, and they know him. They have worked together for years and, importantly, he has never had an issue getting his invoices paid. So why go through the trouble as Jack and Diane are just making some "tweaks" to their planning this time around. He doesn't need to put all that mumbo jumbo in writing like the associates do with their new to the firm clients he tells himself. What could possibly go wrong?

1. Fee Arrangements

The ABA Model Rules of Professional Conduct ("MRPC") do not require a written engagement letter, although a writing is "preferable." MRPC 1.5(b). The Model Rules simply require that the fee agreement is "reasonable." *Id.* On the other hand, contingent fee agreements must be in writing under the Model Rules. *See* MRPC 1.5(c). However, many states have their own specific rules that govern the terms of engagement letters, so counsel should consult their own state's rules of professional conduct carefully.

For example, in California, the Rules of Professional Conduct provide that a lawyer "shall not enter into an agreement for, charge, or collect an illegal or unconscionable fee." Cal. Rule of Prof. Conduct 4-200(A). The Rules of Professional Conduct go on to describe the factors to be considered in determining whether the lawyer's fee is unconscionable, including the amount of the fee in proportion to the value of the services, the relative sophistication of the lawyer and client, the difficulty of the questions involved, and the experience, reputation and ability of the lawyer. *Id.* Rule 4-200(B).

In addition, in California, the Business and Professions Code requires that not only contingent fee arrangements be in writing, but also any other fee arrangement where the lawyer reasonably foresees that the fees will exceed $1,000. Cal. Bus. & Prof. Code §§ 6147, 6148. In addition, the fee agreement must also explain: (1) the basis for the lawyer's compensation, including hourly rates, and statutory or flat fees, and other charges applicable to the case, (2) the general nature of the legal services to be provided, and (3) the general responsibilities of the attorney and client. The lawyer must provide to the client a duplicate copy of the agreement, signed by both the lawyer and the client. *See id.* § 6148(a).

2. Joint Representation and Other Potential Conflicts

The discussion below highlights some typical circumstances attorneys in the trust and estate practice may face in the initial engagement of a client or clients, and the ethical and professional rules that apply. We also provide some sample engagement letter provisions that attempt to address these scenarios. However, we are not attempting to provide a comprehensive guide to the lawyer's ethical obligations in these scenarios, which is beyond the scope of this program. Rather, we are identifying some of the potential dilemmas an attorney may face, which should be evaluated under the applicable law of each attorney's home state.

If the lawyer will be representing more than one client, which can often happen in a trust and estate context, the lawyer has additional obligations to disclose information to the joint clients. First, the lawyer must consider whether the representation is permitted under the applicable ethical rules on conflicts of interest in his jurisdiction. Trust and estate lawyers often represent multiple members of the same family, such as a husband and wife in their estate planning, multiple generations within the same family, or several beneficiaries in trust or estate administration and/or litigation. As the ACTEC Commentaries to the Model Rules correctly note, "In some instances the clients may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations." ACTEC Commentary on MRPC 1.7.

However, in these situations, the lawyer must ensure that any actual or potential conflict does not interfere with the lawyer's ability to provide competent representation to each client. The Model Rule of Professional Conduct provides:

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

MRPC 1.7.

Obviously, the lawyer may not represent multiple clients who are directly adverse to one another. However, he may represent parties with potential conflicts, if the lawyer reasonably believes he will be able to provide competent and diligent representation to each, and ***each client gives informed, written consent*** to the joint representation. This consent is typically given in the engagement letter. The clearer the explanation of the potential conflict, the more likely such written consent will be deemed sufficient. Comment 22 to MRPC Rule 1.7 provides: "The more comprehensive the explanation of the types of future representations that might arise and the actual and reasonably foreseeable adverse consequences of those representations, the greater the likelihood that the client will have the requisite understanding."

On example of such a provision is as follows:

> Because we are representing more than one client, it is conceivable that conflicts of interest may arise between you, although we perceive no such conflicts existing at this time. In such event, since we owe each of you an undivided duty of loyalty, we would not be in a position to advocate the position of one of you versus the others, but might be required to withdraw from the engagement, absent your fully informed joint consent to our continuing to represent you. In no event, however, will we represent one of you against the other should disputes arise among you. Only in this fashion can we insure that our ethical responsibilities to you jointly are met in full. Please initial below to confirm your understanding of this representation.
>
> Initial ____________ ____________

If the lawyer will be representing multiple clients, his engagement letter should also include a provision for how confidential information will be treated between his clients. The ACTEC Commentaries recommend that the lawyer and his clients agree that all information can be freely shared among them: "[J]oint clients should be advised at the outset of the representation that information from either client may be required to be shared with the other if the lawyer considers such sharing of information necessary or beneficial to the representation. This advice should be confirmed in writing, and the lawyer should consider asking the clients to acknowledge that understanding in writing." ACTEC Commentary on MRPC 1.6.

If the lawyer and his clients do not enter into such an agreement, the lawyer may find himself in a difficult situation if one client provides him with information that the client does not want shared with the other client(s). On the one hand, a lawyer has an obligation not to disclose information obtained from a client to anyone else. *See* MRPC 1.6(a) ("A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent"). On the other hand, the lawyer owes an undivided duty of loyalty to each of his clients. If the lawyer obtains confidential information from one client that might prejudice the other – for example, if the lawyer learns that husband has changed the beneficiary designations on his life insurance to someone other than his spouse – the lawyer arguably has an obligation to bring this

information to the spouse's attention. Advance clarification of the lawyer's obligation in such a scenario can help avoid the conflict.

One example of such a provision is as follows:

> It is important for us to explain to you the ethical obligations imposed on attorneys when we represent more than one client. Since we are representing all of you, each of you is our client. As a result, any communications which one of you might make to us are not protected by the attorney-client communications privilege from disclosure to the others. That is to say, although all of your communications to us are privileged as far as the outside world is concerned, our Rules of Professional Conduct specifically prohibit us from agreeing with any of you to withhold information from the others if we are representing you jointly. If you have a difference of opinion about the Engagement, we can point out the pros and cons of such differing opinions. However, the Rules of Professional Conduct prohibit us, as the lawyer for all of you, from advocating one of your positions over the others.
>
> Initial ____________ ____________

Another issue that sometimes arises in trust and estate matters is when the fee is being paid by someone other than the client. For example, a group of beneficiaries may agree that the lawyer's fee will be paid by one beneficiary. Or a parent may agree to pay the fees on behalf of a child. Notwithstanding the source of payment of the fee, the person for whom the services are performed is the client, whose confidences must be safeguarded and whose directions must prevail. In general, the lawyer may accept compensation from a person other than a client only if the client consents after consultation, there is no interference with the lawyer's independence of judgment or with the lawyer-client relationship, and the client's confidences are maintained. *See* MRPC 1.8(f).

State specific rules may differ from jurisdiction to jurisdiction, but will often incorporate the elements of Model Rule 1.8(f). California's Rule of Professional Conduct 3-310(F) provides:

> A member shall not accept compensation for representing a client from one other than the client unless:
>
> (1) There is no interference with the member's independence of professional judgment or with the client-lawyer relationship; and
>
> (2) Information relating to representation of the client is protected as required by Business and Professions Code section 6068, subdivision (e) [the attorney-client privilege]; and
>
> (3) The member obtains the client's informed written consent, provided that no disclosure or consent is required if:
>
> (a) such nondisclosure is otherwise authorized by law; or
>
> (b) the member is rendering legal services on behalf of any public agency which provides legal services to other public agencies or the public.

Again, such consent is typically obtained at the outset of the representation in the engagement letter. One example of such a provision is as follows:

> California Rule of Professional Conduct 3-310(F) prohibits us from accepting compensation for representation of a client from anyone other than the client without the client's informed written consent. As required under that rule, the payment of our fees, costs, and disbursements will not interfere in any way with our professional judgment or our representation of you, and the attorney-client privilege will be maintained as provided

by applicable law below. By your initials, you consent to our representation of all of you under these circumstances.

Initial ____________ ____________

3. Subsequent Changes to the Engagement

In some circumstances, after the initiation of the original attorney-client relationship, there may be a need to revisit certain terms of the engagement. Attorneys should proceed with caution in this area. In some states, the attorney is held to a higher standard when changes are made to an existing engagement agreement. At the outset of the representation, the attorney and client are presumed to be engaging in an arm's length negotiation. See *Ramirez v. Sturdevant*, 21 Cal. App. 4th 904, 913 (1994) ("in general, the negotiation of a fee agreement is an arms-length transaction."). However, after the attorney has been retained, he presumably owes fiduciary duties to his client, so any negotiations are no longer strictly arm's length. *See id.*, at 917 (imposing on attorney a higher evidentiary standard applicable to fiduciaries to prove that attorney did not obtain an unfair advantage over client in negotiating a second engagement agreement).

This rule has been affirmed in other California decisions. *See, e.g., Lewin v. Anselmo*, 55 Cal. App. 4th 694, 701 (1997) ("A transaction between an attorney and client which occurs during the relationship and which is advantageous to the attorney is presumed to violate that fiduciary duty and to have been entered into without sufficient consideration and under undue influence.")

4. Conflicts of Interest

Before undertaking a representation that involves multiple parties or multiple generations of a family, care must be taken to assure that the disparate positions of the parties do not raise conflicts of interest presently or in the future-- when changes in the financial aspects of the transactions or the circumstances of the parties take place. If some of the parties serve as fiduciaries, an analysis of their fiduciary duties must be undertaken to assure that appropriate disclosures are made so that limits on their conduct do not cause breaches of duties as circumstances change. The range of roles that impose fiduciary duties is broad—are some parties trustees of existing trusts while others are beneficiaries? Are some parties directors, officers, or members of pass through entities in which other parties have present or future interests? Will powers of attorney be granted to some parties, imposing duties on them with respect to their principals or to other family members who are impacted by their decisions?

Where fiduciary duties are involved, conflicts of interest may restrict their ability to act freely, may impose heightened duties of disclosure, or may place the attorney or accountant in situations where they must withdraw from representation of all of the parties when such duties are later triggered. Being replaced by new and zealous counsel can be an expensive and trying experience.

Under Model Rules of Professional Conduct 1.6 (a) "A lawyer shall not reveal information relating to representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation." In meetings with potential clients, care must be taken to assure that they understand that confidential information about their financial affairs or personal objectives or goals may be subject to disclosure to other parties who are expected to be represented in the transaction or future transactions. "Informed consent" is a broad concept—any disclosure should be in writing and it should look at not only the current situation, but changes which may take place as a result of changes in the underlying entities, audit challenges, or changes in the personal or investment circumstances of the parties or their successors in interest. Similarly, counsel must scrutinize the transactions to identify issues in which the potential clients may have current or future conflicts. MRCP 1.7 (a) provides "(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:(1) the representation of one client will be directly adverse to another client; or (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."

Disclosures to all potential clients must be full and accurate. MRC P 1.4 provides:

"(a) A lawyer shall:

(1) promptly inform the client of any decision or circumstance with respect to which the client's informed consent, as defined in Rule 1.0(e), is required by these Rules;

(2) reasonably consult with the client about the means by which the client's objectives are to be accomplished;

(3) keep the client reasonably informed about the status of the matter;

(4) promptly comply with reasonable requests for information; and

(5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law.

(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

The fervor to win the beauty contest and lock in multiple generations of rich folk as clients often leads to faulty or incomplete analysis, disclosure and inadequate waiver of conflict documentation.

A failure to obtain informed consent or a consent which is not properly documented may result in a court concluding that one set of clients were denied independent counsel, raising presumptions which may cause the failure of the proposed transactions. For example, if there are estate planning transactions involved where the transferors or transferees assume certain risks of failure, it is necessary to obtain informed consent of the impacted parties. For example, *In re Hanes,* 214 B.R. 786, 814 (Bankr.E.D.Va.1997) involved transactions in which the mother and others allowed one child to use trust assets as security for loans to invest in growth enterprises. The same attorneys represented both the mother and the children. When the investments failed and the son took bankruptcy protection, the court found that the conflicts and risks involved in the transactions had not been adequately disclosed by the counsel. The mother could claim that she had been denied disclosures and lacked independent counsel, leading to claims against the attorney for aiding and abetting the breaches of trust of the child who used the borrowed funds to invest in failing transactions.

The Court in *French v. Wachovia Bank, N.A.*, 800 F. Supp.2d 975 (E.D. Wis.2011) quoted *Hanes* in analyzing an insurance transaction where the broker obtained a substantial commission on an insurance policy involved in the planning. While the trustee and broker involved ultimately prevailed, the litigation was impacted by the presumptions and conflicts involved as found by the District Court. The Court noted the implications of the general rule against conflicts: "The most fundamental duty owed by the trustee is the duty of loyalty. *Pegram v. Herdrich,* 530 U.S. 211, 224, 120 S.Ct. 2143, 147 L.Ed.2d 164 (2000) (citing 2A A. Scott & W. Fratcher, Trusts § 170, p. 311 (4th ed. 1987) and G. Bogert & G. Bogert, Law of Trusts and Trustees § 543 (rev. 2d ed. 1980)); *see also* Restatement (Second) of Trusts § 170. The Frenches claim that the 1035 exchange was a self-dealing transaction because it resulted in a $512,000 commission for WBNA's affiliate, WIS. 'A consistent facet of a fiduciary duty is the constraint on the fiduciary's discretion to act in his own self-interest because by accepting the obligation of a fiduciary he consciously sets another's interests before his own.' *Zastrow v. Journal Comm'n, Inc.,* 291 Wis.2d 426, 718 N.W.2d 51, 59 (2006). The rule of 'undivided loyalty' requires that a trustee 'must neither deal with trust property for the benefit of himself nor place himself in a position inconsistent with the interests of the trust.' *In re Hanes,* 214 B.R. 786, 814 (Bankr.E.D.Va.1997). The law 'stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without undertaking to deal with the question of abstract justice in the particular case.' *Renz v. Beeman,* 589 F.2d 735, 744 (2d Cir.1978). The principle is 'one of prevention, not remedial justice, which operates however fair the transaction may have been—however free from taint of moral wrong.' *Bank of Cal. v. Hoffmann,* 255 Wis. 165, 38 N.W.2d 506, 509 (1949) (describing law of agency). 'Participation in a transaction that benefits oneself instead of another who is owed a fiduciary duty is the 'classic definition' of self-dealing. *Losee v. Marine Bank,* 286 Wis.2d 438, 703 N.W.2d 751, 756 (2005)." 800 F. Supp.2d at 985-86.

While the current set of clients – joined by common financial interests or family bonds – may be eager to elude the Dead Tax or minimize income or other taxes, one always has to take into account the fact that clients divorce and marry spouses who are quite hostile to the beneficiaries of an transaction involving the former mother or father, a party may fail physically or mentally and be succeeded by a conservator who is driven to recover financial benefits bestowed on ungrateful children, a bankruptcy trustee may seek to avoid the transaction to protect third parties, and a kinder, gentler IRS may seek to erase the national deficit at your expense.

Where an estate planning transaction transfers rights to a favored friend, business associate or family member, the existing beneficiaries or heirs may construe the new planning documents and transactions as resulting from lack of capacity or undue influence. Hence, in *Estate of Auen*, (30 Cal. App. 4th 300 (Cal. App, 1994), the court found that the

attorney who changed an estate plan in which several charities had financial interests was not "independent" and hence that a presumption of undue influence arose. Such a presumption, depending on your State's law, may be very difficult to overturn at trial. Independence generally requires a full disclose of material facts as part of conflict waivers signed by the multiple parties.

Where some of the parties are fiduciaries or are given assets and interests subject to fiduciary duties, the stringent rules on disclosure of material information can be used to undercut consents and ratifications given by those disadvantaged by the transactions. *See* Restatement of Trusts (Second) §216, 217 and 218. A consent may be attacked after the fact if the fiduciary did not know his or her rights, if the fiduciary did not reasonably believe the beneficiary was fully informed, if the beneficiary did not have independent counsel, or if the transaction was not fair and reasonable *see e.g.* Cal. Prob. C. §§16463-65.

C. *Kovel* Letters

When embarking on a project fraught with uncertainties and tax risks, consideration should be given to the risks that discussions with counsel and tax professionals may be the subject of discovery efforts by other parties to the transactions or by taxing authorities. A full and candid discussion of potential risks and alternative strategies for reaching optimal results for the clients may touch on sensitive financial risks, as well as evaluations of potential claims against the client with material civil or criminal consequences. The adviser faces tensions between outlining the potential civil and criminal risks associated with a plan in order to assure that the advisor has explored all potential risks in making her evaluation and making sure that the client is aware of risks of a certain course of action and accepts the consequences of failure of all or a portion of the plan. Clients may suffer traumatic amnesia after the tax audit begins and assert that they were never warned of the severe consequences facing them. A documented discussion of the risks is often the only sure way of avoiding recriminations after things have gone badly. If you are going to put concerns in writing, make sure your client understands that the documents must be treated as confidential, clearly labeled as being "attorney client privileged" and placed in a secure location to prevent casual disclosure to third parties.

Preparation of a tax return by counsel is generally not subject to the common law or statutory attorney client privilege, because it is primarily an accounting service, and moreover is intended to be transmitted to a taxing authority, raising a claim of waiver with respect to the attorney's communications. C. Rettig, "Basic Overview: The *Kovel* Accountant and Privileged Communications," Journal of Tax Practice & Procedure, October-November 2015 27, at 28. Moreover, the information provided by the client, since it is designed to be included in the tax return, is not itself privileged. A discussion about what should be included in a return may be privileged.

However, in exercising due diligence in evaluating and explaining the client's options, caution should be exercised to avoid providing documentation to third parties or tax auditors who might construe such warnings as evidencing intent to commit a crime or fraud or to assert unreasonable positions, which might subject the client to penalties or costs if Murphy's Law comes into play.

1. Crime-Fraud Exception to the Attorney Client Privilege

The Restatement of the Law Governing Lawyers notes in Section 82 at 613-14 that the attorney client privilege does not apply where the advice is provided to further the client's "purpose...of obtaining assistance to engage in a crime or fraud or aiding a third person to do so," or, without initial intent, when the client in fact "uses the lawyer's advice or other services to engage in or assist a crime or a fraud." The risk is that some trier of fact will visit the transaction after the fact and conclude that criminal or fraudulent intent was involved. "In *First Union National Bank v. Turney*, 824 So. 2d 172 (Fla. App 2001), the appellate court denied protection of the attorney client privilege based on the crime-fraud exception to the privilege. The Court approved disclosure of attorney client communications, holding "The failure to disclose material facts while seeking a release has been held to be fraudulent concealment. *See, e.g.* , *Pacelli Bros. Transp. v. Pacelli*, 456 A.2d 325, 328 (Conn. 1982) ('the intentional withholding of information for the purpose of inducing action has been regarded ... as equivalent to a fraudulent misrepresentation.'); *Rosebud Sioux Tribe v. Strain*, 432 N.W. 2d 259, 263 (S.D. 1988) ('The mere silence by one under such a [fiduciary] duty to disclose is fraudulent concealment.')" *Ibid.*

Triers of fact who were elected or appointed as judges because of their zeal in prosecuting criminals may find improper intent in circumstances where the attorney in fact may not have considered she or he was seeking to assist their client in violating a criminal statute or perpetrating a fraud in the transaction. *See also In re Chevron Corp.*, 650 F 3d 276, 291 (3rd Cir. 2011); *Cohen v. Donald J. Trump*, (June 9, 2015), 2015 WL 361714 (S.D. CA.).

2. *Kovel* Privilege

Where the issues involved in the proposed transaction or tax strategy involve esoteric issues which are beyond the experience or ken of the attorney, obtaining assistance of an expert accountant may provide a solution. The issue is whether the accountant in question can fall within the attorney client privilege. The seminal case is *United States v. Kovel,* 296 F. 2d 918 (2d Cir, 1961). The government sought to discover the advice which the accountant presented to the attorney for the tax payer, arguing that no attorney client privilege could apply. The Court on appeal noted that the use of agents by attorneys was an accepted practice within the protection of the attorney client privilege:

"Nothing in the policy of the privilege suggests that attorneys, simply by placing accountants, scientists or investigators on their payrolls and maintaining them in their offices, should be able to invest all communications by clients to such persons with a privilege the law has not seen fit to extend when the latter are operating under their own steam. On the other hand, in contrast to the Tudor times when the privilege was first recognized, see 8 Wigmore, Evidence, § 2290, the complexities of modern existence prevent attorneys from effectively handling clients' affairs without the help of others; few lawyers could now practice without the assistance of secretaries, file clerks, telephone operators, messengers, clerks not yet admitted to the bar, and aides of other sorts. 'The assistance of these agents being indispensable to his work and the communications of the client being often necessarily committed to them by the attorney or by the client himself, the privilege must include all the persons who act as the attorney's agents.' 8 Wigmore, Evidence, § 2301." 296 F. 2d at 921.

The Court then looked to the analogy of a translator who assists the attorney in interpreting his client's communication as being within the protection of the privilege. "This analogy of the client speaking a foreign language is by no means irrelevant to the appeal at hand. Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases. Hence the presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, ought not destroy the privilege, any more than would that of the linguist in the second or third variations of the foreign language theme discussed above; the presence of the accountant is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit." 296 F. 2d at 922. The Court distinguished the narrow protection involved in the use by Mr. Kovel of an accountant to assist his attorney in dealing with the foreign language of the Internal Revenue Code and practice. "What is vital to the privilege is that the communication be made in confidence for the purpose of obtaining legal advice from the lawyer. If what is sought is not legal advice but only accounting service, as in *Olender v. United States*, 210 F.2d 795, 805-806 (9 Cir. 1954), see *Reisman v. Caplin*, 61-2 U.S.T.C. P9673 (1961), or if the advice sought is the accountant's rather than the lawyer's, no privilege exists." *Ibid.*

The First Circuit's case of *Cavallaro v. U.S.*, 284 F.3d 236 (1st Cir. 2002), demonstrates the limits of the *Kovel* privilege and the risks of discovery. This involve two family companies, one controlled by the parents, Knight, the second by their sons, Camelot. The sons and their company engaged Ernst & Young to assist them in exploring a structure for transferring the value of the parents' company to them through sales or merger of the companies. The Court on appeal concluded that no privilege applied and allowed the IRS to obtain documents generated by the accounting firm involved, which ultimately represented both the parents and children and their respective companies. Ernst & Young sent a letter to the parents "suggesting a strategy for minimizing transfer tax liability." 284 F. 3d at 241. "The letter explained that the IRS would scrutinize the pre-merger values of Knight and Camelot to determine the proper allocation of the post-merger sale proceeds between the Cavallaros and their sons. The pre-merger values were important because they would be the benchmark for determining whether the Cavallaros had disguised a gift to their sons in the form of post-merger stock and, if so, the size of that gift and the resulting transfer tax liability. Ernst & Young stated that the pre-merger profit disparity between Knight and Camelot did not reflect the true values of the companies…." *Ibid.*

The advice given candidly described the risks involved. "The IRS", Ernst & Young said, "would likely attribute most of the value of the post-merger corporation to the Cavallaros, which would defeat the tax saving goal of allocating most of the profits of the pre-merger corporations to their sons." The letter stated that "[b]ased on the facts that exist today, it would be hard to justify Camelot taking more than a small amount of the allocated proceeds" from a sale of the businesses. More specifically, Ernst & Young suggested that, upon merger, as much as 85% of the shares of the merged entity would go to the Cavallaros, with only 15% of the shares going to their sons." 284 F. 3d at 242. A two-step plan was proposed, merging the two companies and then gifting the resulting stock to the sons, using a GRAT.

The parties did not follow the advice, but instead sought to have the parents' company, Knight, transfer its glue-dispensing machine technology to Camelot. The father and a son ultimately signed affidavits asserting that the technology "had no ascertainable value," "had no reasonable prospect of realizing a profit," and was "no more than a promising but raw idea." The merged corporation was subsequently sold for $97 million. This is proof that it does rain during the daytime in

Camelot. The IRS sent a third-party subpoena to Ernst & Young, seeking the letter which had discussed the problems of such a transaction. The District Court refused to quash the subpoena, finding that the accountants had represented the son and their company, rather than Hale and Dorr, attorneys for the parents. The trial court rejected the attorney client privilege as well as a claim of common interest privilege. This result was affirmed by the First Circuit. "Here, the record does not show that any party hired Ernst & Young to assist Hale and Dorr in providing legal advice, and we note that the agency relationship between the parties is relevant to, but not dispositive of, this question. *Kovel* requires that to sustain a privilege an accountant must be "necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege is designed to permit." *Kovel,* 296 F.2d at 922. This requirement resolves the *Kovel* dispute because the evidence shows that Ernst & Young was not employed *for this purpose.*" 284 F. 3d at 248-49.

The Court also questioned whether the attorney at Hale and Dorr needed an accounting firm to translate the IRC and case law for him to assist his client. "We are skeptical of the Cavallaros' claim that Ernst & Young was present to assist attorney Hamel of Hale and Dorr, who was a senior partner of over twenty years' experience, and a specialist in trusts and estates, including, necessarily, consequent tax advice. Recognizing that an attorney's experience alone is not prima facie evidence that an accountant was not "necessary, or at least highly useful," *Kovel,* 296 F.2d at 922, to the lawyer in providing legal assistance, we note that when a party hires an accountant to provide accounting advice, and only later hires an attorney to provide legal advice, it is particularly important for the party to show that the accountant later acted as an agent necessary to the lawyer in providing legal advice. *See Rice, supra,* § 3:5, at 33–34 (noting that "when the client has previously employed the agent independent of the attorney-client relationship, to perform the same services that he will perform for the attorney[,] .... [t]his creates a risk that the agent's retention by the attorney is simply a subterfuge"); *id.* at 35 n. 66 (citing *Swarthmore Radiation Oncology, Inc. v. Lapes,* No. 92–3055, 1994 U.S. Dist. LEXIS 1970, at *9–12 (E.D.Pa. Feb. 18, 1994)). The Cavallaros have failed to make a sufficient showing here." 284 F. 3d at 249.

The other risk involved here is that since the accountant had represented the sons and their company, their advice prior to the supposed shift to the father and his attorneys was subject to discovery. If you are seeking to perfect a *Kovel* privilege, you may want to engage an accountant who has not previously represented one of the parties and to assure that the advice you wish to protect was given to assist the attorney.

The Second Circuit limited the application of its decision in *Kovel* in *U.S. v. Akert* , 169 F. 3d 136 (2nd Cir. 1999), where an investment banker had provided advice to the attorney for Paramount about the benefits of a proposed investment proposal. The court held that counsel for Paramount had not contacted the investment banker at Goldman, Sachs "to translate or interpret information given to its inside counsel by his employer" but rather simply sought information about the proposed transactions and its tax consequences. 169 F. 3d at 140-41.

D. Pros and Cons of Expert Certification

Since 1973, various states have administered programs to certify specialists in various fields of law. However, the legal profession was a relative latecomer to the certification process, as the accounting profession, through its CPA designation, has already been certifying specialists since 1896, while life insurance specialists had been able to obtain the CLU designation since 1928. Likewise, since 1985, financial representatives have been able to apply for the CFP designation. It is clear that certification and specialization is good for our professions, as well as being good for our clients, but the question becomes whether it is good for the Practitioner?

In Heck's case, he never got around to sitting for his state's board certification exam. Some years he was just too busy to apply for certification, and other years just too afraid of failure. But whatever the reason, Heck was always content to hold himself out as ..... " *limiting my practice to the areas of Trusts and Estate...* " But when things go bad, it could actually matter.

State professional regulatory bodies take varying positions on whether a certification in an area of practice subjects the practitioner to a higher standard of care in malpractice situations. A relatively common position is that once a professional holds themselves out as a specialist or expert in a particular field of specialty that they are thereafter held to a standard of care which judges them against a "reasonably prudent expert practicing in such field of specialty." Such heightened standard of care poses a potential risk to certified specialists in a malpractice context. So it becomes a question of whether the increased referrals, advertising opportunities, and elevated status in the professional community are worth the additional risk. In Heck's case, his state regulatory body takes an even more aggressive approach which can be found across professions and states. His state takes the position that a practitioner does not have to be a certified specialist to be subject to the heightened scrutiny, but rather that such standard of care applies to any practitioner that holds themselves out as an expert in the field. Marketing materials, website biographies or off the cuff client presentations where Heck has professed his competence in a specific area may one day be weighed against him in determining whether his "expertise" will come back to haunt him.

It should be noted that most model rules of professional conduct, regardless of profession, require competency in practice. The ABA's MPRC, as an example, states "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." See MPRC Rule 1.1.

Likewise, the AICPA's Code of Professional Conduct state "Competence represents the attainment and maintenance of a level of understanding and knowledge that enables a member to render services with facility and acumen. It also establishes the limitations of a member's capabilities by dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a member or a member's firm. Each member is responsible for assessing his or her own competence of evaluating whether education, experience, and judgment are adequate for the responsibility to be assumed." See AICPA Rule 0.300.060.04.

With the above in mind, it is expected (if not absolutely required) of professionals to have an adequate level of competency in the matters they chose to handle. In times where the professional may not have the experience or capabilities necessary to undertake a matter, they should seek to bring in the necessary expertise, whether from inside their firm, or outside. Failure to do so, whether the professional is a certified specialist or not, opens the professional to liability.

E. Adequate Malpractice Coverage

By law, many professionals do not have to carry malpractice insurance. The requirements vary from jurisdiction to jurisdiction, and in situations where it may be required, the requirements often cover only certain situations that the practitioner may be involved with. But such lack of required insurance certainly does not mean that it is not beneficial to the practitioner. In fact, the American Bar Association estimates that between 5-6% of attorneys face malpractice claims per year. So how much insurance is enough? What kinds of coverages should a practitioner carry? Do I need to carry fiduciary liability coverage? Will my personal umbrella policy help me if I get sued for malpractice or for fiduciary liability?

All of these are great questions that Heck should have been thinking about on a yearly basis. However, too often practitioners only look at their liability policies upon renewal (when the cost is most important) and after something has gone seriously wrong (when the extent of coverage is most important). An in depth discussion of insurance, fiduciary liability, and the like are discussed in Dom Campisi's materials entitled "*The Search for Deep Pockets*" which can be found as Addendum #1 attached to this outline.

Part II: EMERGING TROUBLE IN PARADISE... WHAT CAN GO WRONG?

A. Case Study #1 – Planning for Multiple Generations

1. Heck has known and worked with Jack and Diane Smith for years. He has watched the kids grow up and become important team members in the family business, and has begun counseling them personally on their individual estate plans. He's even been invited to the family's holiday events where he is often graciously referred to as the Family Counselor. Heck, believes that he can do his very best work when he can work with all of the current generations of the family to implement a cohesive and efficient multigenerational wealth transfer plan. Not to mention that Heck believes he knows how best to begin the transfer of the family business from Jack and Diane to the kids that are most involved in the business.

2. Does Heck have any problems with the multigenerational family planning?

3. What about the conflicts of interest that might occur with representing both the family members as well as the family business? If the business is being left to only certain family members, is there an inherent conflict of interest?

B. Case Study #2 – Planning in Unsettled Waters

1. Heck has been hearing about the use of Self-Cancelling Installment Notes (SCIN's) as a planning tool at several of the continuing education seminars that he has attended. While the IRS is far from accepting of these structures, the courts (as have the IRS with their settlements with taxpayers) have been relatively taxpayer friendly in several recently reported SCIN cases. At worst, Heck believes that he can "settle" with the IRS, if they challenge Jack and Diane's SCIN transaction, on very favorable terms instead of putting it before a court. While not a perfectly defendable plan, Heck convinces Jack and Diane to give it a try because "While there is nothing specific that allows the SCIN to work, there isn't anything that says it won't!"

2. What if anything should Heck be thinking about as he enters into the unsettled waters of SCIN planning?

C. Case Study #3 - Change in Law

1. Jack and Diane want to transfer part of their interest in XYZ LLC into their Trust and achieve maximum tax savings by discounting the fractional interest. Heck advises them on this transaction. Two and a half years later, the IRS issues regulations that preclude the use of this type of fractional interest discount. The IRS also says that they will "look back" at any discounts taken over the last 3 years and invalidate those discounts. Jack and Diane, who don't closely follow the IRS regulations, are not aware of these changes. What should Heck do?

2. What if anything should Heck do if the regulations are still in draft form, and it's unclear what (and when) the IRS will issue as final regulations?

3. What if there has been a lot of discussion among experts in the area over the past several years about the possibility that the IRS might issue some type of regulations along these lines? Did Heck have a duty to draft Jack and Diane's estate plan differently, based on the possibility that the IRS might issue regulations that might invalidate fractional interest discounts in transactions done years prior to the release of final regulations? Does the answer to this question depend on whether Heck has held himself out as an expert in estate and tax planning? Or if Heck has a designation as an expert in estate planning?

Part III: **TIME TO CALL THE CARRIER**

A. Common Defenses

1. Uncertainty in the Law

In most jurisdictions, a lawyer cannot be liable for malpractice when the state of the law is uncertain. This is sometimes referred to as judgmental immunity or protection.

> An attorney who acts in good faith and in an honest belief that his advice and acts are well founded and in the best interest of his client is not answerable for a mere error of judgment or for a mistake in a point of law which has not been settled by the court of last resort in his State and on which reasonable doubt may be entertained by well-informed lawyers.

Hodges v. Carter, 80 S.E.2d 144, 146 (N.C. 1954).

Whether or not a point of law is "settled" can be an open question. If there is disagreement among justices on the state's highest court, or divergent opinions in the appellate courts, this evidence may establish the uncertainty of a particular point of law. On the other hand, if there is no clear guidance from the higher courts, the parties may find themselves with conflicting expert testimony as to whether the lawyer in question acted within the spectrum of acceptable legal opinion. The very existence of conflicting expert opinion on this subject can be construed as evidence of the "unsettled" nature of the law. "As [Attorneys] point out, the disagreement between their legal expert and the [Client's] was sufficient evidence that, as a matter of law, Attorneys were not negligent . . . ." *Schmidt v. Pearson, Evans & Chadwick*, 931 S.W.2d 774, 780 (Ark. 1996).

Some states, including California, employ a two-prong test to determine whether judgmental immunity should attach. Under this test, the court will consider "(1) whether the state of the law was unsettled at the time the professional advice was rendered; (2) and whether that advice was based upon the exercise of an informed judgment." *Davis v. Damrell*, 119 Cal. App. 3d 883, 887 (1981). In other words, not only must the law itself be unsettled, but the lawyer must also show that he performed an investigation into the existing state of the law. Where the lawyer gives the "reasoned exercise of an informed judgment grounded upon a professional evaluation of applicable legal principles," the lawyer should be immune from liability if the law subsequently changes. *Id.*

For example, two different outcomes faced attorneys in California dealing with the distribution of one spouse's pension upon divorce – an area of law that was admittedly unsettled at the time of both representations. Attorneys in both cases advised their clients that the husband's pension was not community property, and a subsequent California Supreme Court ruling found that such pensions were community property subject to division on divorce. Both wives sued their attorneys.

In *Smith v. Lewis*, 13 Cal. 3d 349 (1975), the court found that with respect to the husband's vested retirement benefits accrued from state employment, there was general agreement that such benefits were considered community property, and the attorney failed to do the necessary research to educate himself on the applicable law. Although the state of the law regarding the husband's ***federal*** retirement benefits was unsettled, that did not excuse the attorney's negligence with respect to the established areas of the law.

> If the law on a particular subject is doubtful or debatable, an attorney will not be held responsible for failing to anticipate the manner in which the uncertainty will be resolved. But even with respect to an unsettled area of the law, we believe an attorney assumes an obligation to his client to undertake reasonable research in an effort to ascertain relevant legal principles and to make an informed decision as to a course of conduct based upon an intelligent assessment of the problem.

Id., at 358-59.

On the other hand, in *Davis v. Damrell, supra*, only the unsettled area of federal pension benefits was at issue. There, the attorney, a former judge, demonstrated his ongoing legal research and familiarity with the state of existing law. The court found he was "fully aware of the then controlling precedents and relevant literature, supplemented by a wealth of judicial experience in numerous domestic relations matters involving a variety of retirement benefits issues." *Davis v. Damrell*, 119 Cal. App. 3d. at 888. According, the claim against this attorney was dismissed.

Thus, when navigating uncharted waters, be sure to document the research that you did to confirm that your advice was (a) consistent with the general agreement of the legal community on such issues, and (b) that you made an effort to educate yourself on the relevant legal principles.

2. Knowing Acceptance of Risk

When a client makes a decision that might in retrospect appear questionable (particularly to a discontented beneficiary), the attorney may wish to document the reasons for this decision to provide a defense to potential malpractice down the road. For example, a client may decide to structure an estate plan in a way that does not minimize the overall tax burden on the estate by not taking full advantage of all available deductions. This strategy could make perfect sense in light of other objectives, i.e., family harmony, preserving a family business, etc. However, the attorney would be wise to document this decision.

Some experienced practitioners recommend that the attorney send the client a letter that reiterates the client's goals and decisions, and explains how the estate plan helps to accomplish those goals. In addition, the client can be asked to sign and return a copy of the letter as an acknowledgement of receipt and acceptance of the plan. *See* Susan T. House, Continuing Education of the Bar, Drafting California Revocable Trusts § 2.43 (4th ed. 2015). Particularly when the plan reflects a client's decision not to take full advantage of tax opportunities, this decision should be documented in a writing to the client with sufficient detail to foreclose any later argument that the client was not adequately advised of the tax consequences. *See id.* § 2.45.

3. Statute of Limitations

Another defense that may commonly be asserted in legal malpractice claims is the applicable statute of limitations. This may vary from state to state, but in general, the statute is tolled while the attorney continues to represent the client in the same subject matter. *See, e.g.*, California Code of Civil Procedure § 340.6(a)(2). Thus, for all intents and purposes, the statute will not begin running until the representation – at least with respect to this particular subject – has concluded.

It can sometimes be difficult to determine when an attorney has stopped representing a client with respect to a particular subject matter, especially in the context of estate planning. If the estate planner periodically sends out updates on changes in the relevant law, does that mean the attorney is still representing the client?

Typically, an attorney's representation is considered to have ended when the agreed-upon tasks have been completed or events inherent in the representation have occurred. *See Crouse v. Brobeck, Phleger & Harrison*, 67 Cal. App. 4th 1509, 1528 (1998). However, if the termination of the relationship is not obvious, courts may adopt a subjective analysis, which considers "when the client actually has or reasonably should have no expectation that the attorney will provide further legal services." *Gonzalez v. Kalu*, 140 Cal. App. 4th 21, 30 (2006).

Attorneys should be wary of allowing the courts to focus on a disgruntled client's subjective intent. Best practice supports sending a "closing letter" to all clients, which clearly states that the attorney-client relationship has concluded. Typically, such a letter will serve to terminate the representation and the tolling of the applicable malpractice statute of limitations.

Attorneys may also want to consider limiting the applicable statute of limitations for malpractice claims in their engagement letter. The recent, highly-publicized case of *Aaron v. Deloitte Tax, LLP* is a striking example where this practice was upheld. *Aaron* arises out of the tax planning services provided by Deloitte Tax ("Deloitte") for multi-billionaire William Davidson, who owned (among many other assets) the Detroit Pistons. Mr. Davidson implemented estate planning changes with the advice of Deloitte, and upon his death, his estate was assessed taxes of $2.7 billion by the Internal Revenue Service. His estate settled the tax claims for a mere $457 million, but then his administrators turned around and sued Deloitte for malpractice and a host of other claims.

In its defense, Deloitte argued that the applicable statute of limitations passed years earlier, and relied on a provision in its engagement agreement with Mr. Davidson, which expressly provided: "No action, regardless of form, relating to this engagement, may be brought by either party more than one year after the cause of action has accrued . . . ." Deloitte argued that New York law recognized such contractual limitations, and further, under New York law, a cause of action for malpractice in the provision of tax advice accrues at the time the advice was given, not when the IRS issued a deficiency. Here, Mr. Davidson completed the tax transactions at issue in January 2009, therefore, Deloitte argued, the statute of limitations was a bar to any claim filed after January 2010, including the instant complaint filed in September 2015.

The New York court agreed and dismissed the complaint. The New York court found that the express limitation in the parties' engagement letter was a bar to the estate's claim that Deloitte's ongoing representation tolled the statute of limitation. Here, where the engagement letter also provided that the engagement was for one calendar year only, and a new engagement would be required for the following year, the court disagreed that Deloitte's continuous representation served to toll the statute of limitations.

B. Binding and Settlement Arbitration

1. Binding Arbitration

The advantages of arbitration in the malpractice context are similar to the advantages of arbitration in general. Arbitration is widely considered to be faster and less costly than litigation. Generally speaking, there is typically no right to appeal from an arbitrator's decision, with the exception of allegations of the arbitrator's corruption or misconduct. In addition, arbitration has the added benefit of being private – both for the attorney and the client.

Given the overall advantages of arbitration, most states allow a lawyer to include in her retainer agreement a provision providing for binding arbitration of malpractice claims, provided that the lawyer gives the client sufficient information about the advantages and disadvantages of arbitration to allow the client to make an informed decision on whether

to agree to the arbitration provision. In addition, the American Bar Association Standing Committee on Ethics and Professional Responsibility issued a formal opinion in 2002, which also requires that the attorney cannot limit the liability to which she would otherwise be exposed under existing law. American Bar Association Standing Committee on Ethics and Professional Responsibility, Formal Op. 02-425.

However, different states have different restrictions in place as to whether the attorney must also advise the client to seek independent legal advice before agreeing to the arbitration provision. Some states, including Texas, Illinois, and Pennsylvania, require that the potential client seek independent legal advice before agreeing to arbitrate any prospective malpractice claims. Other states, including California, New York, and New Jersey, do not expressly require that the client seek independent advice about the arbitration provision. *See generally,* Louis A. Russo, Note, *The Consequences of Arbitrating a Legal Malpractice Claim: Rebuilding Faith in the Legal Profession*, 35 Hofstra L. Rev. 327 (2006). However, even in jurisdictions where potential clients are not ***required*** to consult with independent counsel, it is still the best practice to advise clients that they ***may*** seek independent advice over the arbitration provision.

In addition, even states that permit a client to consent to arbitration of malpractice claims will not uniformly uphold those arbitration clauses where circumstances suggest the client did not fully understand the consequences of the agreement. In a recent, highly-publicized case, a Pennsylvania judge held an arbitration agreement in Reed Smith's engagement letter unenforceable because the client was not fully informed of the rights he was waiving. In *Batof v. Widin* (No. 2014102350), the Philadelphia Court of Common Pleas relied on prior opinions to formulate a test for whether a client has been fully informed of the effect of the arbitration agreement. The *Batof* court found that the client should be informed of seven principles: (1) the client is waiving his right to a jury trial; (2) waiving his right to an appeal; (3) waiving broad discovery; (4) the client could pay substantial upfront costs; (5) the client could still make a disciplinary complaint against the attorney; (6) the client could speak with independent counsel before signing the agreement; and (7) the client was fully informed of the types of claims that would have to be submitted to arbitration.

The court in *Batof* found that Reed Smith could not prove that its former client was informed of the effect and scope of arbitration. Significantly, the court noted that the arbitration agreement was included as an addendum to the engagement letter that was neither signed nor initialed by the client. Thus, there was no evidence that the client ever read the arbitration provision, let alone understood it.

2. Settlement of Malpractice Claims

A somewhat related matter is whether a lawyer may obtain a valid waiver of potential malpractice claims in the settlement context. When a client first raises the possibility of a malpractice claim, both the client and the attorney may decide to resolve the case before a lawsuit is actually filed. Alternatively, the client and attorney may settle their dispute after litigation has been initiated. Or the parties may agree to resolve potential malpractice claims in the context of resolving a fee dispute. Under any of these circumstances, the attorney may agree to waive claims for payment, while the client may agree to waive claims for potential malpractice liability. Attorneys should tread carefully in drafting and enforcing these waivers.

In California, the Rules of Professional Conduct prohibit an attorney from settling a claim or potential claim for malpractice "unless the client is informed in writing that the client may seek the advice of an independent lawyer of the client's choice regarding the settlement and is given a reasonable opportunity to seek that advice." Cal. Rule of Prof. Conduct 3-400(B). Notably, if the settlement takes place during a mediation, "the parties to the mediation may have to adjourn the mediation and reconvene in order to permit [the client] to have a meaningful opportunity to seek independent counsel." See the State Bar of Cal., Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. No. 2009-178, at 5-6 (2009) attached as Addendum #2 to this outline.[1] If, on the other hand, the client is repeatedly advised that he may seek the advice of independent counsel and chooses not to do so, the attorney will not be found in violation of his ethical obligations. *See Thelen Reid Brown Raysman & Steiner LLP v. Marland*, 319 Fed. Appx. 676, 678 (9th Cir. 2009) ("[Attorneys] informed [Client] in every draft agreement that he should seek the advice of an independent lawyer, and [Attorneys] provided [Client] a reasonable opportunity (over months of negotiations) to seek such advice. [Client's] claim that he did not actually receive the advice of independent counsel is irrelevant.").

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[1] The State Bar of California, Standing Committee on Professional Responsibility and Conduct, Formal Op. No. 2009-178 is an informative analysis of the various ethical obligations imposed on attorneys under these circumstances, and is attached as an Appendix to these materials. Although the Rules of Professional Conduct are binding only in California, the analysis in this Formal Opinion has broader application.

In addition, whenever an attorney and client are involved in a settlement of potential or actual malpractice claims, and the attorney seeks a waiver from the client of such claims, the attorney has an "adverse interest" that must be disclosed in writing to the client. *See* Cal. Rule of Prof. Conduct 3-310(B)(4) ("A member shall not accept or continue representation of a client without providing written disclosure to the client where: . . . The member has or had a legal, business, financial, or professional interest in the subject matter of the representation."). However, this rule does not apply if the attorney no longer represents the client. State Bar of Cal., Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. No. 2009-178, at 6 (2009).

In addition, if the client has filed litigation against the attorney, the attorney has an actual conflict of interest and cannot continue representing the client absent informed written consent. *See* Cal. Rule of Prof. Conduct 3-310(C)(2).

C. Limitations Involving the Provision of Professional Services

Courts have dealt with a variety of other concepts that deal with the equity of imposing liability on parties who work with trustees in some professional capacity. California courts have wrestled with the problem of attorneys or accountants who assist a trustee, only to be named defendants *(i.e.,* deep pockets) when the transactions in question turn sour. Generally, if the services are provided to an entity without expectation that they will be relied upon by third parties, there may be no negligence claim against the accountant by the unforeseen third parties. *Bily v. Arthur Young & Co.*, 3 Cal.4th 370 (1992). But there may be liability for negligent or intentional misrepresentation, as in an audit where the accountant knows that others will be acting in reliance on the report. Hence where the accountant prepares accounts which he or she knows will be provided to the beneficiaries, arguably a claim would arise on the part of the beneficiary for negligent or intentional misrepresentation. However, in an analogous case involving an attorney, one court has limited that liability.

The Supreme Court of Oregon dealt with the issue of an attorney's liability for providing assistance to a client's breach of fiduciary duty to a third party in *Schrock v. Markley et al.*, 142 P. 3d 1062, 1066-67 (Or. 2006). "[u]nder *Granewich* and the Restatement [Second of Torts], a person who acts 'in concert with' or 'gives substantial assistance or encouragement' to fiduciary who breaches a duty to a third party may be liable for the resulting harm. Markely argues, however, that the general rule does not apply when a lawyer, in the context of the lawyer-client relationship, advised a client who breaches a fiduciary duty to a third party. The Restatement labels any such exemption from liability that the law otherwise would impose as a 'privilege.' See Restatement §890 ('One who otherwise would be liable for a tort is not liable if he acts in pursuance of and within the limits of a privilege***.')"

The Oregon Supreme Court examined the policy behind such a privilege: "for individuals and corporations to obtain the advice and assistance that they must receive from their agents, the agents must have some protection from tort liability to third parties... Not every relationship between a person who breaches a contract or a fiduciary duty and one who substantially assists in such a breach necessarily justifies recognition of a privilege against liability. However, we think that the lawyer-client relationship is one that does. That is true, in our view, because safeguarding the lawyer-client relationship protects more than just an individual or entity in any particular case or transaction; it is integral to the protection of the legal system itself. See Restatement (Third) of the Law Governing Lawyers...ch 2, Introductory Note (2000)...." 142 P. 2d at 1068.

"Accordingly, for a third party to hold a lawyer liable for substantially assisting in a client's breach of fiduciary duty, the third party must prove that the lawyer acted outside the scope of the lawyer-client relationship." 142 P3d at 1069. The Court then cited cases which imposed liability "only if the lawyer 'rendered substantial assistance' to the breach of duty, not merely to the person committing the breach." [*Chem-Age Industries, Inc. v. Glover*, 652 N.W. 2d 756, 774-775 (SD, 2002), if the plaintiff showed that the lawyer "knew of the breach and actively participated in it such that he or she could not reasonably be held to have acted in good faith." [*Spinner v. Nutt*, 631 N.E. 2d 542, 546 (Mass. 1994)]; "most courts have recognized that 'substantial assistance' means something more than the provision of routine professional services' and found that allegations that alleged only that the accountant provides such 'routine services were insufficient to meet the 'substantial assistance' requirement." [*Witzman v. Lehrman & Flom*, 601 N.W. 2d 179, 189 (Minn. 1999)]." 142 P.3d at 1070.

In *Pierce v. Lyman*, 1 Cal.App. 4th 1093 (1991), the court held that an attorney for a trustee could be held liable for actively participating in a trustee's breach of duty if the attorney acted in furtherance of his or her own financial gain, or committed actual fraud by making misrepresentations to the beneficiary. The attorney prepared accounts and made misrepresentations which were knowingly false or misleading. This analysis stemmed from an earlier California Supreme Court case which limited liability for corporate counsel to third parties, except in cases involving such active participation, personal gain, or actual fraudulent statements.

In *City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1998) 68 Cal.App.4th 445, the Court dealt with claims arising from the Orange County municipal bond imbroglio. Restatement (Second) of Trusts §326, com. a

provides as an example of improper conduct: "if the trustee purchases through a stockbroker securities which it is a breach of trust for him to purchase and the broker knows that the purchase is in breach of trust, the broker is liable for participation in the breach of trust." The Court in *Atascadero* held that beneficiaries could bring claims against third parties "who have actively participated with a trustee in a breach of trust for their own financial advantage, whether by inducing, aiding or abetting the trustee's breach of duty, or by receiving trust property from the trustee in knowing breach of trust." 68 Cal.App. 4th at 467.

In *Wolf v. Silberberg & Knupp* (1999) 76 Cal.App.4th 1030, the Court dealt with claims against attorneys who allegedly assisted in the commingling of trust assets with other property and its misuse, allegedly making misrepresentations to a beneficiary to discourage his discovery of the breaches. The Court reversed a grant of summary judgment and remanded the matter for further hearing.

Other courts have required more than simple constructive knowledge to find liability. In *Estate of Goldman* (Ct. App. Mich. 1999) 601 N.W.2d 126 the court dealt with a claim that a successor trustee was guilty of collusion regarding alleged misconduct of a prior trustee who had died. The Court declined to find liability based only on constructive knowledge based on its possession of documents at the time the corporate fiduciary accepted the position of successor trustee. The court held that affirmative steps and profit were required to impose liability. The court also declined to force the successor to file an accounting for the predecessor's term of office.

In *Witzman v. Lehrman, Lehrman & Flom*, (Minn. 1999) 601 N.W.2d 179, the court upheld summary judgment on a RICO claim against accountants for a trustee. The court held that "in cases where aiding and abetting liability is alleged against professionals, we will narrowly and strictly interpret the elements of the claim and require the plaintiff to plead with particularity facts" showing knowledge or "scienter" by the alleged aider and abettor and "substantial" assistance or encouragement of the tortfeasor. The court looked at the policy problems involved in holding accountants and attorneys liable where their conduct was facially a breach of duty, holding that in such circumstances "actual knowledge" of the tortious nature of the conduct was required. 601 N.W.2d at 188. Moreover, "where there is a minimal showing of substantial assistance, a greater showing of scienter is required." *Id.* The court concluded that for purposes of aider and abettor liability, "'substantial assistance' means something more than the provision of routine professional services." 601 N.W.2d at 189.

"Cases which have interpreted the 'financial advantage' exception to the agent's immunity rule to mean a personal advantage or gain that is over and above ordinary professional fees earned as compensation of performance of the agency." *Berg v. Berg Enterprises*, 131 Cal. App. 4th 802, 834 (Cal. App. 2005).

One provides services or assets to a trustee subject to the risk that there may be later findings that the agent or seller should have known that the trustee breached its duties by engaging in the transaction. Disgorgement of proceeds or profits can result from a risky transaction

Addendum #1

The Search for Deep Pockets

Trust and Estate Litigation:
The Search for the Deep Pocket (i.e. Yours)

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The Search for the Deep Pocket

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Whether you act as an express fiduciary, provide services for a fiduciary, act as an agent to perform a fiduciary's duty, or cross the line from arm's length to fiduciary while rushing to assist a client, the world is a very dangerous place.

When your customers or a court or congressional committee anxious to solve problems begins to examine you or your ilk, it sometimes may seem that perfection is the standard. And despite the contrary statements in statutes and case law, the reality is that the professional who serves for or as a fiduciary will be judged in hindsight after the toxics appear, after the IRS changes its position, after markets freeze and the financial geniuses of recent years bail with their golden parachutes to leave shareholders and customers to sort through bankruptcy or sale to current financial geniuses. Whether you relied on a prince, a master of the universe, or a simple billionaire, you may find that your investment choices have left your clients looking for somebody with a deep pocket.

We'll examine all the avenues from which an unhappy client or beneficiary can attempt to salve his injuries with your money. We will look at circumstances where you act as an express fiduciary or where your activities cause you to be burdened with fiduciary duties. We will then go through the variety of persons or entities which may have claims against you for alleged negligence or misconduct.

a. Liability as a Trustee

Being a trustee, executor, conservator or guardian is not a business in the ordinary sense of the marketplace, because of the host of restrictions placed on fiduciaries. As a professional, the CPA, broker, CLU or attorney will likely be held to the highest standard of care, particularly if the professional boasted of prowess and expertise to the settlors or in her application when appointed by the court. Cal. Prob. C. § 16014; Restatement Third of Trusts §77. Disclosure of actual or potential conflicts, mumbled in sales pitches, are highlighted in the courtroom as inadequate, misleading, or untimely.

In addition, the CPA or attorney who serves as trustee must avoid perpetuating family dysfunction – that is, unless the trust instrument directs otherwise. The trustee is burdened with the duty of impartiality among beneficiaries of a given class and between classes, unless expressly modified by the appointing instrument. Unif. Prud. Inv. Act §6; Restatement (Third) of Trusts §79 (2005); Unif. Trust Code §803; Cal. Prob. Code §16003. Thus, if the fiduciary improperly carries the settlor's bias against the wayward child into practice, the fiduciary will be punished. *McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001), aff. and mod. *McNeil v. McNeil,* 798 A.2d 503 (Del. 2002); but see, *Estate of Truang*, 207 Cal.App.2d 818, 835 (1962) (settlor's "overriding intent" was to benefit primary beneficiary).

1) Conflicts—No Further Inquiry

Unlike the more flexible ethical standards in accounting, the ethical standards of a trustee are unyielding: the highest standard, the "highest punctilio of honor."

If there is the hint of a conflict, all burdens shift to the trustee, and good faith may be no defense. *Uzyel v Kadisha* (Cal. App. 2010), 188 Cal. App. 4th 866, 878, *reh. den.*(Oct. 22, 2010), *rev. den.* (Dec. 15, 2010).

The court in *Uzyel* ruled against assertions of good faith by the lay trustee and imposed a presumption of breach where the trustee had a conflict of interest:

"A trustee is strictly prohibited from administering the trust with the motive or purpose of serving interests other than those of the beneficiaries. (Rest.3d Trusts, § 78(1) & com. f, p. 109; see also id., § 87, com. c, p. 244 ["An abuse of discretion may result from the exercise of discretionary authority in bad faith or from improper motive"].) A trustee also is strictly prohibited from engaging in transactions in which the trustee's personal interests may conflict with those of the beneficiaries without the express authorization of either the trust instrument, the court, or the beneficiaries (Bogert, supra, §§ 543 & 543U, pp. 218–219, 422–440; Rest.3d Trusts, § 78(2) & com. b, pp. 95–96.).

"It is no defense that the trustee acted in good faith, that the terms of the transaction were fair, or that the trust suffered no loss or the trustee received no profit. This is known as the no further inquiry rule (Bogert, supra, § 543, pp. 247–248; Rest.3d Trusts, § 78, coms. b & d, pp. 95–96, 103–104.) Such a transaction is voidable at the election of the beneficiaries, and other remedies may be available, including an award of profits that the trust would have made if not for the breach of trust.(Bogert, supra, §§ 543 & 543(V), pp. 247, 441–452; Rest.3d Trusts: Prudent Investor Rule, § 206, com. a, p. 229.) This rule is prophylactic and is justified in part by its deterrent effect….. (Bogert, supra, § 543, pp. 246–247; Rest.3d Trusts, § 78, com. b, p. 96.)" If the original purchase of an asset was a breach of the duty of prudent investing, the beneficiaries are entitled to affirm that transaction, waiving the breach, and enforce their remedies for a separate breach of the duty of loyalty in connection with the sale of the asset….". (Rest.3d Trusts: Prudent Investor Rule, § 205, com. a, pp. 223–224; Rest.3d Trusts (Tent. Draft No. 5, Mar. 2, 2009) § 95, p. 24.)" (emphasis added). *Ibid.* at 905-6.

See also: People v. Larkin (N.D. Cal. 1976), 413 F. Supp. 978, 981.

Care must also be taken not to run afoul of SEC registration requirements which may apply unless the advice you provide "is incidental to the practice of his profession," 15 U.S.C.A. 80b-2(11)(B), or if you serve as a trustee of 15 or fewer trusts.

The decision in *Estate of Witherill*, 828 N.Y.S.2d 722, (N.Y. A.D. Feb. 1, 2007) illustrates the results of serving as a fiduciary for one's clients. The decedent had "employed respondent E. Tefft Barker as her attorney and, after his retirement from the practice of law in 1984, as her financial advisor at a fee of $17,000 per month." 828 N.Y.S.2d at 724.

So far so good—this sounds like the type of retirement everybody would love to enjoy. You have a long-term client who trusts you, you put your decades of expertise to work, and you enjoy a large retirement income for the type of services you had been providing as part of your professional services. The attorney became a coexecutor of the estate of the decedent along with her bookkeeper, Ritchie, after the client passed away.

The executor was removed on the petition of the beneficiary of the estate and surcharged and the decision upheld on appeal.

2) Standard of Care

On appeal, the court found that the trial court "applied the correct standards in assessing Barker's performance, and the record supports its findings of his self-dealing, misfeasance and gross negligence. Because he claimed to be a skilled financial advisor and was paid handsomely for such services during decedent's lifetime, he was obligated to 'exercise such diligence in investing and managing assets as would customarily be exercised by prudent investors of discretion and intelligence have special investment skills' EPTL 11-2-3[b][6]' see *Matter of Janes,* 90 N.Y. 2d 41, 54, 659 N.Y. S. 2d 165, 681 N.E. 2d 332 [1997]. Barker's failure to meet this standard constituted negligence which justified the imposition of surcharges." *Ibid.*(emphasis added). This is the same standard set forth in Cal. Prob. C.§16014.

The Court found that the attorney/financial advisor/coexecutor had taken half of the assets in the estate and invested them with a broker who invested in a junk bond mutual fund, which the court found the coexecutor had ignored for seventeen months. "His gross departure from the obligation to skillfully manage the investment and failure to preserve the principal constituted faithless misfeasance and full justified the inclusion of lost profit or lost appreciation damages in the resulting surcharge (*see Matter of Rothko*, 43 N.Y. 2d 305, 321-322...[1997]; *Scalp & Blade v. Advest*, ...765 N.Y.S. 2d 92 [2003]...." 828 N.Y.S. 2d at 725.

The coexecutor had hired an attorney to sue the broker for the loss, but the Court upheld the trial court's surcharge of such expenses: "Nor was it improper to surcharge him for the cost of legal advice incurred in determining whether to sue Merrill Lynch for this loss. Although this $10,000 fee was billed to the estate, Barker had incurred it in an attempt to rectify his own persistent neglect, and legal action could not be advised because he had ratified the junk bond fund." *Ibid.* The Court upheld the denial of commissions and joint and several liability for the coexecutor "because there was no proof that Ritchie had participated in or been aware of Barker's misfeasance. Given Ritchie's passive, subservient role in handling estate assets and the assessment of surcharges against here in proportion to her conduct, we cannot say that the court abused its discretion." 828 N.Y.S. 2d at 726.

Think again about becoming a fiduciary for your clients. It can be a very expensive proposition when things go wrong.

A number of recent cases have highlighted the risks of the imposition of fiduciary standards on professionals who thought they were dealing with fiduciaries in arm's length relationships. If you take on fiduciaries duties, you will be treated as fiduciaries. Eating what you kill may fine when you are grazing on the general public and enjoying the morals of the marketplace, but it becomes a toxic meal when you shift into a fiduciary role.

b. Potential Claimants and Claims Regarding Services Provided to Fiduciary

Of course, the professional does not need to serve as the fiduciary in order to face potential liability. To the contrary, the attorney, CPA, insurance broker or investment advisor has usually provided services to the fiduciary. Thus, when safeguarding his or her deep pockets, the professional may face a variety of potential claimants.

1) Claims by the Fiduciary

If an attorney, investment advisor, insurance broker or accountant negligently advises the fiduciary, he or she may be liable for malpractice in a claim by the fiduciary.

The fiduciary has a duty to take reasonable care in selecting and overseeing agents, including accountants or legal counsel. For example, §9(a) of the Uniform Prudent Investor Act and Restatement Third of Trusts §80 require the Trustee to utilize due care in the selection and supervision of agents.

California Probate Code §16052 follows the Uniform Act to requires that you exercise reasonable care to comply with the terms of the delegation. If you are performing the service for a fiduciary with the duty of care required for investments, your reliance on "suitability" standards won't protect you—you are performing a fiduciary function and hence must place yourself in the shoes of the fiduciary. Hence you must exercise investment discretion by considering the factors listed in California Probate Code § 16047 (unless the trust instrument or terms of the appointment of the fiduciary impose different requirements). What are the risk and return characteristics of the trust, what are the respective risk tolerances of the beneficiaries in each class, and how should the investment comply with the duty of impartiality as part of the overall portfolio?

As discussed below, in recent decades many of the assumptions of Modern Portfolio Theory have been proven wrong. Blinding following the teachings from 1950 econometrics may lead you to substantial liability when constructing investment portfolios for estates and trusts and conservatorships or advising clients on the risks involved in investments. You need carefully to examine the actual results of investments from 1997 to date, and consider the findings of recent econometric studies, before you put your imprimatur on investment plans doomed to disappoint or fail. Moreover, in the desire to please clients seeking high investment returns in the rarified atmosphere of the American bond bubble, you may find yourself being sued for taking unacceptable risks for clients who, in objective terms, have little or no tolerance for risk. The

retiring couple who no longer can support basic needs with trust income, or who are forced to eat through principal because of losses in portfolio value or increased costs of medical and personal care, may be advised that you were negligent in approving a risky investment or retirement plan. Beware.

See Restatement Third of Trusts §§90-92, revising the original Prudent Investor Rule. *See also* Uniform Trustees' Powers Act §4 (1964); Restatement (Third) of Trusts §171, comment k. The Trustee can be surcharged for the acts of agents where it does not exercise reasonable care in the selection or retention of the agent, does not exercise proper supervision, approves or acquiesces in or conceals the misconduct of the agent, or negligently fails to take proper steps to require the agent to redress the misconduct. Cal. Prob. C. §16052. Restatement (Second) of Trusts, §225.

The Court in *Hesthagen v. Harby*, 481 P.2d 438, 444 (Wash. 1971) held:

> "It is, however, the general rule that, if an administrator exercised due care in the selection and employment of the attorney or other agent to assist him in the management of his trust, he is not absolutely bound by the dereliction of such agent or attorney. Nevertheless, an administrator may not remain totally passive and surrender or delegate all of the duties and functions of his trust to his agent or attorney without himself becoming responsible for losses occasioned by their conduct. In such instances liability arises out of his failure to exercise the attention to and/or superintendence over the activities of his counsel or other agent which a reasonably prudent person, impressed with a trust responsibility, would exercise. Executor -- Liability for Acts of Agent, Annot., 144 A.L.R. 875 (1943)." 481 P.2d at 444.

Hence, if the fiduciary negligently allows the agent to abscond with estate assets, *Estate of Guiol*, 28 Cal.App.3d 818 (1972), the trustee may be surcharged. "A trustee may, under certain circumstances, be surcharged for the negligent acts or omissions of counsel employed by the trustee." *Estate of Lychos*, 470 A.2d 136, 144-45 (Super.Ct. Pa. 1983). The trustee has the duty (where practicable and prudent) to sue for such breaches of contract or negligence by an agent such as accountant for the trust. Restatement (Second) of Trusts §280. The Ohio Court of Appeals affirmed a claim by a fiduciary against its attorney who allegedly failed to use care in establishing an account which should have required two signatures and then in failing to monitor the account. The Court allowed the claim of breach of fiduciary duty to go forward in the probate court, but held that a malpractice suit on the same facts had to be brought in a court of general jurisdiction. This is unpublished, perhaps for good reason. *Gilpin v. Bank One Corporation*, 2004 WL 1301304 (Oh. App. 2004).

In *Estate of Watkins v. Hidman, Hileman & LaCosta*, 91 P.3d 1264 (Mon 2004) the trustee/settlor sued her own attorney for establishing very complex irrevocable trusts which the trustee/settlor was allegedly told were revocable. After the trustee was sued for using the assets as her own, she sued the attorney who prepared the trusts and had advised her. The Montana Supreme reversed summary judgment for the attorneys finding that in light of the complexity of the trusts the settlor/trustee's failure to discover the negligence tolled the statute of limitations

and that the cause of action did not accrue until she was subject to a surcharge and removal suit by the beneficiaries.

In *The Stanley L. and Carolyn M. Watkins Trust v. LaCosta*, 92 P.3d 620 (Mon. 2004), the court held that the personal representative of the settlor's estate had standing to sue the drafting attorney for alleged malpractice, with the statute beginning to run when a will contest was filed. Whether a beneficiary of the estate could also sue was held to be a question of fact to be determined at trial.

Hence, the first type of claimant against the fiduciary's advisor is the fiduciary himself, either suing to redress damages to the trust or seeking indemnification because of a surcharge due to negligent supervision or selection. The executor of a deceased fiduciary may also walk into court with a claim against the negligent advisor, as may the fiduciary's guardian, conservator, or bankruptcy trustee. It should be noted that under Restatement (Second) of Trusts §280, comment k, "the successor trustee can maintain the same actions or suits as could be maintained by the original trustee." The successor trustee "is liable to a beneficiary if he fails to redress a breach of trust committed by the predecessor [trustee].' Restatement (Second) of Trusts §232(2)." *Shriners Hospitals for Crippled Children v. Gardiner*, 733 P.2d 1110, 1114 (Ariz. 1987).

In *Borissoff v. Taylor & Faust*, 35 Cal. 4th 523, 15 Cal.Rptr 3d 735 (2004), the California Supreme Court upheld the claim of a successor personal representative against tax counsel who had allegedly given faulty tax advice to the initial personal representative. The Supreme Court of Wyoming took the opposite view of such claims in *Estate of Drwenski*, 83 P.3d 457 (Wy. 2004).

In *Belt v. Oppenheimer, Blend, Harrison & Tate, Inc.* 192 S.W. 3d 780, (Tex`, 2006), 49 Tex. Sup. Ct. J. 598, the Court allowed a claim for malpractice to be brought by the decedent's executor, recognizing that if the executor could not bring suit, then the malpractice could never be rectified after the death of the estate planning client.

The Court explained: "Thus, in Texas, a legal malpractice claim in the estate-planning context may be maintained only by the estate planner's client. This is the minority rule in the United States – only eight other states require strict privity in estate-planning malpractice suits. In the majority of states, a beneficiary harmed by a lawyer's negligence in drafting a will or trust may bring a malpractice claim against the attorney, even though the beneficiary was not the attorney's client. *See, e.g., Lucas v. Hamm*, 56 Cal. 2d 583, 15 Cal. Rptr. 821, 364 P.2d 685, 689 (Cal. 1961), *cert. denied*, 368 U.S. 987, 82 S. Ct. 603, 7 L. Ed. 2d 525 (1962); *Schreiner v. Scoville*, 410 N.W. 2d 679, 683 (Iowa, 1987)." 192 S.E. 2d at 783.

The Supreme Court expressed some concern that allowing claims against estate planners would pose difficult burdens on courts attempting to determine the intent of dead testators and settlors. In this case, where the malpractice dealt not with dispositive provisions and contending heirs pleading the decedent's abiding affection for them and disgust for their siblings, there was only the issue of a mistake leading to adverse tax consequences. Hence the Court reaffirmed its belief that privity was a strict requirement, but held that this type of dispute did not impose an undue burden on the courts or force estate planning attorneys to face divided loyalties The court

overruled the appellate decision in *Estate of Arlitt v. Paterson*, 995 S.W. 2d 713, 720 (Tex. App. 1999), and held that in these limited circumstances a malpractice case alleging tax errors survived the decedent and could be brought by his executor. 192 S.W. 2d at 785-786

When the trustee or other fiduciary has ignored the investment and other duties imposed by the Uniform Prudent Investor Act, or has failed to establish procedures or maintain records sufficient to demonstrate its prudence, the attorney for the fiduciary may get tagged with liability. If the attorney for the settlor/trustee can be sued for failure to provide for tax savings in structuring the plan, *Sorkowitz v. Lakritz, Wissbrun & Associates, P.C.*, 261 Mich.App. 642, 683 N.W.2d 210 (Mich. App. 2004) [*but see* 706 N.W.2d 9—improper to use extrinsic evidence to prove malpractice re missing *Crummey* power] or for alleged negligence in land sales by the fiduciary, *Spencer v. Sommer*, 91 Fed. Appx.48, 2004 WL 37875 (10th Cir. 2004) [dismissed on statute of limitations grounds], a claim might be made where the attorney allegedly fails to advise the fiduciary about its duties to invest.

The statute of limitations for suing an executor's attorney begins to run on the last date on which the attorney performs the work involved in the alleged negligence. *Carlen v. First State Bank of Beecher City*, 857 N.E. 2d 696, at 735 (Ill. App. Aug. 25, 2006)

2) Where the Agent Negligently Performs Fiduciary Acts

Particularly when the fiduciary is a lay person lacking investment or business skills, there is a substantial temptation for the attorney or accountant to take over management and investment decisions as well as exercise of general discretion in trust matters. When the role of accountant passes into normal fiduciary decision making, he or she faces liability for such conduct just as if he were a professional investment advisor or property manager. *See Bogert, Trust & Trustees* §701 at 202-203. In the ERISA context, any person exercising discretionary authority or discretionary control respecting management may be liable to the beneficiaries or the fiduciary in whose stead he or she acts. *Bouton v. Thompson*, 764 F.Supp. 20, 22 (D. Conn. 1991):

> "To determine whether a person is a fiduciary, the court must look at the functions performed by the individual, not the title that individual holds."

The Court distinguished the situation in *Yeseta v. Baima*, 837 F.2d 380 (9th Cir. 1988):

> "In *Yeseta*, the court held that an attorney rendering professional services is not a fiduciary as defined by ERISA as long as the attorney does not exercise any authority or discretion over the pension plan assets other than providing usual professional services. However, in this case, [attorney] did exercise purported control and discretion over pension plan assets. When, in an instance such as this, an attorney exercises discretionary authority with respect to the management of pension plan assets, the attorney is considered a fiduciary as defined by ERISA." 764 F.Supp. at 23.

Many end up performing fiduciary functions for hapless clients, advising on investment decisions, serving on the boards of directors of closely held companies, conducting real estate

sales for their fiduciary clients. The Uniform Prudent Investor Act permits such delegations, but provides in Section 9(b) that "In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation." Section 9(d) further provides that "By accepting the delegation of a trust function from the trustee of trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State."

As discussed above, the Court in *Gilpin, supra*, allowed a claim for breach of fiduciary duty against the attorney for failure to require two signatures on a fiduciary account and for failing to monitor the account, reversing a summary judgment in favor of the attorney. The dividing line between malpractice and breach of duty in assisting in estate management has thus become blurred.

Several States have modified 9(b) to make it express that the agent has the same standard of care as the fiduciary. New Jersey's version states: "In performing a delegated function, the agent shall owe to the trustee and the beneficiaries the same duties as the fiduciary and shall be held to the same standards as the fiduciary." Kansas provided 58-24a99((b) "In performing a delegated function, an investment agent shall be subject to the same standards that are applicable to the fiduciary." One would think such a standard would apply as a matter of course, because otherwise the trustee would have delegated only a portion of its responsibility, making the selection inappropriate.

It is most important to take care in structuring the terms of the delegation, and to provide limiting language which defines the duties and responsibilities undertaken. Limitations on duties are more easily protected, since they do not raise the presumptions caused by the fiduciary's demand for exculpatory language. However, as seen in the ERISA cases, courts may seek to impose implicit fiduciary duties even where the delegation has limited the institution to purely ministerial functions, *see In re Enron ERISA Litigation,* 284 F.Supp.2d 511 (S.D. Tex. 2003); *Kling v Fidelity Management Trust Co.*, 323 F.Supp.2d 132 (Mass. 2004).

If there is a full delegation of investment responsibilities, exculpatory language might be deemed to be ineffective to the extent it limited the standard of care. In *Will of Jones*, 765 N.Y.S.2d at 756 (Oct. 1, 2003) the Surrogate's Court for Broome's County, New York held that it would be a breach of trust for a trustee to delegate all of its duties to another person or entity: "...a fiduciary cannot delegate the responsibility for the entire administration of the estate or trust. 'The duty of a fiduciary is personal and cannot be divested by delegation.' 41 N.Y. Jur. 2d., Decedent's Estate §1479 at p. 84. A fiduciary who does so is liable for breach of trust and potentially subject to surcharge.*** Consequently, a fiduciary is not authorized to give a general power of attorney." 765 N.Y.S.2d at 757

Consider the case where the settlor has set a negligence standard for the trustee itself for investments. A delegation to an agent for conduct of a fiduciary function such as investments which exculpates the agent for mere negligence, and requires willful conduct or self-dealing for liability, will leave the original fiduciary exposed if the agent negligently, but not willfully, breaches the standard of care. The duty to supervise such an agent would then become most stringent, since otherwise the beneficiary would have been exposed to the risk of negligent conduct. The comments to §9 of the Uniform Prudent Investor Act raise the prudence of such a

delegation and exculpatory provision: "The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation. This sense that it is imprudent to expose beneficiaries to broad exculpation clauses underlies both federal and state legislation restricting exculpatory clauses, e.g., ERISA §§404(a)(1)(D), 410(a), 29 U.S.C. §§ 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law §11-1.7 (McKinney 1967)."

The Court in *Donato v. Bankboston, N.A.,* 110 F.Supp.2d 42 (D. R.I. 2000), dealt with a number of provisions on which the trustee relied to avoid liability for alleged imprudent concentrations in a single security. The trust in question authorized the retention of original assets. In this case, the securities were convertible debentures of CML Group. These, however, had been converted to common stock. The court noted that in some situations, "a security substituted for an original security 'as a result of a reorganization, recapitalization, or other cause' is not subject to the provisions of a retention clause," but held that this was true only if it is "substantially the equivalent of the old security." 110 F. Supp. 2d at 50. The court noted that the convertible debentures offered liquidation preferences, while the common stock did not. It cited Bogert, Trusts & Trustees, §682 at 126-127 (2d ed. 1982) for the proposition that "if in any material respect there has been a change in the nature of the...risk, security, or priority, the new property ought not to be held under the [retention] authorization clause." 110 F.Supp.2d at 51. The court decided to "err on the side of caution" and hold that the retention language did not justify the holding of the common stock.

The trust instrument also authorized investment in "securities not ordinarily considered appropriate for trust investments" and retention of amounts "disproportionately large for trust investments." The court held that such language should be strictly construed and that it merely absolved the trustee for "per se" imprudence in violating normal prudence standards. It cited Restatement (Third) of Trusts §228 com. g for the rule that such provisions are to be strictly construed and "do not ordinarily result in a broadening" of the prudent man standard. 110 F.Supp.2d at 49. Absent words such as "absolute" or "uncontrolled" discretion, a grant of the "broadest discretion" did not reduce the standard of review of conduct from prudence to "abuse of discretion." The trust, however, further provided that the trustee was to be exculpated except in cases of "negligence or bad faith." Hence, the court concluded that it could hold the trustee liable on a negligence standard.

In any event, exculpatory language tracking similar language in the trust instrument or will might be subject to strict scrutiny and disclosure requirements. *See Estate of Stralem* (Surr. 1999) 695 N.Y.S.2d 274. The court cited the Commission comments to a statutory provision subjecting exculpatory clauses to extreme scrutiny:

> "The increasing practice of testamentary draftsmen and corporate fiduciaries in vesting in testamentary fiduciaries almost unlimited powers with a minimum of obligations, is a serious potential menace not only to the rights of a surviving spouse but of the children and other dependents of the testator and all persons

> interested in estates. This tendency must be curbed. The primary duties of ordinary care, diligence and prudence...and of absolute impartiality among the several beneficiaries...are of the very essence of a trust, and an impairment of these or similar obligations of a fiduciary are contrary to public policy." 695 N.Y.S.2d at 720.

The court concluded that "the common theory throughout the cases on the subject is that 'the attempted exoneration of the fiduciary for any loss, unless occasioned by "willful neglect or misconduct", is a nugatory provision amounting to nothing more that a waste of good white paper.'...In today's jargon such provisions are a waste of 'good computer bytes.'" 695 N.Y.S.2d at 720. The court held the provisions void and negated any forfeiture for challenging the provisions.

In *Estate of Saxton*, 712 N.Y.S.2d 225 (App. Div. 2000), the court upheld a surcharge of a corporate trustee for investment breaches, despite the claim that a written Investment Directive Agreement signed by all beneficiaries expressly approved holding all of the trust assets in a single stock. On appeal, the Appellate Division rejected the argument that the investment directive constituted an enforceable contract, pointing out the duty of the trustee to inform the beneficiaries of the consequences of such an agreement:

> "Prior to the instrument being prepared and its subsequent distribution to respondents, not a scintilla of evidence indicates that petitioner fully apprized Saxton or respondents of the effects that their execution of the IDA would have on their legal rights or how their direction to hold the entirety of the trust's corpus in IBM stock would fall short of what would have been required of a prudent corporate trustee." 712 N.Y.S.2d 225, 231.

3) Collusion with the Fiduciary

Even in jurisdictions which follow a strict privity rule or weight the scales against direct malpractice liability claims by beneficiaries, a claim can be brought by the beneficiary for collusion. "A person, though himself not a fiduciary, is liable for the breach of a fiduciary duty if he colludes with a disloyal fiduciary. *Gray v. Sutherland*, 124 Cal.App.2d 280 [268 P2d 754]." *St. James Armenian Church of Los Angeles v. Kurkjian*, 47 Cal.App.3d 547, 552 (1975). This duty is stated variously in Restatement (Second) of Trusts §326 ("A third person who, although not a transferee of trust property, has notice that the trustee is committing a breach of trust and participates therein is liable to the beneficiary for any loss caused by the breach of trust."), Restatement of Restitution §138(2) ("A third person who has colluded with a fiduciary in committing a breach of duty, and who obtained a benefit therefrom, is under a duty of restitution to the beneficiary."), and Restatement of Torts §876 (liability for damages if one "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself.").

Aiding and abetting a breach of fiduciary duty is couched in similar terms. "[T]o state a claim for aiding and abetting breach of a fiduciary duty, plaintiffs must allege that defendant knew about a breach of fiduciary duty and knowingly induced or participated in the breach." *In*

re Bayou Hedge Funds Investment Litigation, 472F. Supp. 2d 528, 2007 AT 532-533 (S.D.N.Y., Jan. 18, 2007) (dismissing claims against counsel). "It is a well-settled principle of New York law that allegations that attorneys represented defrauders in certain transactions do not give rise to any inference that the attorneys were aware of the fraud. *Weskel*, 124 A.D. 2d at 147, 511 N.Y.S. 2d 626. Additionally, the complaint is completely devoid of allegations tending to show that FR & O or Oppenheim gave substantial assistance to Bayou, Israel and Marino in the perpetration of the underlying fraud and breach of fiduciary duty." 472 f.Supp.2d 528 at 533.

In *Moore v. Shaw*, 116 Cal.App.4th 182, 198 (2004), the Court rejected a SLAPP suit filed by contingent beneficiaries against an attorney who had allegedly colluded to terminate a trust without court authorization or notice to the beneficiaries, terminating their interest. The Court relied on Restatement (Second) of Trusts §326 in holding that the beneficiary had demonstrated a reasonable probability of success in her claim that her father's attorney had colluded with him in breaching his fiduciary duty as trustee in improperly terminating the trust, depriving the plaintiff of her rights under the trust.

The Court held:

> "'Section 326 of the Restatement [Second of Trusts] provides that "[a] person who, although not a transferee of trust property, has notice that the trustee is committing a breach of trust and participates therein is liable to the beneficiary for any loss caused by the breach of trust." (See also Bogert, Law of Trusts and Trustees (rev. 2d ed. 1995) §868, pp. 104-109 [person who knowingly aids trustee in committing a breach of his duties is liable to the beneficiary]; 11 Witkin, Summary of Cal. Law (9th ed. 1990) Trusts §164, p. 1017 [beneficiary may sue
>
> third persons who participated in breaches of trust].)....' (*Wolf v. Mitchell, Silverberg & Knupp* (1999) 76 Cal. App. 4th 1030,1039, 90 Cal. Rptr. 2d 792.)"
> 116 Cal.App.4th at 197-198.

Ernst & Young LLP v. Baker O'Neal Holdings Inc., ___F. Supp. 2d ___ , 2004 WL 771230 (S.D. Ind. 2004) dealt with allegations that the accountants for the corporation had aided and abetted the fraudulent transfer of funds from the corporation by its president. The action is purely in the pleading stage, so that the court was required to accept as true the allegations, dealing only with their legal sufficiency. The Court denied motions to dismiss the aiding and abetting claims:

> "Though the law in other jurisdictions is not uniform, the majority view is that a third-party non-beneficiary can be liable for aiding and abetting the breach of a fiduciary duty, especially where the third party is in privity with the fiduciary or has benefited from the breach in some way. See Restatement (Second) of Torts §874 cmt. c (1979) ('A person who knowingly assists a fiduciary in committing a breach of trust is himself guilty of tortuous conduct and is subject to liability for harm thereby caused.'); 3 Am.Jur.2d Torts §299 (1986) ('A person who intentionally causes or assists an agent to violate a duty to the principal is subject

to liability in tort for the harm he has caused to the principal...')." 2004 WL 771230 at 12.

The Court in *Granewich v. Harding*, 985 P.2d 788, 793-794 (Or. 1999) pointed out that "Legal authorities...virtually are unanimous in expressing the proposition that one who knowingly aids another in the breach of a fiduciary duty is liable to the one harmed thereby. That principle readily extends to lawyers."

In *Whitfield v. Lindemann*, 853 F.2d 1298, 1303 (5th Cir. 1988), the court held that the attorney for the pension plan trustee was not a "statutory fiduciary" under ERISA, but affirmed a liability "as a nonfiduciary who knowingly participated in a breach of trust. *Brock v. Hendershott*, 840 F.2d 339, 342 (6th Cir. 1988); *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209, 1220 (2d Cir. 1987); *Foltz v. U.S. News & World Report, Inc.*, 627 F.Supp. 1143, 1167-68 (D.D.C.1986); *Donovan v. Daugherty*, 550 F.Supp. 390, 410-11 (S.D. Ala. 1982)."

To succeed in holding the attorney liable for collusion, however, the beneficiary must show that the attorney knew or should have known that a breach of trust was taking place. *Traub v. Washington*, 591 S.E.2d 382, 385 (Ga. 2003).

Some courts have looked to liability for third parties who participate in a breach of trust or who knowingly benefit from a breach of trust under the theory of "trustee *in invitum*." *Edward D. Jones & Co. LP v Ventura*, 907 So. 2d 1035, 2005 WL 435140 (Ala. 2005); *Belcher v. Brimingham Trust Nat. Bank,* 348 F. Supp. 61 (N.D. Ala. 1968).

In *Weingarten v. Warren*, 753 F.Supp. 491, 496 (S.D.N.Y.1990) a diversity case brought for breach of trust against the trustee and his attorney, the Court held that "To state a claim for aiding and abetting a fiduciary, plaintiffs must show *inter alia* that defendant acted in furtherance of his own self-interest." *See Feinberg Testamentary Trust v. Carter*, 652 F.Supp. 1066, 1082 (S.D.N.Y. 1987).

The Court in *Pierce v. Lyman*, 1 Cal.App.4th 1093, 1103 (1991) described the beneficiary's claim as follows:

> "At common law, in order to state a cause of action against an attorney for active participation in a breach of trust by a trustee, the beneficiaries were required to allege that the attorney knew or should have known that he or she was assisting the trustee to commit a breach of trust, and that the attorney assisted the trustee is such a way that the attorney, as well as the trustee, should be liable for the breach of trust. (4 Scott, The Law of Trusts (4th ed.) §326.4, p. 310; Bogert, Trusts & Trustees (2nd ed. 1982) §901, p. 256.) The rendering of legal advice to the trustee was insufficient; the attorney must have actively colluded with the trustee in breaching the trustee's fiduciary duties."

The Court in *People of State of California v. Larkin*, 413 F.Supp. 978, 983 (N.D. Cal. 1976) invalidated a mortgage on trust property where the lender was on notice that the "hypothecation might constitute a breach of trust." The Court found a violation of Cal. Civ.

Code §2243: "Everyone to whom property is transferred in violation of a trust, holds the same as an involuntary trustee under such trust, unless he purchased it in good faith, and for a valuable consideration." The Court held that lacking good faith, consideration was not enough to save the mortgage, citing Restatement (Second) of Trusts §288.

In *Pierce v. Lyman*, supra, 1 Cal.App.4th at 1104, the Court restricted the application of the doctrine regarding an attorney for a fiduciary from whom liability was sought on a collusion theory. The Court looked to the holding in *Doctors' Co. v. Superior Court*, 49 Cal.3d 39 (1989) which held that noninsurers could not be held to have conspired with an insurance company to violate its statutory duty, since the duty was expressly limited to insurance companies by statute. The Court in *Pierce* pointed to an exception relating to attorneys for fiduciaries:

> "Most notably, where an attorney conspires with a client to violate a statutory duty peculiar to the client, the attorney may be liable for his or her participation in the violation of the duty if the attorney was acting in furtherance of his or her own financial gain." 1 Cal.App.4th at 1104.
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> "This principle is known as the 'agent's immunity rule,' which establishes that 'an agent is not liable for conspiring with the principal when the agent is acting in an official capacity on behalf of the principal.' (*Fiol v. Doellstedt* (1996) 50 Cal. App. 4th 1318, 1326, 58 Cal. Rptr. 2d 308; *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 Cal. 4th 503, 512, 28 Cal. Rptr. 2d 475, 869 P.2d 454 (*Applied*).)
>
> But the Court in *Doctors' Co.* did articulate two settings in which a conspiracy claim might lie against an attorney for participating in the violation of a duty owed by the client to another: (1) where the attorney violates a duty that he or she independently owes to the plaintiff; and (2) where the attorney's acts go beyond the performance of a professional duty owed to the client and are, in addition, done for his or her own personal financial gain."

Berg & Berg Enterprises, LLC v. Sherwood Partners, Inc., 131 Cal.App.4th 802, 817-818, 32 Cal. Rptr.3d 325 (Cal. App. 2005).

Villains v. American Economy Insurance Co., 870 F. Supp. 2d 792 (N.D. Cal. 2012). Insureds sued insurers for violation of a duty of good faith and fair dealing, joining an accounting firm and cpa hired to determine losses from fire damage under the theory of aiding and abetting. The court held that "[u]nder California law...a cause of action [for aiding and abetting] does not require that the aider and abettor owe plaintiff a duty so long as it knows the primary wrongdoer's conduct constitutes a breach of duty, and it substantially assists that breach of duty." *Ibid.* at 795. The Court relied on the agency immunity rule which provides that "the agent is, in effect, immune from liability because 'a corporation cannot conspire with itself' –i,e, 'an agent or employee who is acting within the scope of his authority is (in the eyes of the law) one and the same "person" as the corporation.'" *Ibid.* at 796.

The Court followed *Berg v Berg Enterprises, LLC v Sherwood Partners, Inc*, (2005) 131 Cal. App. 4th 802, 832, holding that the agency immunity did not apply if the agent obtained a "financial advantage" over and above ordinary professional fees earned as compensation for performance of the agency. Since the accounting firm and CPA did not receive "a 'cut' from the insurance companies based on the monies that they did not pay out to Plaintiffs," and only received their professional fees, they were immune from aiding and abetting (or conspiracy) claims. *Ibid.* at 797.

The United States Supreme Court dealt with the issue of collusion in *Harris Trust and Savings Bank v. Salomon Smith Barney, Inc.*, 530 U.S.238, 120 S. Ct. 2180 (2000). This was an ERISA case brought against the plan trustee and others stemming from losses sustained in the purchase of interests in several motel properties by the plan. Salomon allegedly had provided broker-dealer services to the Ameritech Pension Trust in the late 1980's. Salomon sold the properties to the trust. After the loss of the principal of the investment, the trustee sought to sue Salomon under ERISA. A major issue was whether ERISA provided for such a suit - the Supreme Court held that such a cause of action was appropriate. In finding that such a claim was appropriate the Court had to deal with the issue of whether the trustee, allegedly at fault for an imprudent investment, could sue the seller. The Court held that the "common law of trusts, which offers a 'starting point for analysis [of ERISA]...[unless] it is inconsistent with the language of the statute, its structure or its purposes'...plainly countenances the sort of relief sought by petitions against Salomon here." 530 U.S. at 251. The decision cited Restatement (Second) of Trusts §204, com. e to reject the argument that a culpable fiduciary could not seek redress from a seller: "'Although the trustee bases his cause of action upon his own voluntary act, and even though the act was knowingly done in breach of his duty to the beneficiary, he is permitted to maintain the action, since the purpose of the action is to recover money or other property for the trust estate, and whatever he recovers he will hold subject to the trust.'" Id., at 252.

The Court concluded that Salomon could be held liable for collusion with the trustee and for disgorgement of its profit if it had "actual or constructive knowledge of the circumstances that rendered the transaction unlawful." ID., at 251. The decision held:

> "[I]t has long been settled that when a trustee in breach of his fiduciary duty to the beneficiaries transfers trust property to a third person, the third person takes the property subject to the trust, unless he has purchased the property for value and without notice of the fiduciary's breach of duty. The trustee or beneficiaries may then maintain an action for restitution of the property (if not already disposed of) or disgorgement of proceeds (if already disposed of), and disgorgement of the third person's profits derived therefrom." *Id.*

In *Harris*, liability was premised on the fact that the person dealing with the trustee could not have been a bona fide purchaser because of actual or constructive knowledge of the breach.

On June 1, 1999, the Bankruptcy Court for the Eastern District of Virginia issued its opinion on damages against a fiduciary and his counsel, totaling over $9 million. *In re John Hanes, Jr.*, Case No. 93-10238 (E. D. Va. Bankruptcy, 1999). The Bankruptcy Court had

originally held that the debtor/fiduciary had not committed breaches of trust, exonerating both the debtor and his attorney. This was reversed by the District Court for the Eastern District of Virginia in July of 1998.

The District Court found that the debtor had acted in various fiduciary roles regarding various trust and estate assets, borrowing money for a limited partnership (HILP) and a company (DCI) in which he had interests, and using estate assets as collateral without adequate consideration. The decedent had died in 1987 leaving most of the Estate's assets in a Marital Trust. The debtor and his brother were ostensibly granted power to restructure the family assets by a power of attorney signed by the decedent and his wife. A family limited partnership was created to borrow funds using the estate assets as collateral to invest in various business ventures. The various business entities and the fiduciary subsequently filed for Chapter 11 bankruptcy and claims were brought against the debtor, his attorney, and the attorney's law firm by beneficiaries of the various entities. The various trusts were granted standing to obtain damages.

The District Court found that the fiduciary, "with the aiding and abetting" of his attorney: "(1) misappropriated Estate assets by engaging in self-dealing, without proper authority under the will of Hanes, Sr., or under his powers-of-attorney, and without the full and complete disclosure of factual and legal ramifications of such actions to Hope Hanes and the beneficiaries; (2) hypothecated Estate assets for loans to HILP and the DCI Companies, again without proper authority; and (3) failed to provide timely consideration to the Estate from HILP, or provide any consideration from the DCI Companies, for the hypothecation of Estate assets." (slip opinion at 9). The District Court found that the will did not authorize the self-dealing transactions and that there was inadequate disclosure of the conflicts and the "legal ramifications" of the transactions to the widow and beneficiaries, following New York law. (July 29, 1998 opinion at 15). The attorney for the fiduciary was held to have breached his duty of loyalty, which the Court found "stems from his failure to inform [the widow], particularly, but also the other beneficiaries, about the legal problems caused by the issues mentioned above (i.e., unauthorized hypothecation, lack of consideration, and self-dealing). As discussed below, [attorney] not only failed to correct omissions made by others, but also omitted important facts himself when communicating to the Hanes sisters. While he would like to hide behind defendant Hanes' status as attorney-in-fact (saying that so long as he was informed, [attorney] could assume the Estate was informed), the court finds that this is an inadequate defense...." (slip opinion at 20). The Court cited *Heine v. Neuman Tennenbaum*, 856 F.Supp. 190 (S.D. N.Y. 1994) and *Citibank, N.A. v. Nyland Ltd.*, 878 F.2d 620, 624 (2d Cir. 1989) for the proposition that reliance on the attorney-in-fact is misplaced when he or she is acting outside the scope of his real or apparent authority. Absent an authorization for the self-dealing transactions, the court found that the attorney could not act on the authority or rely on disclosures to the conflicted fiduciary.

The attorney was held to have privity with the beneficiaries because of numerous meetings and communications with them. The Court held that the beneficiaries and the fiduciary's attorney "often met face-to-face in family meetings. Further, the beneficiaries relied on his advice (and that of John and David Hanes) throughout. The court finds that the relationship between the two parties sufficiently resembled privity to sustain a malpractice action...." (slip opinion at 23).

On remand to the bankruptcy court, the court denied discharge to the bankrupt on certain claims, and found liability for the attorney for the fiduciary. The bankruptcy court found malpractice liability for the attorney and his firm "by failing to inform [widow] and the beneficiaries about the legal problems caused by Hanes' self-dealing, to correct omissions made by others and to disclose facts when communicating with [widow] and the beneficiaries." (June 1, 1999 Bankruptcy Court slip opinion at 7). The Court held that "Third parties who aid a fiduciary in using trust assets in making unauthorized investments or in violation of the trust or of the trustee's duties may be held liable for damages sustained by the estate. *In re Loomis' Estate*, 45 N.Y.S. 2d 146, 151 (Surr. Ct. 1943) (citing *Stark v. National City Bank*, 16 N.E. 376, 380 (N.Y. 1938)." (op. cit.).

The bankruptcy court assessed damages against the fiduciary in the amount of $4,167,745. Damages against the attorney and his firm were assessed at $9,062,560, plus prejudgment interest at 9% against the attorney, based on Virginia law. The attorneys have posted a supersedes bond and are appealing the bankruptcy decision to the District Court. No appeal had been taken of the prior liability decision of the District Court on the premise that it was interlocutory.

One provides services or assets to a trustee subject to the risk that there may be later findings that the agent or seller should have known that the trustee breached its duties by engaging in the transaction. Disgorgement of proceeds or profits can result from a risk transaction.

Dealing with affiliates poses many of these risks: are the services, assets, or transactions appropriate from the trust's perspective? One needs careful documentation to prove that the affiliate had no reasonable basis for believing that the transaction represented a breach of fiduciary duty. The Supreme Court in *Harris* has raised the risk factor in a host of transactions. Since many of these vendors are sophisticated entities, it may be difficult to rebut the contention that they were ignorant of the imprudence of the transactions. Whether liability will result for Salomon depends on the actual findings on prudence and knowledge of the alleged breaches. However, one should not rest comfortable in supposedly arms-length transactions with fiduciaries.

From the fiduciary's perspective, if you have done something stupid, *Harris* points the way for spreading the damages among other parties to the transaction.

4) Limitations involving the Provision of Professional Services

Courts have dealt with a variety of other concepts that deal with the equity of imposing liability on parties who work with trustees in some professional capacity. California courts have wrestled with the problem of attorneys or accountants who assist a trustee, only to be named defendants (i.e., deep pockets) when the transactions in question turn sour. Generally, if the services are provided to an entity without expectation that they will be relied upon by third parties, there may be no negligence claim against the accountant by the unforeseen third parties. *Bily v. Arthur Young & Co.*, 3 Cal.4th 370 (1992). But there may be liability for negligent or intentional misrepresentation, as in an audit where the accountant knows that others will be

acting in reliance on the report. Hence where the accountant prepares accounts which he or she knows will be provided to the beneficiaries, arguably a claim would arise on the part of the beneficiary for negligent or intentional misrepresentation. However, in an analogous case involving an attorney, one court has limited that liability.

The Supreme Court of Oregon dealt with the issue of an attorney's liability for providing assistance to a client's breach of fiduciary duty to a third party in *Schrock v. Markley et al.*, 142 P. 3d 1062, 1066-67 (Or. 2006). "under *Granewich* and the Restatement [Second of Torts], a person who acts 'in concert with' or 'gives substantial assistance or encouragement' to fiduciary who breaches a duty to a third party may be liable for the resulting harm. Markely argues, however, that the general rule does not apply when a lawyer, in the context of the lawyer-client relationship, advised a client who breaches a fiduciary duty to a third party. The Restatement labels any such exemption from liability that the law otherwise would impose as a 'privilege.'See Restatement §890 ('One who otherwise would be liable for a tort is not liable if he acts in pursuance of and within the limits of a privilege***.')"

The Oregon Supreme Court examined the policy behind such a privilege: "for individuals and corporations to obtain the advice and assistance that they must receive from their agents, the agents must have some protection from tort liability to third parties...Not every relationship between a person who breaches a contract or a fiduciary duty and one who substantially assists in such a breach necessarily justifies recognition of a privilege against liability. However, we think that the lawyer-client relationship is one that does.. That is true, in our view, because safeguarding the lawyer-client relationship protects more than just an individual or entity in any particular case or transaction; it is integral to the protection of the legal system itself. See Restatement (Third) of the Law Governing Lawyers...ch 2, Introductory Note (2000)...." 142 P. 2d at 1068.

"Accordingly, for a third party to hold a lawyer liable for substantially assisting in a client's breach of fiduciary duty, the third party must prove that the lawyer acted outside the scope of the lawyer-client relationship." 142 P3d at 1069. The Court then cited cases which imposed liability "only if the lawyer 'rendered "substantial assistance" to the breach of duty, not merely to the person committing the breach.'" [*Chem-Age Industries, Inc. v. Glover*, 652 N.W. 2d 756, 774-775 (SD, 2002), if the plaintiff showed that the lawyer "' knew of the breach and actively participated in it such that he or she could not reasonably be held to have acted in good faith.' [*Spinner v. Nutt*, 631 N.E. 2d 542, 546 (Mass. 1994)]; "'most courts have recognized that "substantial assistance" means something more than the provision of routine professional services' and found that allegations that alleged only that the accountant provides such 'routine services were insufficient to meet the 'substantial assistance' requirement." [*Witzman v. Lehrman & Flom*, 601 N.W. 2d 179, 189 (Minn. 1999)]." 142 P.3d at 1070.

In *Pierce v. Lyman*, 1 Cal.App. 4th 1093 (1991), the court held that an attorney for a trustee could be held liable for actively participating in a trustee's breach of duty if the attorney acted in furtherance of his or her own financial gain, or committed actual fraud by making misrepresentations to the beneficiary. The attorney prepared accounts and made misrepresentations which were knowingly false or misleading. This analysis stemmed from an earlier California Supreme Court case which limited liability for corporate counsel to third

parties, except in cases involving such active participation, personal gain, or actual fraudulent statements.

In *City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1998) 68 Cal.App.4th 445, the Court dealt with claims arising from the Orange County municipal bond imbroglio. Restatement (Second) of Trusts §326, com. a provides as an example of improper conduct: "if the trustee purchases through a stockbroker securities which it is a breach of trust for him to purchase and the broker knows that the purchase is in breach of trust, the broker is liable for participation in the breach of trust." The Court in *Atascadero* held that beneficiaries could bring claims against third parties "who have actively participated with a trustee in a breach of trust for their own financial advantage, whether by inducing, aiding or abetting the trustee's breach of duty, or by receiving trust property from the trustee in knowing breach of trust." 68 Cal.App. 4th at 467.

In *Wolf v. Silberberg & Knupp* (1999) 76 Cal.App.4th 1030, the Court dealt with claims against attorneys who allegedly assisted in the commingling of trust assets with other property and its misuse, allegedly making misrepresentations to a beneficiary to discourage his discovery of the breaches. The Court reversed a grant of summary judgment and remanded the matter for further hearing.

Other courts have required more than simple constructive knowledge to find liability. In *Estate of Goldman* (Ct. App. Mich. 1999) 601 N.W.2d 126 the court dealt with a claim that a successor trustee was guilty of collusion regarding alleged misconduct of a prior trustee who had died. The Court declined to find liability based only on constructive knowledge based on its possession of documents at the time the corporate fiduciary accepted the position of successor trustee. The court held that affirmative steps and profit were required to impose liability. The court also declined to force the successor to file an accounting for the predecessor's term of office.

In *Witzman v. Lehrman, Lehrman & Flom*, (Minn. 1999) 601 N.W.2d 179, the court upheld summary judgment on a RICO claim against accountants for a trustee. The court held that "in cases where aiding and abetting liability is alleged against professionals, we will narrowly and strictly interpret the elements of the claim and require the plaintiff to plead with particularity facts" showing knowledge or "scienter" by the alleged aider and abettor and "substantial" assistance or encouragement of the tortfeasor. The court looked at the policy problems involved in holding accountants and attorneys liable where their conduct was facially a breach of duty, holding that in such circumstances "actual knowledge" of the tortious nature of the conduct was required. 601 N.W.2d at 188. Moreover, "where there is a minimal showing of substantial assistance, a greater showing of scienter is required." Id. The court concluded that for purposes of aider and abettor liability, "'substantial assistance' means something more than the provision of routine professional services." 601 N.W.2d at 189.

"Cases which have interpreted the 'financial advantage' exception to the agent's immunity rule to mean a personal advantage or gain that is over and above ordinary professional fees earned as compensation of performance of the agency." *Berg v. Berg Enterprises*, 131 Cal. App. 4th 802, 834 (Cal. App. 2005).

One provides services or assets to a trustee subject to the risk that there may be later findings that the agent or seller should have known that the trustee breached its duties by engaging in the transaction. Disgorgement of proceeds or profits can result from a risky transaction.

5) Enforcement of Trust Claims by the Beneficiary

Under Restatement (Second) of Trusts §282, a beneficiary may file a suit in equity against the trustee and a third party who has breached a duty to the trust if the trustee improperly refuses or neglects to bring an action. As the Court noted in *Firestone v. Galbreath*, 976 F.2d 279, 284 (6th Cir. 1992), "According to SCOTT ON TRUSTS §294.1 (4th ed. 1989), as quoted by the district court. The beneficiary can maintain a suit in equity against the tortfeasor only if the trustee improperly refuses or neglects to bring an action.'" In that case, however, there had been no demand for suit and the court held that the beneficiaries' interest had not been vested at the relevant times.

In *Triplett v. Williams*, 269 Cal.App.2d 135, 138 (1969), the Court reiterated this common-law rule, holding that:

> "If the trustee cannot or will not enforce the cause of action which the trustee ought to bring against a third person, the beneficiary may seek judicial compulsion against the trustee (Rest. 2d Trusts, §199); or the beneficiary may enforce his rights by a suit in which the third person and the trustee are joined in order that the claim may not be lost or prejudiced (Rest. 2d Trusts, §282...)."

Where jurisdiction cannot be obtained over the trustee, a suit in equity against the third party was authorized by Restatement (Second) of Trusts §282 (3).

Where the trustee has a clear conflict of interest in enforcing or defending claims related to the trust, one court has authorized the appointment of a trustee ad litem to conduct the litigation. *Getty v. Getty* (1988) 205 Cal.App.3d 134, 140-142.

In *Saks v. Damon Raike & Co.*, 7 Cal.App.4th 419 (1992) the claim was made that the attorney for the trustee and a real estate broker had failed various professional duties in the acquisition of a commercial property. After its purchase, a toxic spill occurred at the property. The tenant and guarantor went bankrupt. The case had a complicated procedural setting since it was first brought in the wrong venue and then resulted in a suit brought separately in civil court against the attorney and broker while a separate surcharge action proceeded against the trustee. The beneficiaries faced a dicey tactical problem since they had been co-trustees at the time of the decisions in question, and resigned thereafter.

The desire for a separate civil suit against the two agents may have been motivated by a desire to obtain a jury trial. However, it is clear from the Restatement, as pointed out in *Uselman v. Uselman*, 464 N.W.2d 130, 137 (Minn. 1990), that the action is a derivative one to recover damages for the trust and is brought in equity:

> "However, '[t]he beneficiaries of a trust cannot maintain an action at law against a third person who commits a tort or other wrong with respect to the trust property ***' 4 A. Scott & W. Fratcher, The Law of Trusts §281 (4th ed. 1989)."

Uselman, 464 N.W.2d at 137.

Other states have allowed beneficiaries to bring actions directly:

> "Although Utah substantive law is especially sparse in this area, it appears the beneficiary has the right to bring an action against a third party when the beneficiary's interests are hostile to those of the trustee....Other jurisdictions also allow a beneficiary to sue third parties directly. *E.g., Alioto v. United States*, 593 F.Supp.1402, 1412 (N.D. Cal. 1984) (in action where beneficiary has been damaged by trustee and third party, beneficiary may bring action against third party separately); *Booth v. Security Mut. Life Ins. Co.*, 155 F.Supp. 755, 761 (D.N.J.1957) (where the trustee transfers property in breach of trust with assistance of third parties, third parties are primarily liable to the beneficiary, rather than to the trustee; the right of the beneficiary against the third party is a direct right not derived through the trustee); *Hoyle v. Dickinson*, 155 Ariz. 277, 279, 746 P.2d 18, 20 (Ct. App. 1987) (trust beneficiary may bring action for damages against third party for breach of trust agreement); *Apollinari v. Johnson*, 104 Mich.App. 673, 305 N.W. 2d 565, 567 (1981) (beneficiary may sue third party without joining trustee.).**Further, most jurisdictions follow the general rule set out in Restatement (Second) of Trusts §282 (1976)...."

Anderson v. Dean Witter Reynolds, Inc. 841 P.2d 742, 745 (Utah. App. 1992). The beneficiary was allowed to sue directly and the court did not reach the claim that the trustee was an indispensable party. In *Siegemund v. Shapland*, 324 F.Supp.2d 176 (D. Me. 2004), the federal court sitting in diversity held that only an executor could bring an estate's claim against the testator's guardians for negligence as well as against the guardian's law firm. The decedent's daughter attempted to bring a suit, joining the executor with the guardians. After the daughter's death, her executor sought to prosecute the suit. The Court noted that Maine barred such claims, since only an executor could bring such suits. It noted that Massachusetts law would have allowed such an action where the fiduciary wrongfully failed to sue. 324 F.Supp.2d at 192-193.

In *Pillsbury v. Karmgard*, 22 Cal.App.4th 743 (1994) the beneficiary sought to bring an action under Restatement (Second) of Trusts §282 against a real estate broker on the basis of alleged malicious prosecution. The trustee examined the issue and obtained the advice of counsel and decided that litigation would not be appropriate. The Court held that the trustee had acted prudently in making this decision and granted nonsuit on the beneficiary's claim, based on the fact that under §282 the refusal of the trustee to bring the action had to be wrongful. In addition to evidence of the trustee's knowledge of the underlying facts, the

> "trust officer sat through two days of testimony...and could judge the witnesses' credibility; Wells Fargo sought and obtained an opinion from trusted and

> experienced' counsel; and based upon the facts known to them and reasonable inferences when faced with a questionable claim costly to pursue, Wells Fargo's trust officers weighed the risks and benefits in concluding pursuing the litigation was not in the trust's best interest....Such evidence amply supported the court's finding Wells Fargo did not violate its responsibility to trust beneficiaries in declining to sue."

22 Cal.App.4th at 762-763.

Hence the trustee might be able to save itself from being joined in an action under Restatement (Second) of Trusts §282 by careful examination and documentation of its decision not to bring a questionable suit.

6) Suit by Beneficiary against Estate Planning Attorney

California has long allowed beneficiaries or heirs to file suit for malpractice in an estate plan, based on a detailed balancing test. *Lucas v. Hamm* (1961) 56 Cal.2d 583, 588-89, 364 P.2d 685 (Cal. 1961):

> "the determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury, and the policy of preventing future harm....**[and] whether the recognition of liability to beneficiaries of wills negligently drawn by attorneys would impose an undue burden on the profession."

"That balancing test has been cited with approval by most jurisdictions which have considered the issue. Mallen and Smith...§7.11, at 383." *Donahue v. Shughart, Thompson Kilroy*, 900 S.W.2d 624, 627 (Mo. 1995).

Other States also rely on classic third party beneficiary law regarding contracts to allow a contractual recovery by a beneficiary or heir whose inheritance was injured by malpractice in the estate plan. *Caba v. Barker*, 93 P.3d 74, 79 (Or. App. 2004) followed *Hale v. Groce*, 744 P.2d 1289 (Or. 1987) and Restatement (Second) of Contracts §302(1) in holding that a claim had been stated by the disappointed beneficiary against the attorney who drafted the decedent's will. The court also allowed a claim for malpractice, a tort. *See also Cave v. OBryan*, 2004 WL 869364 (Ky. App. 2004) (third party beneficiary standing for heir in malpractice); *Harrigfeld v. J.D. Hancock and Smith, Hancock & Zollinger*, 93 P.3d 884 (Id. 2004) (malpractice claim based on duty to testator's intended beneficiaries); *Kimble v. Arney*, 90 P.3d 598 (Ok. App. 2004) (failure to properly execute will, claim by devisees allowed); *Rajcan v. Donald Garvey and Associates, Ltd.*, 807 N.E. 2d 725 (Ill. App. 2004) (failure to advise creation of special needs trust, claim brought by beneficiaries and trustee of existing trust). In *Moen v. Thomas*, 682 N.W.2d 738 (N.D. 2004) the Court upheld dismissal of a purported third party beneficiary of estate planning advice because of a failure to prove such status.

Malpractice claims can also be brought in some States by the executor of the decedent. *Sorkowitz v. Lakritz, Wissbrun & Assoc.P.C.*, 683 N.W.2d 210 (Mich. App. 2004) (executor stated claim for alleged negligent failure to advise of, or include Crummey power in estate plan, that would have prevented tax liability in excess of $1 million). Subsequently, the Michigan Supreme Court affirmed the trial court's decision in favor of the attorney, based on the exclusion of extrinsic evidence to prove that the testator had some different intent than stated in the document, 474 Mich. 925, 706 N. W. 2d 9 (Mich. 2005) (*see* the blistering dissent which points out that the "four corners" doctrine makes no sense when it is the attorney's job to place such a power within the document drafted, 706 N.W. 2d at 1-2).

Texas has long stood in the minority in its insistence on privity between the attorney and the plaintiff with respect to malpractice in estate planning. *Barcelo v. Elliott*, 923 S.W. 2d 575 (Tex. 1996). While the States may be the laboratories of democracy, if the courts of other States ignore the experience of other jurisdictions, this all comes to naught. Texas has begun to look beyond its borders to see that other States have adopted policies which have not brought them to ruin, and which may have good policy reasons in their support. Hence in *Sterling Trust Co. v. Adderley*, 168 S.W. 3d 835, (Tex. 2005), in dealing with a uniform law, the Court looked to the uniformity provision of the statute and sought to conform its ruling with the positions taken by other States in interpreting that law. In *Belt v. Oppenheimer, Blend, Harrison & Tate, Inc.* 192 S.W. 3d 780, (Tex`, 2006), 49 Tex. Sup. Ct. J. 598, the Court allowed a claim for malpractice to be brought by the decedent's executor, recognizing that if the executor could not bring suit, then the malpractice could never be rectified after the death of the estate planning client.

The Court explained: "Thus, in Texas, a legal malpractice claim in the estate-planning context may be maintained only by the estate planner's client. This is the minority rule in the United States – only eight other states require strict privity in estate-planning malpractice suits. In the majority of states, a beneficiary harmed by a lawyer's negligence in drafting a will or trust may bring a malpractice claim against the attorney, even though the beneficiary was not the attorney's client. *See, e.g., Lucas v. Hamm*, 56 Cal. 2d 583, 15 Cal. Rptr. 821, 364 P.2d 685, 689 (Cal. 1961), *cert. denied*, 368 U.S. 987, 82 S. Ct. 603, 7 L. Ed. 2d 525 (1962); *Schreiner v. Scoville*, 410 N.W. 2d 679, 683 (Iowa, 1987)." 192 S.E. 2d at 783.

The Supreme Court expressed some concern that allowing claims against estate planners would pose difficult burdens on courts attempting to determine the intent of dead testators and settlors. In this case, where the malpractice dealt not with dispositive provisions and contending heirs pleading the decedent's abiding affection for them and disgust for their siblings, there was only the issue of a mistake leading to adverse tax consequences. Hence the Court reaffirmed its belief that privity was a strict requirement, but held that this type of dispute did not impose an undue burden on the courts or force estate planning attorneys to face divided loyalties The court overruled the appellate decision in *Estate of Arlitt v. Paterson*, 995 S.W. 2d 713, 720 (Tex. App. 1999), and held that in these limited circumstances a malpractice case alleging tax errors survived the decedent and could be brought by his executor. 192 S.W. 2d at 785-786

In *Glazer v. Brookhouse*, 471 F. Supp. 2d 945, 2007 WL 313564 (E.D. Wisc. Jan.30, 2007), the court dismissed an attempt to sue a retired law partner whose name was nonetheless

listed on the firm's masthead, for negligence in allegedly modifying an estate plan for an incompetent person. The court granted a motion for summary judgment in favor of the retired attorney, holding that "a reasonable jury could not return a verdict finding A. Brookhouse liable under the partnership by estoppel doctrine." *Id* at 950.

The court denied a companion motion to dismiss as moot, but not before expressing its disagreement with the decision in *Moore v. Anderson Zeigler Disharoom Gallaher & Gray*, 109 Cal. App. 4th 1287, 135 Cal. Rptr. 2d 888 (Cal. Ct. App. 2003) which Brookhouse had relied upon. *Moore* limited the liability of counsel for failing to ascertain the competence of a testator in preparing estate planning amendments. It relying on the Restatement of the Law Governing Lawyers, §51, which provided an illustration stating "Recognizing a duty by lawyers to heirs to use care in not assisting incompetent clients to execute wills would impair performance of lawyers' duty to assist clients even when the clients' competence might later be challenged..." 109 Cal. App. 4th at 1302. The liability of an estate planner for determining the competence of a testator or settlor remains an issue of dispute among the States and within California. *See Osornio v. Weingarten*, 124 Cal. App. 4th 304 (2004)

Estate planners may often find themselves dealing with clients whose testamentary capacity is in doubt. In these circumstances, the estate planner should endeavor to follow the principle set forth in Model Rules of Professional Conduct 1.14 (2000), which states that "When a client's ability to make adequately considered decisions in connection with the representation is impaired, whether because of minority, mental disability or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client." The ACTEC commentaries to this rule state that due to the importance of testamentary freedom, the lawyer may properly assist a client whose testamentary capacity is borderline.

> "If the testamentary capacity of a client is uncertain, the lawyer should exercise particular caution in assisting the client to modify his or her estate plan. The lawyer generally should not prepare a will or other dispositive instrument for a client who the lawyer reasonably believes lacks the requisite capacity. On the other hand, because of the importance of testamentary freedom, the lawyer may properly assist clients whose testamentary capacity appears to be borderline. **In any such case the lawyer should take steps to preserve evidence regarding the client's testamentary capacity.**" (emphasis added).

7) Mandatory Arbitration

In *Larson v. Speetjens*, ___F. Supp. 2d___, 2006 WL 2567873 (N.D. Cal. Sept. 5, 2006) the court enforced an arbitration clause contained in attorney representation agreements, regarding a claim by fiduciaries that the attorneys had allegedly negligently failed timely to sue an investment advisor who had advised a trustee to purchase a $10 million insurance policy and place it in a life insurance trust.

The contract in question did not identify the client as a trustee. The trustee then sought to avoid arbitration, claiming that she had not signed the agreement. The Court held that "[A] party need not sign an arbitration agreement to be bound by it. It can agree to submit to

arbitration by means other than personally signing the agreement. *International Paper*, 206 F. 3d at 416. Thus, a nonsignatory of an arbitration agreement may be bound by it under ordinary contract and agency principles. *Comer v. Micor, Inc.*, 436 F.3d 1098, 1101 (9th Cir. 2006). 'Among these principles are "(1) incorporation by reference; (2) assumption; (3) agency; (4) veil-piercing/alter ego; and (5) estoppel."' *Id.* The rule is an outgrowth of the strong federal policy favoring arbitration. *Letizia v. Prudential Bache Securities, Inc.*, 802 F.2d 1185, 1188 (9th Cir. 1986). The determination whether a nonsignatory is bound by the arbitration contract is governed by the federal substantive law on arbitrability. *Id.* At 1187; *International Paper*, 206 F.3d at 417 n.4." 2006 WL 2567873, at *3.

The Court enforced the agreement because the trustee had accepted the benefits of the agreement, even if she had not signed in her capacity as trustee. "Plaintiffs seek to avoid the burdens of the Agreements – the arbitration requirement. Plaintiffs' entire case hinges of the attorney-client relationship created by the Agreements. Plaintiffs' claims are inextricably intertwined with the Agreements, as they are based on Defendants' alleged breach of their fiduciary duty that was created by the Agreements. They cannot seek to enforce the rights the attorney-client relationship provided them and avoid the requirement that any dispute arising out of the Agreements be arbitrated. See *NORCAL Mutual Inc. Co. v. Newton* (2000) 84 Cal. App. 4th 64, 84 ('No person can be permitted to adopt that part of an entire transaction which is beneficial to him/her, and then reject its burdens.')...Plaintiffs' situation is analogous to those in which courts have found equitable estoppel." 2006 WL 2567873 at *7.

The Court also held that the trustee had actual authority to hire the attorneys and that by representing that she had the authority to hire the attorneys, she also had ostensible authority to do so. 2006 WL 2567873 at *8.

In *Johnson v. Clark*, ___F. Supp.2d ___, 2006 WL 3780511 (Dec. 20, 2006, M.D. Fla.) a beneficiary of a trust claimed that he was not bound by a mediation between the trustee of the testamentary trust and the executor of the will funding the trust since the beneficiary had not signed the mediation agreement. The mediation resolved claims of alleged misconduct by the executor and resulted in a court-approved settlement releasing the executor from all claims. The beneficiary had been notified of the settlement, objected to it, and filed an appeal. All to no avail.

When the executor filed a defamation suit against the beneficiary, the beneficiary filed a counterclaim against the executor for various breaches. Both sides moved for summary judgment. The court rejected the beneficiary's arguments and dismissed the counterclaims under the doctrine of virtual representation. "The doctrine of virtual representation provides that 'a[a] person who is not a party to an action but who is represented by a party is bound by and entitled to the benefits of a judgment as though he were a party.' Restatement (Second) of Judgments §41 (1). Further it is well-settled that in cases involving claims by a trustee and individual beneficiaries, a trustee, in his representative capacity, acts on behalf of the trust representing the interests of the trust and its beneficiary; a beneficiary is therefore bound by a *judgment* properly obtained by a trustee acting in his representative capacity. *See* §737.402(t), Florida Statutes (2006); Restatement (Second) of Judgments §41 (1)(a) ('A person is represented by a party who is a the trustee of an estate or interest of which the person is a beneficiary....')." 2006 WL

3780511 at *5. The Court found that at the time of the mediation there were no conflicts between the trustee and the beneficiary.

The Court concluded that "in sum, the plain language of the Florida Virtual Representation Statute provides that the trustee of an express trust has the power to settle claims on behalf of the trust, Fla. Stat. §737.402(t), and that orders binding a trustee bind beneficiaries of a trust in proceedings reviewing the acts or accounts of a prior fiduciary, Fla. State. §731.303. To hold that a beneficiary who simply objects to and refuses to sign a settlement agreement is not bound by the order approving a trustee's settlement on behalf of the trust would contravene the plain language and purpose of the Virtual Representation Statute." 2006 WL 3780511 at *8

8) Breaches and Aiding and Abetting Breaches

Paradee v. Paradee (Del. Ch. 2010) 2010 WL 3959604 provides a further example of the efforts of courts to enforce compliance by fiduciaries of their duties. Charles Paradee had created an Irrevocable Life Insurance Trust for his grandson, Trey, naming his insurance agent as the trustee. The trust provided that when Trey turned age 30 he could become trustee. The trust was funded with a combination of whole life and term life paid for with a single premium, designed to pay a death benefit of $1,150,700 to the grandson. This was a second-to-die policy based on his life and that of his second wife, Eleanor. Charles had married his second wife Eleanor shortly before the establishment of the ILIT. She began to assume responsibility for managing the family company, with her role increasing as her husband grew older.

When faced with an unexpected levy of back taxes in the amount of $200,000 for the family company, Eleanor sought some way to pay the bill without reducing the funds available to her. The Chancery Court concluded that "Eleanor simply preferred for selfish reasons to shift the cost of their tax bill to someone else. Although there is no such thing as a free lunch, it is always nice (all else equal) if someone else pays. Eleanor wanted someone else to pay." 2010 WL 3959604 at *3. She contacted the trustee and asked if they could revoke the ILIT in order to use the value of the policies to provide the money she needed. The family attorney heard about this effort and advised Eleanor that "'irrevocable' meant 'irrevocable,' and that the Paradees could not access the Policy's cash value by revoking the Trust." *Ibid.* Eleanor asked the trustee to see whether the Trust could loan the $200,000, despite having been warned that a policy loan would be deducted from the benefit paid on the policy and that if loan payments were not made, the policy might lapse. Having been rejected by the family attorney, the trustee then contacted another attorney who recommended terms for the loan involving security, monthly amortization of the loan, and the requirement that "in no case should the trustee make a loan unless the loan payments will be adequate to cover debt service on the policy loan plus the amount required to keep premiums current." 2010 WL 3959604 at *4. The trustee then obtained a policy loan and lent the loan amount to the family company, but failed to obtain a secured loan from the family company or policy terms such that the payments on the company loan would have a floating rate sufficient to match the policy loan's rate of interest.

A year later, Eleanor again attempted to revoke the ILIT. Sterling obtained advice of counsel, who warned that revocation could lead to possible liability from Trey, if the surrender

value of the ILIT was not invested to be able to produce the same value of the policy on the death of Charles. This letter was provided to Eleanor.

In 2003 after the death of the trustee, Eleanor appointed herself trustee of the ILIT. In that year the family company failed to pay the interest on its loan with the trust, with the consequence that the value of the policy was reduced and the amount of the loan balance was increased. The Court found that "Eleanor consciously, intentionally, and vengefully refused to take any action to protect or preserve the Policy because she did not want Trey to benefit." At *8. After In 2005, with a continued failure to make loan payments, the policy lapsed. *Ibid.* At the time of the lapse, the ILIT held approximately $300,000 of other assets, obtained when the insurance company demutualized and transferred shares in the new company to policy holders.

Eleanor then appointed her handyman as the trustee of the Trust. The Court found Smith to be a "straightforward and honest workingman whose character would be captured in a rural area like Virginia's Shenandoah Valley by the grammatically challenged phrase, 'he's good people.' Although Smith certainly is loyal to Eleanor, he exhibits the commendable fealty of a longtime employee who recognized both the virtues and the shortcomings of his employer. I do not believe he acted with avarice, ill-will, or as a co-conspirator in Eleanor's campaign to harm Trey." 2010 WL 3959604 at *9. Eleanor adopted the handyman, although the court notes that this it was for "estate planning reasons." 2010 WL 3959604 at *8.

Trey did not know about the existence of the ILIT until after the lapse of the policy. After learning the facts, he brought an action to recover the damages he suffered. The Court found that the first insurance agent/trustee had breached his duties. "When deciding whether the Trust should loan money to the Paradees, Sterling breached his duty of loyalty. Instead of evaluating what was in the best interests of the Trust, he evaluated whether he could please his long-time clients, the Paradees." 2010 WL 3959604 at *10. The Court held that "As a part of the duty of loyalty, a trustee 'must exclude all selfish interest and all consideration of the interests of third persons.' George Gleason Bogert & George Taylor Bogert, *The Law of Trusts and Trustees* §543 (2d ed., 1993)."

It is important to note that a conflict of interest violating the duty of loyalty does not require that the breaching fiduciary put the money in his pocket, but injuring the trust to allow third parties to benefit is breach enough for actual and punitive damages.

The Court also concluded that Eleanor knowingly participated in the trustee's breach. "'[I]t is bedrock law that the conduct of one who knowingly joins with a fiduciary ...in breaching a fiduciary obligation, is equally culpable.'*** *Mills Acq. Co. v. Macmillan, Inc.*, 559 A.2d 1261,1284, n. 33 (Del. 1989); *see also Laventhol, Krekstein, Horwath & Horwath v. Tuckman*, 372 A.2d 168, 170-171 (Del. 1976) ('[P]ersons who knowingly join a fiduciary in an enterprise which constitutes a breach of his fiduciary duty of trust are jointly and severally liable for any injury which results.')" 2010 WL 3959604 at *12.

The Court also found that Eleanor committed additional breaches: "Eleanor should have informed Trey about the Trust, should have paid Trey the net income from the Trust, and should have used trust assets to maintain the Policy." *Ibid.*

The Court award Trey as damages for the breaches of Eleanor the face value of the Policy, $1,150,700, which represented "the death benefit that the Policy was designed to achieve under the most likely range of future states of the world at the time the Policy was purchased." 2010 WL 3959604 at *13. The Court made this award despite the fact that Eleanor was still living. "I reject as inequitable the respondents' contention that any award of damages should be withheld until Eleanor's actual death." *Ibid.* Because of the policy loans, the number of insurance company shares the Trust received upon the demutualization were reduced. Coupled with the concealment of the Trust and Trey's ability to become trustee when he turned 30, these facts led the Court to grant Trey the benefit of a 2 for 1 stock split and the highest value the stock achieved. "Where a party has wrongfully deprived another of the ability to sell shares, damages are measured using the **highest intermediate value of the shares less the value at the time of judgment**. *See Duncan v. Theratyx, Inc.*, 775 A. 2d 1019, 1023 (Del. 2000)" *Ibid.* (emphasis added)

The Court held that "[a]lthough it would be improbable (bordering on impossible) for the Trust to have sold precisely at the top of the market, the faithless fiduciary must bear that risk, not the innocent beneficiary" *Ibid.* Damages for the sale of stock totaled $599,766.96 plus prejudgment interest. 2010 WL 3959604 at *14. The Court also awarded damages to compensate the beneficiary for the loss of the tax advantaged insurance payment. "To the extent the Trust is required to pay income tax on the portion of the damages award attributed to the lost Policy Value, such that the after-tax value of that portion of the award is less than $1,150,700., then Eleanor shall pay an additional sum equal to the amount of the income tax due on that portion of the award." *Ibid.* The Court declined to force Eleanor to pay any amount to gross-up the award to reflect any tax on the award for taxes because "the cost of a gross-up is overly punitive to Eleanor." *Ibid.*

Trey was awarded the value of the dividends he did not receive from the insurance company stock. The Court ordered Eleanor to pay the attorney's fees incurred in prosecuting the case. The Court held that "[t]he American Rule recognizes an exception 'where the pre-litigation conduct of the losing party was so egregious as to justify an award of attorney's fees as an element of damages.' *Estate of Carpenter v. Dinneen*, 2008 WL 859309, at *17 (Del. Ch. March 6, 2008); *see Arbitrium (Cayman Islands) Handels AG v. Johnston*, 705 A. 2d 225, 231 (Del Ch. 1997), *aff'd*, 720 A. 2d 542 (Del. 1998). The pre-litigation conduct must have been in 'bad faith...totally unjustified, or the like' *Weinberger v. UOP, Inc.*, 517 A.2d 653, 656 (Del. Ch. 1986); *accord Law v. Law*, 1999 WL 126997, at *1 (Del. Ch. Feb. 24, 1999) (requiring 'intentional, unconscionable and egregious conduct'), *aff'd in part, rev'd in part on other grounds,* 753 A. 2d 443 (Del. 2000). A less breach of fiduciary duty alone will not merit departing from the American Rule. *See HMG/Courtland Props., Inc. v Gray*, 749 A. 2d 94, 124-25." 2010 WL 3959604 at *15.

9) Insurance Policy Issues

The Court in *Branch Banking & Trust Co. v. Pacific Life Insurance Co.*, ___F. Supp. 2d___2011 WL 1157703 (W.D. Ky., March 29, 2011) granted summary judgment in favor of the trustee of an Irrevocable Life Insurance Trust because of a delay in exchanging life insurance policies. The defendant had provided a variable life insurance policy held in the trust; however

the trustee exercised its right to cancel the policy and conduct a Section 1035 exchange to substitute a new policy with better terms. The structure of the trade would have John Hancock exchange a new policy for the Pacific Life policy and then cancel the original policy, using the proceeds to fund the purchase the new policy. The surrender documentation was delivered in September of 2008 when the cash surrender value of the variable life policy was $779,818.19. Pacific Life raised various objections, delaying the exchange until December of 2008. By this time the cash surrender value had fallen by $259,926.33. The defendant argued that since the new policy would have been subjected to market forces, there was no proof of the actual loss involved. The Court found that the investment returns which would have been obtained if the transfer had been timely honored were speculation. *Ibid.*, 2011 WL 1157703 at *3. Deciding under Kentucky law regarding a breach of contract, the court gave a judgment calculated on fall in value, plus 8% interest, with 12% post judgment interest. *Ibid.*

In *In re Stuart Cochran Irrevocable Trust v. KeyBank, N.A.,*901 N.E. 2d 1128 (Ind. App. 2009), *transfer den.* 915 N.E.2d 992 (table), the Court held that the fiduciary had acted properly in replacing Variable Annuity Policies hammered by market declines in 2001 which could terminate well before the life expectancy of the insured parent, by acquiring whole life policies designed to last for the balance of his life. As can be expected, the insured died early and the beneficiaries sued, claiming imprudent action by the trustee and reliance on consultants. The Court affirmed the judgment of the trial court in favor of the trustee, holding that the actions of the fiduciary in consulting with independent insurance experts to evaluate alternatives were appropriate.

The Seventh Circuit denied the attempt of the bank formerly known as Wachovia from staying litigation over the replacement of whole life policies in existing trusts in *French v. Wachovia Bank*, 574 F.3d 830 (7th Cir. 2009). This matter was originally brought by the beneficiaries in Wisconsin State court, but the matter was removed to federal court based on diversity jurisdiction. Resolution was delayed for several years, pending arbitration of one of two claims. The plaintiffs then obtained leave to amend their complaint, dropping the claim which was subject to arbitration. *French v. Wachovia Bank*, 2008 WL 2439717 (E.D.Wis. Jun 16, 2008). Wachovia finally moved for summary judgment of the remaining claim of the plaintiffs. *French v. Wachovia Bank, NA* 800 F. Supp.2d 975 (E.D. Wis.July 6, 2011).

In July of 2011, the US District Court for the Eastern District of Wisconsin issued its decision, *French v. Wachovia Bank, N.A.*, 800 F. Supp.2d 975 (E.D. Wis.2011), granting summary judgment for Wachovia, and dismissing a demand for a jury trial. The settlor had created two irrevocable trusts for the benefit of his children, with one of the trusts containing two life insurance policies on the life of the settlor: a $5million death benefit policy with an annual premium of $164,000 and a second-to-die policy with a $5 million death benefit, whose premium was scheduled to increase more than $40,000 to maintain the policy amount. The two policies in May of 2005 had a combined cash value of $2.2 million.

There were substantial assets held in the trusts, with income provided by the second trust to the first trust. There appeared to be sufficient assets to meet policy premiums. The beneficiaries had substantial assets outside the trusts and stood to inherit more upon their parents' deaths.

The trusteeship of the trusts was moved from Northern Trust to Wachovia after discussions with the settlor's counsel and Wachovia trust personnel about an evaluation of the two life insurance policies and overall investment performance estimates. 800 F. Supp.2d at 978-80. An affiliate of Wachovia, Wachovia Insurance Services (WIS) reviewed the policies and made proposals for changes. The insurance personnel met with counsel for the settlor and beneficiaries, who provided an evaluation of the situation presented by WIS.

The Court found that the attorney for the Frenches "was very familiar with 'no lapse' guaranteed life insurance policies and had written and presented on the subject more than eight times in 2004 and 2005. A no lapse guarantee policy is a universal life policy which guarantees that regardless of the balance in the policy cash value account, the contract will provide a promised death benefit so long as a specified premium is paid when due and other conditions are met. By their very nature, no lapse policies are not designed to accumulate cash value and it would be a mistake to recommend no lapse policies to any potential insurance that had an interest in maintaining or growing cash value in a life insurance policy, or if the Policy was not going to be kept until death." *Ibid.*

The attorney for the Frenches provided a memorandum of their meeting with WIS "highlighted for French the principal disadvantages of no lapse insurance policies –specifically the diminished cash value and loss of flexibility." *Ibid.* The Court found that the attorney "described a no lapse guarantee policy as a 'trade off' of flexibility for certainty. He further described the existing Prudential policy as 'volatile,' observing that the premiums would have to increase in the future to maintain the insurance." *Ibid.* The settlor (who had no formal role in the trusts involved, but was the settlor and wealthy parent of the beneficiaries), ultimately agreed to have a physical to obtain replacement insurance, after purportedly being advised that a conflict waiver would have to be obtained for the Wachovia affiliate to provide such insurance. Hence the record showed some substantial review of the circumstances by experienced counsel for the beneficiaries.

WIS obtained bids from six insurance companies for replacement policies, with John Hancock providing the lowest rates. The Frenches attorneys had multiple meetings with WIS to discuss obtaining replacement policies and conducting a section 1035 exchange for the original policies. When presented with a conflict waiver which disclosed that WIS would obtain an unspecified commission from the transaction, the counsel asked that this be waived. When WIS refused to waive the commissions, the counsel asked whether trustee fee rebates could be made to offset the commission. Wachovia "provided legal authority that such an arrangement was prohibited." 800 F. Supp.2d at 983. Wachovia then had a review done by an in-house expert as to the suitability of the new policies. Counsel had several discussions with Wachovia about issuance of the policies, with conflicting testimony as to whether such counsel approved the transaction during a meeting. Wachovia then again sent a conflicts waiver to the settlor, who refused to sign it and urged his children, the beneficiaries, to refuse to sign it. Wachovia then withdrew the request for a conflict waiver. *Ibid.* Lesson No. 1 is that if you perceive a conflict and ask for a waiver, make sure you get it before going forward.

The trustee went through with the 1035 exchange in May of 2005, with the affiliate receiving an immediate commission of $512,000, plus $4,000 per year for the next 10 years. "The amount of these commissions were not disclosed prior to the exchange," the Court found. 800 F. Supp.2d at 984. The commission information was provided to the settlor the following month.

In November of 2005, when it was too late to rescind the transaction, the beneficiaries objected, claiming breach of fiduciary duty and citing the conflict of interest involved.

The second lesson here is that trustees will always regret having employees of an affiliate get commissions far in excess of the annual salary of the judge presiding in the subsequent case. However, after years of litigation, the trustee prevailed.

The Court noted the implications of the general rule against conflicts: "The most fundamental duty owed by the trustee is the duty of loyalty. *Pegram v. Herdrich,* 530 U.S. 211, 224, 120 S.Ct. 2143, 147 L.Ed.2d 164 (2000) (citing 2A A. Scott & W. Fratcher, Trusts § 170, p. 311 (4th ed. 1987) and G. Bogert & G. Bogert, Law of Trusts and Trustees § 543 (rev. 2d ed. 1980)); *see also* Restatement (Second) of Trusts § 170. The Frenches claim that the 1035 exchange was a self-dealing transaction because it resulted in a $512,000 commission for WBNA's affiliate, WIS. 'A consistent facet of a fiduciary duty is the constraint on the fiduciary's discretion to act in his own self-interest because by accepting the obligation of a fiduciary he consciously sets another's interests before his own.' *Zastrow v. Journal Comm'n, Inc.,* 291 Wis.2d 426, 718 N.W.2d 51, 59 (2006). "The rule of 'undivided loyalty' requires that a trustee 'must neither deal with trust property for the benefit of himself nor place himself in a position inconsistent with the interests of the trust.' *In re Hanes,* 214 B.R. 786, 814 (Bankr.E.D.Va.1997). The law 'stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without undertaking to deal with the question of abstract justice in the particular case.' *Renz v. Beeman,* 589 F.2d 735, 744 (2d Cir.1978). The principle is 'one of prevention, not remedial justice, which operates however fair the transaction may have been—however free from taint of moral wrong.' *Bank of Cal. v. Hoffmann,* 255 Wis. 165, 38 N.W.2d 506, 509 (1949) (describing law of agency). 'Participation in a transaction that benefits oneself instead of another who is owed a fiduciary duty' is the 'classic definition' of self-dealing. *Losee v. Marine Bank,* 286 Wis.2d 438, 703 N.W.2d 751, 756 (2005)." 800 F. Supp.2d at 985-86.

The Court, however, held that the trust instrument had waived the rule against self-dealing, citing language in the Trust: "[T]he scope of the trustee's duties are defined by the trust instrument, which may in fact authorize self-dealing. 'By the terms of the trust the trustee may be permitted to sell trust property to himself individually, or as trustee to purchase property from himself individually, or to lend himself money held by him in trust, or otherwise to deal with the trust property on his own account.' *Welch v. Welch,* 235 Wis. 282, 290 N.W. 758, 782 (1940) (quoting Restatement Trusts § 170, cmt. s); *Estate of Fruehauf v. Comm'r of Internal Revenue,* 427 F.2d 80, 86 (6th Cir.1970) ('a fiduciary may be authorized by the terms of the instrument creating his powers to do that which in the absence of such provision would be a violation of his fiduciary duty of loyalty'); *Renz* at 744. The French Trust provides that '[w]ithout limiting powers incidental to the purposes of the trust or otherwise existing by law, the trustee and all

successors shall have, without approval of any court, the power ... to continue as trustee and to deal with any trust hereunder *without regard to conflicts of interest* ...' D. 141–1, Trust 1, Art. III(B)(1) (emphasis added)." 800 F. Supp.2d at 986.

Having found a waiver of self-dealing, the Court then held that the appropriate standard for judging the trustee's conduct was "good faith" and an evaluation of the merits of the transaction:

> " 'A trustee's duty of loyalty can be reduced by means of language in the trust instrument permitting certain transactions involving self-interest.... Express language in the trust instrument or consent reduces the standard of duty to good faith and permits the court to weigh the merits of the transaction.' *[In re Hanes,* 214 B.R. 786, 814 (Bankr.E.D.Va.1997)] at 814 (citing *Renz* at 744; *Matter of Balfe's Will,* 245 A.D. 22, 280 N.Y.S. 128 (N.Y.App.Div.1935)). 'The trustee violates his duty to the beneficiary ... if he acts in bad faith, no matter how broad may be the provisions of the terms of the trust in conferring power upon him to deal with the trust property on his own account.' Restatement (Second) of Trusts § 170, cmt. t; *Welch* at 782."
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> "The requirement to act in good faith is considered a 'subsidiary element' of the fundamental duty of loyalty. *Stone v. Ritter,* 911 A.2d 362, 370 (Del.2006). At least 'three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label.' *In re Walt Disney Co. Derivative Lit.,* 906 A.2d 27, 64 (Del.2006). The first category involves 'subjective bad faith,' that is, 'fiduciary conduct motivated by an actual intent to do harm.' *Id.* In this sense, bad faith is '"not simply bad judgment or negligence," but rather "implies the conscious doing of a wrong because of dishonest purpose or moral obliquity ... it contemplates a state of mind affirmatively operating with furtive design or ill will."' *McGowan v. Ferro,* 859 A.2d 1012, 1036 (Del.Ch.2004) (quoting *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.,* 624 A.2d 1199, 1208 n. 16 (Del.1993)). The second category 'involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent.' *Disney,* 906 A.2d at 64. The third category lies in between subjective bad faith and gross negligence—'intentional dereliction of duty, a conscious disregard for one's responsibilities.' *Id.* at 66. In this sense, a 'failure to act in good faith may be shown ... where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.' *Id.* at 67 (quoting *In re Walt Disney Co. Derivative Lit.,* 907 A.2d 693, 755–56 (Del.Ch.2005))." 800 F. Supp.2d at 989.

The Court held that the conduct of Wachovia did not fit into any of the three categories, granting summary judgment for the trustee. "As for the third category ('intentional dereliction of

duty, a conscious disregard for one's responsibilities'), it is undisputed that WBNA engaged in self-dealing. But simply because the 1035 exchange was a self-interested transaction does not preclude the possibility that it was undertaken in the best interests of the trust. *Cf. In re Save Our Springs (S.O.S.) Alliance, Inc.,* 388 B.R. 202, 231 (Bankr.W.D.Tex.2008) ('Mere selfishness does not rise to the level of bad faith, ... self-dealing and good faith are not mutually exclusive'). A fiduciary acts in bad faith only when he places his own interests *before* or *above* the welfare of those to whom he owes a fiduciary duty. *Disney,* 907 A.2d at 754."

"The Frenches focus on the fact that WBNA initiated the concept of an insurance exchange. Even so, this was before WBNA was trustee, and the Frenches still moved the trusts to WBNA. Once WBNA became trustee, the proposed transaction was analyzed and discussed over the course of an entire year. WBNA knew that WIS was in line for a commission, but so did the Frenches. The conflict was freely disclosed to French, the parties engaged in negotiations regarding the possibility of a rebate, and French was told on multiple occasions that the transaction could not proceed without a waiver." 800 F. Supp.2d at 989-90.

The Court looked to Delaware corporate law to conclude that "gross negligence" could not be treated a bad faith: "[h]owever, the court in *Disney* explained that gross negligence, without more, cannot constitute bad faith under Delaware law in the context of corporate fiduciaries. 'To adopt a definition that conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections and defeat the General Assembly's intent.' *Disney,* 906 A.2d at 66." 800 F. Supp.2d at 989, fn8.

This is a type of Gordon Gecko analysis, where greed is good as long as the transaction is reasonable. Hence the Court looked for evidence that the conduct was reasonable under the circumstances and concluded, in a summary judgment motion, that the facts were **undisputed** that the transaction was in the best interests of the trust. Faced with claims by the beneficiaries that the trust lost substantial value as a result of the exchange, the Court defined the issue was one of law, not fact, pointing to the standard for judging exercises of discretion by trustees. "'The test ... is not whether, in hindsight, a more lucrative investment could have been made measured from the standpoint of safety, value, income, or tax consequences. Rather, the question is whether, *under the circumstances then prevailing,* a prudent man would have acted differently.' *Ames,* 448 N.W.2d at 256 (emphasis in original); *Matter of Estate of Kugler,* 117 Wis.2d 314, 344 N.W.2d 160, 164 (1984) (fiduciary must exercise the judgment and care that persons of prudence, discretion and intelligence exercise in the management of their own affairs); §881.01(11). What a trustee did or did not do is a question of fact; what a reasonable trustee would have done in the same circumstances is a question of law. *Ames* at 255." 800 F. Supp.2d at 990-91.

The Court could have asked whether the fact of a $512,000 commission influenced the decision of the trustee. Instead, it looked at the policies involved and the trade-off, acknowledged prior to the transaction by the attorney for the plaintiffs, between cash value increases and the benefits of a "no lapse policy." It looked to the substantial involvement of the plaintiffs' attorneys and the settlor in structuring and evaluating the transaction, ignoring the failure to disclose the huge commission prior to the execution of the trade. Some courts might have

concluded that the amount, $512,000, of the commission was itself a material fact for the beneficiaries which should have been disclosed to them in advance. Sticker shock apparently is not a consideration in Wisconsin, when the beneficiaries are extremely well off (as noted by the court several times).

Court noted that the plaintiffs were aware that the exchange would reduce the cash value of the policies, concluding that the amount of the commission was thus irrelevant to the reasonableness or prudence of the transaction. "However, since the entire premise of the exchange was the immediate loss of cash value in favor of lower premiums and a guaranteed death benefit, the exact amount of the commission was not material to the transaction. The commission was simply paid by John Hancock out of the cash value of the old policies." 800 F. Supp.2d at 990. Doubtless there will be an appeal and claims for reimbursement of the trustee's expenses of litigation to come. If you want to avoid this type of prolonged litigation, make a full disclosure and get a written waiver of conflicts in advance. Also, beware of insurance brokers bringing new trusts to your trust departments.

In October of 2011, the Court ruled on Wachovia's motion for costs and attorney's fees, *French v. Wachovia Bank, NA*, ___F. Supp.2d___, 2011 WL 5008337 (E.D. Wis. October 20, 2011). The Court looked to Wisconsin law for recovery of costs and attorney's fees, citing "[t]he general rule is that the trustee 'is entitled to reimbursement for all necessary expenditures, if the services were performed to preserve, protect or administer the fund under [his] control.'...As explained by Judge Learned Hand, when the 'trustee's administration of the assets is unjustifiably assailed it is part of his duty to defend himself, for in so doing he is realizing the settlor's purpose. To compel him to bear the expenses of an unsuccessful attack would be to diminish his compensation to which he is entitled and which was a part of the inducement to his acceptance of the burden of his duties.' *Weidlich v. Comley*, 267 f. 2d 133, 134 (2d Cir. 1959). The rule logically extends to the situation at bar, where the trustee successfully defended himself against a claim for breach of fiduciary duty." 2011 WL 5008337 at *1.

The Court held that the fees and expenses should be paid by the complaining beneficiaries, not out of the trust corpus. "Typically, an award of fees is paid out of the trust, but WBNA requests an order that the fees be paid directly by the plaintiffs. 'There is no room for doubt that an equity court may, under extraordinary circumstances, impose upon the defeated plaintiff in an equity case, the entire cost of defense notwithstanding statutory limitations upon costs to be taxed at law.' *Cleveland v. Second Nat. Bank*, 149 F. 2d 466, 469 (6th Cir. 1945) (citing *Sprague v. Taconic Bank*, 307 U.S. 161, 59 S.Ct. 777, 83 L.Ed. 1184 (1939) and *Guardian Trust Co. v. Kansas City Co.R.Co.*, 28 F.2d 233, 245 (8th Cir. 1928)). This concept 'may be invoked against one of the parties as 'fair justice' to the other will permit, and...the allowance of such costs in appropriate situations is part of equity jurisdiction of which the federal courts were given cognizance ever since the first Judiciary Act, 1 Stat. 73, consisting of that body of remedies, procedures, and practices which theretofore had been evolved in the English Courts of Chancery.'*Id.*" 2011 WL 5008337 at *2.

The Court granted the requested fees and costs in the amount of $675,174.58. The Court explained its decision first on the equities, and then by pointing out that the successor trustee had agreed to reimburse such fees from the trust corpus: "The equities of this case favor an

assessment of fees and costs against the individual plaintiffs. The plaintiffs already dragged WBNA through years of costly litigation, only to have the case dismissed on summary judgment. If the Court did not impose fees directly on the plaintiffs, WBNA would be forced to engage in separate litigation to recover its fees from the trust. This would only multiply costs and delay the inevitable. How much delay is hard to predict, but given the background of this case, the Court thinks it would be lengthy. Moreover, the plaintiffs are of substantial means, and the successor trustee already agreed to reimburse the plaintiffs for their own attorneys' fees. The plaintiffs can determine the proper allocation of the instant fee award amongst themselves and the successor trustee." 2011 WL 5008337 at *3.

10) ADR

Diaz v. Bukey, 125 Cal. Rptr.3d 610 (2011), *rev granted,* 257 P. 3d 1129, 129 Cal. Rptr. 324 (CA 2011). The appellate court had held that an arbitration clause in a trust was unenforceable, citing *Estate of Carpenter* (1900) 127 Cal. 582 and *Schoneberger v. Oelze* (AZ 2004) 96 P.3d 1078. Subsequently the California Supreme Court upheld an arbitration clause contained in CC&Rs created prior to the purchase of any property based on federal policy and the fact that purchasers had notice of the mandatory arbitration provision, *Pinnacle Museum Tower Association v. Pinnacle Market Development* 55 Cal. 4th 223 (2012), which precedent has been used to validate numerous arbitration clauses against third parties who had never formally agreed to the specific arbitration provisions involved.

The Supreme Court of Texas upheld an arbitration clause in a trust agreement against claims that the beneficiaries had not signed an agreement to arbitrate, *Rachal v. Reitz*, 403 S.W.3d 840 (Texas, 2013) . The Court held that "the settlor determines the conditions attached to her gifts, and we enforce trust restrictions on the basis of the settlor's intent." The arbitration agreement in the trust did not condition distributions to the beneficiaries on the condition that they agree to arbitrate any dispute involving the trust. Instead, the trust language stated "I intend that as to any dispute of any kind involving this Trust or any of the parties or persons concerned herewith (e.g. beneficiaries, Trustees), arbitration as provided herein shall be the sole and exclusive remedy, and no legal proceedings shall be allowed or given effect except as they may relate to enforcing or implementing such arbitration in accordance herewith." The second ground for enforcing the provision was the terms of the Texas Arbitration Act which the Court had previously held provided that the assent to arbitration "may be manifested through the doctrine of direct benefits estoppel." The Court held in *Rachal* that "[A] beneficiary who attempts to enforce rights that would not exist without the trust manifests her assent to the trust's arbitration clause.... [¶] Here, [the plaintiff beneficiary] both sought the benefits granted to him under the trust and sued to enforce the provisions of the trust.... [This] conduct indicated acceptance of the terms and validity of the trust." 403 S.W.3d at 847.

The Texas Supreme Court had previously ruled n *In re Kellogg Brown & Root, Inc.*, 166 S.W. 3d 732, 739 (Tex. 2005), that "a non-signatory who is seeking the benefits of a contract or seeking to enforce it 'is estopped from simultaneously attempting to avoid the contract's burdens, such as the obligation to arbitrate disputes.'"

The California Court of Appeals in *McArthur v. McArthur,* 224 Cal.App.4th 651 (Ct. App, 2014) denied enforcement of an arbitration clause contained in a trust amendment where the petition sought to have the amendment declared invalid.

" 'A written agreement to submit to arbitration an existing controversy or a controversy thereafter arising is valid, enforceable and irrevocable, save upon such grounds as exist for the revocation of any contract." (Code Civ. Proc., § 1281.) A party seeking to compel arbitration of a dispute "bears the burden of proving the existence of an arbitration agreement, and the party opposing arbitration bears the burden of proving any defense, such as unconscionability. [Citation.] Where ... the evidence is not in conflict, we review the trial court's denial of arbitration de novo. [Citation.]" (Pinnacle, supra, 55 Cal.4th at p. 236, 145 Cal.Rptr.3d 514, 282 P.3d 1217.)

"There are circumstances in which nonsignatories to an agreement containing an arbitration clause can be compelled to arbitrate under that agreement. (Suh, supra, 181 Cal.App.4th at p. 1513, 105 Cal.Rptr.3d 585.) Whether an arbitration agreement is operative against a nonsignatory is likewise reviewed de novo. (Id. at p. 1512, 105 Cal.Rptr.3d 585.)" 224 Cal.App.4th 651 at 656.

The court in *McArthur* explained:

> "Other courts have similarly concluded that a beneficiary who seeks to enforce rights under a trustee's contract with a third party may be compelled to arbitrate the dispute pursuant to an arbitration clause in the contract: "[the beneficiary] cannot simultaneously assert a claim against [the third party] based on the [contract] and seek to repudiate the arbitration clause in the [contract]...." (*In re Blumenkrantz* (N.Y.Surr.Ct.2006) 14 Misc.3d 462, 824 N.Y.S.2d 884, 888; see *In re Jean F. Gardner Amended Blind Trust* (2003) 117 Wash.App. 235, 70 P.3d 168, 238–239; *Smith v. Multi–Financial Securities Corp.* (Colo.Ct.App.2007) 171 P.3d 1267, 1273–1274.) The Schoneberger court also recognized that a nonsignatory may be barred from avoiding arbitration if he has claimed or received some direct benefit from the agreement containing the arbitration clause. (Schoneberger, supra, 96 P.3d at p. 1081.)
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> "Here, Pamela has not accepted benefits under the 2011 Trust nor has she attempted to enforce rights under the amended trust instrument. Instead, Pamela argues the 2011 Trust is invalid and seeks to have it set aside. Rachal acknowledges that a "beneficiary may disclaim an interest in a trust. [Citations.] And a beneficiary is also free to challenge the validity of a trust: conduct that is incompatible with the idea that she has consented to the instrument. [Citation.] Thus, beneficiaries have the opportunity to opt out of the arrangement proposed by the settlor" and consequently to not be bound by the arbitration provision. (Rachal, supra, 403 S.W.3d at p. 847.) We agree." 224 Cal.App.4th 651 at 658.

Other courts have required beneficiaries to be bound by arbitration clauses executed by their fiduciaries on the theory that "[i]f a nonsignatory to a contract containing an arbitration

provision has obtained or seeks to obtain the benefit of the contract, the nonsignatory may not avoid the application of the arbitration provision." *Edward D. Jones, Co., LP v. Ventura* , 907 So. 2d 1035, 1042 (Ala. 2005). The Court held that "[b]ecause Ventura is a third-party beneficiary of the accounts and because his claims arise out of the manner in which the investment accounts were managed or should have been managed, he is seeking the benefits of the investment agreements entered into by Dutton." *Ibid.*

The Court of Appeal in Ohio in *McKee v. Merrill, Lynch, Pierce, Fenner, Smith*, 2004 WL 1631147 (Oh. App, 2004) held that the beneficiary was bound by the arbitration clause signed by her husband with respect to an IRA account, sweeping in other accounts held by the wife which did not have arbitration agreements signed by her. The Court followed the benefit theory, holding that "where a non-signatory third party derives its interests from contracting parties who agreed to arbitration under a medical malpractice liability insurance policy, they too are bound by an arbitration provision and have no greater right to a judicial interpretation of the agreement." 2004 WL 1631147 at 2. The Court, however, remanded for fact finding as to whether the provision contained elements of adhesion and unconscionability, making it unenforceable.

In re Prudential Securities, Inc., 159 S.W. 3d 279 (Tex. App. 2005) dealt with claims by a divorced wife, claiming both as to investments made for her and also under claims assigned to her by her former husband as part of the divorce settlement. The Court concluded that "by alleging claims as Ned's assignee, Lynda seeks to enforce the contract and is subject to the arbitration clause. Although Lynda's original claims are grounded in legal theories distinct from the claims she brings as assignee under the contract Ned signed, they are factually intertwined and subject to the arbitration provision of the contract." 159 S.W. 3d at 284.

In *Sanford v. Castleton Health Care Center, LLC*, 813 N.E.2d 411 (Ind. App. 2004) the Court enforced an arbitration clause in a nursing home contract entered into by the executor in her capacity under a power of attorney, holding that she was bound as executor despite not having signed the contract in such capacity.

The Arizona Supreme Court denied enforcement of an arbitration clause contained in inter vivos trusts in *Schoneberger v. Oelze*, 96 P. 3d 1078. The Court held that a trust agreement is not a contract, and hence code provisions dealing with enforcement of arbitration provisions in contracts did not apply to claims made by the beneficiaries against the trustees. The beneficiaries cited Restatement, Third, of Trusts §37 for the proposition that the settlor can create powers to which the trustee will be subjected. "A trustor's right to reserve power over trust administration matters is not, however, absolute and a trustor of an inter vivos trust may not unilaterally strip trust beneficiaries of their right to access the courts absent their agreement. 'Although it is commonly said that the law favors arbitration, it is more accurate to say that the law favors arbitration of disputes that the parties have agreed to arbitrate.'" 96 P.3d at 1083-1084.

A century ago, before the development of authorizing litigation and the development of case law supporting alternate dispute resolution, rejection of the petition to compel arbitration would have been likely. In *Carpenter v. Bailey*, 127 Cal. 582, 60 P.162 (CA, 1900) the Court rejected an attempt by beneficiaries to arbitrate disputes regarding a will, citing jurisdictional

grounds and the due process shortcomings of the arbitration agreement signed by the adult beneficiaries. "The matter of the probate of a will is a proceeding in rem binding on the whole world. A few individuals claiming to be the heirs cannot, by stipulation, determine such controversy. There are many other reasons why this submission cannot be sustained. The principal beneficiary under the will, being a minor, was not bound by it. The terms of the agreement itself are contradictory and absurd. Frank T. Baldwin is to arbitrate the matter, and to get his information as he pleases, neither party having a right to submit any evidence to him." 127 Cal at 585.

Any arbitration proceeding requires "some minimum levels of integrity," to assure the due process rights of the contestants. *Hines v. Anchor Motor Freight* (1976), 424 U.S. 554, 571. *The Court in Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 623 P.2d 165 (CA 1981) rejected an arbitration contract under adhesion grounds and because of due process shortcomings. The Court held that an arbitrator could not be "someone so identified with the party as to be in fact, even though not in name, the party...such an agreement is illusory; for while in form it provides for arbitration, in substances it yields the power to an adverse party to decide disputes under the contract." 28 Cal. 3d at 824. The Court held that even if the arbitrator could be deemed fair, if it proceeds "under rules which deny a party the fair opportunity to present his side of the dispute," the agreement should not be enforced. 28 Cal. 3d at 826.

Stay Pending Arbitration

The Seventh Circuit denied the attempt of the bank formerly known as Wachovia from staying litigation over the replacement of whole life policies in existing trusts in *French v. Wachovia Bank*, 574 F.3d 830 (7th Cir. 2009). This matter was originally brought by the beneficiaries in Wisconsin State court, but the matter was removed to federal court based on diversity jurisdiction. Resolution was delayed for several years, pending arbitration of one of two claims. The plaintiffs then obtained leave to amend their complaint, dropping the claim which was subject to arbitration. *French v. Wachovia Bank*, 2008 WL 2439717 (E.D.Wis. Jun 16, 2008). Wachovia finally moved for summary judgment of the remaining claim of the plaintiffs. *French v. Wachovia Bank, NA* 800 F. Supp.2d 975 (E.D. Wis.July 6, 2011).
In July of 2011, the US District Court for the Eastern District of Wisconsin issued its decision, *French v. Wachovia Bank, N.A.*, 800 F. Supp.2d 975 (E.D. Wis.2011), granting summary judgment for Wachovia, and dismissing a demand for a jury trial.

Addendum #2

State Bar of Cal., Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. No. 2009-178, at 5-6 (2009)

THE STATE BAR OF CALIFORNIA
STANDING COMMITTEE ON
PROFESSIONAL RESPONSIBILITY AND CONDUCT
FORMAL OPINION NO. 2009-178

ISSUES: Is it ethically proper for an attorney who is settling a fee dispute with a client to include a general release and a Civil Code section 1542 waiver in the settlement agreement? Does the existence of a legal malpractice claim against the attorney alter the ethical propriety of including a general release and section 1542 waiver in the settlement agreement?

DIGEST: An attorney must promptly disclose to the client the facts giving rise to any legal malpractice claim against the attorney. When an attorney contemplates entering into a settlement agreement with a current client that would limit the attorney's liability to the client for the lawyer's professional malpractice, the attorney must consider whether it is necessary or appropriate to withdraw from the representation. If the attorney does not withdraw, the attorney must:

1. Comply with rule 3-400(B) by advising the client of the right to seek independent counsel regarding the settlement and giving the client an opportunity to do so;
2. Advise the client that the lawyer is not representing or advising the client as to the settlement of the fee dispute or the legal malpractice claim; and
3. Fully disclose to the client the terms of the settlement agreement, in writing, including the possible effect of the provisions limiting the lawyer's liability to the client, unless the client is represented by independent counsel.

AUTHORITIES INTERPRETED: Rules 2-100, 3-300, 3-310, 3-400, and 3-500 of the Rules of Professional Conduct of the State Bar of California.[1]

Business and Professions Code section 6068, subdivision (m).

Civil Code section 1542.

STATEMENT OF FACTS

Fact Pattern 1: Client 1 engages Attorney A to represent Client 1. During the representation, a dispute develops regarding attorneys' fees. Client 1 and Attorney A decide to settle the attorneys' fees dispute by entering into a written settlement agreement. Client 1 and Attorney A intend that Attorney A continue to represent Client 1 in the ongoing matter. Although Attorney A is not aware of any basis for a legal malpractice claim, Attorney A is concerned that Client 1 may allege that Attorney A committed legal malpractice at some future date. To resolve the fee dispute and protect against any future legal malpractice allegation regarding Attorney A's completed services, and to allow the continuation of the representation, Attorney A proposes a settlement of the fee dispute, memorialized by a written settlement agreement including a general release of all claims known and unknown to the date of the settlement and a provision waiving Civil Code section 1542

[1] Unless otherwise noted, all rule references are to the Rules of Professional Conduct of the State Bar of California.

(hereinafter "section 1542"). The proposed settlement agreement is broad enough to release any legal malpractice claim. Section 1542 provides that:

> A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.

Client 1 is unaware of any legal malpractice by Attorney A, and has not alleged legal malpractice against Attorney A, formally or informally. Client 1 and Attorney A execute the settlement agreement, including the section 1542 waiver. Later, Client 1 files a lawsuit for legal malpractice against Attorney A with regard to services rendered before the settlement agreement was executed. At that time, Attorney A relies upon the general release and the section 1542 waiver, asserting that Client 1 released the claim for legal malpractice against Attorney A.

Fact Pattern 2: Attorney B believes that she has committed legal malpractice in a matter that she is handling on behalf of Client 2. Client 2 is delinquent in payment of attorneys' fees to Attorney B. Near the end of the engagement, Attorney B demands payment of all past due attorneys' fees. Attorney B and Client 2 decide to mediate their dispute. At the mediation, Client 2 is not represented by independent counsel. Without disclosing the potential malpractice claim to Client 2, Attorney B settles the fee dispute with Client 2, and the parties enter into a settlement agreement and mutual general release of all claims, known and unknown. Attorney B and Client 2 both intend that the settlement agreement resolve any claim for legal malpractice, and the terms of the settlement agreement are broad enough to do so. The settlement agreement includes a section 1542 waiver.

Fact Pattern 3: Client 3 engages Attorney C to represent Client 3. The representation comes to a conclusion because the case in which Attorney C represented Client 3 is resolved through a settlement. However, Client 3 has not paid Attorney C's billings for attorneys' fees in full. Attorney C sends a letter to Client 3 demanding payment of the outstanding fees. In response, Client 3 refuses to pay the outstanding attorneys' fees and asserts that Attorney C has committed legal malpractice. Attorney C disagrees that he has committed legal malpractice. Client 3 engages Attorney D to represent Client 3 in reference to the dispute with Attorney C, including the dispute concerning the payment of attorneys' fees and Client 3's legal malpractice claim against Attorney C. While Client 3 is represented by Attorney D, Client 3 and Attorney C resolve their dispute, memorializing the resolution in a written settlement agreement and mutual general release of all claims, known and unknown, which includes a section 1542 waiver. Attorney C intends that the settlement agreement resolve Client 3's claim for legal malpractice against Attorney C, and the terms of the settlement agreement are broad enough to do so.

This opinion discusses the ethical issues raised by the above scenarios. The issues include: (1) whether the attorney in each factual scenario has a conflict of interest; (2) how the attorney in each scenario must proceed in order to fulfill his or her fiduciary duties; (3) the duty of the attorney in each scenario to make disclosures to the client, including disclosure of the facts giving rise to a legal malpractice claim and disclosure fully explaining the terms and conditions of the proposed settlement; and (4) under what circumstances the attorney must withdraw from the representation of the client.

The effect of a settlement agreement between a lawyer and a client releasing all claims, known and unknown, combined with a section 1542 waiver, is a matter of contract law. In some cases, depending on the facts and circumstances, the precise language of the release, whether the client is represented by independent counsel, and the intentions of the parties in entering into the settlement agreement, the settlement agreement may result in the client's release of the lawyer from all claims, known or unknown, including any claims that the client may have against the lawyer for legal malpractice. (See, e.g., *Winet v. Price* (1992) 4 Cal.App.4th 1159, 1168 [6 Cal.Rptr.2d 554];[2/] *Donnelly v. Ayer* (1986) 183 Cal.App.3d 978, 983-984 [228 Cal.Rptr. 764].) The enforceability of the settlement agreement, depending as it may on whether the client has independent counsel,

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[2/] Note, however, that a section 1542 waiver may not be effective to support a release where the releaser suffers from mental incapacity, or where the release is induced by fraud. (*Winet v. Price, supra,* 4 Cal.App.4th at p. 1169, fn. 6.)

whether a viable malpractice claim is concealed by the attorney from the client, and whether the client signed the release and section 1542 waiver without intending to release the attorney from liability for legal malpractice, is a legal matter of contract law that is beyond the scope of this opinion. We consider here only the ethical obligations of a lawyer entering into such an agreement with a present or former client.

DISCUSSION

1. Withdrawal from Representation

A fee dispute between a lawyer and client does not, by itself, require the lawyer to withdraw as counsel. (Los Angeles County Bar Assn. Formal Opn. No. 521 (2007).) At the initial stages of a fee dispute, withdrawal is permissive. (*Ibid.*) Prior to an attorney initiating a suit for the collection of fees against a client, the attorney should withdraw from the representation of the client. (Rule 3-700(C)(1)(f) [breach of obligation to pay fees is basis for permissive withdrawal]; *Santa Clara County Counsel Attys. Assn. v. Woodside* (1994) 7 Cal.4th 525, 548-549 [28 Cal.Rptr.2d 617] [noting in dictum the potential for the duty of loyalty to preclude an attorney's lawsuit against a current client]; Los Angeles County Bar Assn. Formal Opn. No. 476 (1994) ["an attorney should withdraw from all matters in which representation is being provided to the client prior to commencing litigation for costs or fees"]; Los Angeles County Bar Assn. Formal Opn. No. 212 (1953) [same].)

Before entering into a settlement agreement and obtaining a general release and section 1542 waiver from a client, the lawyer should consider whether it is appropriate to withdraw from the representation. In making this decision, the lawyer should consider the circumstances motivating the request for a general release and section 1542 waiver, the level of antagonism between the lawyer and client, and the degree to which withdrawal from representation would cause prejudice to the client. (Rule 3-700(A)(2).)

2. Settling Claims for Attorney's Liability

A fee dispute with a client, by itself, also does not create an ethical conflict of interest. (Los Angeles County Bar Assn. Formal Opn. No. 521.) However, where the fee dispute involves a potential claim of legal malpractice, and where the lawyer intends through the settlement agreement to obtain a release of that legal malpractice claim, or where the settlement agreement itself is broad enough to effectively release the client's legal malpractice claim against the lawyer, a general release including a waiver of section 1542 from the client in connection with the resolution of that fee dispute is subject to rule 3-400(B). Rule 3-400(B) provides that an attorney shall not settle a *claim or potential claim* for an attorney's liability to a client for an attorney's professional malpractice unless (1) the client is informed in writing that the client may seek the advice of independent counsel regarding the settlement, and (2) the client is given a reasonable opportunity to seek that advice. (Rule 3-400(B).)[3/]

3. Duty of Loyalty and Conflict of Interest

A conflict of interest arises in scenarios involving a lawyer's settlement of a fee dispute with a client that also involve the release of a potential or actual legal malpractice claim. A member should not accept or continue representation of a client without providing written disclosure to the client where the member has or had financial or professional interests in the potential or actual malpractice claim involving the representation. (*Cf.* Rule 3-310(B)(4).) "The primary purpose of this prophylactic rule is to prevent situations in which an attorney might compromise his or her representation of the client in order to advance the attorney's own financial or personal interests." (*Santa Clara County Counsel Attys. Assn. v. Woodside, supra,* 7 Cal.4th at p. 546.) Written

[3/] Rule 3-400(A) provides that an attorney may not contract with a client "prospectively" limiting the attorney's liability to the client for malpractice. This provision applies to agreements limiting liability for future acts of malpractice. Because none of the fact patterns described in this opinion involve an attorney attempting to limit future liability for legal malpractice, which has not already occurred, rule 3-400(A) is inapplicable here.

disclosure to the client of the conflict of interest arising from the lawyer's financial or professional interests in the dispute should be given. (*Cf.* Rule 3-310(B).)[4]

Although the lawyer does not have a financial interest that creates a conflict of interest in a situation involving solely a fee dispute (Los Angeles County Bar Assn. Formal Opn. No. 521), once a potential or actual legal malpractice claim is involved, and once the attorney seeks a release from such a claim, the lawyer has a financial and professional interest in avoiding a suit for legal malpractice arising from the lawyer's representation and in minimizing the lawyer's exposure to the client. (See *People v. Bonin* (1989) 47 Cal.3d 808, 835 [254 Cal.Rptr. 298] ["Conflicts of interest broadly embrace all situations in which an attorney's loyalty to, or efforts on behalf of, a client are threatened by . . . his own interests."].) Where the attorney's interest in securing an enforceable waiver of a client's legal malpractice claim against the attorney conflicts with the client's interests, the attorney must assure that his or her own financial interests do not interfere with the best interests of the client. (See *Ramirez v. Sturdevant* (1994) 21 Cal.App.4th 904, 924 [26 Cal.Rptr.2d 554] [recognizing the conflict of interest inherent in an attorney's dual representation of the interests of the client and the attorney in settlement negotiations with a third party].) Accordingly, the lawyer negotiating such a settlement with a client must advise the client that the lawyer cannot represent the client in connection with that matter, whether or not the fee dispute also involves a potential or actual legal malpractice claim. (*Cf.* Rules 3-310(C) and 3-500; *Flatt v. Superior Court (Daniel)* (1995) 9 Cal.4th 275, 289 [36 Cal.Rptr.2d 537] ["the duty of loyalty to the client forbids any act that would interfere with the dedication of an attorney's 'entire energies to [the] client's interests'"].)

4. Disclosure of Facts Giving Rise to Potential Malpractice Claim to Client

A lawyer has an ethical obligation to keep a client informed of significant developments relating to the representation of the client. (Bus. & Prof. Code, § 6068, subd. (m); rule 3-500.) Where the lawyer believes that he or she has committed legal malpractice, the lawyer must promptly communicate the factual information pertaining to the client's potential malpractice claim against the lawyer to the client, because it is a "significant development." *Beal Bank, SSB v. Arter & Hadden, LLP* (2007) 42 Cal.4th 503, 514 [66 Cal.Rptr.3d 52] ["attorneys have a fiduciary obligation to disclose material facts to their clients, an obligation that includes disclosure of acts of malpractice."].[5] We previously stated that:

> It would, of course, be unethical for an attorney, knowing he/she had committed malpractice, to attempt to negotiate an arbitration provision into an existing retainer agreement without fully disclosing the fact of the attorney's negligence to the client.
> (State Bar Formal Opn. No. 1989-116, fn. 4.)

5. Inapplicability of Rule 3-300

Rule 3-300 imposes certain requirements before an attorney may "enter into a business transaction with a client; or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client[.]" The requirements include: (1) a fair and reasonable transaction or acquisition and terms; (2) full written disclosure of such terms; (3) a written advisory that the client may seek advice from an independent attorney of the client's choice; (4) a reasonable opportunity to obtain such advice from an independent attorney; and (5) written consent by the client to the terms of the transaction or acquisition. (Rule 3-300(A)-(C).) While no published California authorities have specifically addressed whether an attorney's cash settlement of a fee dispute that includes a general release and a section 1542 waiver of actual or potential malpractice claims for past legal services falls within the prescriptions of this rule, it is the Committee's opinion that rule 3-300 should not apply.

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[4] "Disclosure" means informing the client or former client of the relevant circumstances and of the actual and reasonably foreseeable adverse consequences. (Rule 3-310(A)(1).)

[5] Note, however, that there is no ethical obligation to discuss the various types of malpractice recovery the client may obtain against the lawyer. (*Expansion Pointe Properties Ltd. Partnership v. Procopio, Cory, Hargreaves & Savich, LLP* (2007) 152 Cal.App.4th 42, 55 [61 Cal.Rptr.3d 166].)

First, rule 3-400(B) expressly addresses an attorney's ability to settle an actual or potential claim for malpractice by imposing the requirements set forth in Section 2, *supra*. Specifically, the client must be advised in writing that he or she may seek advice of an independent attorney of his or her choice regarding the settlement and must be given a reasonable opportunity to do so. (Rule 3-400(B).) Rule 3-300, however, lacks any reference to the settlement of such claims.

Second, if the prescriptions of rule 3-300 were to apply to these circumstances, rule 3-400(B) would be rendered mere surplusage. Rule 3-400(B)'s requirements are more narrow in scope than those in rule 3-300, but are nonetheless contained within rule 3-300.[6] Consequently, there would be no need for rule 3-400(B)'s existence if rule 3-300 also applied.[7] (See *People v. Hawes* (1982) 129 Cal.App.3d 930, 936-937 [181 Cal.Rptr. 456] ["specific statutory provision controls a general one even where the general one standing alone would be broad enough to include the subject matter of the specific statute"].)

For these reasons, the Committee believes that the prescriptions of rule 3-300 are inapplicable when an attorney and client are negotiating a cash settlement of a fee dispute in exchange for a section 1542 release of claims, including malpractice claims for prior services rendered.

6. Application to Fact Patterns

In Fact Pattern 1, where Attorney A and Client 1 have an ongoing attorney-client relationship, and Client 1 has no independent counsel, Attorney A must advise Client 1 that Attorney A does not represent Client 1 in reference to that dispute. Attorney A must advise Client 1 in writing that Client 1 may seek the advice of independent counsel regarding the general release and section 1542 waiver, and must give Client 1 an opportunity to do so. (Rule 3-400(B).) After Client 1 has filed a lawsuit for legal malpractice against Attorney A, absent informed written consent, Attorney A should withdraw from representation of Client 1 in the ongoing, underlying matter.

In Fact Pattern 2, Attorney B has an interest in not only resolving the fee dispute favorably, but also in obtaining an enforceable release of the legal malpractice claim which Client 2 may have against Attorney B. Because Client 2's interest is adverse to that of Attorney B, Attorney B should consider whether it is appropriate to withdraw from the representation of Client 2. Because the dispute involves a legal malpractice claim, a matter beyond the compensation and hiring arrangements in the attorney-client relationship, the settlement agreement including the general release and section 1542 waiver is presumed to involve a breach of Attorney B's fiduciary duties to Client 2 (see *Ramirez v. Sturdevant, supra,* 21 Cal.App.4th at p. 917), subject to rebuttal by Attorney B. Attorney B is further obliged to fully disclose the facts pertaining to the potential legal malpractice claim to Client 2. (Rule 3-500; cf. rule 3-310(A)-(B).)

Attorney B must also advise Client 2 in writing of Client 2's right to seek the advice of independent counsel regarding the settlement agreement and must give Client 2 a meaningful opportunity to do so. (Rule 3-400(B).) Where the settlement takes place during a mediation, in order to comply with rule 3-400(B), the parties to the mediation may have to adjourn the mediation and reconvene in order to permit Client 2 to have a meaningful

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[6] The American Bar Association Model Rules of Professional Conduct also contain a provision dealing with the settlement of an actual or potential malpractice claim that corresponds to the more narrow requirements of rule 3-400(B). (ABA Model Rules, rule 1.8(h)(2).) Similarly, the Restatement (Third) of the Law Governing Lawyers requires, "for purposes of professional discipline," written advice that independent representation is appropriate when settling a malpractice claim. (Rest.3d, Law Governing Lawyers, § 54(4).) Only in a separate provision addressing when a client or former client may *rescind* such a settlement agreement is the lack of a fair and reasonable settlement paired with the lack of independent representation. Thus, under the Restatement, this additional requirement affects the enforceability of the contract, not the lawyer's professional duties.

[7] This opinion does not address the situation where an attorney obtains an interest in a client's property for purposes of securing the attorney's past due fees. Such a situation is expressly intended to be subject to rule 3-300. (See discussion to rule 3-300.)

opportunity to seek independent counsel, depending upon when the advice required by rule 3-400(B) is given, and upon Client 2's desires.

In Fact Pattern 3, because Client 3 and Attorney C have terminated their attorney-client relationship, and Client 3 has independent counsel (Attorney D), the obligation to keep a "client" informed of significant developments no longer applies. (Bus. & Prof. Code, § 6068, subd. (m); rule 3-500.) Likewise, rule 3-400, which by its terms is applicable only to "clients," is not applicable to this factual scenario because Client 3 is no longer a client of Attorney C. (State Bar Formal Opn. No. 1992-127, fn. 7 [rule 3-400 does not apply where the attorney-client relationship is terminated]; see *Donnelly v. Ayer, supra,* 183 Cal.App.3d at p. 984.) Where Client 3 is represented by Attorney D in connection with the dispute that is the subject of the settlement agreement, Attorney C may communicate directly with Client 3, even though Client 3 is represented by counsel. (Discussion to rule 2-100(A) [the rule does not prohibit a member who is also a party from communicating directly or indirectly on his or her own behalf with a represented party].)

CONCLUSION

Before entering into a settlement agreement with a current client that includes a general release and a section 1542 waiver, an attorney must promptly disclose to the client the facts giving rise to any potential or actual malpractice claim. The attorney should consider whether it is necessary or appropriate to withdraw from the representation. If the attorney does not withdraw, the attorney must comply with rule 3-400(B), advise the client that the lawyer does not represent the client in reference to the fee dispute or legal malpractice claim, and fully disclose to the client the terms of the settlement agreement, in writing, including the possible effects of the general release and section 1542 waiver, assuming the client does not have independent counsel.

This opinion is issued by the Standing Committee on Professional Responsibility and Conduct of the State Bar of California. It is advisory only. It is not binding upon the courts, the State Bar of California, its Board of Governors, any persons or tribunals charged with regulatory responsibilities, or any member of the State Bar.

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