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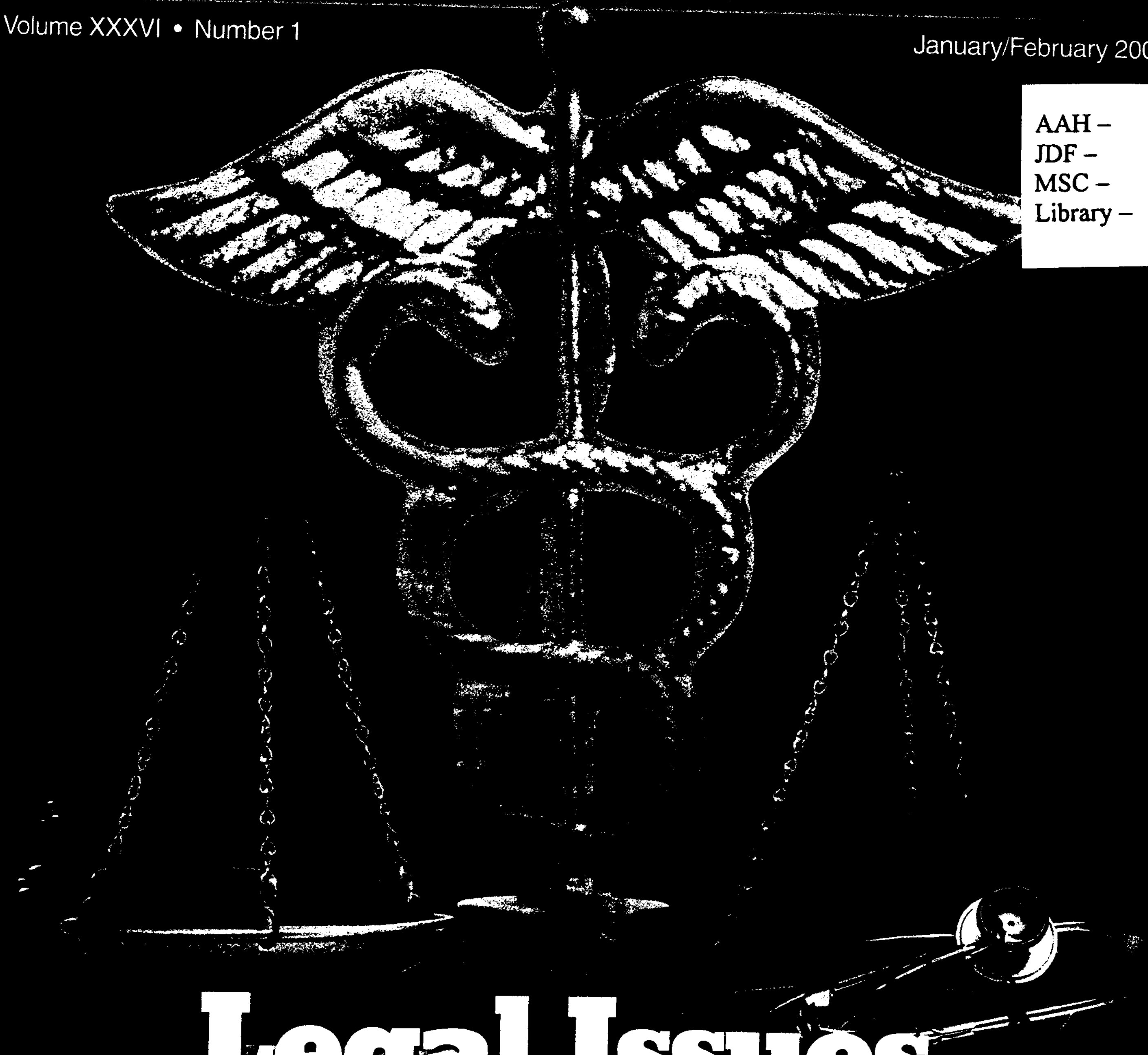

Legal Issues Surrounding Health Care

PRACTICE TIPS

The Lawyer As Trustee: Do Exculpatory Provisions Mitigate Liability Under Prudent Investor Standards?

Clients, from time to time, request their attorney to act as trustee. It is natural for the attorney who wishes to serve in a fiduciary capacity to want to mitigate liabilities. The question is whether today's attorney can comfortably rely on exculpatory provisions to achieve this objective in face of changes in the common law landscape brought about by Restatement 3rd, the Uniform Prudent Investor Act (UPIA) [Annotated Code §15-114], and in light of certain pronouncements by the Maryland Bar Committee on Ethics.

The ACTEC *Commentaries on The Model Rules of Professional Conduct* defines an exculpatory provision as "one that exonerates a fiduciary from liability for certain acts and omissions affecting the fiduciary estate. An exculpatory provision may properly be included in any document with the informed approval of the client. An exculpatory clause is often desired by a client who wishes to appoint an individual nonprofessional or family member as fiduciary." These individuals often serve without compensation. However, the courts have generally held that the lawyer (acting as a "professional trustee") will be held to a higher standard of performance than a layman. Additionally, in the words of Charles Rounds in the 2000 edition of *Loring A Trustee's Handbook* the lawyer-trustee "brushes with a conflict of interest."

Under common law of trusts governed by Restatement 2nd [§222], exculpatory clauses never relieved a fiduciary of liability for fraud, gross negligence and other egregious behavior. However, given the significant change in fiduciary standards and duties brought about by Restatement 3rd, and given current interpretations of the Model Rules of Professional Conduct, attorneys acting as trustees may find that exculpation clauses will not shield them from broad scope liability.

Consider, for example, the opinion of the Maryland State Bar Association's Committee on Ethics rendered on August 2, 1995. In response to an inquiry regarding the permissibility of acting as trustee while, simultaneously, providing the client with legal representation, the opinion states:

"...this Committee has previously concluded that the Rules of Professional Conduct allow an attorney to engage in a second "law-related profession...the Committee has consistently concluded, in the previously cited opinions, that an attorney who engages in a second related profession must comply with the Rules of Professional Conduct in that second profession."

At least two rules may have application to the attorney who receives compensation as trustee:

1. Maryland Rule 1.8(h) (Conflict of Interest: Prohibited Transactions) states "A lawyer shall not make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless permitted by law..."
2. Maryland Rule 1.1 (Competence) states "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary to the representation."

The interpretation of Rule 1.8(h) by the Committee on Ethics suggests that the lawyer-trustee cannot raise a defense against liability based on a theory that exculpation provisions shield the attorney by virtue of the fact that he is acting as a trustee and not as an attorney. Although this had been a successful defense in the Tennessee Court of Appeals case of *Petty v. Privette* [818 S.W. 2d 743 (Tenn. Ct. App. 1989)]; nevertheless, many jurisdictions hold to the position that when an attorney renders services (such as completion of forms in real estate transactions) which would not constitute practice of law if performed by a lay person, they are in fact practice of law when performed by an attorney.

A possible second line of defense argues that Rule 1.8(h) applies primarily to business situations where a client is either a counterparty or a business partner. By contrast, entering into a fiduciary relationship with a client is nonadversarial. Indeed, *The Report Of The Special Study Committee On Professional Responsibility: Preparation Of Wills And Trusts That Name Drafting Lawyer As Fiduciary* takes the position that: "Rule 1.7 should be regarded as the more relevant rule...." *The Report*, however, brings rule 1.8 back into play for "business transactions." Bringing back even part of rule 1.8, however, generates ambiguity (does the term "adverse" modify only "pecuniary interest" or does it modify "business transaction" as well?). According to some academic-oriented commentary, when the attorney-trustee receives compensation, it is difficult to argue that there is no business relationship. Finally, some commentaries stress that the idea that a drafter can exonerate himself from the duties inherent in a fiduciary office is abhorrent.

The extent to which Rule 1.8(h) applies to the lawyer-trustee remains an open question. Therefore, placing complete trust in exculpatory provisions when ethics committees have difficulty interpreting even the syntactical or denotative meaning of the provisions of the Rules of Professional Conduct is problematical. Although the Maryland Court of Appeals [*Sullivan v. Mosner* 295 A.2d 482 Md. 1972] upheld the validity of exculpation clauses with respect to short-term intervivos trusts used to supervise and manage the completion of a construction project, nevertheless, there is the public policy issue of "moral hazard" when these provisions are used for the benefit of a professional trustee. Moral hazard is a term common in the insurance industry and refers to the increased likelihood that an insured will be more likely to engage in dangerous or imprudent behaviors if he is indemnified against loss.

Rule 1.1, however, may have the greater relevance to this discussion. This is especially the case where a lawyer-trustee's actions (or lack of action in the area of investment performance monitoring and evaluation) injure the trust's beneficiaries who, in turn, cannot recover because of the existence of an exculpatory clause. Restatement 3rd exacerbates this problem because it creates new fiduciary standards by integrating Modern Portfolio Theory with the duties of trust administration.

Competent trusteeship now demands not only the willingness to provide appropriate administrative resources but also demands a deep understanding of complex and often non-intuitive principles of financial economics. The efficacy of exculpatory provisions must be reexamined in light of the profound changes in the very definition of the role of trustee.

The core of this change lies in the elevation of the importance of developing and implementing prudent investment policy and the unique linkage between investment responsibilities and the trustee function by augmenting the duty to diversify trust assets according to modern scientific principles. Professor Halbach, reporter for Restatement 3rd, emphasizes that a "major purpose of Restatement Third was to make sure fiduciaries could not escape liability for inadequate investment strategies."

Under the new standards of prudent trust administration, is failure to develop and monitor an "overall investment strategy...reasonably suitable to the trust" gross negligence? A *Trusts & Estates* article on "Diversification, Risk, and Modern Portfolio Theory," makes this argument in reference to a 1980 Pennsylvania case [Estate of Knipp, 414 A.2d 1007, 1007-10 (Pa. 1980)] where the trustee maintained an undiversified stock position that evidenced a level of risk more than 60 percent greater than the S&P 500 index [October, 1985, p. 36]. Restatement 3rd's emphasis on Modern Portfolio Theory significantly strengthens the plaintiff's ability to advance a "reckless indifference" [Uniform Trust Code §1008] argument. Trustee investment decisions must now be legally defensible, administratively reasonable, and academically justifiable.

One of the most significant changes in trust law is the repeal of the anti-delegation provisions of Restatement 2nd. Under Restatement 2nd it was clear that "A Trustee cannot properly delegate to another power to select investments." [§171] The prohibition against delegation effectively placed responsibility on the trustee for all aspects of trust administration (except for certain ministerial functions) including responsibility for investments. If, however, broad-scope exculpatory clauses were widely used by lawyer-trustees during a period when they retained liability for investment decisions, do these provisions have any justification under revised common law?

Trustees lacking investment experience or knowledge of financial economics are now encouraged to delegate investment responsibilities. Indeed, many commentators remark that there may be a duty to delegate investment functions where it is clear that the trustee is incapable of designing and executing portfolios appropriate to the purposes, terms, distribution requirements, and other circumstances of the trust. A primary justification for repeal of the prohibition against delegation of investment responsibility was to assist and protect non-professional trustees, serving without compensation, who lack a background in investment theory or a capacity to execute investment strategy. Offloading liability for competent portfolio design and management is no longer (if it ever was) an exoneration from an ancillary trustee function.

Additionally, the Uniform Prudent Investor Act makes it clear that delegation of investment responsibility is itself a fiduciary obligation: "The trustee shall exercise reasonable care, skill, and caution in (1) selecting an agent, (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust and (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation." The reporter continues: "...a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement."

We may soon have a judicial ruling on whether failure to uphold the general standards of prudent investment as promulgated in §227 of Restatement 3rd constitutes "reckless mismanagement;" or, in terms of UTC §1008 constitutes "reckless indifference to the purposes of the trust or the interests of the beneficiaries." If investment duties can be delegated, what is the rationale for retaining broad-scope exculpation provisions? If the presence of such provisions causes the lawyer-trustee to fail to exercise care, skill and caution with respect to the duty to invest prudently, does such a failure constitute gross negligence? Section 1(b) of the UPIA provides that "the prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust."

But there is a substantial difference between grantor-directed provisions for management of trust assets and grantor agreement to open-ended exculpation provisions that may or may not result in investment management that would be considered imprudent under modern trust law. In fact, the trustee may have a duty to seek court guidance in cases where grantor-directed instructions cease to make economic sense [*Green v. Lombard*, 343 A.2d 905, 28 Md. App. 1]. A court can decide to set aside or amend any trust provision if its further enforcement can be shown to harm the interests of trust beneficiaries [§15-114(f)]. Presumably, this power also extends to exculpatory provisions.

The increased emphasis in Restatement 3rd of the principles of prudence – i.e. trustee administration in accordance with Modern Portfolio Theory, would, absent any other factors, argue for a reassessment of §222 of Restatement 2nd. This section specifies the conditions under which a trustee may be relieved of liability for breach of trust. The official comment to subsection (3) indicates that, among other factors, the following are to be considered:

- Was the instrument drafted by the fiduciary or someone allied with the fiduciary?
- Was the settler experienced or inexperienced with business affairs, and further, does the settler have an understanding of the exculpatory provision?
- How reasonable is the provision itself?

Even if the attorney-trustee can demonstrate that the exoneration provisions were inserted at the direction of the grantor, the fact that most grantors are incompetent in the areas of investments and the skills necessary for successful portfolio management still leaves the court with potentially thorny issues in light of a trend towards increased emphasis on beneficiary protections. [The UTC, for example, tightens the criteria for determining the validity of exculpatory language by assuming that such provisions are presumptively invalid unless the trustee passes a two-fold test. He must: (1) prove that the exculpatory term is fair under the circumstances; and, (2) that its existence and contents were adequately communicated to the settlor.]

Both the provisions of §9 of the Uniform Prudent Investor Act and the Rules of Professional Conduct provide helpful guidance to the lawyer who wishes to provide trustee services to his or her client. It has long been recognized that trusteeship involves

- Mechanics (Administrative services),
- Investments (real property management as well as portfolio management); and,
- Discretion (distribution decisions according to powers granted by the trust instrument).

Likewise, it has long been recognized that law firms may have distinct advantages over other service providers with respect to the discretion functions of trusteeship. Not only do lawyers have an advantage regarding the legal interpretation of trust provisions, they may also have deep knowledge of grantor objectives and family dynamics by virtue of a long-standing relationship with the client. Absent capacity to provide tax, custodial and administrative services or absent employment of investment advisors along the model of some large Boston law firms, the lawyer may want to retain the discretionary functions and delegate most other tasks. Needless to say, prudent delegation of responsibilities obviates the need for blanket exculpation provisions.

There may be considerable opportunity for lawyers to act in the capacity as "trust protectors" and, to the greatest extent possible, work to assure that the delegatees are accomplishing the grantor's purpose. Otherwise, emphasizing a duty to delegate becomes merely a sale's pitch made by commercial fiduciaries to the referring lawyer despite the possibility that the commercial institution's investment performance may be substandard and their fees may be difficult to justify. As local and state bar associations work through acceptable standards of practice, it may be that the broad-scope boilerplate exculpatory language favoring the attorney-trustee will inevitably go the way of the dinosaur.

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Attorney GRIEVANCE COMMISSION

Gallimaufry II

In 1988, I authored a *Maryland Bar Journal* article entitled "Gallimaufry." Synonyms for that word are: "hodgepodge;" "medley;" "mishmash;" and my gastronomical favorite, "salmagundi." Fourteen years later, it is time for "Gallimaufry II." A play is often in three acts. This article is in three parts.

Part One

In the July/August 2002 issue of the *Maryland Bar Journal* I wrote about the subject of articles written by discipline counsel in other states. These are submitted to me as the single person committee for the National Organization of Bar Counsel, collecting articles and serving as a clearing house where others can obtain these articles when a similar problem discussed in these articles has surfaced in his/her state. The following articles were published in the period. January 2001 to June 30, 2002.

In the District of Columbia articles were authored about the perils of multi-jurisdictional practice (MJP); lawyers moving between firms; fee agreements; litigating a bar counsel complaint; advance waivers of conflicts of interest; keeping client's secrets; vicarious liability traps; and representation of impaired clients.

In Nebraska, Bar members were treated to a series of short but interesting articles. "Think before you speak – False accusations and cheap shots against judges." "An attorney's duty to disclose adverse cases." "Criminal Prosecutors – Unique Powers/Unique Responsibilities." Additional ones were about the duty of fairness and candor to a court and opposing counsel; ethical issues faced by criminal defense attorneys; when to speak and when to refrain from doing so; attorney advertisements; when you make a mistake; fees; divorce client and sex; and finally, one with the unusual title, "Denial is not a river in Egypt" (this one about alcohol use by attorneys).

Ohio's articles were about guidelines for the disposition of a law practice; ethics, loyalty and harm to third parties; unauthorized practice of law; and ten reasons why Ohio's ethics rules are unique.

Oregon's articles are always thought-provoking. One discussed whether an attorney admitted elsewhere could avoid the Oregon bar examination by practicing only "federal law." (See this issue raised in calls to me found below). Another subject was that of making contact with employees of represented entities [This issue has been the subject of several decisions by judges of the U.S. District Court in Maryland]. An update of MJP; what it means to be an "officer of the court"; and compensating a lawyer who also serves as a personal representative.

New York submitted an article in the *Harvard Journal of Law & Technology* which dealt with the practice of law over the Internet. Hawaii, an article on lawyers departing from law firms and copies of a three part series in a Hawaii newspaper on complaints to Hawaii's discipline office and claims made to Hawaii's client security trust fund.

Pennsylvania's lone article was on the subject of a judge as the enforcer of the Code of Civility. Massachusetts' articles dealt with fee payments by credit cards; ghostwriting pleadings; solicitation of clients; and post-verdict questions to jurors.

Part Two

The American Bar Association Survey on Lawyer Discipline for the year 2000 reflected the following information for states with a lawyer population close to or within 5,000 members of the lawyer population of Maryland. Total complaints (we report on a fiscal year July 1, 1999 to June 30, 2000) received in our office was 1,891. Connecticut reported a total of 1,174; Georgia, 2,076; Louisiana, 2,985; Missouri, 1,786. States with a larger attorney population, such as California, New York, New Jersey and Pennsylvania reported larger numbers; smaller states such as Delaware, Rhode Island, Idaho, the Dakotas, Wyoming and Montana had fewer total grievances inventoried.

The total lawyer population for all