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SURROGATE'S PRACTICE AND PROCEEDINGS

Exoneration Clauses: Two Cautionary Tales

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The use of exoneration or exculpatory clauses that purport to limit a fiduciary's liability and obligation to account have been the subject of much discussion and judicial action in recent years. Two recent decisions by our local surrogates stand for the proposition that public policy, and not the provisions of the underlying instruments, will guide the court as to the enforceability of exoneration clauses.

In view of the increasing use of lifetime trusts and powers of attorney as part of an estate plan, every estate planner and Surrogate's Court practitioner should be aware of these decisions and their underlying principles.

'Matter of Shore'

In Matter of Shore, [FN1] Surrogate Judge Renee R. Roth, voided, on public policy grounds, a provision in a lifetime trust that purported to exonerate the trustee from any accountability

during the income beneficiary's lifetime. The trust had been created to receive and hold the proceeds of a personal injury action commenced by Mr. Shore. The attorney who drafted the trust was named as both the grantor and trustee. The instrument vested the trustee with 'absolute discretion' to make distributions of income and principal to Mr. Shore; at his death, the principal and accumulated income was to be paid to his distributees.

Disputes arose between Mr. Shore and the trustee concerning the amount of distributions, and Mr. Shore, as the trust beneficiary, sought to compel an accounting from the trustee. After the court determined that Mr. Shore was a person under a disability, the surrogate appointed a guardian ad litem. In opposing the application to account, the trustee claimed that she had no duty to account until the trust terminated because the instrument provided that:

In order to minimize costs and expenses, neither...the Trustee nor any successor...shall be required to render a formal judicial account of her transactions.... The [T]rustee shall prepare, as an expense of the Trust, a final accounting upon termination of the trust and shall submit a copy of same to the Primary Beneficiary....

The surrogate rejected the trustee's argument and held that even if the instrument could be construed as excusing the trustee from accounting, such a provision is inconsistent with the essence of a trust relationship and void as against public policy. [FN2] Since the trustee had failed to render an account, as had been previously directed by the court, the surrogate granted the application to remove the trustee and to take and state her account.

The court noted that Estates Powers and Trust Law (EPTL) §11-1.7(a)(1) provides that an attempt to relieve a testamentary trustee from the duty to account is void as against public policy. The public policy cited was that the very nature of a trust requires that there is some party capable of holding the trustee accountable. While EPTL §11-1.7(a)(1) is limited to testamentary trusts by its very terms, Surrogate Roth held that the public policy it embodies is equally applicable to inter vivos trusts where, as here, the exoneration clause would leave no one to

protect the beneficiary's interest.

As Surrogate Roth stated, there is a line of cases that is often cited for the proposition that, since EPTL §11-1.7(a)(1) only prohibits exoneration clauses in testamentary trusts, exoneration clauses in inter vivos trusts are not expressly forbidden and therefore must be permissible. The authors note that the decisions cited in Shore are often relied upon by practitioners for the general proposition that an inter vivos trust may exonerate a trustee from accountability to the beneficiaries. However, as Surrogate Roth found, an actual reading of those decisions makes clear that the courts have limited the enforceability of exoneration clauses to the period during the grantor's lifetime so long as the trustee remains accountable to the grantor, who must be a different person than the trustee (unless the trust is revocable, as revocation is the ultimate form of accountability). [FN3]

Although the trust instrument in Shore described the attorney-draftsperson as both the trustee and grantor, Mr. Shore was the true grantor of the trust. The Shore exoneration clause, if enforceable, would have left the trustee accountable to no one. As Surrogate Roth noted, this would have been a violation of the requirement of accountability that is present in all of the decisions enforcing exoneration clauses.

An 'Ethical Question'

Practitioners should also be mindful of Surrogate Roth's admonition that an attorney/trustee's 'attempt to draft a trust instrument that would render her unaccountable under any circumstances' may well violate the Code of Professional Responsibility's proscription against knowingly advancing a claim that is unwarranted under existing law. [FN4] The court also cited Surrogate Lee L. Holzman's decision in Matter of Lubin, [FN5] which involved a will drafted by an attorney/fiduciary who included an exoneration clause in Mr. Lubin's will.

In the Lubin decision, Surrogate Holzman couched the issue of including such a clause in a will as an 'ethical question which a segment of the Bar appears to have ignored.' [FN6] The court stated that counsel has an obligation to inform the client that such a provision is unenforceable. The court also posed, but did not address, the question of whether counsel is guilty of having become a coconspirator in an act declared against public policy, if the attorney still includes an exoneration clause at the client's insistence after having informed the client that the clause violates public policy. In rather harsh language the surrogate concluded that if the attorney is also the nominated fiduciary, and has included such a clause to deceive the beneficiaries of the estate, he is 'displaying a contempt for the law which is antithetical to the honor that the profession requires.' [FN7]

The Surrogate's Court Advisory Committee to the Chief Administrative Judge of the Courts is currently studying the Uniform Trust Code (UTC) and is expected to make a recommendation before the end of the year as to what portions, if any, should be enacted in New York. Interestingly, even the UTC has left it to the individual states to determine to what extent a settlor can, under limited circumstances, limit the trustee's duty to account. See, UTC §105 (b)(8)- (9). As the commentary to UTC §813 (Duty to Inform and Report) makes clear: 'The duty to keep the beneficiaries reasonably informed of the administration of the trust is a fundamental duty of a trustee.' However, the UTC does sanction exoneration clauses that do not relieve the trustee from liability for breaches of trust committed in bad faith or with reckless indifference to the terms of the trust or the interests of the beneficiaries, so long as, the clause was not inserted in the trust instrument as the result of abuse by a person in a fiduciary or confidential relationship. UTC §1008(a).

The UTC also includes a presumption that any exoneration clause drafted or caused to be drafted by the trustee is invalid unless the trustee can prove that the exoneration clause is fair and that its existence and import were communicated to the grantor. UTC §1008(b). Therefore, it appears that, even if New York adopts the Uniform Trust Code's view of exoneration clauses, Surrogate Roth's holding in Shore would remain undisturbed.

'Matter of Francis'

The second recent decision involving the attempted exoneration of a fiduciary is Matter of Francis, [FN8] where Surrogate Anthony A. Scarpino voided, on public policy grounds, an exoneration clause contained in a power of attorney. The clause, pertinently provided:

No accounting shall be required of my attorney-in-fact during or after my life. My attorney-in-fact shall not incur any liability to me, my estate, my heirs, successors or assigns or to anyone else for acting or refraining from acting under this document.

Here, as in Shore, the instrument at issue was drafted by the fiduciary. The attorney-in-fact in Francis was not an attorney-at-law, but was the 98-year-old principal's long-time tenant. Using the power of attorney, the tenant not only transferred all of his principal's liquid assets to himself, he executed on his principal's behalf a lifetime tenancy agreement which permitted him and his mother the right to continue to reside as tenants for their lifetimes. Following Ms. Francis' death, her administrator commenced a Surrogate's Court Procedure Act (SCPA) 2103 Discovery Proceeding against the attorney-in-fact for a turnover of the transferred assets. The attorney-in-fact moved to dismiss the proceeding on the grounds of the statute of limitations, arguing that the transfers took place more than three years prior to the commencement of the discovery proceeding and the claim was therefore barred by the three-year statute of limitations for conversion actions. [FN9] The administrator cross-moved to compel an accounting and for summary judgment.

The surrogate rejected the statute of limitations argument and held that the proceeding was timely commenced as it was governed by the six-year statute of limitations for actions based on breach of fiduciary duty [FN10] and that the statute does not begin to run until the fiduciary has openly repudiated his obligation to render an account. The court also rejected the attorney-in-fact's argument that the exoneration clause in the power of attorney was a complete defense to the claim. Surrogate Scarpino first noted that the Court of Appeals in Matter of

Ferrara, [FN11] held that an attorney-in-fact is held to the traditional fiduciary standards of utmost good faith and undivided loyalty toward the principal. The surrogate then held that a clause in a power of attorney exonerating the agent from all liability runs afoul of the spirit of New York's public policy against such clauses, as well as, the duty of an attorney-in-fact to act in accordance with the highest principles of morality, fidelity, loyalty and fair dealing. Since the attorney-in-fact was unable to proffer any evidence that decedent benefitted from the transfers, [FN12] or of her intent to make the gifts, the court awarded summary judgment to the administrator.

Conclusion

Shore and Francis should act as a guide to the bar when advising clients of their ability to exonerate a fiduciary or limit accountability. More importantly, these cases serve as warning sign to fiduciaries who have an unwarranted sense of security due to their reliance on such clauses.

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FN1. 2008 NY Slip Op 28102 (Sur. Ct. New York Co.) (Dec. March 19, 2008) (http://www.nycourts.gov/reporter/3dseries/2008/2008_28102.htm).

FN2. As Surrogate George A. Wingate stated nearly 75 years ago: 'The attempted exoneration of [a] fiduciary for any loss unless occasioned by 'willful neglect or misconduct' is a nugatory provision amounting to nothing more than a waste of good white paper....' Matter of Curley, 151 Misc. 664, 675, 272 NYS 489, 501, mod. on other grounds, 245 App.Div. 255, 280 NYS 80 (2d Dept. 1935), aff'd, 269 NY 548 (1935). For a comprehensive discussion of the leading authorities see Valente and Palumbo, 'Exculpatory Provisions,' NYLJ, April 29, 1998, p. 3, col. 1.

FN3. Matter of Central Hanover Bank & Trust Co., 176 Misc. 183, 26 NYS2d 924 (Sup. Ct. NY Co. 1941); Matter of Kassover, 124 Misc. 2d 630, 476 NYS2d 763 (Sur. Ct. Nassau Co. 1984); Bauer v. Bauernschmidt, 187 AD2d 477. 589 NYS2d 582 (2d Dept. 1992); Matter of Malasky, 290 AD2d 631, 736 NYS2d 151 (3d Dept. 2002).

FN4. 22 NYCRR §1200.33 (a)(2).

FN5. 143 Misc2d 121, 539 NYS2d 695 (Sur. Ct Bronx Co. 1989).

FN6. Indeed, notwithstanding the clear language of EPTL §11-1.7, as well as the history of that section and its predecessor, all four writers of this column are constantly amazed at how many of the testamentary instruments that we have come across in our respective practices contain such unenforceable provisions.

FN7. 143 Misc2d at 122, 539 NYS2d at 696. Fortunately, the attorney/draftsperson in Lubin did not get into ethical trouble. The surrogate found that he had no reason to believe that the attorney was aware of the provisions of EPTL §11-1.7.

FN8. 2008 NY Slip Op 28077 (Sur. Ct. Westchester Co.) (Dec. March 5, 2008) (http://www.nycourts.gov/reporter/3dseries/2008/2008_28077.htm).

FN9. CPLR §214 (3).

FN10. CPLR §213 (1).

FN11. 7 NY3d 244, 819 NYS2d 215 (2006).

FN12. Matter of Ferrara, supra, fn. 10.