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Self-Dealing Fiduciaries: What Is the Appropriate Standard?

C. Raymond Radigan and Jennifer F. Hillman

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The duty of loyalty has been held to require that trustees administer a trust solely in the interest of the beneficiary. Not even the slightest hint of self-dealing is tolerable in the relationship between a fiduciary and those whose interests he or she is to protect. As stated in *Meinhard v. Salmon*, "[u]ncompromising rigidity has been the attitude of the courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions."[1]

In attempting to address the problem of self-dealing, a bright-line prohibition has evolved in trust law so that where self-dealing is found, the court will make "no further inquiry." The fairness or unfairness of the transaction is "immaterial" and is simply not considered by the court.[2] The transaction itself is voidable by the beneficiaries.[3]

There is a debate waging in the legal community concerning whether the "no further inquiry" rule should be supplanted by a best interest standard. This article discusses the origins of the "no further inquiry" rule and why an inquiry into the best interest of the trust may be the more practical standard.

Origins of the Rule

The origins of the "no further inquiry" rule in New York are discussed in detail in *In re Kilmer*, 61 NYS2d 51 (Sur Ct 1946). In *Kilmer*, the executors of an estate needed to sell some of the estate's real property assets in order to pay estate taxes. The executors had the property appraised and then proceeded to market the property; however, they received very low offers. One of the co-executors believed that he could broker a deal for a higher price from F.W. Woolworth Company, but the other co-executors were hesitant to turn down any offer, even if it was low. The executors finally agreed to allow their co-executor to negotiate with Woolworth if the co-executor agreed to purchase the property for the amount of the low offer in the event the deal fell through. The deal with Woolworth did not come to fruition, so the co-executor bought the real property for the initial low offer, as promised.

Several years later, some of the estate beneficiaries sought to void the transaction, and the Surrogate's Court held in their favor. Upon review, the Surrogate acknowledged that he had "no doubt" that the transaction had been free of "any ulterior motive on the part of any of the executors."[4] Yet, the court still felt that "upholding…this sale would be a very bad precedent. It might well practically provide a blueprint to be followed by some fiduciary of a character less reputable than" these executors.[5]

In reviewing *Kilmer* and the cases cited therein,[6] the clear policy was against permitting any insertion, under any circumstances, of a trustee's own private interest into the management of the estate. The *Kilmer* court found that the idea of self-dealing was so

dangerous that it should never be permitted, unless the beneficiaries freely consented to the transaction or there was prior judicial approval. The court found that even in a case where there may be some persuasive special circumstances, the idea of self-dealing was simply too dangerous.

Scholarly Debate

In recent years, there has been some scholarly debate concerning whether the "no further inquiry" rule has a place in current trust law. For example, John Langbein, the Sterling Professor of Law and Legal History at Yale Law School, favored the elimination of the "no further inquiry" rule in his article, "Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest."[7] Essentially, Mr. Langbein argues that an "inquiry into the merits is better than 'no further inquiry.'"[8] If the trustee is able to prove that the transaction was prudently undertaken in the best interests of the beneficiaries, the transaction should be upheld, even if the trustee might or does derive some benefit.[9]

Mr. Langbein expands on this view and states that the rule is a remnant from a time when the courts had shortcomings in their fact-finding processes which made concealing a wrongdoing easier and that it fosters overdeterence.[10] Mr. Langbein further argues that trust law standards of loyalty should be more like the standards of loyalty that apply to corporate fiduciaries which protects corporate fiduciaries from liability for self-dealing if the fiduciary can prove that the transaction was fair to the corporation. The article notes that the potential difficulty of a beneficiary to monitor a trustee's actions does not justify the "no further inquiry" rule.[11] The article also points out that when a fiduciary seeks prior judicial approval of conflicted transactions, the "best interest" standard is utilized.

A vocal opponent to Mr. Langbein is Melanie Leslie, a professor at Cardozo Law School. In her article, "In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein,"[12] Ms. Leslie asserts that utilizing the best interest standard would be problematic because a trustee whose self-dealing actually harmed the beneficiaries could escape liability as long as the trustee could establish that he or she reasonably believed that the deal would prove to be in the beneficiaries' best interests.[13]

Among other arguments, Ms. Leslie argues that trustees of private trusts face fewer incentives to act in the financial interest of trust beneficiaries than other parties who face conflicts of interest. Typically, trust beneficiaries do not actively monitor trust behavior; they have fewer opportunities to sever the trust relationship; and market considerations play a more limited role in disciplining trustee behavior than they do in the case of the corporate fiduciary.[14] Ms. Leslie asserts that the "no further inquiry" rule with its bright-line prohibition and advance approval requirement, compensates for the unique vulnerability of trust beneficiaries.

A Fact-Specific Analysis

Adding to this debate is the very fact-specific nature of many of these types of transactions. The "no further inquiry" rule is solely to be utilized in cases where there is explicit self-dealing by the fiduciary. However, the distinction between self-dealing and a conflict of interest is not always easily distinguishable.

For example, in *Matter of Rothko*,[15] the executors of the estate of the famed artist entered into several improper contracts to sell various paintings. After a trial, two of the co-executors were found liable of such conflicts of interest that essentially amounted to self-dealing—even though they did not benefit directly from the sale of the paintings. The Surrogate applied the "no further inquiry" rule, but also made additional findings that the underlying transactions were not fair and were not in the best interests of the estate. The Appellate Division affirmed the Surrogate's Court with one minor modification, and made some additional comments.

In seeking a reversal, the appellants argued that the "no further inquiry" rule was improperly utilized because it only applies to cases concerning self-dealing, and not in a case of a conflict of interest where there is no self-dealing alleged. In affirming the lower court decisions, the Court of Appeals rejected this argument and found that the court had not relied solely upon the "no further inquiry" rule, but also considered and determined that the contracts were neither fair nor in the best interests of the estate.[16]

Rothko highlights the blurry line between conflict of interest and self-dealing. A conflict of interest is found when a fiduciary finds himself or herself in a dual role. A trustee may not place himself in a position where his or her own interests conflict, or possibly conflict, with the interests of the trust or its beneficiaries. Self-dealing by a trustee is one type of a conflict of interest. As such, a trustee is prohibited from profiting personally at the expense of the trust, or letting his personal interests in a transaction supersede those of the trust.

A Practical Approach

The desire for a "no further inquiry" standard was fueled by a desire for an effective punitive measure against any self-dealing by fiduciaries. However, it seems that the strict nature of the "no further inquiry" rule has not provided the appropriate level of deterrence. Even though the standard for the fiduciary duty of loyalty has been strict since the creation of trust law, there continue to be problems with fiduciary misconduct.

Moreover, even in the context of this attempt at strict liability, there is still necessary fact-finding that must occur. Inevitably, because of the very nature of these types of cases, any proceeding which argues that a fiduciary's actions were self-dealing will also argue that a conflict of interest occurred.

When a trustee does engage in self-dealing, the beneficiaries are entitled to choose among a variety of remedies including rescinding the transaction, damages and/or lost profits or appreciation damages.[17] Other than rescinding the transaction, each of the other remedies assumes that there were actually damages. If the transaction was indeed in the "best interest" of the trust or estate, there may not actually be calculable damages. Regardless, the blurred roles in the *Rothko* case further illustrate that an inquiry into the best interests may need to be undertaken in any proceeding where self-dealing is alleged, despite the strict nature of the "no further inquiry" rule.

Avoiding Liability

Allegations of self-dealing by a fiduciary are quite serious and, if found liable, the remedies are also quite severe.

In some instances, self-dealing is authorized by the language of the governing instrument. However, even the broadest exoneration provision will not provide unfettered exoneration for a self-dealing fiduciary. For example, in *O'Hayer v. de St. Aubin*, 30 A.D.2d 419 (2d Dept. 1968), the settler, in appointing his son a trustee, clearly wanted his son to retain the fullest control over the operation and continuation of the family corporations. The settler expressly stated that the general rule prohibiting self-dealing and individual profit by the trustee should not apply; and it was his "express wish and desire that my said son and myself shall benefit and profit from our trusteeships hereunder by the control of the majority of the stock of said corporations herein effectuated."[18]

Notwithstanding this broad language, the court still noted that a trustee is liable if he "commits a breach of trust in bad faith or intentionally or with reckless indifference to the interests of the beneficiaries, or if he has personally profited through a breach of trust."[19] Moreover, any exoneration clause will be strictly construed.[20] Thus, an exoneration clause may not protect a self-dealing fiduciary.

A fiduciary can also avoid liability if he or she receives prior judicial approval of an interested transaction, upon a full and complete disclosure of all relevant information by the fiduciary and where it is shown that it is for the benefit of the trust or estate. *Matter of Scarborough Properties*, 25 NY2d 553 (1969). See also Surrogate Court Procedure Act 2107(2) which provides that "the court may entertain applications by a fiduciary to advise and direct in other extraordinary circumstances such as…where there is conflict among interested parties…."

Self-dealing can also be authorized by beneficiary consent; however, the level of full and complete disclosure may come into dispute later. The best practice is to fully apprise the beneficiaries, receive their consent, and then seek court approval of the deal.

Conclusion

As detailed above, when reviewing the actions of an alleged self-dealing fiduciary, it may be more practical for the court to inquire into the best interests of the beneficiaries, rather than rely solely upon the strict liability of the "no further inquiry" rule. This approach allows the court to look at the totality of the circumstances and the actions by the fiduciary.

C. Raymond Radigan *is a former Surrogate of Nassau County and of counsel to Ruskin Moscou Faltischek.* **Jennifer F. Hillman** *is an attorney at the firm.*

Endnotes:

1. 249 NY 458, 464 (1928). This article is based on a research paper by Rosemary Harnisher, a student at St. John's University School of Law.

2. *In re Kilmer,* 61 NYS2d 51, 57 (Sur Ct Broome Co 1946).

3. Id. at 57.

4. Id at 55.

5. Id at 59.

6. See e.g., *Wendt v. Fischer*, 243 NY 439 (1926); *Meinhard v. Salmon*, 249 NY 458, 464 (1928); *In re Fulton's Will,* 2 NYS2d 917 (1938).

7. John Langbein, "Questioning the Trust-Law Duty of Loyalty: Sole Interest or Best Interest?" 114 Yale L.J. 929 (2005).

8. Id at 932.

9. Id at 932.

10. Id. at 945-946.

11. Id. at 957.

12. Melanie B. Leslie, "In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein," 47 Wm. & Mary L. Rev. 541 (2005).

13. Id. at 549.

14. Id at 558-563.

15. 43 NY2d 305 (1977).

16. Id at 319.

17. See e.g., *Matter of Rothko*, 84 Misc. 2d 830 (Sur Ct New York Co 1975); *Matter of Witherall*, 37 AD3d 879, 881 (3d Dept. 2007).

18. Id at 424-425.

19. Id at 424.

20. Id.
