

## Dimming the bright line: An analysis of Amended I.C. §30-4-3-5

Effective July 1, 2006, the Indiana General Assembly has amended Indiana Code §30-4-3-5, which governs the exercise of a trustee's powers when there is a conflict of interest.<sup>1</sup> Previously, Section 5 had provided a bright-line prohibition on trustees acting with a conflict of interest, absent Court approval. The amendments expand the number of circumstances in which a trustee's conflict of interest does not represent a *per se* breach of trust.

The changes to Section 5 may prove to be a useful tool which estate planning counsel can use to help their clients achieve their objectives. However, the changes may also lead an unwary trustee into trouble.

The purpose of this article is not to debate the legislative wisdom of the changes. Rather, the purpose of this article is to assess those changes, and to evaluate the effect of those changes for attorneys, whether their clients are seeking counsel in estate planning, trust administration, or in the resolution of a dispute in the administration of a trust.

One of the fundamental tenets of trust law is that, as a fiduciary, a trustee owes a duty of undivided loyalty to the trust.<sup>2</sup> Prior to July 1, 2006, Indiana Code §30-4-3-5 preserved this duty of loyalty with a very simple, bright-line rule, providing as follows:

### Conflict of Interest in Exercise of Powers

- (a) If the duty of the trustee in the exercise of any power conflicts with his individual interest or his interest as trustee of another trust, *the power may be exercised only with court supervision.* (Emphasis added).

The practical effect of the previous statement of the rule, was that any act by the trustee, when there was a conflict between his interest and that of the trust, represented a *per se* breach of the trustee's duties, unless the trustee obtained prior court approval.<sup>3</sup> Note that the amendments to Section 5 do not necessarily bless additional conflict of interest transactions. Rather, the amendments provide additional circumstances in which conflict of interest transactions will not be considered a *per se* violation of the trustee's duties. Those additional circumstances are as follows:

When the terms of the trust specifically authorize the trustee's exercise of the power in question; and

When the trustee receives written authorization of all interested persons to the proposed action, after having given notice to such persons.

The recently-decided case of *Bender v. Bender*, 844 N.E.2d 170 (Ind. App. 2006), helps to illustrate how these new provisions may provide both a tool to the estate

planning attorney, and a trap to the unwary fiduciary. In *Bender*, the personal representative of a supervised estate purchased closely-held business interests from the estate, pursuant to the terms of buy-sell agreements entered into with the decedent during his lifetime. The transactions were neither authorized by the decedent's will, nor approved of by the probate court. The Court of Appeals affirmed the trial court's decision that the transactions represented a prohibited act of self-dealing, and were therefore void.<sup>4</sup>

Would the result in *Bender* have been different if the fiduciary in question was the trustee of a trust which specifically authorized the transactions in question? Technically, the result would have been different. A significant part of the Court's reasoning was that the transaction was improper, *per se*, because it was neither authorized by the will in that case nor approved by the Court.<sup>5</sup>

However, the Court may still have arrived at the same substantive conclusion, through a different theory. Section 5 requires that an authorization in the terms of the trust be "specific", but does not identify the required level of specificity. Further, Section 5 does not purport to abrogate either the general duty of undivided loyalty or its specific manifestation in the terms of I.C. §30-4-3-7(d), which requires that a trustee engaging in a self-dealing transaction deal "fairly" with the beneficiary.

Nor should Section 5 be read to erode, in any way, a trustee's duty of undivided loyalty. For the term "fiduciary" and the duty of loyalty to have any meaning at all, Courts interpreting Section 5 should not compromise the straight line which trustees are required to walk. As Judge Cardozo and others have noted: "only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."<sup>6</sup> If the changes are interpreted as more than a very narrow exception to the rule that conflict of interest transactions represent a *per se* breach of trust, then the changes may represent a first, and significant step down what may prove to be a slippery slope that ultimately leads to a compromise of a trustee's fundamental duty of undivided loyalty to the trust and its beneficiaries.

Nevertheless, estate planning counsel does now have the opportunity to draft language in a trust which authorizes the trustee to acquire, among other things, closely-held interests from the trust. Before counsel rushes out to do this, however, consider whether such a bald authorization really provides any security for a fiduciary in the context of such a transaction.

The value of a closely-held interest is often the subject of dispute, and is generally difficult to determine. As such, if the trust language does not specify the terms of the transaction by which the trustee can acquire the interests from the trust, the result may be that the trustee has been led into a situation where has engaged in a transaction, only to have the beneficiaries question the fairness of that transaction.

In addition, the trustee may be accused of exercising undue influence in either the creation of the terms of the trust, or in the actual transaction with the trust itself. The relationship of trustee and beneficiary is a fiduciary and “confidential” relationship.<sup>7</sup> As such, if a trustee benefits from a transaction with a trust, the transaction may be presumed to be the result of undue influence; thus, the trustee will bear the burden of proving by clear and unequivocal evidence that the transaction was fair and that no undue influence was exercised.

Clearly, the amended provisions of I.C. §30-4-3-5 are not, in and of themselves, a panacea for estate planning counsel. The section is a tool which the attorney can use – but this tool must generally be used in connection with other tools for it to be effective. A non-exhaustive list of other tools is as follows:

- § The appointment of a co-trustee or trust advisor who can act on behalf of the trust in the transaction. The simplest and most effective way to handle the situation is to eliminate the conflict of interest by having a different individual act in the role of fiduciary.
- § The establishment of transactional terms in the trust, or the incorporation by reference of buy-sell agreements or other documents. This may eliminate certain elements of a possible dispute; however, because the value of closely-held interests can fluctuate over time, the expression of terms in the trust will not guarantee the elimination of all elements of a possible dispute.
- § The establishment of a form and procedure for resolving any dispute between the trustee and trust. If the trustee is authorized to enter into the transaction, the question then becomes whether the terms of the transaction are “fair”. The settlor of the trust can provide a way that the parties will determine the settlor’s intent as to what will be fair (i.e., specifying valuation methodology or averaging appraisal prices).

Section 5 also purports to permit a trustee to proceed with a transaction if he has the written authorization of the interested parties. To rely upon that authorization, the trustee must provide the interested persons with notice of the proposed transaction, which includes at least the following information:

- § contact information for the trustee;
- § a description of the action proposed to be taken and an explanation of the reasons for the proposed action; and
- § the time at which the action is proposed to be taken.

Would the result in *Bender* have been different if the fiduciary was a trustee who gave notice of the proposed transaction to the beneficiaries? That is difficult to say. The notice would only have provided insurance for the trustee if the beneficiaries of the

trust affirmatively consented to the transaction. Based upon the reported facts of that case, it may be that no such consent would have been given.

The notice and consent may not be the best insurance, anyway. The notice and consent provisions of Section 5 incorporate by reference portions of the Uniform Principal and Income Act (the "Principal and Income Act"). This incorporation results in an uncomfortable fit. The Principal and Income Act contemplates actions by the trustee upon the acquiescence of the beneficiaries. Section 5 does not; the affirmative consent of all beneficiaries is required.

Neither Section 5 nor the Principal and Income Act identify the level of specificity required in the description of the proposed transaction. Trustees seeking to rely upon the notice provisions of Section 5 and their counsel should be concerned that if any fact which is even potentially material is omitted from the description given in the notice, the notice may be considered at best insufficient and at worst an act of constructive fraud.<sup>8</sup>

In the end, the most prudent counsel an attorney can give to his fiduciary client may be to step back behind the bright line, and get prior court approval for any conflict of interest transaction. Fiduciaries walk a path which is full of duties and is wrought with potential problems. The most significant service that counsel for a fiduciary can provide to his client is not to help him navigate this path quickly and expeditiously, but rather to navigate it safely and cleanly. There is peril in entering into a conflict of interest transaction, even if it is baldly authorized by the terms of a trust. There is also peril in relying on the consent of a beneficiary, if there can be any question as to the adequacy of disclosure or the fairness of the terms of the transaction.

Counsel should obviously consider the facts of any given situation before advising his or her client. However, the amendments to Section 5 do not change the safest and most conservative advice that an attorney can give to a fiduciary client contemplating a transaction in which he or she has a conflict of interest: get prior approval of the Court.

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1. The changes were enacted pursuant to P.L. 61-2006.
  2. "One of the most fundamental duties of the trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary, and must exclude all selfish interest and all consideration of the interests of third persons." *Massey v. St. Joseph Bank & Trust Co.*, 411 N.E.2d 751, 754 (Ind. App. 1987) (citing *Bogert, Trusts & Trustees*, §543, p. 197-98 (2d Ed., 1978)).
  3. "In order for Pearl [the trustee] to have violated the conflict of interest prohibition of Ind. Code 30-4-3-5, the following must be shown: (1) that Pearl or an affiliate of hers, either as an

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individual or as the trustee of some other trust, has an interest adverse to the main trust; and (2) that permission to allow her to exercise her trustee powers given the conflict of interest has not been given by the trial court.” *In re Trust of Loeb*, 492 N.E.2d 40, 44 (Ind. App. 1986).

4. One fact distinguishing *Bender* from I.C. §30-4-3-5 is the fact that the fiduciary in question was acting as personal representative. However, the Court of Appeals noted in its opinion that a personal representative is regarded as a trustee. *Bender*, 844 N.E.2d at 179. As such, the distinction is one without a difference.

5. *Bender*, 844 N.E.2d at 178.

6. *Meinhard v. Salmons*, 164 N.E. 545 (N.Y. 1929) (cited with approval at *Rigby v. Leister*, 261 N.E.2d 891, 893-94 (Ind. App. 1970)).

7. *See Teegarden v. Lewis*, 145 Ind. 98, 112 (1896).

8. I.C. §30-4-3-19 also generally relieves a trustee from a breach of trust, when the beneficiary consents. However, this remedy for a trustee requires that a beneficiary have adequate knowledge of the transaction (I.C. §30-4-3-19(b)(2)); further, the terms of any self-dealing transaction must still be “fair and reasonable” (I.C. §30-4-3-19(b)(4)).