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Learning from Disasters and Near Disasters

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Have you ever attempted to change lanes on a freeway only to discover that a large truck is barreling by, narrowly missing you, and sending your heart rate soaring? In the aftermath, you remind yourself that empty lanes can be filled up quickly and that you have to take extreme care not to end up as a headline. If this has happened to you, you possess the two essential qualities to become a successful risk manager: 1) you survived 2) you learned from your mistakes.

The market crashes of 2000 through 2002 are winding they way through the courts, testing the ability of judges to comprehend modern portfolio theory and the strictures of the Uniform Prudent Investor Act and providing many disasters and near disasters for fiduciaries. Whether the recent cases result in surcharge or exoneration, the real test for risk managers is to analyze these experiences to determine the steps that your institution can take to avoid repeating these unpleasant experiences.

A review of recent surcharge decisions illustrates that the outcomes are often the result of chance—sophisticated or confused judges, inept plaintiff's or defense counsel, sympathetic or distasteful witnesses or experts, and the length of the chancellor's foot.

"('Equity is a roguish thing. For Law we have a measure, know what to trust to; Equity is according to the conscience of him that is Chancellor, and as that is larger or narrower, so is Equity.' 'Tis all one as if they should make the standard for the measure we call a "foot" a Chancellor's foot; what an uncertain measure would this be! One Chancellor has a long foot, another a short foot, a third an indifferent foot. 'Tis the same thing in the Chancellor's conscience') Despite the imprecision of some of the standards we apply in equity, we can only conclude, under any standard, that the [defendants] would unjustly benefit in the absence of a constructive trust. Accordingly, we reverse the decision of the court of appeals." *Estate of Cowling*, 109 Oh. St. 3d 276, 284, 847 N.E.2d 405 (Ohio , 2006)(emphasis), citing John Selden, Table Talk(1689).

The judge often decides what is just under the circumstances and then writes his or her opinion accordingly, structuring the recitation of facts or legal approach to support a defensible judgment by circumventing pesky precedents, statutes and inconvenient facts. A rash of recent cases come to very different outcomes based on the peculiar facts of each case and the length of the chancellors' feet in each case. This makes it most difficult to predict outcomes based on supposedly uniform laws and application of the Restatements and common law. One must not take comfort in near misses or despair at a surcharge—instead the task of the risk manager is to figure out how to set up procedures and policies so that one never has to confront the

chancellor's foot and the sublime pleasure of paying attorneys to accompany you to depositions and trials and appeals.

Courts of Appeal are often anxious to resolve cases in which there has been some error demonstrated, but with little prospect of victory on a remand. Hence they may affirm on some other basis so long as the right result was achieved, under the "tipsy coachman" doctrine. *Arthur v. Milstein*, ___S.2d___, 2007 WL 602630 (Fla. App. Feb. 28, 2007) (authorizing the guardian ad litem for Dannielynn Hope Marshall Stern to decide on the disposition of the body of the infant's deceased mother).

1. Modern Dispute Resolution

Civility between litigation attorneys has fallen to such lows that Congress appears to be a haven of good will and cooperation in comparison. The federal district court in the Middle District of Florida found a unique dispute resolution methodology for one such intractable dispute whether a deposition should be taken in the office of the plaintiff or the defendant. The court resolved this enormous controversy by ruling that:

"If counsel cannot agree on a neutral site, they shall meet on the front steps of the Sam M. Gibbons U.S. Courthouse, 801 North Florida Ave., Tampa, Florida 33602. Each lawyer shall be entitled to be accompanied by one paralegal who shall act as an attendant and witness. At that time and location, counsel shall engage in one (1) game of 'rock, paper, scissors.' The winner of this engagement shall be entitled to select the location for the 30(b)(6) deposition...." *Avista Management, Inc. v Wausau Underwriters Ins. Co.*, 2006 WL 1562246 (M.D. Fla, June 6, 2006). Specialists opined that most attorneys lead with the "paper" alternative, providing a clear defensive approach. We will await word of the success of this ADR.

2. Investment Discretion

As the Restatement (Third) of Trusts §227, com. g pointed out, "Whether and to what extent a specific investment authorization may affect the normal duty to diversify the trust portfolio (see §227 comment *g*) can be a difficult question of interpretation."

The truth of this statement has been proven in spades in a series of recent decisions, many of which pay little attention to the fundamentals of interpretation and the Prudent Investor Rule. The trustee must carefully review the terms of the trust (and extrinsic evidence in some jurisdictions) to parse and interpret varying provisions:

Mandatory investment directions or permissive investment directions or precatory language

Grants of investment powers: to invest, retain original assets, to hold assets or classes of assets in disproportionate amounts, or withholding of powers to invest or diversify

Discretionary grants: sole/absolute/unfettered versus ordinary discretion

Exculpatory language: limiting liability for ordinary negligence versus exculpating for failing to diversify or for retaining certain assets

Impact of the UPIA on standards of care

Statutory or common law restrictions on arbitrary or capricious or self-dealing conduct in investments

Statutory or case law liability for the failure to exercise discretion

This is not a new issue. Diversification was held to be the duty of trustees under Restatement (Second) of Trusts §228 (1959), although there were a paucity of cases finding liability in those happier times. Section 227 of the Second Restatement distinguished between **mandatory directions** in a trust (which should be followed unless contrary to public policy or there was a change of circumstances requiring instructions from the court), §227, com. q, and those which were merely permissive and subject to the duty of prudence:

If he is merely authorized to make certain investments, he has a privilege but not a duty to make such investment; if he is directed to make such investments, he has not merely a privilege but a duty to do so." Restatement (Second) of Trusts §227, com.t.

The Restatement (Third) of Trusts and the adoption of the Uniform Prudent Investor Act have clouded the picture even further, placing on trustees a standard of care which sets a benchmark for the conduct of the trustee in making investment decisions. As the Court held in *Matter of the Estate of Janes*, 630 N.Y.S.2d 472, 477 (N.Y. Sur. 1995), "In reality, the bank's responsiveness to the admittedly turbulent and precipitous tenor of the times (1973) was to do nothing. To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person where action and activity are indicated, tests the Court's sense of reason and logic and more importantly flies in the face of the surcharge cases heretofore cited."

The requirements of the Third Restatement (§27(2)) and the UPIA (§5) that the trust should be invested solely in the interests of the beneficiary, cause closer scrutiny of the investment conduct of the trustee, when diversification is not followed. **"A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.**" UPIA §5, comment.

Retention clauses are generally treated as mandatory or permissive. "When a term of the trust merely authorizes a particular investment, or a particular type or pattern of investment, the provision is permissive rather than mandatory." Restatement (Third) of Trusts §228, com. f. at 106. That commentary goes on:

"The distinction between permissive and mandatory provisions may be significant in several ways. A trustee is not under a duty to make or retain investments that are made merely permissive by trust provision. Less clear is the degree to which the trustee may have to give special consideration to specifically authorized investments, as against simply omitting them from serious consideration. This is a question of interpretation of a particular provision.

"In any event, the fact that an investment is permitted does not relieve the trustee of the fundamental duty to act with prudence. The fiduciary must still exercise care, skill, and caution in making decisions to acquire or retain the investment." *Ibid.*

Where the language is mandatory, the trustee still faces some risk if circumstances unanticipated by the trustee pose risks to the purposes of the trust. Under Restatement (Second) of Trusts §167(1959), such deviation from the trust where "compliance would defeat or substantially impair the accomplishment of the purposes of the trust..."

Under Restatement (Third) of Trusts §66 (2003), modification is now permissible if it would "further the purposes of the trust." Section 66(2) provides an express duty of the trustee to seek instructions in such circumstances:

"If a trustee knows or should know of circumstances that justify judicial action under Subsection (1) with respect to an administrative provision, and of the potential of those circumstances *to cause substantial harm* to the trust or its beneficiaries, the trustee has a duty to petition the court for appropriate modification of or deviation from the terms of the trust." (emphasis added). The protection of the beneficiaries is the paramount concern, not servile adherence to mandatory requirements which are undercut by changes in the investment, in the market, or in the needs or risk tolerance of the beneficiary.

Delay in Diversifying a CRUT: Cost $1,040,222
Procedural Prudence: Priceless

In *Fifth Third Bank v. Firstar Bank, N.A.*, 2006 WL 2520329 (Oh. App. Sept. 1, 2006), *app. not accepted* 860 N.E. 2d 768 (Oh. 2007), a jury surcharged Firstar for failing to diversify a concentrated position within one year. The trial court had removed the initial trustee, appointing Fifth Third Bank as successor trustee. Fifth Third and the Ohio Attorney General prosecuted the case.

The court of appeals upheld judgment against the corporate trustee of an 8% charitable remainder unitrust funded with stock of Proctor and Gamble (P&G). The charities, including The Hole in the Wall Gang, were not too charitable when the trust lost half its value. The Court on appeal found that, according to the settlor, the trustee "understood that one purpose of the CRUT was to diversify out of the P&G stock." The settlor, a descendant of a founder of Proctor and Gamble, had earlier suffered a substantial loss when some of her P&G shares were stolen and subsequently sold, leaving her with a substantial capital gains. She attempted to ameliorate this situation by transferring $2 million of her remaining P&G stock to a CRUT for her benefit. Her purpose thus was to get a charitable deduction, but also to replace her embezzlement losses with a constant income stream, without incurring additional capital gains. Hence the income beneficiary of the trust had a reason to seek diversification out of P&G in order to safeguard her income from a deterioration in the value of P&G.

The trustee did not liquidate the concentrated position immediately, but made monthly sales. However, when the price of the stock dropped, the investment officer postponed sales, waiting for a rebound. Hence, what should have been a signal of increased risk for the stock

was taken as a reason to assume more risk by retaining the concentrated position. In fairness to the trustee, this is a strategy for some corporate trustees, delaying sales until market upticks, but taking the risk that there will be none. Indeed, there are a number of computerized liquidation strategies offered by trustee's which seek to harvest market upticks, indeed many of them increasing sales volumes when a stock moves up by a standard deviation or more. However, some of these models also trigger sales when there are drops in value, based on the premise that momentum should not be fought when there is need to diversify. Since one cannot know whether a drop in price is simply the result of noise or signals a slide into the abyss, a price drop is often taken as a sell signal. Other diversification models include periodic sales, with the goal of liquidating the position within a specific time frame irrespective of the price movements of the concentrated investment. An informal survey of corporate trustees by the author found that most liquidated concentrated positions in taxable trusts over more than one tax year.

Since the price movement of individual stocks is highly impacted by firm-specific events, with major downside moves resulting from adverse information, the general goal of diversification is to eliminate this firm-specific risk by diversifying into the broad market, whose price reflects the general market risk. In the taxable estate, the capital gains tax may pose a rationale for staggering sales over multiple tax years, if the volume of sales will lead to higher marginal brackets. With the end of capital gains inclusion for AMT computation, and high trust tax rates, the rationale for delay has been lessened. Principal lost to capital gains taxes can earn no returns; however this requires an analysis of the opportunity cost of the reinvested funds. Depending on the purposes of the trust, the funds can be reinvested for income, principal appreciation or total return, more closely meeting the needs of the trust beneficiaries. However, the major risk of a concentration generally presented is of substantial loss of principal, not the failure to earn higher returns. The individual investor can rebound from investment losses by earning more money from employment and placing it back into the investment fund, the trust cannot. It is a closed universe. The comparable analysis is to an elderly investor who has no way of earning surplus capital and hence has a low risk tolerance for losses in his or her portfolio.

In the charitable trust context, tax considerations are generally not relevant. The issue of risk to principal is hence paramount. The charity may wish to assume some risk in the portfolio in order to generate sufficient total return in order to prevent the annual distributions to the CRUT beneficiary from cannibalizing the portfolio. However, a diversified portfolio is more likely to produce such an investment strategy than a single stock. A failure to diversify may doom the charity's interest if the mix of income and growth is unlikely to meet a large annual deduction. The appellate decision in *Fifth Third* does not delve into such issues because the case was presented to a jury. Instead, it looks to the issues of due diligence under the UPIA as a proper basis for the jury to find imprudence in the diversification process. The successor trustee had presented evidence that the investment officer had "failed 'to verify facts relevant to the investment and management' of the CRUT, as required" by the Ohio UPIA. Evidence had also been presented that the investment officer "did not take into consideration the economic conditions, the tax consequences, and the need for liquidity when he chose to sell the P&G stock gradually over the course of a year. This evidence was sufficient to create questions of fact that were properly resolved by the jury." 2006 WL 2520329 at *5.

The failure to follow the procedural requirements of the UPIA thus raised a jury question in this case, dooming the trustee at the trial and intermediate appellate court levels. It is not clear whether this decision will be reviewed by the Ohio Supreme Court (which now has a number of inconsistent intermediate court decisions ripe for harmonization).

Moreover, such procedural steps are designed to compel trustees to evaluate what the proper strategy should be. Going back to basics and placing the investment decision in context can compel a cautious investment officer to confront the risks of a decision to delay diversification in hopes that the price will come back.

By the end of the first year, the value of the trust had fallen by 50% from the start of the year. Faced with evidence of substantial losses in P&G and of procedural imprudence in implementing the diversification process, the jury which tried the case awarded damages of $1,040,222.

The court on appeal affirmed the judgment. It also held that the participation of the Ohio Attorney General in the matter had been proper, even though the A.G. had not initiated the proceeding. 2006 WL 2520329 at*2. The Trial Court had allowed testimony of expert witnesses on the reason why the CRUT did not mandate diversification. The Court on appeal held that the instructions were proper and that the Court had warned the jury that they were to follow the Court's instruction on the law, rather than that of a witness. Moreover, the Court held that the trustee "opened the door to much of the testimony when it suggested that the CRUT did not require it to diversify." 2006 WL 25210329 at *3.

In upholding the denial of a JNOV (Judgment Notwithstanding a Verdict) by the bank, the court noted its recent decision in *Wood v. U.S. Bank*, 828 N.E.2d 1072 (Ohio App. 2005) that even if the instrument allowed a trustee to "'retain' assets that would not normally be suitable, the trustee's duty to diversify remains, unless there are special circumstances...In this case, the CRUT provided in part that '[t]he trustee shall have expressly the following powers * * * to retain, without liability for loss or depreciation resulting from such retention, original property,...although it may represent a disproportionate part of the trust.' **We conclude that this language did not clearly indicate the intention to abrogate the duty to diversify.**" 2006 WL 2520329 at *4 (emphasis added).

Retention clauses are generally treated as mandatory or permissive. "When a term of the trust merely authorizes a particular investment, or a particular type or pattern of investment, the provision is permissive rather than mandatory." Restatement (Third) of Trusts §228, com. f. at 106. That commentary goes on:

"The distinction between permissive and mandatory provisions may be significant in several ways. A trustee is not under a duty to make or retain investments that are made merely permissive by trust provision. Less clear is the degree to which the trustee may have to give special consideration to specifically authorized investments, as against simply omitting them from serious consideration. This is a question of interpretation of a particular provision.

"In any event, the fact that an investment is permitted does not relieve the trustee of the fundamental duty to act with prudence. The fiduciary must still exercise care, skill, and caution in making decisions to acquire or retain the investment." *Ibid.*

Where the language is mandatory, the trustee still faces some risk if circumstances unanticipated by the trustee pose risks to the purposes of the trust. Under Restatement (Second) of Trusts §167 (1959), such deviation from the trust where "compliance would defeat or substantially impair the accomplishment of the purposes of the trust..."

Under Restatement (Third) of Trusts §66 (2003), modification is now permissible if it would "further the purposes of the trust." Section 66(2) provides an express duty of the trustee to seek instructions in such circumstances:

"If a trustee knows or should know of circumstances that justify judicial action under Subsection (1) with respect to an administrative provision, and of the potential of those circumstances to cause substantial harm to the trust or its beneficiaries, the trustee has a duty to petition the court for appropriate modification of or deviation from the terms of the trust." (emphasis added). The protection of the beneficiaries is the paramount concern, not servile adherence to mandatory requirements which are undercut by changes in the investment, in the market, or in the needs or risk tolerance of the beneficiary.

Time to Diversify

In *Matter of Estate of Janes*, 90 N.Y. 41, 359 N.Y.S.2d 165 (1997), the court held that the proper time to diversify is a question of fact, holding in that case that diversification should have been undertaken when first started to sell the concentrated stock to generate cash for anticipated needs of administration two months after appointment. In *Estate of Saxton*, 696 N.Y.S.2d 573, aff'd 274 A.D. 110, 712 N.Y.S.2d 225 (2000), the court followed *Janes* and based damages on the failure to liquidate the concentrated position within 30 days. *Donato v. BankBoston, N.A.*, 110 F.Supp.2d 42 (D. R.I. 2000), held that immediate liquidation was not mandated when the stock in question was thinly traded and hence could not be sold without incurring reduced prices, particularly when the beneficiary who had become successor trustee had failed to liquidate the balance of the stock held in the trust.

Hence, the requirement to diversify in a period shorter than a year is consistent with New York decisions involving liquid stocks traded on major exchanges. Because the damages were computed by the jury, the *Fifth Third* decision does not present a specific time frame for required diversification. As will be seen below, other recent cases have been more flexible is assessing damages for a failure to diversify.

Fifth Third is also consistent with another major case involving diversification in charitable trusts. In *Matter of Estate of Rowe*, 274 A.D.2d 87, 712 N.Y.S.2d 662 (2000), the court dealt with a charitable lead trust which was required to distribute 8% of its tax value annually for 15 years, and then distribute the balance to the remaindermen. The trust was funded entirely with IBM stock, valued at the time of funding at $117 per share. The Trust Committee of the corporate fiduciary made an initial review of the trust in 1989 but concluded "that it would be

imprudent to diversify immediately, but gave its approval to a plan of diversifying at a later time when the stock had reached a higher price." (emphasis added). 712 N.Y.S.2d at 664. While some sales were made (when the stock moved up), by 1994 two thirds of the initial shares were still held in trust, valued at $74 per share.

The trial court surcharged the trustee, awarding compound interest to the value of the stock, then deducting the value at the close of the account or at the time of sales, as well as dividends received. Retention of the stock was held imprudent, in part because the dividends were less than the required annual distribution, necessitating the sale of stock to meet distributions. Since harvesting corpus to support annual distributions is the mantra of the unitrust acolytes, one must wonder whether such principles will save a trustee from surcharge when the investments are unsuitable and fall in value, leading to excessive sales.

In affirming the surcharge, the Court cited the plaintiffs' expert who stated "that petitioner's tactic of waiting for the IBM stock to rise was based on '**wishful hoping**' and that any hesitancy on the part of petitioner to sell the IBM stock below acquisition costs was a 'cosmetic kind of consideration.' Finally, [expert] testified that the use of call options increased the risk of the portfolio." 712 N.Y.S.2d at 665 (emphasis added).

Investment and risk officers must be reminded that delaying diversification may be "wishful hoping" for positive movements in a concentrated stock, a risk which the UPIA and Third Restatement of Trusts considers "uncompensated risk." If you allow your investment officers to take on uncompensated risk, the bank may end up compensating the trust when such risk is realized.

Nine-Month Diversification

The decision in *Americans for the Arts v. Ruth Lilly CRAT*, 855 N.E.2d 592 (Ind. App. 2006) poses a variety of contrasts with *Fifth Third.* This trust was funded with Eli Lilly stock, valued at $286 million, with National City Bank of Indiana diversifying the portfolio within nine months of funding. The stock fell precipitously, as did many other blue chips in 2002. The size of the position thus created the potential for enormous damages if the precedents of *Janes* and *Saxton* had been followed.

The trustee successfully defended its investment plan on summary judgment and was upheld on appeal, citing trust language allowing it to retain assets, as well as an exculpatory clause. The retention language allowed the trustee "To retain indefinitely any property received by the trustee and invest and reinvest...and any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments." 855 N.E.2d at 595. Under *Fifth Third* this might have been construed as not imposing a mandatory retention, but rather allowing inquiry into the prudence of the conduct. The "good faith" exculpatory provision proved decisive here. There was no claim of bad faith, and hence the decision turned on whether the insertion of the exculpatory provision by the trustee was proper.

Here the terms of the trust had been negotiated with the charitable foundations, including the exculpatory and retention language. The Court on appeal found that "[a]t the time the parties were negotiating the terms of the CRATs, National City had neither taken nor contemplated taking an action that would constitute a breach of trust. That is simply not the issue. National City and the probate court afforded the appellants and their attorneys every opportunity to question or object to every facet of the proposed estate plan. The appellants chose not to quarrel with any portion of paragraph 10(b), and they are not now entitled to turn back the clock and claim that, in hindsight, the clauses are problematic and unenforceable." 855 N.E.2d at 597-598.

While not mentioned by the Court, the issues it considered in determining the propriety of the exculpatory clause in the trust tracks the terms of Uniform Trust Code §1008, which invalidates exculpatory clauses which relieve the trustee of liability for breaches "committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiary," which are inserted in the trust as a result of an abuse by the trustee of a confidential or fiduciary relationship.

The court also rejected a claim that even if the beneficiaries had approved the trust language, the trustee bears the burden of proving the "substantive fairness" of the exculpatory clause. The court rejected this argument, distinguishing the cases cited by the charities: "[W]e conclude that these cases are distinguishable inasmuch as they involve self-dealing fiduciaries who exerted undue influence over a subordinate party to take advantage of a position of trust." "Under those circumstances, the burden deservedly shifts to the fiduciary to prove that the transaction was fair. Here, on the other hand, the bank owed no duty to the appellants at the time of the drafting of the CRATs, the appellants participated in the drafting, there is no evidence of self-dealing by National City, and the probate court approved the CRAT document. Thus, the bank has no obligation to prove the substantive fairness of the Exculpatory Clause." 855 N.E.2d at 598-99. The court also rejected the general attack based on the "benefit" obtained by the trustee by inserting the exculpatory clause: "We observe, however, that there is no evidence that National City 'benefited' from the insertion of paragraph 10(b). Its failure to diversify the assets of the CRATs did not result in a windfall or a profit of any kind to the bank. Unlike the cases to which a trustee is found to have engaged in self-dealing, here, National City did not receive a profit or benefit at the expense of the beneficiaries of the CRATs. Thus, even if we were to conclude that the bank is required to establish the substantive fairness of the clauses at issue, we see nothing in the record tending to suggest that it would be unable to make such a showing." 855 N.E.2d at 599.

The Court ignored the provisions here of UTC §1008(b) which place the burden on the trustee who drafts or causes the exculpatory clause to be drafted, making it invalid unless the trustee proves it was "fair under the circumstances and that its existence and contents were adequately communicated to the settlor." Ohio's version of the UTC did not go into effect until 2007. Some jurisdictions do not make such a trustee drafted clause invalid, but rather subject it to strict scrutiny, while others follow the Restatement position that such clauses provide a benefit to the trustee by reducing their standard of care and hence provide a benefit to the trustee which must be examined for its fairness.

Dealing with the Obdurate Co-Trustee

The Orphan's Court decision, *In re Rosenfeld Foundation Trust*, 2006 WL 3040020 (Pa. Com. Pl. July 31, 2006), provides another complex set of facts leading to surcharge for individual trustees but exoneration for Wachovia Bank as co-trustee. The trust had been funded with stock of Pep Boys, a car parts retail chain. The trust had been created in the 1950's and risen substantially from its funding value. However, in the late 1990's, the Pep stock began to decline with the earnings of the company, severely underperforming the S&P 500. This prompted the corporate trustee to wring its hands in its Reg 9 reviews starting in 1995, but not to create a clear record at the time of pressing the individual co-trustees, including two directors of Pep, to diversify. One individual trustee joined the bank, but they were blocked by the vote of the two other trustees, creating a deadlock that was not resolved before substantial losses were sustained. Because of the fall in value of the trust corpus from $15 million to $2 million (before a rebound), the distributions to the charities were severely compromised during this period. While the stock later rebounded, it had lost a substantial portion of its value.

In 1997, the bank wrote to the co-trustees proposing a two-year diversification program, moving to 65% stocks and 35% bonds. The equities were to be split between the S&P 500, midcaps, and international stock. The Court found that the two-year diversification program was appropriate since it was designed to win over the "obdurate" insiders who refused to contemplate sales: "In suggesting the timing for selling Pep Boys stock, the bank was constrained by its authority under the terms of the trust document, the history of animosity among its co-trustees, and its consequently limited role as intermediary. Based on these facts, it was therefore not imprudent for the bank to suggest a two year span for diversification with the option of accelerating the process since its most pressing goal was to win over the Rosenfelds who might easily be alarmed by a too rapid sale of the Pep Boys stock." 2006 WL 3040020 at *25. In 2004 the Court granted summary judgment in favor of the bank and the case proceeded against the two objecting trustees.

The Court surcharged the individual trustees, although it used a constrained measure of damages, looking to the time of the bank's 1997 letter as the starting point for damage calculations. The court rejected the individual trustee's claim that a retention provision exonerated them. The court cited *Estate of Knipp*, 489 Pa. 509, 414 A.2d 1007 (1980) for the proposition that retention language did not abrogate the duty of prudence: "even where the testator gives a fiduciary discretion to retain assets, the decision to retain those assets must still be prudent. [*Knipp*], 489 Pa. At 513, 44 A.2d at 1009." 2006 WL 3040020 at *14. It also rejected the claim that since the trust was worth more than its inception value, no losses could be assessed, looking to damages based on what the trust would have earned but for the breach, citing *Appeal of Sky Trust*, 868 A.2d 464 (Pa. Super. 2005) and *Estate of Scharlach*, 809 A.2d 376 (Pa. Super. 2002), 2006 WL 3040020 at *21-22, and surcharging the two co-trustees who had blocked diversification for $593,546, 2006 WL 3040020 at *30. The court also made the trustees pay the expenses of the corporate trustee: "In the instant case, it was the obdurate refusal of the Rosenfelds to perform their duties as Trustees of the Foundation that necessitated the prolonged litigation. As a matter of equity, it would be unconscionably unjust to charge the charitable beneficiaries with the costs incurred due to the dysfunctional breakdown of communication and cooperation among the Trustees whose duty it was to safeguard the interests

of the beneficiaries. If the costs of defending a surcharge action among trustees can be passed on to the charitable beneficiaries of a trust, there is no incentive for the trustees to make rational compromises and decisions. They would thus [be] immunized from costs of venting their discord through endless litigation." 2006 WL 3040020 at *40.

In other jurisdictions, trustees faced with a deadlock on investment decisions might face removal and surcharge. For example, in *Lynch v. John M. Redfield Foundation,* 9 Cal.app.3d 293, 88 Cal.Rptr 86 (1970), the trustees were held liable for damages from a failure to invest trust funds where they had unreasonably delayed in seeking instructions to resolve various impasses preventing them from making proper investments. The 1992 revisions to former §184 in the Third Restatement state in comment c that "if, however, the non-participating trustee or trustees have reason to believe that the responsible trustee or trustees may be committing or about to commit a breach of trust, the non-participating trustee or trustees have a duty to take reasonable steps to investigate and, if necessary, to prevent breach of trust." Restatement (Third) of Trusts, Prudent Investor Rule, at 150.

The Chicago School

For the Chicago viewpoint on the duty to diversify, *see Summers v. State Street Bank & Trust Co.*, 453 F.3d 404 (7th Cir. 2006), where diversification by the custodial trustee of the United Airlines ESOP was at issue. The court argued that even after public announcements of a possible bankruptcy, the custodial trustee under ERISA, dealing with an ESOP, was not obligated to sell the stock since the price of the NYSE stock "provides the best estimate of the value of the stocks traded on it that is available to him." 453 F.3d at 408. The Court held that "it would be *hubris* for a trust company like State Street to think it could predict United's future more accurately than the market could, and **preposterous for a committee of union officials (the named fiduciary) to challenge the market's valuation**.[emphasis added] Nor was State Street duty-bound to offer the Committee's members a tutorial on the obligations of an ERISA trustee; the Committee had its own lawyers for that." *Ibid.*

The Court did note that if any sales had taken place, "the stock held by the ESOP is a very large fraction of the outstanding stock of the employer, as in this case, the sell-off would have to be gradual in order to avoid precipitating a sharp drop in price, Louis K. Chan & Josef Lakonishok, 'The Behavior of Stock Prices Around Institutional Trades,' J. Finance 1147, 1147-48 (1996); the market does not treat the stocks of different companies as being perfectly substitutable." A similar approach was taken with respect to a thinly traded stock by the District Court in *Donato, supra*, however this is one of the first decisions to provide an econometric support for staging sales to prevent a precipitous drop in prices. In any large capitalization stock in a liquid market, e.g. IBM on the NYSE, the time need to ease through a large block sale is represented by days not months. Here the ESOP's position was not only a huge proportion of outstanding stock but it was highly visible and the decision to sell would have had major market impact as traders reacted to a sale by the largest shareholder.

The principle espoused by the *Summers* court would argue that if one is foolish enough to hold any individual stock, trades make no sense since the market will always perfectly price the stock and it would be overweening pride of Homeric proportions for a trust company to think it

could predict the performance of an individual stock (let alone preposterous for lay persons to do so) and hence passivity is prudence. Judge Posner is, of course, the author of the seminal article on the fiduciary's duty to invest in index funds, and his ardor for Modern Portfolio Theory remains unabated by empirical evidence. Whether this result has any relation to the real world outside of ERISA cases in the Seventh Circuit remains to be seen.

This is good news for State Street, which faced a difficult problem because of the crisis at United, whose management used the threat of bankruptcy to attempt to coerce concessions by its union members, who owned a large portion of the trust in the ESOP. The impact of that threat combined with the poor fundamentals of the airline industry and United after 9/11, combined to destroy the value of the stock. The custodian lacked the authority to overrule its directing trustees, who were locked in a difficult and ultimately fruitless negotiation with management over their compensation.

In a stunning reversal, the appellate division overturned the $20 million surcharge decision in *Matter of Dumont*, 4 Misc.3d 1003(A), 2004 WL 1468746 (Surr. Ct. 2004), *rev.*, 809 N.Y.S.2d 360 (A.D. 2006), and appeal was denied by the New York Court of Appeals, *In re Judicial Settlement of Chase Manhattan Bank, leave to appeal den.* 822 N.Y.S.2d 753 (N.Y. 2006), *rearg. den.*, F N.Y.3d 922, 860 N.E.2d 993 (N.Y. 2006).

The trial decision dealt with a trust which appeared to have precatory language in which the testator expressed: "It is my desire and hope that said stock will be held by my said Executors and by my said Trustee to be distributed to the ultimate beneficiaries under this Will, and neither my Executors nor my said Trustee shall dispose of such stock for the purpose of diversification of investment and neither they [n]or it shall be held liable for any diminution in the value of such stock." 2004 WL 1468746 at *1 The next sentence, however, provided that "The foregoing...shall not prevent my said Executors or my said Trustee from disposing of all or part of the stock of [Kodak] in case there shall be some compelling reason other than diversification of investment for doing so." *Ibid.* The trustee had routinely sold stock to pay for trustee fees.

The trial court had found: "There is no disputing the fact that the language which authorizes the sale of stock is worded much more strongly than the language which urges retention. In fact, the empowerment language is written using mandatory terms whereas the retention language which relies upon the phrase it is my 'desire and hope' is clearly precatory. Precatory phrases are not binding on a fiduciary (see discussion in Warren's Heaton on Surrogate's Courts, § 187.02[8][a]), and Dumont's words 'desire and hope', have even less proverbial teeth than precatory phrases at issue in prior cases. See, *In re Flanagan*, 184 Misc. 938, 55 N.Y.S.2d 200 (1945)." 2004 WL 1468746 at *6.

On appeal, the court held that the Objections to the accounting stated two "compelling reasons" for sale of 95% of the stock by the end of January, 1973, basing its allegations on the holding in *Matter of Janes*, 90 N.Y.2d 41 (1997). Those allegations were that the concentration of the portfolio in a single stock and the miniscule income yield were compelling reasons for sale of the stock as of the end of January, 1973. The trial court had cited a number of procedural prudence bases for a finding of liability, including the failure to determine the risk tolerance of the beneficiary, and a failure to reassess the risk tolerance of the trust when the mother died and

the trust then changed from a sprinkle trust for the mother and her daughter to a income trust solely for the daughter.

The trial court found that the risks of the concentration and the failure to determine the income needs and desires of the successor income beneficiary, along with a precipitous fall in the value of the stock, resulted in compelling reasons for sale as of January 31, 1974, a year after that alleged in the Objections. On appeal, the trustee argued that no compelling reason for diversification existed until the period between the late 1990's and 2001, when Kodak shifted from film to digital media. 809 N.Y.S.2d at 363.

On appeal, the Court concluded that "the Surrogate properly rejected the contention of objectants that a compelling reason to sell the stock existed as of January 31, 1973, based on low income yield combined with the risk to remainder beneficiaries caused by the concentration itself." *Ibid.* It then held that a finding of breach at a later date was improper, since it would involve a claim neither pled nor proved at trial, citing *Matter of Doelger*, 254 App.Div. 178, 182, 4 N.Y.S.2d 334, *aff'd*, 279 N.Y. 646, 18 N.E.2d 42. *Id.*, at 364Given the losses suffered over the period of the accounting, and the position of the trustee that compelling reasons did not exist until the late 1990's, it is not clear why the Court felt that such allegations were not at issue. There were conflicting allegations by the parties as to when diversification was required, the Court heard the evidence, and it ruled on the facts presented that diversification was required by January of 1974, rather than 1973 as alleged by the beneficiaries or the late 1990's as alleged by the fiduciary. Particularly where there are remaindermen involved, the courts generally attempt to do equity in resolving a multi-year account (let alone a multi-decade account). However, the amounts involved and the change of heart of the income beneficiary who only late in the game realized that her income and trust principal were compromised, may have led a unanimous appellate panel to conclude that the trustee had been treated unfairly. Review was denied by the New York Court of Appeals. 855 N.E.2d 1167 (2006) and reargument den., 7. N.Y.3d 922, 860 N.E. 2d 993.

The Appellate Division decision had concluded that the "Surrogate sua sponte determined that the trustee acted imprudently on an unpleaded date based on a composite, unpleaded theory of imprudence. Objectants neither alleged nor offered proof that a compelling reason for the sale of the Kodak stock other than diversification existed on January 31, 1974." 809 N.Y.S.2d 364. The assumption of this decision is that the "It is my desire and hope..." language in fact is not precatory. The trial court had found that this language was merely precatory. On appeal, the Court stated: "Thus, the fluctuation in stock price could not constitute a compelling reason for the trustee to sell the stock on January 31, 1974, particularly in light of the **expansive retention clause.**" 809 N.Y.S. 2d at 364-65 (emphasis added).

There is no dispute that over the term of the trust Kodak fell substantially in value and did not serve the income beneficiary or remaindermen. Kodak essentially had no growth in the following 20 years while the S&P 500 soared over a thousand percent.

The Court on appeal then provided a second basis for its reversal, doubtless because there had been some proof at trial of the subsequent performance of Kodak and the change of beneficiary status as of the death of the mother and because the courts of equity are approving

the entire accounting, including the subsequent years. If there is evidence of imprudence, generally a court of equity will act to redress the breach in order to protect the beneficiaries.

The Court then went directly to the issue of what is a compelling basis for selling a concentrated position. It held that a fall in the price of the stock from $148 on January 12, 1973 to $115 on January 11, 1974 was not a compelling reason. A 22% drop thus was held not to be a compelling reason for diversification in light of the desire and hope of the testator that the stock be retained. Of course, this was a time of general market decline, with the broad market falling substantially. The Court swept away the trial court's findings, based on expert testimony, that the trustee should have explained to the income beneficiary her rights to income as well as the language of the trust and determined how much money she needed. The trial court had held that the failure to inquire of the income needs of the beneficiary was a breach, and that the fact that she had a substantial amount of income was not dispositive: "The law protects the wealthy no less than the poor." 2004 WL 1468746 at *21.

The Court on appeal cited the comments of an expert that he did not know what the income needs of the beneficiary were, holding that there was no proof of a failure to meet her needs. Clearly, the rule that "you can't be too rich or too thin" does not hold sway in the Appellate Division. The trial court had held that the failure to determine the income needs, after a disclosure of her rights under the trust, was itself a breach and that the trustee could not take advantage of her acceptance of the income, in light of the trustee's representation that it had to retain the stock.

Here the stock returned income of 1% (as its principal value was falling), but the court noted that the return had increased to 1.7% (doubtless aided by the fall in its market value) by January of 1974. The court found that this was within "the average percentage yield for a growth stock" at this period. The Court does not explain why the yield of a growth stock is the appropriate measure, when *Janes* and modern portfolio theory require diversification into different sectors as well as types of investments. One would think that the life income beneficiary would have been better served by diversification, both into other equities and investment vehicles. Clearly, the charitable remaindermen were not being well served by this concentrated investment in a single stock.

The Court of Appeals in *Janes* had held the 71% concentration in Kodak to be imprudent, in light of the lack of income it generated: "Testimony by petitioner's investment manager, and by the objectants' experts, disclosed that the annual yield on Kodak stock in 1973 was approximately 1.06%, and that the aggregate annual income from all estate stockholdings was $43,961, a scant 1.7% of the $2.5 million estate securities portfolio. Thus, retention of a high concentration of Kodak jeopardized the interests of the primary income beneficiary of the estate and led to the eventual need to substantially invade the principal of the marital testamentary trust." 90 N.Y.2d at 53-54.

The *Dumont* Appellate Division opinion concluded that the decision as to breach as of January of 1974 was based on "hindsight," despite the subsequent collapse of the stock and its income in the remainder of the accounting period. The Court looked to the beta of the stock of ".71 to 1.02 between January 14, 1972 and January 11, 1974, with [Valuline's] safety rating of

one and a 12-month performance ratings of two and three." 809 N.Y.S.2d at 364. Indeed, this was a period of generally volatile markets, so that the relative performance of Kodak was not unusual. However, this begs the question of the risk of such concentrations, particularly as the stock and its dividends declined.

Clearly a court will hold beneficiaries to their pleadings and compel them to provide clear evidence of imprudence in establishing a breach. The disregard of portfolio theory in the appellate decision, as well as the duty to maximize income consistent with safety, raises questions about further appellate review.

The language in the Dumont trust was not strong. Indeed, it was clearly precatory under New York precedents. *Matter of County of Suffolk v. Greater N.Y. Councils, Boy Scouts of America*, 51 N.Y.2d 830, 413 N.E.2d 363 (1980); Restatement (Third) of Trusts §13 at 209. This was not strong language mandating retention. Moreover, even if retention had been mandated, the low income of the trust and its principal losses raised questions whether the purposes of the trust would be frustrated.

Other recent cases have struggled to reconcile conflicting trust provisions regarding the duty of the trustee to diversify under the UPIA and the risk and return characteristics of the trust.

Diversification Requirements

In *Wood v. U.S. Bank*, 828 N.E.2d 1072 (Ohio App. 2005), the court overturned a jury verdict on failure to diversify, granting the beneficiary a new trial. "We hold that even if the trust document allows the trustee to 'retain' assets that would not normally be suitable, the trustee's duty to diversify remains unless there are special circumstances. Of course, a trustee's duty to diversify may be expanded, restricted, eliminated, or otherwise altered by the terms of the trust [citing Ohio R. C. 1339.52(C)]. But this statement is true only if the instrument creating the trust **clearly indicates an intention to abrogate the common-law, now statutory, duty to diversify."** 828 N.E.2d at 1074 (emphasis added).

The Court held that the beneficiaries had been entitled to a jury instruction on the duty of the trustee to diversify, despite language authorizing retention of original assets (the stock of the predecessor trustee, Firstar). The language in question granted the trustee the power to "'retain any securities in the same form as when received, including shares of a corporate trustee*** even though all such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash uninvested as they deem advisable or proper.'" *Ibid.* The Court noted, in a warning to estate planners and trustees, "The unfortunate wording of this sentence makes it unclear whether the 'advisable or proper' –a redundant couplet—applied to the cash only, not the other assets. Grammatically, that is the meaning. Luckily, our holding makes it unnecessary to construe this language; but we caution that this type of **fuzzy drafting** can create problems." 828 N.E.2d at 1074-1075 (emphasis added).

The trust held $8 million of assets, $6 million of which was Firstar stock, 82%. The Court cited Restatement (Third) of Trusts §229, Comment d, in support of its conclusion that the wording in the trust was merely a general authorization which did not abrogate the duty to

diversify: "A general authorization in an applicable statute or in the terms of the trust to retain investments received as a part of the trust estate does not ordinarily abrogate the trustee's duty with respect to diversification or the trustee's general duty to act with prudence in investment matters." 828 N.E.2d at 1078.

"We hold that to abrogate the duty to diversify, the trust must contain specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent. The authorization to 'retain' here was not sufficient – it only authorized the trustee to retain its own stock—something it could not otherwise do." 828 N.E.2d at 1078. The Court did not have to reach the issue whether changes in the investment or the needs of the beneficiaries would have trumped even mandatory language.

Removing Power to Supervise

In *McGinley v. Bank of America, N.A.*, 109 P.3d 1146 (Kan. 2005), the court dealt with a revocable trust holding a concentrated position in Enron, governed by successive Kansas versions of the Uniform Trustee Powers Act and a prudent investor law, and the Uniform Prudent Investor Act, which allowed the trustee to follow the directions of the settlor in a revocable trust to retain concentrated positions "'regardless of any fiduciary obligations to which the directing party may also be subject.'" The trust required the trustee to consult with the settlor about any sales of stock. At the peak of its price in December of 2000, the Enron stock represented 77% of the market value of the stock. The 79 year old settlor, holding the power to revoke, signed a written direction to retain the concentrated position, and held the bank harmless for following the direction, and "'I relieve the Bank from any responsibility for analyzing or monitoring these securities in any way.'" *Ibid.* Hence, the court faced language removing investment review power, making it difficult to find liability. There was no discussion of the requirements of former Restatement (Second) §167 or Restatement (Third) §66(2) of the trustee to seek modification to prevent substantial harm to the beneficiaries.

After the fall, the beneficiary sued, claiming that the trustee had not disclosed the risks of such a concentration, and moreover had not explained the issue to her, but rather talked to her husband who then obtained her signature. The Court held that there were no authorities for the proposition that seeking approval through the husband was a breach of trust. Both the expert who testified that the disclaimer was invalid and the briefing apparently failed to cite authorities for the requirement to make disclosures when seeking to obtain an indemnification. The court dismissed the argument that the Bank had failed to disclose its internal guideline that concentrations above 15% should be examined. The Court found that claims that Bank of America failed to disclose the financial dealings of its subsidiaries with Enron had been dropped during the appeal process and not adequately briefed on appeal.

It is not clear whether anyone cited to the Court the decision in *Estate of Saxton* 274 A.D.2d 110, 712 N.Y.S.2d 225 (N.Y. App Div. 2000).

This is a common practice to seek indemnification and exculpation from beneficiaries, and the decision provides some comfort for those involved in revocable trusts that one can effectively rely on such documents, particularly when supported by the directed trustee language in the Trustee Powers Act and Prudent Investor Act in place in Kansas.

Procedural Prudence Breaches

In *Kenerson v. Fleet National Bank*, 65 Mass. App. Ct. 1110, 2005 WL 3536194, 840 N.E.2d 66 (table)(Ct. App. Mass., December 27, 2005), an unpublished opinion, the Court on appeal reversed the dismissal of a case filed against a trustee for retention of Xerox stock following the death of the life beneficiary. The stock represented 35% and 27% of the two trusts involved. Because of its low basis, the settlors had retained the stock, and provided exculpatory clauses making the trustee liable only for "'his own willful default.'" 2005 WL 3536194 at *1.

Following the death of the income beneficiaries, two remaindermen wrote to the trustee asking that the Xerox stock be liquidated to pay substantial estate taxes. The trustee instead sold a mutual fund. The assets in one trust were not distributed until 16 months after the death of the surviving spouse, while the other trust was not distributed until almost two years after her death. Xerox fell from $60.44 per share on the date of death to $24.94 when the shares were distributed to the remaindermen of the first trust, and fell further to $8 per share when the shares in the second trust were distributed. Approximately $800,000 in losses were alleged.

The trial court dismissed the beneficiaries' claims, pointing to the exculpatory clause. The Court on appeal held that "In the context of trustee exculpatory clauses, the phrase 'wilful default' has been defined to include 'intentionally making away with the trust property' or a breach of trust 'committed in bad faith or intentionally *or with reckless indifference to the interest of the beneficiary.' New England Trust Co. v. Paine*, 317 Mass. at 548, 550 (emphasis supplied.)." 2005 WL 3536194 at *2. The Court also cited Restatement (Second) of Trusts §222 (1959).

The Appeals Court held that "During the period after Mrs. Kenerson's death, the bank failed to comply with its own regulations, policies and guidelines in that it did not conduct a complete or accurate Annual Investment Review (AIR) for the trusts or provide quarterly written communications or face-to-face meetings with the Kenerson family...and the principal investment officer of the trusts failed to review each account four times a year." *Ibid.*

The Court also traced the internal reports of the bank investment division following the widow's death, first removing the stock from its recommended list, then downgrading it to a "Trim/Sell" rating, and then to a "Sell" rating.

The court reversed, stating:

"On this record there is evidence which, if credited by a finder of fact, demonstrates that the bank failed to take appropriate action despite knowing: (1) the risk to the trusts by maintaining a high concentration of Xerox stock; (2) the express purpose for holding that high concentration, i.e., to pay the Kenersons' estate taxes upon the condition of Mrs. Kenerson's

death; (3) the occurrence of that condition; (4) the precipitous decline in the value of the Xerox stock; (5) the family's objections to retaining the Xerox stock; and (6) the bank's failure to follow its own policies, regulations and guidelines. We think this exceeds mere negligence and that, in such circumstances, the plaintiffs have demonstrated enough to establish an issue of fact as to whether the bank acted with reckless indifference to their interests as beneficiaries." 2005 WL 3536194 at *3.

These are very low concentrations to be the subject of a potential surcharge. In *Trusteeship of Williams*, 591 N.W.2d 743 (Minn. App. 1999) *rev. and remanded,* 631 N.W.2d 398 (Minn. App. 2001)(examine the role of the subject stock in the entire portfolio), the trial court held that a concentration of 39% was improper. However, this case raises the same issues discussed in *In re Scheidmantel, Appeal of Trustee Sky Trust, N.A.,* 868 A.2d 464 (Pa. Super. 2005), where the trustee failed to consult with the remainderpersons regarding their risk tolerance and their desire regarding distribution of the trust corpus in kind.

No Duty to Protect Principal

SunTrust Bank v. Merritt, 612 S.E.2d 818 (Ga. App. 2005) denied surcharge of the corporate trustee who invested all of the assets of a trust in tax-free bonds. There were three trusts in question, one for each of the children of the settlor, with each child sitting as a co-trustee with the corporate trustee. Two of the trusts were diversified, but the subject trust was invested solely for tax-free income. The diversified trusts were worth 300% of the starting value at the time of the death of the sibling, while the subject trust had increased only 8% in value during the same period. The beneficiary had objected to investment in stock because he was "reluctant to invest in such high risk investments." 612 S.E.2d at 820. In discussions after the beneficiary had accepted appointment as a co-trustee, the beneficiary "preferred low-risk investments that yielded high, tax-free income." *Ibid.,* fn. 5.

The trust terms provided for income to be distributed to the income beneficiary, but strictly limited invasions of principal for his benefit to circumstances where he was in "'actual need of support and has no other adequate means of support, including the income from this trust and any other means of support,'" and "'I do not intend that the Trustees encroach on the corpus in order to provide a standard of living equal to that to which he may have been accustomed, but I intend the power of encroachment to be exercised only in case of absolute necessity.'" 612 S.E.2d at 820. Hence, there was a clear desire to protect the remainderpersons at the expense of the income beneficiary's standard of living.

Absent language favoring distributions to the income beneficiaries at the expense of the remainderpersons, one would expect that the trustee had to balance the competing interests of the classes of beneficiaries, and invest accordingly. Hence, when a trustee invests primarily in tax-free bonds for his personal benefit, a breach of the duty of impartiality and duty to invest is normally found. *Estate of Cooper*, 913 P.2d 393 (Wash. App. 1996). Investment of the entire portfolio in bonds is generally a breach of the duty of prudence. *Noggle vs. Bank of America,* 70 C.A.4th 853 (Cal. App. 1999); *Estate of Scharlach*, 809 A.2d 376 (Pa. Super. 2002).

One would expect a trustee in a trust with remaindermen to invest between 50 and 60% in equities, depending on the expected duration of the trust. *See Noggle* and *Scharlach, supra.* Thus, as in the *Scheidmantel* case, the simplified statement of the duty of the trustee is to fulfill "both the income beneficiary's interest in producing income and the remaindermen's interest in capital growth." 868 A.2d at 488. Particularly in a trust which is expected to continue for a number of years, the trustee generally takes care to prevent inflation from eroding the value of the principal and leaving the beneficiary with a diminishing income stream in constant dollars. A beneficiary who desires to invest all in bonds is either shortsighted or doesn't care about the remaindermen. A trustee faced with a duty of impartiality should seek to educate the income beneficiary as to the realities of investment risk or seek instructions if the beneficiary seeks to impose an investment strategy which is imprudent. Indeed, the beneficiary who accepts the position as co-trustee faces his own fundamental duty to protect the interests of the remainderpersons and not to allow his desire for tax-free income to adversely impact his beneficiaries, as stated in *Cooper* and *Noggle.*

Georgia has not adopted the Uniform Prudent Investor Act, but is governed by a portfolio standard of care. Georgia Code Annotated §53-12-287(b) provides that "In making investment decisions, a trustee may consider the general economic conditions, the anticipated tax consequences of the investments, the anticipated duration of the account, and the needs of its beneficiaries."

The standard for review of such decisions is stated in subsection c: "The propriety of an investment decision is to be determined by what the trustee knew or should have known at the time of the decision about the inherent nature and expected performance of the investment (including probable yield), the attributes of the portfolio, the general economy, and the needs and objectives of the beneficiaries of the account as they existed at the time of the decision. Any determination of liability for investment performance shall consider not only the performance of a particular investment but also the performance of the individual's portfolio as a whole."

Hence, a trustee in Georgia is required to determine the needs and objectives of the beneficiaries and the inherent nature and expected performance of the investment. Investing wholly in tax-free bonds should have been a breach in this case.

The Court in its decision cited the Restatement (Third) of Trusts §232 dealing with the duty of impartiality, including com. c which imposes "a duty to the remainder beneficiaries to exercise reasonable care in an effort to preserve the trust property, and this duty ordinarily includes a goal of protecting the property's purchasing power…" 612 S.E. 2d at 822, fn 14. Indeed, this is the point of investing in equities so that the erosion of value caused by ceaseless inflation will not destroy the real value of the total portfolio as a result of a vulnerable bond position.

Instead of recognizing these investment fundamentals, the court endorsed the investment of the entire trust entirely in tax-free bonds. Faced with the performance of the other two Merritt trusts of which SunTrust was the trustee, the Court rejected damages, holding that there was no duty to increase the value of the trust:

"Again, the instrument at issue makes clear that William Merritt is entitled to the income and the Merritts, as remainder beneficiaries, are entitled to the corpus. Under these circumstances, the duty owed to the remainder beneficiaries is to preserve and protect–not increase—the corpus of the trust. It follows that SunTrust cannot be held liable for breaching a fiduciary duty by investing the trust in such manner as to maximize the income payable to William Merritt rather than expand the corpus of the trust."

612 S.E.2d at 822.

Georgia's damage statute is modeled on Restatement (Second) of Trust §205. It provides as one alternative: "Any amount that would reasonably have accrued to the trust or beneficiary if there had been no breach of trust with interest; and (4) in the discretion of the court, expenses of litigation, including reasonable attorney's fees incurred by the beneficiary in bringing an action on the breach or threat to commit a breach." Ga. Code Ann. §53-12-193.

Given the portfolio requirement and terms of Georgia's investment statute, and the terms of the trust restricting the possible encroachments on principal, the trust should have been invested at least half in equities. Hence the proper measure of damages would have been what the trust would have earned on that fifty percent, with a clear measure of damages provided in the sister trusts. This is a surprising decision and emphasizes the need for education of trustees (and judges) in investment fundamentals. The Supreme Court of Georgia denied cert. by a 4 to 3 vote. Reportedly, three cases have already been filed by disgruntled income beneficiaries, seeking to obtain the benefits of an all bond portfolio.

3. Damages for Breach of Trust

The decision in *Estate of Witherill*, ___N.Y.S.2d___, 2007 WL 268946 (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." 2007 WL 268946 at *1.

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 years 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.

a. 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).

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]...." *Ibid.* at *2.

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." *Ibid.* at *2.

b. **Other Appreciation Damage Cases**

In *Adler v. B.C. Ziegler & Co.*, 2006 WL 2380631 (E. D. Wis. Aug. 16, 2006) the successor trustee of a pension plan was surcharged for negligently causing the liquidation of certain stocks which represented approximately 66% of the assets. The prior trustee, Bank One, had raised questions about the prudence of continuing to hold such stocks and was consequently removed as trustee and replaced with defendant Ziegler & Co. The officers of the company directed the new trustee not to liquidate such stocks. The successor trustee, however, sent directions to Bank One liquidate the portfolio and provide the successor trustee with a check for the proceeds. The stocks were liquidated at the end of 2000 and the proceeds transferred subsequently to the successor trustee. However the plaintiffs failed to realize that the stocks had been liquidated along with the rest of the portfolio until months after the fact. They then sued both Bank One and the successor trustee for the sale of the stock and sought to recover the appreciation that would have been earned had the stocks not been sold.

The court held that Bank One had properly followed the directions it received to liquidate the stocks and turn the proceeds over to the successor trustee, including the finding that it "took several steps to insure that the liquidation instructions it received from Alder were accurate." The Court thus found that Bank One "acted with the requisite degree of prudence" and ruled in its favor after a trial on the merits. 2006 WL 2380631 at *10.

The court found that the successor trustee negligently had directed the sale of stocks which the plaintiffs had instructed it to retain. However, the court found that the plaintiffs would be unjustly enriched if damages included appreciation after the time when the Plaintiffs learned or reasonably should have learned that the subject stock had been sold. The court found that the plaintiffs should have learned of the sale from the fourth quarter and year end statements they received and hence limited damages to the appreciation of the stocks between the sale date and January 16, 2001, totaling $69,823.83. 2006 WL 2380631 at *11.

In *Scalp & Blade Inc. and Scalp & Blade Scholarship Association v. Advest, Inc.* 765 N.Y.S. 2d 92 (App. Div. Oct. 2, 2003) the court reversed a jury instruction which denied a trust the right to collect appreciation damages based on a market index. The defendants included an advisor to the board of a charitable trust who also served as a trustee. The claims included churning and other inappropriate investments. The trial court had relied on *Matter of Janes*, 90 N.Y. 2d 41, 681 N.E. 2d 332 for such denial. The Court held that Janes dealt with mere investment negligence and did not reject the application of appreciation damages where the fiduciary's misconduct consisted of deliberate self-dealing and faithless transfers of trust property. 765 N.Y.S. 2d at 99. The Court held that in a case "involving claims of churning, investment unsuitability, or other acts of unauthorized trading by defendants, an appropriate measure of damages in plaintiffs' 'gross economic loss, adjusted for the overall market's performance.'" 765 N.Y.S.2d at 100.

In *Account of Beiny*, 2003 WL 21729779 (N.Y. Surr. 2003), a trustee was surcharged for the present value of assets which had been diverted into Lichtenstein accounts in any effort to shift money to one sibling in violation of the terms of the trust.

In *Toussaint v. James*, 2003 WL 21738974, (S.D. N.Y. 2003), the trustees of a pension plan sued their attorneys and predecessor trustees for investing primarily in fixed income securities. The court held that the proper measure of damages was what the trust would have earned but for the breach of trust. The court noted that "a pure heart and an empty head" are not enough to avoid liability for a duty to diversify. Summary judgment was denied where there was a question about whether the lay trustees should have obtained expert assistance in investing at least a portion of the trust.

In *Brown v. Schwegmann*, 861 So.2d 862 (La. App. 2004), the Court on appeal found that the trustee had breached his duties as trustee in investing the trust primarily in the family business, by diverting trust income to a partnership from which he personally obtained loans and financial benefit, and by investing in the partnership when it began to fail and ultimately went into bankruptcy. The court noted with respect to the investment in the family grocery business:

> "Although investing solely in the family business may have been wise during the senior Schwegmann's prosperous administration of the business, as the business declined in financial strength such a plan ceased being prudent management of trust funds. Clearly, after the partnership began declining in value in 1996, investing the trust property solely in the family business was not prudent—particularly by a trustee with appellee's specialized knowledge of financial health of the Schwegmann

> companies—or designed to protect and preserve the trust property in the interest of the beneficiary."

861 So.2d at 869.

The matter was remanded for calculation of damages based on the alternative measures contained in La. Rev. Stat. 9:2201, which is patterned on Restatement Second of Trusts §205.

Sims v. Heath, 577 S.E. 2d 789 (Ct. App. Ga, Nov. 22, 2002), affirmed a jury award against executors of $1,000,781 in compensatory damages and remitted $404,633 in punitive damages to $250,000. Liability was based on delays in selling estate property which subsequently dropped substantially in value. Damages were assessed per OCGA § 53-12-193(a)(3): "[a]ny amount that would reasonably have accrued to the trust or beneficiary if there had been no breach of trust with interest." Georgia did not adopt the Uniform Prudent Investor Act, but did adopt a portfolio investment model similar to that of California's prudent man rule. The damage statute quoted is based on Restatement Third of Trusts §205.

In *Trieweiler v. Sears*, 268 Neb. 952, 2004 WL 2913253 (Neb. Dec. 17, 2004) the Supreme Court of Nebraska held that a director was liable for failing to monitor the conduct of other employees and agents of the company. In a derivative action, the court affirmed a damage claim against the director and imposed a constructive trust on a corporate opportunity taken in violation of the parties' duties to the corporation. Because of the failure of the defendants to account or to keep records, the Court held that the defendants had the burden of proof to establish the value of the property they had improperly taken. "It was the appellants' burden to account for corporate revenues, and Anderson's testimony was not required to establish to the penny how much money was earned and where it ended up—rather, once Anderson established with reasonable certainty that the corporation's records were incomplete, it was the appellants' burden to make a proper accounting to the shareholders." 2004 WL 2913253 at 22. Because of the absence or destruction of records, the court upheld the damage calculation reached in the trial court based on the plaintiff's forensic expert, despite gaps in the record. The Court held that 'although the record does not allow calculation of Varsity Investments' losses to the penny, the law does not require such specificity. See *C &B Sales & Service, Inc. v. McDonald*, 177 F. 3d 384 (5th Cir. 1999). Anderson's testimony provided an approximation of Varsity Investments' damages that was reasonable given the circumstances." 2004 WL 2913253 at 23.

In *Bluebird Partners, L.P. v. First Fidelity Bank, N.A., New Jersey*, 784 N.Y.S. 2d 479 (N.Y. A.D., 2004), the court upheld breach of fiduciary duty claims against an indenture trustee which had allegedly failed to act to lift a bankruptcy stay in a timely manner, leading to losses to the collateral it held. The court upheld estimates of damages based on expert testimony of the decline in the value of the assets. The trustee argued that after it was removed as indenture trustee, its liability should have been cut off with respect to further losses. The Court rejected this: "Nor does the termination of First Fidelity as trustee immunize it from liability for damages that continued to accrue afterward as a result of its conduct or inaction while it still held that position. (*see LNC Investments, Inc. v. First Fidelity Bank*, 1997 WL 528283 [SDNY 1997]." 784 N.Y.S. 2d at 482.

4. Ratification of Breach by Beneficiary

a. Beneficiary in Cahoots

The Court of Appeals of Ohio upheld summary judgment in favor of an individual trustee who had delegated investment responsibility for a trust to an outside investment firm in *O'Neill v. O'Neill*, 2006 WL 3517909 (Oh. App. Dec. 7, 2006). The trustee had turned management of the investments over to a broker at Merrill Lynch. The claims against the broker and Merrill Lynch are being litigated separately in an NASD arbitration. 2006 WL 3517909. The trial court denied a motion for summary judgment against the trustee based on allegations of failure to supervise the broker, and granted the trustee's motion for summary judgment. On appeal, the court upheld the decision in favor of the trustee:

> "There is no evidence in the record that [broker] did anything with the Trust assets that was inconsistent with the Trust objective 'to invest' There is also no evidence that Trustee failed in his duty to review and monitor. While it is safe to say that Trustee was not heavily involved in the duties delegated to [broker], nothing suggests that Trustee 'fell asleep at the wheel,' so to speak. Investing in stocks is an inherently risky endeavor, and investing in high technology stocks increases that risk, while at the same time increasing the potential gain. Many people lost money in the stock market, particular in high-tech stocks, at the dawn of the new millennium....However, because of the speculative and unpredictable nature of both the stock market in general, and the staying power of start up, high-tech companies, many investment strategies were to stay the course, even in the midst of the so-called Tech Wreck."

2007 WL 3517909 at *5. The court found that the "collapse of a volatile stock market caused, at least in part, the Trust assets to diminish. *Ibid.* At this point, one would have some concerns about this result, particularly on summary judgment.

The Court went on, however, to examine the involvement of the beneficiary in decisions made by the broker. "That [broker] and [beneficiary] were 'in cahoots' is evidenced by appellant's testimony that he spoke with [broker] multiple times each week and listened in on Merrill Lynch conference calls regarding investing in high-tech stocks." 2006 WL 3517909 at *6. The beneficiary had authorized the transfer of the trust assets to the broker, signing the transfer as a co-trustee, when he was merely a beneficiary. *Ibid.* It appears that he had other accounts with the same broker and took an active part in the investments. The court concluded on appeal, "[Broker] and [beneficiary] invested in risky, high-tech stocks and when they lost big, nearly depleting the Trust assets, appellant pointed his finger at everyone else and [Broker] dodged his responsibility." *Ibid.*

b. Ratifying "Tara-like" affluent Lifestyle

In *Wherry v. Union Planters Bank, N.A.* 2007 WL 431317 (Tenn. App. Feb 9, 2007) the executors of Mrs. Archer sued the trustee of her inter vivos trust for negligent management of a $1.7 million trust which had been reduced in value to $880,000 after 35 years of distributions to

maintain her "Tara-like" lifestyle. From 1964 through the year of her death, 1999, the trustee had distributed at least $2,299,046 at the settlor's direction. The trial court had found that Mrs. Archer's "silence on [the Bank's] investment decisions constituted her ratification of the bank's decision relative to the investment where there is no showing that the bank made any illegal investments or any investment[s] that were clearly worthless." 2007 WL 431317 at *3.

c. Failure to object is not ratification

In *Burns v. Prudential Securities, Inc.*, 857 N.E. 2d 621 (Oh. App. 2006) the court affirmed a jury verdict for damages suffered when a broker dealing with non-discretionary accounts sold stocks without permission. The defendants argued that their account statements and notices required the plaintiffs to object within various specified times regarding any trades reflected in account statements and that the failure timely to object constituted ratification of the trades. Moreover, they argued that in non-discretionary investment accounts the broker had only a limited duty to disclose since it did not act in a fiduciary capacity. The trial court rejected a motion for judgment not withstanding the verdict (JNOV) and the ruling was affirmed on appeal.

The court on appeal noted that a broker under Ohio law was treated as an agent, with some fiduciary duties. The Court noted:

"In general, the duties of a broker associated with a nondiscretionary account, such as these, include the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; the duty to inform the customer of the risk involved in the transaction; and the duty to transact business only after receiving prior authorization from the customer. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (E.D. Mich. 1978), 461 F. Supp. 951, 953, affirmed (C.A.6, 1981), 647 F. 2d 165. On the other hand, brokers who handle discretionary accounts become fiduciaries in the broad sense and have increased duties to keep customers informed regarding the changes in the market that affect the customer's interest and to explain the practical impact and potential risks of the course of dealing in which the broker is engaged. *Id.*" 857 N.E. 2d at 635.

The Court noted that "Some courts have held that if a broker assumes control over an account by acting without the customer's prior authorization, he owes his customer the same fiduciary duties he would have had if the account had been discretionary from the moment of its creation. *Id.*; *De Kwiatkowski v. Bear, Stearns & Co., Inc.* (C.A. 2, 2002), 306 F. 3d 1293; *J. C. Bradford Futures, Inc. v. Dahlongega Mint, Inc.*(C.A. 6, 1990), 907 F.2d 150." *Ibid.*

It held that "if a nondiscretionary broker assumes control of his clients' accounts and performs transactions *at his own discretion* without the clients' approval, the broker must take on the duties of a discretionary broker, including the continuing duty to keep the clients informed of financial information that may affect their investments and the duty to disclose all material information to the clients. See *Leib*, 461 F. Supp. At 953; *Silverberg v. Thomson, McKinnon Securities, Inc.* (Feb 14, 1985), 8th Dist No. 48545, at *4." 857 N.E. 2d at 635-6.

The Court on appeal held that "There are stringent criteria that must be met for the application of an affirmative defense such as ratification. *LNC Investments, Inc. v. First Fid.*

Bank, N.A. New Jersey (C.A. 2, 1999), 173 F.3d 454, 463. In this case, in order to establish that the plaintiffs acquiesced to [broker's] reallocation of their investments, [Broker] would have to demonstrate, among other things, that the plaintiffs acted 'with full knowledge of all material facts relating to the transaction.' *Id.*., citing 57 N.Y. Jur.2d (1986) 108, Estoppel, Ratification and Waiver, Section 76." 857 N.E. 2d at 631.

The Court concluded that "we find that the plaintiffs presented substantial evidence that the information provided to them concerning the reallocations did not include all the material facts and that they were not made aware of all of the circumstances of the trades. In addition, we hold that [broker's] unauthorized trading of his clients' accounts elevated his duties as a fiduciary to the extent that he was required to disclose all material facts of his unauthorized trades, even after the trades had been completed, including his clients' right to reversal of the trades at PSI's expense. In the absence of the disclosure of all material facts, we cannot conclude that the plaintiff ratified the unauthorized trades made by [broker] by failing to object in writing. Ratification occurs only when the customer, with full knowledge of the facts, manifests his intention to adopt the unauthorized transaction. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng* (C.A.D.C. 1990), 901 F. 2d 1124, 1129. Without full knowledge, there can be no ratification." 857 N.E. 2d at 636.

The court partially reversed the award of $250,000,000 in punitive damages. It held that while punitive damages could not be awarded for breach of contract, they could be awarded for breach of fiduciary duty. "Specific to the action herein, punitive damages may be awarded for breach of fiduciary duty, as for other intentional torts, upon proof of actual or implied malice. *Schafer v. RMS Realty* (2000), 138 Ohio App. 3d 244, 302, 741 N.E. 2d 155, citing *Dunn v. Zimmerman* (1994) 69 Ohio St. 3d 304, 631 N.E. 2d 1040. As we have concluded previously herein, when [broker] took control of the plaintiffs' investments and reallocated them, [broker] and PSI assumed 'enhanced' fiduciary duties, including the duty to notify the plaintiffs of all of the circumstances of the unauthorized trades and their options relating to those trades. The failure to uphold those duties gave rise to a cognizable claim for breach of fiduciary duty. Accordingly, we find that the award of punitive damages was an available remedy for that breach upon clear and convincing proof of actual or implied malice." 857 N.E.2d at 646-7.

Citing *Preston v. Murty* (1987) 32 Ohio St. 3d 334, 336, 512 N.E. 2d 1174, the court held that a finding of actual malice could be supported by "a conscious disregard for the rights and safety of other persons that has a great probability of causing substantial harm." 857 N.E.2d at 647. The court held that "actual malice can be inferred from conduct and surrounding circumstances that may be characterized as reckless, wanton, willful, or gross." *Ibid.*

Here the jury had answered interrogatories stating that they found clear and convincing evidence of malice on the part of PSI., which had been charged with negligent supervision of the broker, among other claims. The court on appeal listed as evidence supporting the jury finding a variety of conduct by the PSI following the disclosures of the trades:

"The plaintiffs specifically point to PSI's sponsorship of the November 12, 1998 seminar, where the plaintiffs were led to believe that the market was about to crash. Meanwhile, PSI was representing to its other clients that it was a good time to buy into the market, a claim

substantiated by PSI's market analysts and economists. Additionally, the plaintiffs point to PSI's other conduct after the trades in failing to pay for the reversal of the trades for the one client who requested it; failing to notify that client that PSI's practice was to reverse unauthorized trades at no cost to the client; filing a false report with the Securities and Exchange Commission on November 18, 1998 that stated [broker] was not under any type of internal review for violating 'i9nvestment related statutes, regulations, rules or industry standards of conduct' when, on the same day, general counsel for PSI had indicated that he wanted [broker] terminated; contravening the rules and requirements of the New York Stock Exchange by failing to promptly report [broker's] actions and, instead, waiting until march 17, 1999, after [broker] had been terminated, to report his unauthorized trading; ordering all records regarding the complaints from [broker's] clients to be sent to the corporate office in New York without retaining any copies at the local level, contrary to normal procedure; failing to respond to the clients' concerns and ignoring the pleas of the brokers who took over [broker's] accounts to find a resolution to the clients' situation; and failing to provide any advice to the plaintiffs that would have enabled them to properly exercise their rights following the unauthorized trades." 857 N.E. 2d at 648.

"Therefore, we hold that there was clear and convincing evidence introduced from which the jury could conclude that PSI's actions following the unauthorized trades demonstrated a conscious disregard for the rights and safety of the plaintiffs that had a great probability of causing substantial harm to the plaintiffs and, hence, that PSI acted with actual malice." 857 N.E. 2d at 649.

The court held that the award of $250 million dollars in a case with $5.9 million of actual damages "exceeds by a very significant degree the single digit marker across which, the United States Supreme Court has determined, few awards can survive due process. See *State Farm [Mut.Auto. Ins. Co. v. Campbell* (2003)] 538 U.S.[408] at 425, 123 S. Ct. 1513, 155 L. Ed. 2d 585." 857 N.E. 2d at 653. The court reduced punitive damages to $6,851,186, which was double "the amount of money that prompted PSI to undertake its cover-up," in order to deter similar conduct in the future and punishing it for its tortuous conduct." 857 N.E. 2d at 659-60.

Actual damages had been based on the "New York rule" under choice of law provisions in the account documents. "Pursuant to this theory, a plaintiff can receive either the value for the stock at the time of the wrongful act or the highest intermediate stock price between the date of the act and a reasonable time thereafter during which the stock could have been replaced by the plaintiff, whichever is greater." 857 N.E. 2d at 638. The court explained the purpose of the reasonable time rule is to allow the plaintiff "reasonable opportunity to consult counsel, to employ other brokers and to watch the market for the purpose of determining whether it is advisable to purchase on a particular day or when the stock reaches a particular quotation, and to raise funds if he decides to repurchase," citing *Caballero v. Anselmo* (S.D. N.Y. 1991), 759 F. Supp. 144, 149. 857 N.E. 2d at 640. It upheld the jury's finding on the reasonable time based on the particular facts of the case.

d. **Becoming a De Facto Fiduciary**

When the broker in *Burns* took discretionary actions in a non-discretionary account, he was held to have assumed a set of fiduciary duties, including that of full disclosure. The test was

not the language of the brokerage agreement, but rather the undertaking of actions involving the exercise of a fiduciary decision over the property of another. Under the Uniform Prudent Investor Rule §9, an agent who performs a fiduciary function for an express fiduciary is treated as a fiduciary. The same general concept is contained in ERISA. Several other recent cases have turned on the type of analysis.

The Court in *Allen Trust Co. v. Cowlitz Bank*, ___P3d___, 2007 WL 404084 (Feb. 7, 2007, Or. App.) dissected the difference between a "trustee de son tort" and a "trustee de facto," in holding that a trust company which had acted as a trustee under a "colorable" appointment was entitled to its reasonable fees for its services, even though it was later determined that the appointment by a beneficiary was without authority. The test was "whether Allen trust had a reasonable basis for believing that [beneficiary's] appointment of it was valid and whether it relied on that appointment in good faith and acted as a trustee *de facto*." A trustee *de facto* "usually refers to a person who has at least a colorable claim to be a trustee, who acts as one, and, in some instances, who seeks the benefits of one." 2007 WL 404084 at 2 and fn. 2. The Court found authority for such a status citing *In re Bankers Trust*, 403 F. 2d 16 (7th Cir. 1968) and *Crocker-Citizens Nat. Bank v. Younger*, 4 Cal 3d. 902, 481 P2d 222, 224-5 (1971).

The court rejected the claim that the trust company should be treated as a trustee *de son tort* which would not be entitled to compensation (but which could be held to fiduciary standards for any management of the trust assets). The Court on appeal relied on *Stephan v. Equitable S&L. Assn.*, 522 P.2d 478, 268 Or. 544, 559 (1974) which held that "A person may become a trustee by construction by intermeddling with, and assuming the management of, trust property without authority. Such persons are trustees *de son tort*. During the possession and management by such constructive trustees, they are subject to the same rules and remedies as other trustees; and they cannot avoid their liability by showing that they were not, in fact, trustees***." *Ibid.* at fn3.

In *Alpert v. Gerstner*, ___S.W. 3d___, 2006 WL 2523028 (Aug. 31, 2006, Tex. App.) the court held that a receiver was entitled to derived judicial immunity only for duties functionally comparable to that of a judge in denying the receiver summary judgment on claims that the receiver and the attorney hired to assist her had allowed the investment portfolio of the trust to suffer substantial losses. The receiver had been appointed to hold the trust assets pending litigation between the beneficiaries and the existing trustee. The court noted that "The policy for judicial immunity, to protect both the individual judge as well as the public's interest in an independent judiciary, 'are also implicated when a judge delegates or appoints another person to perform services for the court or when a person otherwise serves as an officer of the court.'" Citing *Dallas County v. Halsey*, 87 S.W. 3d 552, 554 (Tec. 2002). Earlier decisions had granted full judicial immunity to court-appointed receivers and trustees. *Delcourt v.Silverman*, 919 S.W. 3d 777, 781 (Tex. App. 1996).

The court on appeal, however, looked to the actual functions performed to determine whether they were the equivalent of judicial functions. "In short, we look at the nature of the function performed, not the identity of the actor, and consider 'whether the court officer's conduct is like that of the delegating or appointing judge.' *Halsey*, 87 S.W. 3d at 555. Whether a court-appointed receiver with powers similar to those of Gerstner is entitled to derived judicial

immunity for the performance of those powers is one of first impression." 2006 WL 2523028 at *7.

The Court held that the receiver "is entitled to derived judicial immunity to the extent that she was authorized, as a receiver of the property in the Trusts, to take charge and keep possession of the Trust property...and to the extent that she was appointed to assist the court in determining the proper trustee of the Trusts and to make an inventory of the property subject to the receivership. These functions are intimately associated with the judicial process and involve the exercise of discretionary judgment comparable to that of a judge. See *Halsey*, 87 S.W. 3d at 554."

"However, we further hold that [receiver] is not entitled to derived judicial immunity to the extent that she may have breached any fiduciary duties to the beneficiaries in failing to exercise good faith or ordinary care in protecting the stock portfolio assets of the Trusts. In this latter capacity, [receiver] was acting as a representative of the interests of the beneficiaries and not as an agent of the Court." 2006 WL 2523028 at *12. The denied the summary judgment brought by the receiver on the investment claims and further denied the summary judgment brought by the attorney hired to assist the receiver, based on allegations that he had assisted in the administration of the trust. *Ibid.* at *13.

The appointment of a receiver is often the only solution where a trustee resigns or is removed and no one can be found who will become successor trustee because of claims involving trust property or intractable beneficiaries. Hence, after a landslide raised the prospect that a trust would be subjected to claims from persons whose downhill property was damaged, the trustee resigned and the court appointed a receiver in *McCarthy v. Poulsen*, 173 Cal. App. 3d 1212 (Cal. App. 1985). The court held that the existing trustee had a right to resign and could not be forced to serve as a trustee against his will. The Court noted that under then existing law a receiver was liable in tort solely in an official capacity, not a personal one, and that claims for torts committed in the performance of receivership duties can be satisfied only from receivership funds." 173 Cal. App. 3d at 1219.

The States have split over the extent of judicial immunity for agents appointed by the court, with some allowing liability claims where the agent is representing the interests of a beneficiary rather than performing a strictly judicial function.

5. Supreme Court Speaks: Diversity Jurisdiction

Parties must continually evaluate whether a particular piece of litigation can be best conducted in a state probate or other equity court, or whether the federal courts may offer a better forum for resolution of such controversies. If there is a federal question, such as bankruptcy, securities laws, ERISA, or matters controlled by the Private Securities Litigation Reform Act, the choice may be simple. However, when a trust is not subject to continuing state court jurisdiction, and when the dispute involves beneficiaries who live in a different state than the trustee's main office, there may be diversity jurisdiction.

However, for a number of years there has been a split among federal courts as to whether a national bank has citizenship only in the state where it has its main office, or whether it is a

"citizen" for diversity jurisdiction purposes in every state where it does business. The latter rule often limited the ability of a national bank to bring a diversity action to resolve claims that dealt with a single beneficiary or group of beneficiaries, or to remove from state court a claim being brought against them by beneficiaries who have citizenship in other states. The Supreme Court has now resolved this controversy in *Wachovia Bank v. Schmidt*, 546 U.S. 303 126 S. Ct. 941 (2006). A unanimous court (Justice Thomas not participating) held that a national bank is a citizen only of the state in which its main office is located. Id., at 942. It explained the setting of the dispute:

> "Congress empowered federal district courts to adjudicate civil actions between 'citizens of different States' where the amount in controversy exceeds $75,000. 28 U.S.C. §1332(a)(1). A business organized as a corporation, for diversity purposes, is 'deemed to be a citizen of any State by which it has been incorporated' and, since 1958, also 'of the State where it has its principal place of business.' §1332(c)(1). State banks, usually chartered as corporate bodies by a particular State, ordinarily fit comfortably within this prescription. Federally chartered national banks do not, for they are not incorporated by 'any State.' For diversity jurisdiction purposes, therefore, Congress has discretely provided that national banks 'shall...be deemed citizens of the States in which they are respectively located.'§1348."

126 S. Ct. at 945. The Court held that these statutes should be read to hold that a national bank is deemed a citizen only of the state where it has its main office, as provided in its articles of association. This provides a major benefit for a national bank, presuming that the federal bench of the state in which it has its main headquarters is staffed with good judges and clerks and the federal circuit does not have any noxious holdings regarding your controversy which might be avoided by sticking to the state court. In diversity, the substantive law of the state in which the controversy arose controls.

Parties must take special care to evaluate the quality of the local courts as against the federal courts, including the right to a jury trial in matters involving trusts. In a complex matter, the federal court may have more experience in business or financial matters and generally will have three highly qualified former law journal editors as clerks. If you have a technical defense, that expertise may be most useful. Summary judgment practice may also be more liberal in federal court, offering options for resolving cases short of trial. In cases involving a jury issue, a federal jury panel may also include more highly educated and more affluent members than a state court can offer. Federal judges also have endured a close examination of their biases in the course of approval by the United States Senate, which might not have happened in state court appointments or elections. Federal judges face staggering case loads, and may be more willing to force settlements or dismiss cases than a state probate judge. Also in many States, a probate judge may send a lengthy disputed matter out to trial with a general duty judge, who may have no experience with financial or fiduciary issues. The probate court may have developed some unfortunate opinions about your client or you from earlier trust or probate matters, leading your client to seek a fresh viewpoint in federal court. Just because counsel professes to be tight with the local probate judge is not a sufficient reason for failing to make such an evaluation.

Hence, in *Hill v. Bank of America Corporation*, 2006 WL 1518874 (N.D. Ga. May 30, 2006), the bank removed the case from state court to the federal district court. The plaintiff had alleged mismanagement of the trust by the trustee. The plaintiff obviously felt it had a more hospitable forum in the Superior Court and moved to remand the case to a state judge. Based on *Wachovia Bank v. Schmidt*, 126 S. Ct. 941, 942 (January 17, 2006), the federal court denied the motion.

In *Anderson v. Bank of America*, 2006 WL 889491 (N.D. Cal. Apr. 5, 2006) the court remanded a removed case to State court because of the untimeliness of the motion to remove and because there was not complete diversity. The bank had the burden of proving diversity of citizenship, but had only alleged the residence of the plaintiffs. Moreover, the bank could not show that the amount in controversy for the plaintiffs and class members exceeded $75,000, hence it failed its burden of proof in this regard.

Bank of America also prevailed in obtaining dismissal of a class action brought in federal court alleging improper conversions from common trust funds to proprietary mutual funds and excessive fees in *Kutten v. Bank of America, N.A.*, 2006 WL 1520588 (E.D. Mo. May 26, 2006). Here the issue was whether the plaintiff class representatives could meet the $75,000 amount in controversy threshold for diversity jurisdiction. Bank of America challenged whether the allegations had any hope of rising to $75,000 per plaintiff. The Court held that "Plaintiffs must establish by a preponderance of the evidence that at least one named plaintiff satisfied the amount-in-controversy requirement." Id., at *2. The amended complaint "was silent on the amount of compensatory damages Kutten has incurred." *Ibid.* As to the other two class representatives, they did not contest the calculations of maximum compensatory damages submitted by the trustee showing amounts of $4,847 and $12,947: "Plaintiffs seemingly concede this and present no evidence to establish the compensatory damages incurred by either Arnold or Scharff. Clearly, neither of these amounts exceeds the requisite $75,000." *Ibid.*

In opposition to the motion to dismiss, the court found that the "Plaintiffs fail to submit a scintilla of evidence to establish these alleged damages." *Ibid.*

The Court conceded that it could consider punitive damages in the Eighth Circuit in computing the amount-in-controversy, but it pointed to the heightened burden of proof in both California (clear and convincing evidence of oppression, fraud, or malice) and Missouri (clear and convincing showing that the defendant acted with evil motive and reckless indifference to the plaintiff's rights) which is imposed on the plaintiff seeking punitive damages for breach of fiduciary duty claims. The court held that the allegations of the amended complaint were insufficient to meet the standard for punitive damages. "Moreover, Plaintiffs have not produced any evidence that Bank of America acted with nefarious intent. Because Plaintiffs have failed to provide or even allege facts sufficient to support a punitive damages award, their request for this relief cannot contribute to the mount in controversy necessary to invoke federal jurisdiction." Id., at *3.

The court also dismissed claims for injunctive relief: two of the plaintiffs were no longer customers of Bank of America and hence had no future harm which could have been stopped. The remaining class representative "has failed to articulate any real or tangible way in which the

requested injunctive relief will benefit her as a current customer...." 2006 WL 1520588 at *4. Since only statutory attorneys fees could be utilized in computing a jurisdictional amount, and since none were alleged, such fees could not be counted in meeting the $75,000 minimum for federal diversity jurisdiction. Thus, the court granted the bank's motion to dismiss for lack of subject matter jurisdiction.

5. Fiduciary Liability Cases

a. Dismissal of Proprietary Fund Class Actions

On May 10, 2006, the United States District Court for the Southern District of New York dismissed a class action involving claims that trust funds had improperly been invested in proprietary mutual funds, including claims of undisclosed and excessive fees in *Spencer v. Wachovia Bank, N.A.*, ___F.Supp.2d___ (S.D. N.Y. 2006). The Court based its decision on the Securities Litigation Uniform Standards Act (SLUSA) which was designed to prevent certain State private securities class actions involving fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act, 15 U.S. C. §78u-4. Since the proprietary mutual funds in question were "covered securities" under SLUSA, heightened pleading and standing burdens were imposed, which had not been met, requiring dismissal of the class action.

Wachovia also faces an unrelated class action in federal court in Pennsylvania involving claims of imprudent and improper conversion from common trust funds and from proprietary funds of banks merged into Wachovia into Evergreen Funds. *Brooks v. Wachovia*, Action 06-955, U.S. District Court for Eastern District of Pennsylvania.

Wachovia also prevailed against claims brought under the Investment Company Act, the Investment Advisers Act and state common law regarding its Evergreen mutual funds, including claims involving payments made for "shelf space," at various brokerage houses. *In re Evergreen Mutual Funds Fee Litigation*, 423 F.Supp.2d 249 (S.D. N.Y. 2006), motion to set or for leave to amend denied, ___F.Supp.2d___, 2007 WL 442158 (S.D. N.Y. Feb. 5, 2007).

Bank of America obtained dismissal of the sixth related class action alleging breaches of trust related to the conversion of common trust funds into proprietary mutual funds in *Siepel v. Bank of America, N.A.*, ___F.R.D.___, 2006 WL 3837129 (Dec. 27, 2006, E.D. Mo). The Court dismissed the complaint and denied leave to file an amended complaint, holding:

> "The record provides ample evidence that Plaintiffs are forum shopping. Plaintiffs' counsel began filing lawsuits against the Bank four years ago seeking to certify a nationwide class to challenge the practices at issue in this litigation. They filed five cases in four states prior to commencing this action. Three were voluntarily dismissed just before the class certification deadline. Two were dismissed because the plaintiffs failed to plead the amount-in-controversy requirements. The record shows that Plaintiffs have filed numerous cases, voluntarily dismissed them in order to avoid court-imposed deadlines and unfavorable rulings, and reasserted the dismissed claims in this case."

2006 WL 3837 129 at *4.

The Court relied on the Securities Litigation Uniform Standards Act of 1998 (SLUSA) to preempt the attempt to allege state law claims based on securities fraud claims. *Ibid.*, at *8. In denying leave to amend, the Court concluded that "Plaintiffs' attempt to cast their allegations of misrepresentations and omissions as breach of fiduciary duty and unjust enrichment claims is unavailing." *Ibid.* at *9. The Court looked to *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, ___U.S.___, 126 S. Ct. 1503 (2006), which took an expansive view of the reach of SLUSA in preempting state law securities violation claims. It held, "'in connection with the purchase or sale of a covered security' phrase must be read broadly to cover not only purchasers and sellers of securities, but also holders of securities where the alleged fraud coincides with a securities transaction." 126 S.Ct. at 1513.

The *Siepel* court also relied on *Sofonia v. Principal Life Ins. Co.*, 465 F.3d 873, 879 n.4 (8th Cir. 2006) and *Spencer, supra*, 2006 WL 3408043, at *6-7, holding that "a trust beneficiary's state law claims concerning investment of trust assets in affiliated mutual funds satisfied the 'in connection with a purchase or sale of security' requirement of SLUSA." 2006 WL 3837129 at *11. The Court held that it would not allow an amendment which merely repackaged the allegations as state law claims, citing approvingly the decision in *Felton v. Morgan Stanley Dean Witter & Co.*, 429 F.Supp.2d 684, 693 (S.D. N.Y. 2006) that dismissal under SLUSA was appropriate where the claim is a "securities fraud wolf dressed up in a breach of contract sheep's clothing." 2006 WL 3837129 at *12. The court declined to allow another round of pleading, instructing that

> "Pleading is not an interactive game in which plaintiffs file a complaint and then volley it over a rhetorical net with the court until a viable complaint emerges. Plaintiffs have the responsibility to plead their case adequately, without the defendants' or the court's assistance. A court may deny a plaintiff leave to replead when the party 'has been given ample opportunity to allege a claim.'" Citing *S. Constructors Group, Inc. v. Dyalectric Co.*, 2 F. 3d 606, 612 (5th Cir. 1993).

2006 WL 3837129 at *12.

A similar result was had with respect to claims brought against Mellon premised on breach of Washington's Consumer Protection Act, RCW 19.86, alleging breach of fiduciary duties and contract claims. *Beckett v. Mellon Investor Services, LLC*, ___F. Supp. 2d___, 2006 WL 3249189 at *4 (W.D. Wash. Nov. 8, 2006). "Claims that investment advisors breached fiduciary duties in charging unauthorized fees have been held to necessarily coincide with the sale or purchase of securities and are based in part on material omissions or the misrepresentations concerning the fees. Accordingly, breach of fiduciary duty claims are subject to SLUSA removal and preemption." *Ibid.*

Hence, class actions involving these investment duty claims face a tough road in light of the legislative initiatives and such court decisions.

b. Breach of Fiduciary Duty Claims

Alleged Breaches by Executor and Estate Planner

The $65.5 million judgment against Wells Fargo Bank and the Baker Botts law firm has been reversed by the Texas Court of Appeal in *Baker Botts, L.L.P and Wells Fargo Bank Texas, N.A. v. Cailloux*, ___S.W. 3d.___, 2007 WL 460643 (Tex. App., Feb. 14, 2007). Baker Botts had begun creation of a complex estate plan for Floyd and Kathleen Cailloux, however Floyd died before it could be completed. "Baker Botts designed a revised estate plan for Kathleen immediately following her husband's death. Under the revised plan, Kathleen voluntarily disclaimed her right to her husband's share of the martial estate. As a result of Kathleen's disclaimer, $65.5 million vested immediately in various charitable organizations Floyd had designated in his will." 2007 WL 460643 at *1. Six years after the disclaimer, Kathleen's son as the next friend of his mother, filed suit in 2003 against executor Wells Fargo and Baker Botts, claiming among other things, that they had breached their fiduciary duty regarding Kathleen's exercise of the disclaimer.

The case was tried to a jury with multiple interrogatories. While the jury found that there had been breaches of fiduciary duty, it allocated causal responsibility 25% each to Baker Botts, Wells Fargo, a Wells employee who served in the family charity, and Kathleen herself. *Ibid.* at *8. The Wells employee had been released in related litigation in which the son had brought against the family charity.

As is often found in complex matters, the jury's responses to detailed interrogatories raised problems rather than solving them. The jury also answered questions to the effect that Kathleen had suffered zero "lost income" as a result of the disclaimer and zero "economic loss" damages. The trust interest which she had disclaimed would have provided her income and a 5 and 5 power. Hence, the jury's finding seemed to indicate that Kathleen had no damages. The assets disclaimed were in the hands of the family foundation and other charities long before the trial. Kathleen's share of the marital estate had left her with substantial assets subject to her own estate plan, which was revised after her husband's death. While the jury answered an interrogatory that Baker Botts had breached its fiduciary duty by failing to "fully and fairly disclose all important information to Kathleen," it found in favor of the law firm on all other causes of action against it, including negligence and malpractice. *Ibid,* at *7. A finding of breach of fiduciary duty was made against the executor.

The Court then attempted to deal with the intransitivities in the jury verdict by fashioning an "equitable trust."

As the court on appeal found, "This 'equitable trust' was to be funded by Banker Botts and Wells Fargo and was similar to the trust that would have existed had Kathleen not executed the disclaimer." *Ibid.*

The revised estate plan and disclaimer had been the subject of a probate court action brought in 1997 by Kathleen, her children, and Wells Fargo as executor of Floyd's estate: "Kathleen and the children specifically sought a judgment vesting Floyd's estate in the charitable

beneficiaries. The probate court declared that Kathleen had 'disclaimed all of her interest in any part of the residuary estate devised and bequeathed to trusts for her benefit.'" *Ibid.* at *6. A second petition had then been brought by Wells Fargo as trustee of the children's trusts in the probate court to approve a "Withdrawal Transaction." "The court found that the withdrawal transaction was in the best interest of Floyd's estate and approved the withdrawal. Wells Fargo subsequently distributed Floyd's estate to the Old Foundation and other charities in several installments between the months of April and August 1998." *Ibid.*

The defendants attacked the judgment on a variety of grounds, arguing that there was insufficient evidence to support the jury's findings that their alleged breaches of fiduciary duty proximately caused Kathleen damage. This is a difficult claim to make in a jury case. "Evidence is legally insufficient when: (a) there is a complete absence of evidence of a vital fact; (b) the trial court is barred by rules of law or evidence from giving eight to the only evidence offered to prove a vital fact; (c) the evidence offered to prove that fact is no more than a mere scintilla; or (d) the evidence conclusively establishes the opposite of the vital fact. *Merrell Dow Pharms., Inc. v. Havner*, 953 S.W. 2d 706, 711 (Tex. 1997)." *Ibid.* at *8. The Court concluded that there was "no evidence that any of the alleged breaches of duty by Wells Fargo caused Kathleen to disclaim her right to Floyd's estate. The only evidence on the issue of causation is speculative." *Ibid.* The court on appeal held that "None of the witnesses who testified at trial, however, had any knowledge of Kathleen's true wishes or intentions. Thus, at best, any assumption about what Kathleen would have done had she known of the purported failures of Wells Fargo is based on nothing more than conjecture." *Ibid.* at *9.

The plaintiff argued that the disclaimer was "inapposite with logic and human nature." The court on appeal found that "Ken's argument, however, ignores that the probate court accepted Kathleen's disclaimer. Although Ken may have made a different decision than his mother did, such does not render his mother's decision unreasonable as a matter of law. Kathleen was independently wealthy and made a choice to support her husband's charities now, rather than later. We therefore cannot say this particular evidence establishes causation as a matter of law." *Ibid.* at *10. Baker Botts prevailed on the same analysis of the court on appeal.

Taking care lest its decision be overturned by some scintilla of evidence on further appeal, the court then ruled alternatively that "the trial court abused its discretion by imposing an 'equitable trust' upon Baker Botts and Wells Fargo." *Ibid.* The Court on appeal noted that the plaintiff had opposed Baker Botts' attempt to join the charities as parties, which would have allowed the plaintiff to obtain a constructive trust on the disclaimed assets. Since neither Baker Botts nor Wells Fargo had the assets, and since the jury had answered interrogatories that found no losses resulting to Kathleen from the alleged breaches of fiduciary duty, the appeals court found that the "equitable trust" was an abuse of discretion. *Ibid.* at *11.

The court was also troubled by the fact that "Kathleen gained the benefit of making a substantial charitable gift ($65.5 million) during her lifetime, reduced the risk of an IRS audit concerning her estate upon her death, and virtually eliminated her estate's tax liability upon her death." *Ibid.* at *12. Hence the equitable trust would have substantially improved her position, rather than simply restoring her position but for the alleged misconduct. You can't give away your cake and eat it too.

The case is still subject to further appeal, so stay tuned for future developments.

A similar result was had in a case involving a claim of tortious interference with right to inherit. In *Miller v. Keybank National Assoc.*, 2006 WL 871621 (Ohio App. Apr. 6, 2006), *app. not accepted*, 852 N.E.2d 1215 (Oh. 2006), the court affirmed summary judgment in favor of Keybank on claims involving negligence, breach of fiduciary duties, fraud and intentional interference with an expectancy. The claims were based on various modifications to an estate plan by an elderly settlor, brought by a beneficiary and trust advisor who alleged undue influence and lack of capacity on the part of the settlor and actions or omissions by the trustee which facilitated the allegedly improper transactions. The court held that there was no evidence of incompetence at the time of the transactions and hence that there was no duty which the trustee had violated. Id., at *5.

As to the interference claim, the Court found that the plaintiff "had no idea what, if anything, he was going to inherit" if the plan had not been changed. The appeals court pointed out that while Ohio had recognized tortious interference, one element of the tort is "reasonable certainty that expectancy of inheritance would have been realized, but for interference by defendant; and damage resulting from interference." Id., at *6. Absent reasonable certainty as to the prospective inheritance, summary judgment was appropriate. Absent evidence of underlying independent compensatory damages, punitive damages were properly rejected by the trial court. Id., at *7.

1) Trustee could accept modification of estate plan

Wells Fargo prevailed in *Stanton v. Wells Fargo Bank Montana, N.A.*, ___P3d___,2007 WL 242566 (Mont. Jan. 30, 2007). In this case the settlor, after the death of her husband and daughter, amended her trust to benefit her former son-in-law Stanton, and directed her trustee to transfer $532,500 worth of stock to Stanton. Stanton was an attorney and drafted the amendment which benefited him. The charity named in the prior trust instrument, Trail's End, filed suit against Stanton, alleging undue influence and sued the trustee alleging breach of its fiduciary duty under the revocable trust of which it was trustee.

In many jurisdictions, an attorney who drafts a testamentary instrument which benefits him or her is void, or at least raises a presumption of undue influence. The trial court, however, had granted summary judgment in favor of the son-in-law and trustee of decedent's revocable trust who had transferred assets to the son-in-law at the decedent's direction. The Supreme Court of Montana affirmed.

Since the time of Nero, attorneys have faced prohibitions against drafting wills benefiting them, except in the case of relatives. Nero, not known for fiduciary behavior, nonetheless promulgated a decree barring attorney draftsmen from receiving legacies under Wills they prepared for clients. Suetonius, *The Twelve Ceasars*, tr. by Robert Graves, Penguin Book edition, 1980, at 191. "From very ancient times, bequests to the draughtsman of a will have been reprehended by the law. By the Roman law, they were invalid. Page on Wills, Lifetime Ed., section 829: Justinian, Digest, Book XLCIII, Tit. 10, 15." *In re Lobb's Will*, 160 P.2d 295, 305

(Or. 1945). "Suetonius mentions a law promulgated by the Emperor Nero that 'no one who writes a will for another shall write in a legacy for himself.'" William McGovern, Jr., "Undue Influence and professional Responsibility," 28 Real Property Probate and Trust Journal 643, 647 (1994). Other authorities attribute this to an ordinance by Nero's successor, Claudius, "that the writer of another's will should not mark down a legacy for himself." *In re Blake's Will* (N.J. 1956) 120 A2d 745, 753.

Most States, while not citing Nero's law, follow suit. Here the Montana Supreme Court noted that while the drafting of the trust amendment by the former son-in-law violated Rule 1.8 (c) of the Montana Rules of Professional Conduct, violation of such rules "'should not give rise to a cause of action nor should it create any presumption that a legal duty has been breached.' *Schuff v. A.T. Klemens & Son*...16 P.3d 1002 [Mont. 2000]." 2007 WL 242566 at *4. The Court held that Trail's End had the burden of proving undue influence.

Although the Court found that Stanton's role in drafting his ex-mother-in-law's 2000 Trust and will established the existence of a confidential relationship, "The mere opportunity to exercise undue influence on the testator is not sufficient, however, to prove undue influence. We must consider and correlate the opportunity to exercise undue influence with the alleged acts of influence to determine if the acts amount to undue influence." 2007 WL 242566 at *5.

The Court noted that the decedent was described by friends as "mentally sharp and strong-willed even into her 90's. [Her former attorney] described her as a 'pragmatic kind of woman of steely determination.'...In fact, Trail's End 'admits that the medical records and apparent actions by Mrs. Barker seem to indicate that she was in control of her decisions.'" 2007 WL 242566 at *5. Not a good admission to make on summary judgment.

The trial court had struck the testimony of a doctor regarding possible Alzheimers, however Wells Fargo successfully struck the testimony from the record "on the grounds that his opinion was speculative because he never met or examined Frances. The District Court considered Dr. Williams's deposition testimony and correctly concluded that his testimony presented only speculation as to Frances's mental condition in 2000." *Ibid.* "Dr. Williams never met or examined Frances and she never had undergone a neuropsychological evaluation for him to review. Dr. Williams opined that Frances probably suffered some intellectual decline, but he could not state a level of impairment with a reasonable degree of medical certainty. Dr. Williams's testimony represents his speculation as to Frances's mental condition based on literature regarding the rate of intellectual decline of Alzheimer's patients. **Speculative statements, however, are insufficient to raise genuine issues of material fact....Instead, the testimony from individuals who knew Frances revealed that she was healthy, self-sufficient, aware, and actively involved in her investments."** (emphasis added).

This is a rare statement from a Supreme Court on the speculative nature of an expert medical opinion based only on hindsight and with little medical data to interpret. While the findings on presumptions may have little application outside Montana, these findings are of major interest to litigators in this arena.

The Court also affirmed the District Court's conclusion that Stanton was the more natural

distribution, rather than a charity she had picked from a list provided by her prior attorney and which had never met or had any connections with her. "The District Court correctly concluded that the disposition was natural and that this factor raised no questions of fact regarding the presence of undue influence." 2007 WL 242566 at *6. The provision of charitable entities by estate planners is a typical practice. But it is rare to find a situation where the lack of connection with the charity leads to the conclusion that its initial selection by the testator raises no question of fact as to whether it was a natural object of her bounty. Many states treat this as a question of fact to be determined at trial. *Estate of Sarabia* , 221 Cal.App.3d 599 (Cal. App. 1990). The Montana Supreme Court pointed to testimony by a variety of friends and relatives as to her desire to benefit her former son-in-law, who had stayed in active contact with Frances after his divorce and the death of his former wife, her daughter.

Trail's End argued on appeal that Wells Fargo owed a duty as trustee to the beneficiary under the trust prior to its amendment in the face of her alleged lack of capacity. Since this was a revocable trust, the Supreme Court found under Montana law that the trustee owed a duty only to the person holding the power of revocation. Since it also had found that she was competent, "Therefore, Wells Fargo owed a fiduciary duty only to Frances regarding her Trust, and not to Trail's End." 2007 WL 242566 at *7. Since the charity had failed to provide any evidence at the summary judgment that Frances lacked the capacity to amend her trust to benefit Stanton, the Supreme Court held that summary judgment in favor of Wells Fargo on the breach of fiduciary duty claim had been proper.

2) **Breach of Fiduciary Duty in Conduct of Express Fiduciaries—a Tort?**

Violation of fiduciary duty is included in the Restatement (Second) of Torts §874 as a tort: "One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation." When an express trustee is involved, such as a trustee of a trust or an executor or conservator, the question is raised as to whether the conduct of the fiduciary is governed by tort procedures and remedies or rather by equitable procedures and remedies. The key issues are right to a jury trial and punitive damages.

Comment b to §874 states in part that "A fiduciary who commits a breach of his duty as a fiduciary is guilty of tortuous conduct to the person for whom he should act. **The local rules of procedure, the type of relation between the parties and the intricacy of the transaction involved, determine whether the beneficiary is entitled to redress at law or in equity.**" (emphasis added) The jury verdict in *Cailloux* points to the problem of forcing juries to understand enormously complex estate plans and the intricacies of fiduciary duties—such matters in many circumstances are left to the experienced judge of an equity or probate court or a special master in order to avoid a confused verdict by a panel of laypersons attempting to master tax and fiduciary law as part of their deliberations.

The Reporter's Note to 874 points out a distinction in torts not often appreciated: "Some fiduciary relationships, such as those of trustee and beneficiary, principal and agent and director and corporation are the subject of a considerable group of substantive law rules governing the relationship. But the action may properly be regarded as in tort for damages, being an **equitable tort even when the action is in the traditional scope of equitable jurisdiction.** " (emphasis

added).

Some Courts have attempted to restrict the proliferation of tort causes of action, along with the right to jury trial and the ability to get punitive damages. *Vinogradova v. Suntrust Bank, Inc.*, 875 A2d. 222 (Md. App. 2005) dealt with a claim that a bank breached its fiduciary duty when it allowed the holder of a power of attorney to manage the account of a customer of the bank, leading to losses. The customer sued under negligence and breach of fiduciary duty. The trial court had dismissed the breach of fiduciary duty claim and then granted summary judgment on the negligence claim.

The Court of Special Appeals of Maryland affirmed, holding that the bank had no duty to question a power of attorney managing a bank customer's account, where the broad power of attorney exculpated persons relying on the power. The Power of Attorney provided that "any persons firm, or corporation shall be fully protected in relying upon this power of attorney unless and until actual notice of its revocation …is received." On appeal, the court held that "In sum, even assuming that SunTrust ordinarily would have a duty to warn Ms. Vinogradova of suspicious activity in her accounts, the POA absolved SunTrust of such duty by the broad language that gave Besson every right to take the actions he took with regard to Ms. Vinogradova's funds and by *fully* protecting SunTrust while it relied on the POA." 875 A.2d at 229.

As to the breach of fiduciary duty claim that was dismissed, the Court affirmed dismissal, noting that the Maryland Court of Appeals had rejected the recognition of a separate tort for breach of fiduciary duty in *Kann v. Kann*, 690 A.2d 509 (Md. 1997). The court held that the plaintiff might have brought an action for breach of contract on the facts alleged, but the claim for breach of fiduciary duty was improper. Hence the bank won.

This is a decision of some import, particularly in states adopting the Uniform Power of Attorney Act or similar provisions designed to allow institutions to accept directions under valid powers of attorney without having to scrutinize them for improprieties. It points to the need to obtain clear exculpatory language in the POA, or a expansive statute protecting a person or entity relying on the exercise of such power.

In *Kann,* the Court had rejected the recognition of an independent tort for breach of fiduciary duty in the context of claims by a beneficiary against a trustee. It rejected such a tort, explaining that a beneficiaries remedies were in equity, citing Restatement (Second) of Trusts §§197 and 198, 690 A.2d at 516, rejecting both the right to a jury trial and the remedy of punitive damages which might otherwise be available if an independent tort remedy were allowed:

"Comment b further states that 'the beneficiary is entitled to tort damages ... in accordance with the rules stated in §§ 901-932.' Restatement (Second) of Torts § 902 defines 'damages' to mean 'a sum of money awarded to a person injured by the tort of another.' Comment a to that section states that

"'[t]he word "damages" is used in this Restatement in the same sense in which it is used in the Restatement of Contracts. It has reference to an award made to a person by a competent

judicial tribunal in a proceeding at law or in equity because of a legal wrong done to him by another.'

"Comment b to Restatement (Second) of Torts § 874 also refers to Restatement (Second) of Trusts §§ 197 through 226A as '[s]pecial application [s]' of the rules in Torts § 874. As noted, *supra,* Restatement (Second) of Trusts § 197 states that, with limited exceptions, 'the remedies of the beneficiary against the trustee are exclusively equitable.'

"Thus, the Restatement simply refers us back to Maryland procedure which, as set forth in Parts I and II, *supra,* does not recognize that Regina's claim is triable to a jury." 690 A.2d at 517-18. The Court of Appeals concluded in rejecting the recognition of a separate cause of action for breach of fiduciary duty for express trustees: "**Nor shall we preside over the death of equity by adopting Regina's contentions.**" 690 A.2d at 521.

In *Brooks v. Key Trust Co. N.A.*, 809 N.Y.S. 2d 270 (A.D. 2006) the court dealt with claims regarding an investment management agreement, "alleging causes of action for breach of contract, breach of fiduciary duties, violation of General Business Law §349, common-law rescission of loans extended by defendants, an accounting, and punitive damages." The trial court dismissed all claims except breach of contract and accounting. The decision was affirmed.

The court on appeal held that "The allegations underlying plaintiff's fiduciary duty claim – based upon defendants' self-dealing, conflict of interests, and failure to advise plaintiff and prudently manage and diversify his portfolio, and encouraging improper loans to plaintiff –are **either expressly raised in plaintiff's breach of contract claim or encompassed within the contractual relationship by the requirement implicit in all contracts of fair dealing and good faith.** (*see 511 W. 232nd Owners Corp v. Jennifer Realty Co.*, 98 N.Y. 2d 144, 153, 746 N.Y.S.2d 131, 773 N.E. 2d 496 [2002]). As such, plaintiff has not 'set [ ] forth allegations that, *apart from the terms of the contract*'...so as to permit a cause of action for breach of a fiduciary duty independent of the contractual duties. (*see Kaminsky [v. FSP Inc.*5 A.D. 3d 251, 252, 773 N.Y.S.2d 292 (2004)])." 809 N.Y.S.2d at 272-73. The court then dismissed the punitive damages claim since it could not be based on a contract action. 809 N.Y.S. 2d at 273. Hence, the policy issues and result were similar to those in *Kann.*

Not everybody seems to have followed the lead of Maryland on the existence of a tort claim and elimination of tort procedures. Many states have either statutory or constitutional rights to trial of disputed facts by juries (as seen in *Cailloux*) and a majority allow judges sitting in equity or probate to assess punitive or exemplary damages in cases involving fiduciaries. There are a variety of recent cases where claimants seek the benefits of a tort remedy in contexts where probate or equity courts may ordinarily have exclusive jurisdiction. Equity may not be dead in such jurisdiction, but perhaps merely wounded.

Burt v. Rhode Island Hospital Trust, NA, 2006 WL 2089254 (R.I Super. July 26, 2006) involved a claim that closely held stock in an estate was sold at an inadequate price to insiders in the corporation, and that the executor committed a breach of fiduciary duty "by failing to obtain an independent appraisal of [the stock] and instead, allowing the estate's shares to be sold at a price well below their true value." 2006 WL 2089254 at *3. The instant case had been filed in the general jurisdiction trial court after rejection in the probate court and denial of an appeal

because of improper venue. *Ibid.* The defendants then moved for summary judgment, *inter alia*, on the grounds that the court lacked jurisdiction and on the basis of res judicata and laches.

Conceding that existing Rhode Island law supported a finding of lack of jurisdiction because of exclusive jurisdiction in the probate court, 2006 WL 2089254 at *5, the court analogized to the opinion of the US Supreme Court in *Marshall, supra*. The court pointed to the allegations of breach of fiduciary duty for failure to obtain an appraisal, as well as the claim that "the plaintiffs alleged that the executor defendants breached their fiduciary duties by failing to bring an action against the [purchasers] or to take any other action to seek relief for the substantial dilution in value of the stock at issue.. Like the claim of the decedent's widow in *Marshall*, the plaintiffs' claim 'does not "involve the administration of an estate, the probate of a will, or any other purely probate matter."' *Marshall v. Marshall*, 126 S.Ct. at 1748. Rather, as tortuous interference is 'a widely recognized tort,' long-accepted as being within the jurisdiction of the federal courts, so is breach of fiduciary duty a well-established cause of action within the jurisdiction of the Rhode Island Superior Court." 2006 WL 2089254 at *7. The court noted that the plaintiffs were seeking in persona judgment against the defendants, rather than a claim against the res in the custody of the probate court. *Ibid.* Consequently, it denied the motion to dismiss.

The court then looked to the allegations of negligent conduct by the plaintiffs, and the defendants' claims that they reasonably acted "in light of the instructions left by the testator and assert that their actions did not constitute a breach of their fiduciary duties to the plaintiffs." 2006 WL 2089254 at*8.

The trial court concluded that "whether a breach of trust has occurred – or in this case, whether the executor defendants have violated their legal obligations to the plaintiffs – is a question of fact." Citing Restatement (Second) of Trusts §201, com a. and Rhode Island precedents. 2006 WL 2089254 at *9. The court concluded that there were questions of fact which precluded granting summary judgment for either side. *Ibid.*

The trial court denied defense of res judicata and laches, despite the existence of a pending, but inactive probate case.

Similar arguments regarding the existence of fiduciary duty claims in the context of express fiduciaries were discussed in *Jones v. Brennan*, 465 F. 3d 304 (7th Cir. 2006), in which an heir filed pro se claims against several state probate judges and the public guardian, alleging a variety of claims including breach of fiduciary duty. Judge Posner wrote the decision, holding that *Marshall* held that the probate exception might not apply to a claim for breach of fiduciary duty. "Jones for the most part is complaining simply about the maladministration of her father's estate by the Cook County probate court, and this complaint, brought while the probate proceedings were in progress though they have since concluded, was tantamount to asking the federal district court to take over the administration of the estate. That clearly would violate the probate exception." 465 F. 3d at 307.

"But she is also accusing the guardians of having mismanaged the estate, and as an heir she may have a claim for breach of fiduciary duty by them. *Miller v. Rich*, 204 Ill. 444, 451-452,

68 N.E. 4888 (1903); *Estate of Lis v. Kwiatt & Ruben, Ltd.*, 365 Ill. App. 3d1, 301 Ill. Dec. 869, 847 N.E. 2d 879, 886-87 (2006). Such a claim does not ask the court in which it is filed to administer the estate, but rather to impose tort liability on the guardians for breach of fiduciary duty. Although both the public guardians and guardians *ad litem* are agents of the probate court as long as they are acting at the court's direction, and so have to that extent absolute quasi-judicial immunity...they can be sued if they step outside the scope of their agency and engage in self-dealing, as charged by the plaintiff. *Dornheim v. Sholes, supra*, 430 F.3d at 925; *Cok v. Cosentino*, 876 F.2d 1, 2-4 (1st Cir. 1989." 465 F.3d at 307-08. Although dubious that any of the plaintiffs' federal claims were outside the probate exception, the case was remanded to determine if there were any colorable federal claim not barred by the probate exception.

The *Lis* case cited by the Court held that an executor, absent an independent confidential relationship, did not owe a fiduciary duty to beneficiaries regarding a pension plan which was not part of the probate estate, barring claims of breach of fiduciary duty against the executor. 847 N.E. 2d at 886-888.

Jones was followed by the 7th Circuit in *Bedree v. Lebamoff*, 2006 WL 2860575 (Nov. 21, 2006), holding that "The breach of fiduciary duty claim...is not barred by the probate exception because it need not necessarily affect the administration of the estate." 2006 WL 2860575 at *3. The complaint involved claims of errors in the state court's administration of an estate.

In *Estate of Wallace*, 2006 WL 3611277 (Tex. App. Dec. 13, 2006), the appeals court affirmed summary judgment in favor of defendants involving breach of fiduciary duty claims in the context of a claim for a contract to make a will. The plaintiff had provided legal services to the decedent and claimed a fiduciary relationship which allowed him to rely on the alleged promise by the client to include the attorney in his will. The court held that "Before an informal fiduciary duty in a business transaction will be imposed, it must be established that the special relationship of trust and confidence existed prior to and separate from, the agreement made the basis of the suit.[citing *Meyer v. Cathey* 167 S.W. 3d 327, 331 (Tex. 2005)] Further, subjective trust alone will not create a fiduciary relationship; instead the nature of the relationship must be established from objective facts." 2006 WL 3611277 at *6. The estate defended against the claim based on his provision of legal services to the decedent:

"Thus Riddick's admission that he was **on call to provide legal advice and services to Wallace on a 24-hour basis**, in addition to the legal services admittedly performed and set forth in footnote 13 of this opinion, clearly indicates an attorney client relationship, thereby obviating any finding that Wallace owed a fiduciary duty to Riddick. *Cathey*, 167 S.W. 3d at 330 (holding that an attorney-client relationship establishes a fiduciary duty, as a matter of law, from the attorney to the client)." 2006 WL 3611277 at *8 (emphasis added). *Cathey* required objective proof of a relationship of trust and confidence, noting that an attorney client relationship imposed fiduciary duty on the attorney as a matter of law. However it is comforting to know that clients have no fiduciary duties to their attorney, at least those who offer legal advice and services on a 24-hour basis.

Miller v. J.J.B. Hilliard, W.L. Lyons, Inc., 2007 WL 29647 (Ky. App. Jan. 5, 2007) dealt with claims by heirs that the decedent's stock brokers had made negligent misrepresentations to the decedent and breached their fiduciary duties **to the heirs** regarding the purchase by the decedent of five annuity contracts which named as the sole beneficiary of the annuities a person who held her power of attorney and subsequently became her executor. The court held that the plaintiffs had stated a colorable claim of negligent misrepresentation to the decedent regarding the effect of the beneficiary designation on the heirs, remanding that cause of action to the trial court.

The court affirmed the breach of fiduciary duty claim, however, noting that the broker had no fiduciary duty to the heirs of its client. "Regardless of the duties owed to Ms. Thacker, we cannot conclude that any fiduciary duties extended to the appellants. The appellants were strangers to the broker-client relationship between Hilliard Lyons and Ms. Thacker. Indeed, 'one cannot faithfully or fairly serve two masters or interests with diverse of conflicting claims.' *Aero Drapery of Kentucky, Inc. v. Engdahl*, 507 S.W. 2d166, 169 (Ky. 1974). Although courts have not uniformly decided the extent of fiduciary duties in a brokerage situation, we have not been cited to a single case extending the fiduciary duty to third-parties outside the broker-client relationship and decline to do so here. The trial court properly dismissed the claim pertaining to breach of fiduciary duty." 2007 WL 29647 at *2.

In evaluating claims of breach of fiduciary duty, one must take care to determine the extent to which local law allows a tort cause of action to be imposed on express fiduciaries outside of the context of a probate or specialized equity court proceeding. The existence of an equitable tort is one as described in the reporter's notes to Restatement (Second) of Torts §874 may provide some defenses to the fiduciary depending on the jurisdiction. Uniform Probate Code and Uniform Trust Code jurisdictions which require all claims dealing with the internal affairs of trusts be brought exclusively in the probate court may offer defenses to attempts to impose legal tort liability and procedures on the fiduciary.

c. Investment Management Account Claims

Breach of fiduciary duty and deceptive business practice act claims against Key Trust Co. N.A. were dismissed in *Brooks v. Key Trust Co., N.A.*, 809 N.Y.S. 2d 270 (N.Y. App. Div. 2006). The claims involved investments made under an investment management agreement as well as loans extended to the customers. The complaint sought breach of contract claims, and also sought punitive damages, alleging breach of fiduciary duties and violations of New York's deceptive practices act, General Business Law §349.

The court held that the even though the plaintiff had demonstrated that "defendants' role as his financial advisor with discretionary authority to manage his investment accounts created a fiduciary duty," the allegations properly were dismissed as **duplicative of the contract claims.** 809 N.Y.S.2d at 272.

The Court then affirmed the dismissal of the deceptive business practices claims, based on the plaintiff's failure to allege conduct that was "'[c]onsumer-oriented' i.e. that defendants engaged in 'acts or practices [that] have a broader impact on consumers at large.'" *Id.*, at 273.

The appeals court concluded that "his claims concern defendants' investment advice and management of his accounts, a 'private contract dispute...unique to the parties,' which did not amount to conduct affecting the consuming public at large and which is outside the ambit of this statute." *Ibid.* Since punitive damages could not be assessed in the remaining cause of action for breach of contract, the punitive damages claims were therefore dismissed. Again, the *Kann* approach is used to eliminate the possibility of punitive damages.

In *Quinton v. Gavin*, 835 N.E.2d 1124 (Mass. App. 2005), the Court upheld liability and treble damages under the Massachusetts Consumer Protection Act (CPA) against an "independent trustee" serving as trustee for fifty trusts. The Court distinguished *Steele v. Kelley*, 710 N.E.2d 973 (Mass. App. 1999) and *Lattuca v. Robsham*, 812 N.E.2d 877 (Mass. App. 2004) which held that the CPA did not apply to internal disputes between a beneficiary and trustee, because it was an internal dispute between coventurers in a business enterprise. "Here, Gavin advertised and sold his services as a financial manager and self-styled 'independent trustee' to members of the public in the ordinary course of business. We fail to see why his use of trust arrangements in the conduct of his enterprise converted these commercial dealings into private relationships." 835 N.E.2d at 1129. The court's view of the integrity of the transaction may have impacted its analysis: "Furthermore, whether or not professional trustees generally should be viewed as engaged in trade or commerce, in this case Gavin's use of the trust form was a sham. As the judge specifically found, Gavin's intent from the outset was to gain easy access to funds for his own purposes rather than to manage the funds for the benefit of his clients. In these circumstances, Gavin may not rely on his status as a trustee to shield him from liability under G.L. c. 93A. Indeed, it is difficult to conceive of a more fitting use of the statute than to police the behavior of one whose business was designed to bilk unwitting customers into entrusting their assets to him for his own private gain." 835 N.E.2d at 1129.

d. Duty Regarding Embezzlements By Agents

Generally an institution holding assets for a fiduciary account is not liable for defalcations by a fiduciary unless it has actual knowledge and actively assists in the breach of fiduciary duty. *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835, (Tex. 2005); *Casey v. U.S. Bank N.A.*, 127 Cal.App.4th 1138 (2005); *Neilson v. Union Bank of California, N.A.*, 290 F.Supp.2d 1101 (C.D. Cal. 2003) (banks allegedly assisted "a crooked investment advisor, in running 'a classic Ponzi scheme,'" and alleged knowledge on the part of the banks); *In re Sharp Intern. Corp.* (281 B.R. 506 (Bankr. E.D. N.Y. 2002) (where knowledge of inflated receivables was not proof of scienter of siphoning money from the victim: "suspicion and surmise do not constitute actual knowledge." 281 B.R. at 515); *Micale v. Bank One N.A.*, 382 F.Supp.2d 1207 (D.Colo. 2005).

In *Westchester Teamsters Local 456 Annuity Fund v. Fleet National Bank et al*, 2006 WL 2385261 (S.D.N.Y. Aug. 18, 2006) a custodian for a pension plan, held liable for breach of contract, was denied the ability to obtain indemnity from other fiduciaries under ERISA, but held jointly and severally liable with other plan fiduciaries for embezzlement losses. "This case arises from the embezzlement of $2.8 million from Plaintiffs' pension, annuity, unemployment, and health and welfare funds. An executive of the funds' investment manager –Unity Management, Inc. ('Unity') – instructed the custodian bank – Fleet National Bank ('Fleet') – to transfer

Plaintiffs' assets for the purchase of non-existent instruments, and subsequently squandered the money." 2006 WL 2385261 at *1. Judgment in the aggregate amount of $4,333,740 were issued jointly and severally in August of 2006 against the defendants, including the custodial trustee. 2007 WL 548778 at *1 (S.D.N.Y. Feb. 21, 2007).

The bank had a Custodial Agreement which authorized it "'to accept and rely upon trade instructions of Unity without authorization by Plaintiffs...or further inquiry by Fleet.' The Custodial Agreement required Plaintiffs to indemnify Fleet for 'and and all losses, costs, expenses, claims and liabilities which it may suffer or incur arising out of a breach of or as a result of any inaccuracy of the...representations and warranties...'. It also provided that Fleet 'shall have no liability to any person for the acts or omissions of any third party.'" 2006 WL 2385261 at *1. Ordinarily who could sleep well at night after accepting investment directions from the investment manager when one had such provisions in a Custodial Agreement.

However, in this case the court found the custodial trustee liable for breach of contract for failing to follow directions in an investment instruction to confirm the directed transfer of funds to a Swiss bank for a CD and for failure to follow its own internal guidelines requiring it to confirm the existence of directed investments held at other institutions. The president of the directing investment manager "issued ten fraudulent instructions to Fleet for $2.8 million during the period between December 16, 1996 and April 27, 1998. In those ten written instructions, Decter instructed Fleet to transfer funds to private accounts at third party banks (Credit Suisse and Summit Bank of New Jersey) to pay for certificates of deposit ('CDs') that he stated he had purchased but which, in fact were never purchased.***This first request contained explicit instructions for Fleet to request confirmation from Credit Suisse of the CD...The remaining nine instructions requested the transfer of funds to a particular bank account...at Summit Bank, with the name of H. Phillipp Hufnagel and his phone number as contact information. The instructions did not instruct Fleet to request confirmation from Summit Bank." 2006 WL 2385261 at *2.

In fact, no CD's existed and Decter spent or lost all of the funds in "risky, unsuccessful investments." Liability for breach of contracted was granted by the trial court on summary judgment, based on evidence that "In the Credit Suisse transaction, Fleet failed to follow Unity's directions to seek confirmation from Credit Suisse. In the Summit transactions, fleet failed to follow its internal policy of requiring confirmation from issuing bank of CDs when the CDs were held by the issuing bank.***As early as 1996, the lack of documentation was detected by Fleet's internal controls. Fleet contacted ...Unity to report the discrepancy, but did not contact the issuing banks to check on the CDs. When Summit and Fleet merged, confirmation of the CDs failed, but a number of years passed before Fleet reported the discrepancy in confirmations to Unity and Plaintiffs in March 2002." 2006 WL 2385261 at *3.

The Court granted the plaintiffs' summary judgment for breach of contract against the custodian, "Specifically I found that 'Fleet breached its contractual duties owed to Plaintiffs, [and] that Fleet's breach proximately caused Plaintiffs' losses....I also indicated that indemnification under Fleet's counterclaim was not applicable, because, on the record as it then stood, Fleet was liable due to its own acts of negligence, not those of a third party." 2006 WL 2385261 at *7.

Despite evidence of negligence by the investment manager, indemnity was denied: "Fleet's liability to Plaintiffs is due to its failure to hold and administer the assets that the wire transfers instructed it to purchase. Fleet is not held liable for heeding Unity's written instructions without further inquiry. The provisions for indemnification under the Custodial Agreement do not apply to the case at hand." 2006 WL 2385261 at *8.

In a related area, the Uniform Fiduciaries Act generally denies liability of a banking institution for a breach of fiduciary duty by a fiduciary customer of the bank involving a transaction involving the bank, unless the institution has actual knowledge of the breach or acts which such knowledge of such facts that its action amount to bad faith. In *Watson Coatings, Inc. v. American Express Travel Related Services, Inc.*, 436 F.3d 1036 (8th Cir. 2006) the court held that "'it is not entirely accurate to equate "bad faith" with "dishonesty," if the latter term is taken to denote a high degree of moral guilt, or evil motives.'" Citing *Trenton Trust Co. v. Western Sur. Co.*, 559 S.W. 2d 481, 492 (Mo. 1980). The Eighth Circuit held that "The test of bad faith is 'whether it is commercially unjustifiable for the person accepting a negotiable instrument to disregard and refuse to learn facts readily available. Where circumstances suggestive of the fiduciary's breach become sufficiently obvious it is 'bad faith' to remain passive." 436 F.3d at 1041. In that case the Court held that electronic, automated check processing to be commercially reasonable where the failure to examine a check was not in violation of the bank's prescribed procedures and where such procedures do not unreasonably vary from general banking usage. *Ibid.* The court held that "constructive knowledge under the UFA is insufficient to impose liability upon the payee because the UFA limits liability 'to relatively uncommon cases in which the person who deals with the fiduciary knows all the relevant facts.'" 436 F.3d at 1042-3.

In *C-Wood Lumber Co, Inc. v. Wayne County Bank*, 2007 WL 187892 (Tenn App. Jan. 24, 2007) the court rejected liability under the UFA for the negotiating bank where there was a corporate resolution authorizing the deposit of funds into the corporate officer's personal account, but upheld liability for deposits into her children's accounts at the bank.2007 WL 187892 at *17. In that case bank employees receiving the deposits were sufficiently concerned that they had called the deposits to the attention of the bank's officers.

e. **Indemnification/Contribution**

The custodial trustee's claims for indemnification, for fraud, and for conversion were denied on the bank's summary judgment motion. Fraud was eliminated based on New York precedents that " 'Where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance.' *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 737 (2d Cir. 1984)." 2006 WL 2385261 at *9.

The Court denied Fleet's claim for common law indemnification under Restatement, Restitution §76, and though the liability with the other defendants was joint and several, "Fleet does not have a right of indemnification. None is provided by ERISA, and, in the absence of such, sound policy does not permit a custodian to escape responsibility by claims that someone else is more culpable." 2006 WL 2385261 at *10. One might look at *Harris Trust and Savings Bank v. Salomon Smith Barney, Inc.*, 530 U.S.238, 120 S. Ct. 2180 (2000) where the court read

into ERISA the right of a breaching trustee to sue a party which allegedly knew of should have known that the transaction it participated in was a breach of trust. In that case, however, the recover was being sought for the trust, rather than to indemnify the custodial trustee.

In *Summers v. State Street Bank & Trust Co.*, 453 F.3d 404 (7th Cir. 2006), the court in dicta discussed the availability of contribution of a custodial trustee against the directing trustees (pointing out that the trustees of that ESOP trust had been in turn indemnified by the employee unions). This was raised in the context of a settlement with the directing trustees in which a settlement bar against State Street had been entered. "The settlement-bar approach assumes, moreover, that there is a right of contribution, and it is unsettled whether ERISA defendants have such a right. *Lumpkin v. Environdyne Indus. Inc.*, 933 F2d 449, 464 n. 10 (7th Cir. 1991); compare *Chemung Canal Trust Co. v. Sovran Bank/Maryland*, 939 F. 2d 12, 16-17(2d Cir. 1991) (yes, contribution), with *Kim v Fujikawa*, 871 F.2d 1427, 1432033 (9th Cir. 1989) (no). We assumed in *Alton Memorial Hospital v. Metropolitan Life Ins. Co.*, 656 F.2d 245, 250 (7th Cir. 1981), that they do, but did not actually discuss the question, which remains an open one in this circuit. This is not the case in which to close it, as it would not affect our result; we mention it merely in the hope of heading off such errors in the future." 452 F.3d at 413. Former law professors never give up their teaching.

The case is significant because of the use of internal guidelines to establish a breach of contract claim. Other courts have split over the ability of a third party to utilize such guidelines to establish a breach of duty. The case raises a large flag for trust risk managers, since internal guidelines may end up being sources of liability if not followed.

A subsequent ruling in the case, found at 2007 WL 548778 (SDNY Feb. 21, 2007) involved the order of the court awarding 60% of the plaintiffs' attorneys fees, $331,394.69, against the custodial trustee and investment manager. 2007 WL 548778 at *4.

For liability of an ERISA fiduciary for hiring a firm to collect plan contribution which had previously misappropriated pension contributions, see *Chao v. Merino*, 452 174 (2d Cir. 2006) applying the prudence standard developed in the common law of trusts. 452 F. 3d at 182.

f. **Standard of Care and Review of ESOP Trustee**

Lasalle Bank faces continued liability after the Seventh Circuit overturned summary judgment in its favor in *Armstrong v. Lasalle Bank N.A.*, 446 F.3d 728 (7th Cir. 2006). Lasalle was the trustee of Amsted Industries, which was owned by an ESOP, which permitted employees who terminated their employment to have their shares redeemed in full for cash. The redemption price was set annually, with the employees having 9 months to decide whether to redeem their stock at this fixed price. As Judge Posner described in his opinion, "a drop in the stock's value between September 30, and the following June 30 would increase the departure rate because employees who didn't expect the value to recover could truncate their loss by redeeming their stock at the higher September value. 446 F.3d at 730. Amsted made an acquisition, obtaining an unsecured $1 billion loan. This increased the risk to the employee-shareholders. In September of 1999, a consulting firm hired by Lasalle valued the stock at $184 a share, 32% higher than the previous year. However, in 2000, the redemption rate by employees jumped to 32%, causing a

liquidity crisis for the company, causing the company to amend the ESOP to defer eligibility for liquidations generally to five years after the employee left the company and made other changes in the plan, allegedly adverse to the class of plaintiffs. The valuation of the shares in 2000 was $90, and $44 the following year. The Court on appeal concluded that "the Amsted ESOP was ripe for a 'run' in 2000; and the more employees who left, redeeming their shares for cash at $184 a share, the more acute Amsted's liquidity problem would be and therefore the greater the incentive of other employees to leave before the roof caved in. **The question is whether LaSalle, as the ESOP's trustee, behaved imprudently in the face of this risk."** 446 F.3d at 731 (emphasis added).

The Court then examined whether the conduct of the trustee should be evaluated deferentially, i.e., on an abuse of discretion standard, or plenary, as a breach of the standard of care. "A trustee is not an entrepreneur. His services are more like those of a professional. He is supposed to be careful rather than bold. And care is something that courts are more comfortable in appraising than **entrepreneurial panache,** as when they decide that a driver was negligent because he failed to exercise due care and as a result injured a pedestrian. It is natural for a court to consider whether a trustee was prudent rather than whether he abused his discretion." 446 F.3d at 733 (emphasis added). The Court noted that while it might have been prudent to reduce the redemption price to prevent a liquidity crisis, this might have caused it to be sued by unhappy employees. "We must not seat ESOP trustees on a razor's edge. We agree therefore with those courts that review the ESOP trustee's balancing decision deferentially." *Ibid.*

The Court held that "Even if, as we assumed in *Eyler* [*v. Commissioner*, 88 F.3d 445, 454-56 (7th Cir. 1996)], the *general* standard of review of an ESOP's decisions for prudence is plenary, a decision that involves a balancing of competing interests under conditions of uncertainty requires an exercise of discretion, and the standard of judicial review of discretionary judgments is abuse of discretion." *Ibid.* The Court did not examine the impact of the Uniform Prudent Investor Act, with its standard of care for investment decisions.

The Court then raised the question whether the trustee had in fact exercised its discretion, noting that "a discretionary judgment cannot be upheld when discretion has not been exercised. *United States v. Cunningham*, 449 F.3d 673, 679 (7th Cir. 2005); *Miami Nation of Indians of Indiana, Inc. v. U.S. Dept. of Interior*, 255 F.3d 342, 350 (7th Cir. 2001). We cannot find in the record as now constituted...any indication that LaSalle considered how best to balance the interests of the various participants in the ESOP in the novel circumstances created by Amsted's acquisition of Varlen. LaSalle acted as if nothing had changed, without (so far as appears) attempting to determine the consequences of the acquisition for the risk borne by the ESOP's participants." 446 F.3d at 733-734.

The Court concluded, "A trustee who simply ignores changed circumstances that have increased the risk of loss to the trust's beneficiaries is imprudent. Whether that is an accurate characterization of LaSalle's conduct is a critical issue requiring exploration by the district court." Id., at 734. It then ruled that if LaSalle did consider the risks involved in the changed circumstances, the test would be whether it abused its discretion under the deferential review standard.

The Court helpfully pointed out "One way to pose the question – we do not say the only way – is to ask whether it was unreasonable for LaSalle, in the circumstances that confronted it, to fail to apply a 'marketability discount' to the redemption price." *Ibid.* It then explained how a marketability discount could have been calculated.

This decision by Judge Posner, as usual for this remarkable judge, is very carefully reasoned. It raises a host of issues for fiduciaries, setting out the proposition that most decisions will be judged in a plenary fashion, that is, whether there was negligence involved. However, it properly concludes that where the trustee faces balancing issues between alternative courses of action, its actions must be judged on the more lenient standard of abuse of discretion. The court did note that where a conflict of interest is involved, the plenary review standard is appropriate, citing *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 111-15 (1989) and *Howard v. Shay*, 100 F.3d 1484, 1488-89 (9th Cir. 1996). 446 F.3d at 732.

However, the trustee must be able to demonstrate that it in fact exercised its discretion. If it failed to examine the changed circumstances, and thus conduct an informed exercise of discretion, then the plenary or negligence standard would apply. Here, the appeals court makes clear that such a failure would be imprudent. Trustees take note of the need to take action when changed circumstances require a prudent trustee to investigate and properly exercise its discretion in deciding whether action is required.

g. POD Accounts

The Ohio Supreme Court ruled on the standards for evaluation whether a constructive trust can be imposed over withdrawals by a joint owner from a pay on death account under Uniform Probate Code (UPC) §6-103. *Estate of Cowling*, 847 N.E.2d 405 (Ohio 2006). The trial court had imposed a constructive trust on withdrawals from various joint brokerage accounts and stock investments owned jointly with rights of survivorship. This was a second marriage, with the husband having children from a prior marriage. The wife sued, claiming that her husband had improperly withdrawn assets in excess of his contributions to the joint investments, and seeking to impose a constructive trust on assets which had been transferred to her stepchildren. The intermediate court had reversed the imposition of a constructive trust. The Supreme Court reversed and reinstated the constructive trust, now over cash deposits with the clerk of the court.

The Court held that the existence of a joint and survivorship bank account raises a rebuttable presumption that co-owners of the account share equally in the ownership of the funds on deposit," the *moiety rule*. *See* Campisi, "Joint Tenancy Accounts: An Un-Uniform Law." 30 Real Property Probate and Trust Journal 399 (Fall 1995). The Court held, as provided in the UPC, that joint accounts belong, during the lifetime of the parties, to the parties in proportion to the net contributions of each to the sums on deposit, unless "there is clear and convincing evidence of a different intent.'" 847 N.W.2d at 409-410. The Court concluded that despite the language of §6-103, "This language indicates that, although we adopted a new presumption for determining ownership of joint and survivorship accounts, the presumption of equal ownership continues to exist where net contributions are not proven." *Ibid.* "Net contributions", as defined in the UPC, "'accurately reflect[s] the common experiences of mankind in regard to joint and

survivorship accounts' and we adopt this definition as the law of Ohio." Id., at 410

Hence, net contributions are defined as "'the sum of all deposits to an account made by or for the party, less all payments from the account made to or for the party which have not been paid to or applied to the use of another party and a proportionate share of any charges deducted from the account, plus a proportionate share of any interest or dividends earned,'" citing UPC 6-211. *Ibid.* While the jury was not instructed as to the definition of "net contributions," the court concluded that since the husband had transferred to his children only assets withdrawn from the joint accounts, the jury award is "the equivalent of a determination of Grace's net contributions." Id., at 410-411. However, the defendants had failed to appeal the jury's damage award, avoiding this issue on appeal. The Supreme Court held that a constructive trust can only be imposed where there is clear and convincing evidence. It also held that "a constructive trust cannot be imposed absent tracing by the claimant." Id., at 411. The court held that the burden of proof for establishing tracing is clear and convincing evidence. Id., at 412. The court found that there had been clear and convincing evidence to support the jury's award. Id., at 414.

The court explained "A constructive trust is an equitable remedy that must be imposed on particular assets, not on a value. For example, if a party is inequitably deprived of 100 shares of stock that are valued at $10,000, a constructive trust should be imposed over 100 shares of stock, not $10,000. The value of the stock may decrease to $9,000 through no fault of the present possessor. In that instance, it would be inequitable to impose a constructive trust for a higher dollar amount than the stock's new value. Similarly, should the stock rise, the beneficiary of a constructive trust should not be deprived of that increase in value." Id., at 412. This is a difficult statement. Generally, the shares are sold, the injured party gets a constructive trust over the proceeds or over what has been acquired with the funds. If the transfer is innocent of complicity or knowledge of the wrongdoing, the goal should be to make the victim whole by placing a trust over the shares of stock or their proceeds. If the proceeds have been dissipated, an innocent transferee should not be liable; if reinvested in assets, the constructive trust should be placed over assets into which the funds can be traced.

Whatever the imprecision of its analysis, the Ohio Supreme Court looked to the powers of the equity court as explained in John Selden, Table Talk (1689):

"('Equity is a roguish thing. For Law we have a measure, know what to trust to; Equity is according to the conscience of him that is Chancellor, and as that is larger or narrower, so is Equity.' 'Tis all one as if they should make the standard for the measure we call a "foot" a Chancellor's foot; what an uncertain measure would this be! One Chancellor has a long foot, another a short foot, a third an indifferent foot. 'Tis the same thing in the Chancellor's conscience'). Despite the **imprecision** of some of the standards we apply in equity, we can only conclude, under any standard, that the Cowlings would unjustly benefit in the absence of a constructive trust. Accordingly, we reverse the decision of the court of appeals." 847 N.E. 2d at 414 (emphasis added).

h. Have Your Attorney Read This Case In Briefing Your Next Appeal

In *Estate of Gerstein*, 2006 WL 728762 (Cal. App. March 23, 2006), the Court faced a

"skimpy" appellate brief and no reply by the winner below. The Court on appeal announced that "We have cobbled together some context for the reader." Comment: It is tough being an appellate judge trying to do justice. It noted that "This is an appeal both sides deserve to lose." However, the Court, like the Ohio Supreme Court, did its best to reach a just decision, despite the efforts (or lack of them) of counsel. "Thus, despite respondents' best efforts to lose this appeal, we will affirm the order." 2006 WL 728762 at *2. The moral is that sometimes justice prevails, but you will be better off hiring an attorney and filing a brief to defend your position.

i. **Removal Cases**

The trial court had surcharged the trustee regarding various allegedly improper invasions, but declined to remove it. On appeal, the court in *Estate of Collins*, ___N.Y.S. 2d___, 2007 WL 174470 (N.Y. A. D. Jan. 25, 2007) upheld the refusal to remove, but instructed the trial court on remand to take into consideration the impact of mergers in evaluating removal after resolving open issues with respect to investment prudence: "Not every breach of fiduciary duty warrants removal, and courts are generally hesitant to exercise the power to remove a fiduciary, as such action 'constitutes a judicial nullification of the testator's choice.' (*Matter of Duke*....640 N.Y.S.2d 446, 663 N.E.2d 602; *see Matter of Venner*, 235 A.D. 2d 805, 807, 653 N.Y.S. 2d150 [1997]. Here, the testator chose his hometown bank as trustee and, due to mergers over the years, respondent, acting from an office in Cleveland, Ohio, took over the role of trustee. **The Court may take these circumstances into consideration when determining whether to remove the trustee, realizing that a removal would not entirely subvert the testator's intentions.**" 2007 W.L. 174470 at *1 (emphasis added).

Restatement, Third, of Trusts §37 reflects a more flexible standard for removing a trustee where "changes in the place of trust administration, location of beneficiaries, or other developments causing serious geographic inconvenience to the beneficiaries or to the administration of the trust" are present. §37 com. e at 135. Similarly, the deference given to the settlor's choice of a trustee "may no longer be justified if, after being designated, a corporate trustee undergoes a significant structural change, such as by merger, or any trustee significantly reduces the level of quality of service to the trust or its beneficiaries." §37 com. f at 137. Uniform Trust Code §706 (f) embodies such comments, allowing removal where "there has been a substantial change of circumstances" and the "court finds that removal of the trustee best serves the interests of all of the beneficiaries and is not inconsistent with a material purpose of the trust, and a suitable cotrustee or successor trustee is available." The comments to §706 explains that "Changed circumstances justifying removal of a trustee might include a substantial change in the character of the service or location of the trustee. A corporate reorganization of an institutional trustee **is not itself a change of circumstances if it does not affect the service provided the individual trust account**." §706 com (emphasis added). *See Fleet Bank v. Foote Trust*, 2003 WL 22962488 (removal under Connecticut's version of the UTC after trustee officers moved to a different corporate trustee after a merger).

In *Haines v. Kimble*, ___S.E. 2d ___, 2006 WL 695752 (W. Va. Mar. 17, 2006), the Court reversed the trial court for abusing its discretion in refusing to remove an executrix in a hostile relationship with the heir. "In this case, while there may be facts in dispute as to the specific reasons surrounding the hostile relations between appellee and the appellant, there is no

dispute that such hostile relations in fact do exist and that the parties cannot work together with any sense of civility or common purpose. We believe that such hostile relations, regardless of who is at fault, necessarily have already damaged, and in the future will continue to damage, the estate and the appellant's interest in it." 2006 WL 695752 at *3. "In the instant case, it is not necessary to inquire into how these controversies and disputes arose or who may be responsible for creating a particular controversy because there are no joint fiduciaries or co-executrixes and there are no multiple or joint heirs. ***However, we do not mean to say that there can never be a case wherein a court or fiduciary commissioner should inquire into such issues. For example, in an appropriate case where co-executrixes or joint fiduciaries or multiple heirs are in a dispute over the administration of a given estate it may be appropriate and necessary to determine if one fiduciary or heir intentionally and deliberately created the controversy solely for the purpose of causing the removal of an executrix or administratrix. That is simply not the case here where there is only one heir." Id., at *4. The Court's decision doubtless was influenced by the fact that the legal fees involved in the acrimony were "estimated to approach $1 million." *Ibid.*

The Court affirmed an order denying removal of a trustee in *In re 1996 JBL Trust*, 817 N.Y.S.2d 224 (N.Y. App. Div. June 6, 2006). The trust was administered in New York but governed by California law. The settlor sought to remove the trustee. The settlor claimed that the trustee had not complied with the detailed California requirements for accountings. The court rejected this, pointing out that there was no duty under California law to provide an accounting to a settlor. The court also rejected as a basis for removal the fact that the trustee also personally held stock in a publicly traded company, which was also held in the trust. "Respondent's ownership of the shares was known to petitioner at the time of respondent's appointment as trustee, and a trustee may not be removed for a potential conflict of interest known by the settlor at the time of appointment (*see Copley v. Copley*, 126 Cal.App.3d at 286-287; *Estate of Keyston*, 102 Cal.App.2d 223 [1951]). Further, petitioner failed to demonstrate that the trustee's simultaneous sale of his stock and the stock of the trust, almost eight years prior to the instant removal petition, was detrimental to the trust. Indeed, the trust netted a substantial profit from the sale of the stock, which was sold two years prior to the issuing company's bankruptcy." 817 N.Y.S.2d at 225. Again, a court with good reasons for its decision.

j. Indemnification Demand to Successor Trustee Improper under ERISA

The District Court in *Adler v. B.C. Ziegler and Co. and Bank One Trust Co., N.A.*, 2006 WL 2380638 (E.D. Wisc. Aug. 16, 2006) dismissed a suit for indemnification by a former ERISA trustee against its successor. The suit was based on a corporate resolution of the successor, authorizing the indemnification of Bank One, its predecessor. The Court held that "The effort of Bank One, a plan fiduciary, to seek indemnification for its performance as a plan fiduciary from Alder Group, another plan fiduciary, and pursuant to a purported indemnification arrangement contained in a plan document drafted for the purpose of transferring fiduciary responsibilities from a plan trustee to successor plan trustees is an attempt to relieve a fiduciary from liability and is void as against public policy pursuant to §401(a) of the Employment Retirement Income Security Act, 29 U.S. C. §1110(a)." 2006 WL 2380638 at 2. The court stated its willingness to consider the successor trustee's application for attorneys fees. *Ibid.*

k. Settlement Agreement Strictly Construed

The Court in *Fuller Family Holdings, LLC v. The Northern Trust Co.*, ___N.E. 2d ___ 2007 WL 465641 (Ill. App. Feb. 13, 2007) held that a settlement agreement which did not expressly include breach of fiduciary duty claims subsequently raised was limited to its terms. "The operative facts underlying that earlier litigation involved the birth dates of two of the trust settlor's lineal descendants and the agreement that the trust assets could properly be disposed of by transferring them to a holding company established by the beneficiaries. These facts wee entirely unrelated to the facts underlying the breach of fiduciary duty claim asserted in this case, which was premised on the terms of the guarantee and on the contention that Northern could and should have taken action to enforce the guarantee and to foreclose on the Civic Center mortgage. Because this action and the prior litigation were not predicated on a single group of operative facts, the doctrine of *res judicata* does not bar the breach of fiduciary duty claim, and the circuit court correctly refused to dismiss the claim on that basis." 2007 WL 465641 at *7.

The court also upheld a refusal to dismiss on grounds of statute of limitation, holding that on the record as pleading, it could not be said as a matter of law when the beneficiaries had sufficient knowledge to apprise them of the breach of fiduciary duty claims, noting that "the issue of when a plaintiff knew or should have known of the cause of action is a question of fact." 2007 WL 465641 at *8.

The Court also upheld the refusal of the trial court to dismiss spoliation of evidence claims. "To state a cause of action for the negligent spoliation of evidence, a plaintiff must plead the existence of a duty owed by the defendant to the plaintiff, a breach of that duty, an injury proximately caused by the breach, and damages. *Boyd v Travelers Ins. Co.*, 166 Ill. 2d 188, 194-95, 652 N.E. 2d 267 (1965). Although the general rule is that there is no duty to preserve evidence, a duty to preserve evidence may arise through an agreement, a contract, a statute, or another special circumstance. *Boyd*, 166 Ill. 2d at 195. In any of the foregoing circumstances, a defendant owes a duty of due care to preserve evidence if a reasonable person in the defendant's position should have foreseen that the evidence was material to a potential civil action." 2007 WL 465641 at *10.

The court concluded that "the corrected complaint sufficiently alleged a duty to preserve the guarantee based on the fiduciary relationship between the trustee and the trust beneficiaries and upon the trustee's obligation to maintain all records that relate to the assets and interests of the trust." 2007 WL 465641 at *10. Given the trustee's duty to maintain the books and records of the trust under Restatement, Second, of Trusts §192, this holding raises a serious warning to fiduciaries to maintain material records about trust investments.

l. Summary Judgment Standards

In *Deafen v. Keybank USA N.A.*, 2006 WL 1580053 (Ohio App. June 9, 2006), the trustee was removed pursuant to a power in the trust instrument. Subsequently, a beneficiary sought to surcharge the trustee. The trustee obtained summary judgment in its favor, which was then appealed. The court upheld the summary judgment on several surcharge issue, but reversed as to certain claims of negligence.

The Appellate Court held that "The standard of care and skill required of a trustee in administering the trust and in preserving the trust property is the objective standard of a reasonable person in dealing with his or her own property. *Cassner* [*v. Bank One Trust Co., N.A.*] citing Restatement of the Law, 2d, Trusts (1959), Sections 174 and 176. When a trustee, through acts or omissions, falls below the required standard of care and negligently manages the trust property, an aggrieved beneficiary may pursue an action to recover the loss or depreciation in value of the trust estate resulting from the breach of trust. *Cassner, supra*, at ¶ 29, citing Restatement of the Law 2d, Trusts (1959), 458, Section 205." 2006 WL 1580058 at *3. Since Ohio adopted the Uniform Prudent Investor Act in 1998, it is not clear why the Court continues to rely on the Second Restatement of Trust on these issues.

The Court examined claims that the Trial Court should not have relied on the trustee's expert whose opinion had formed the basis of portions of the summary judgment, in light of the testimony of the beneficiary's expert. It held that "Weaknesses in the factual bases of an expert's testimony go to the weight and credibility of the expert's testimony, not to its admissibility." Id., at *4. However, it concluded that "the trial court failed to indicate specifically which parts of [expert's] testimony it deemed inadmissible. Moreover, even presuming [expert] based his opinion on incomplete facts, this would not make his testimony inadmissible. Rather, his testimony and credibility would have been merely subject to attack by cross-examination. Evidence weight and credibility are not properly considered on summary judgment." *Ibid.* The Trial Court had apparently overlooked a second volume of the expert's deposition where he opined as to the effect of a delay by the trustee in transferring assets.

The court found that the opposing expert had confronted the trustee's expert on several grounds. "Consequently, based upon all the evidence presented to the trial court, appellant's expert testimony sufficiently rebutted appellee's expert's opinion for the purposes of summary judgment. Therefore, the trial court erred in weighing the evidence and granting summary judgment to appellee on this issue, since the evidence presented established that material issues of fact remained in dispute as the to reasonableness of appellee's action and delay in making the one-fifth distribution of the trust assets." 2006 WL 1580053 at *5.

Summary judgment was overturned in *Williams v. Bank of America Corporation*, 927 So.2d 1091 (Fla. App. 2006) where the summary judgment motion was based on a ground not properly raised in the summary judgment motion. At issue was whether the parent corporation of the trustee was properly a party based on the allegations raised. As usual, plaintiffs seek to name the parent corporation so they can attempt to take the deposition of the holding company president and look to the parent's assets in claiming enormous punitive damages. The motion for summary judgment raised only the issue of statute of limitations. A single footnote in the motion pointed out that the plaintiffs had no relationship with the holding company and that "there is no basis, factual or legal, to support a claim against BAC here." 927 So.2d at 1092.

At oral argument there was some colloquy about the lack of allegations regarding the parent. The Trial Court then granted summary judgment, ruling that the parent company had no liability "'based on Plaintiffs' allegations.'" Id., at 1093. The Court on appeal cited Florida Rule of Civil Procedure 1.510(c) which provides "The motion shall state with particularity the grounds upon which it is based and the substantial matters of law to be argued...." In reversing

the summary judgment ruling, the Court explained: "The purpose of this rule is to eliminate surprise and to provide the parties 'a full and fair opportunity to argue the issues.' ...It is reversible error to enter summary judgment on a ground not raised with particularity in the motion....In applying the rule, the trial court should take a strict reading of the papers filed by the moving party." *Ibid.* It noted: "We reject BAC's argument that its single conclusory statement regarding liability, contained in a footnote of a nineteen-page memorandum of law devoted solely to the statute of limitations issue, sufficed as a separate ground for its motion for summary judgment. BAC's motion and memorandum do not substantively address any facts or law pertaining to its entitlement to summary judgment on the plaintiffs' claims of aiding and abetting or unjust enrichment. We thus conclude that the trial court erred in entering summary judgment on a ground not asserted in BAC's motion." *Ibid.*

Abuse Of Discretion In Delaying Merger Of Subtrusts

The Court in *Dejaiffe*, supra, held that the trust instrument had granted the trustee discretion to merge the subtrusts. Although the merging may have been delayed, under the terms of the trust, appellee acted within its discretionary powers and did not have an absolute duty to merge the two trusts at a specific time." 2006 WL 15800053 at *6.

Negligent Misrepresentation Of Facts Regarding Transfer And Distribution Of Trust Assets

The Court in *Dejaiffe* then reversed the Trial Court for granting summary judgment with respect to a negligent misrepresentation claim. It held that "'A representation made with an honest belief in its truth may still be negligent, because of lack of reasonable care in ascertaining the facts, or in the manner of expression, or absence of the skill and competence required by a particular business or profession'....Where an actor used reasonable care in acquiring or communicating information is a question for the jury, 'unless the facts are so clear as to permit only one conclusion,'" citing Restatement (Second) of Torts Section 552, com e. 2006 WL 15800053 at *7. The Court concluded: "In the present case, appellant presented evidence that appellee's agents may have provided false information regarding the transfer and distribution of the trust assets. Unlike fraud, negligent misrepresentation does not require appellant to show that the actions complained of were made with intent to deceive. Rather, the misrepresentations may have been the result of the lack of reasonable care by appellee's agents, an issue which, generally, must be determined by the trier of fact." *Ibid.*

Discovery of Administrative Advice of Counsel

The Trial Court had granted summary judgment on a claim of waste, after refusing to allow discovery of the trustee's attorney records following in camera review by the court. The Court noted that obtaining discovery of materials prepared in anticipation of litigation or trial can only be granted "upon a showing of good cause." 2006 WL 15800058 at *8. While the Court held that trial courts have broad discretion over discovery, "Nevertheless, '[t]he trial court cannot very well require the party opposing a motion for summary judgment to produce rebuttal evidence and at the same time deny that party an opportunity to discover that evidence.'" *Ibid.* The court had reviewed the documents in camera, but had not concluded that they were work

product. The court held that there had been an abuse of discretion in denying access to the records:

> "After its in camera review of documents provided by [attorneys], the trial court merely determined that the documents were 'unrelated and immaterial' to appellant's claims. The court did not deem the documents to be 'attorney work product.' By determining relevance, rather than that the documents were protected, the **trial court improperly weighed evidence.** Relevant or not, appellant should have been permitted to view the documents, since apparently they were not privileged or protected. Therefore, the trial court abused its discretion in denying appellant's motion to compel discovery and to view the billing and estate documents associated with the two trusts." *Ibid.* (Emphasis added).

m. Statute of Limitations

In *Union v. Branch Banking and Trust Co.*, 627 S.E.2d 276, (N.C. App. March 21, 2006), the Court upheld summary judgment in favor of a bank where it had honored checks drawn on a ward's account where the checks had been forged. The Court held that a guardian for a ward is required to report a ward's unauthorized signature to the bank within one year of obtaining the allegedly forged checks from the bank. The guardian having failed to provide such notice within a year of obtaining the checks, summary judgment was held to have been proper. The court held that "failure of a customer or his representative to report his unauthorized signature within one year after the bank makes account statements available precludes a claim against the bank, **even if the customer is incompetent (whether adjudicated or unadjudicated) during the one year period for providing notice."** 2006 WL 694615 at *4 (emphasis added). The Court supported its decision with cases from other jurisdictions:

> "Our interpretation of section 5-4-406(f) is consistent with the courts of other jurisdictions interpreting similar statutes. *See Siecinski v. First State Bank of East Detroit*, 209 Mich.App. 459, 531 N.W.2d 768 (Mich App. 1995) (affirming the trial court's grant of summary judgment to a bank where plaintiff, although incompetent, failed to comply with notice requirement for filing a claim against a bank for honoring unauthorized checks); *Brown v. Cash Management Trust of America*, 963 F.Supp. 504 (D. Md. 1997) (holding that the one-year notice provision for forged checks is 'an unalterable condition precedent to suit,' against a bank and mental incompetence does not excuse failure to provide notice); *see also Jensen v. Essexbank*, 396 Mass. 65, 483 N.E.2d 821 (Mass. 1985) (holding that the one-year notice requirement for filing a claim against a bank for forged checks governed the time within which a party to a contract was obligated to act, and was not a statute of limitations subject to tolling); *Indiana Nat'l Corp. v. Faco, Inc.* 400 N.E. 2d 202 (Ind. Ct. App. 1980 (same)." *Ibid.*

n. Discovery of Information About Entity Controlled by Trust

The Court in *In re Richard R. Rogers, Mary Kay Holding Corp. and Mary Kay Inc., Relators*, 200 S.W. 3d 318 (Tex. App. 2006) upheld orders compelling trustees to provide information about a holding company and corporation owned by the trustees or the holding

company controlled by the trust. The bulk of the trusts' assets was stock in Mary Kay Holding Company which in turn owned interests in the Mary Kay corporation. The beneficiaries claimed "imprudent management, self-dealing, failure to diversify the assets of the trusts, failure to make sufficient and reasonable distributions from the trusts, and failure to disclose certain information to [beneficiary]. 200 S.W.3d at 320. The court on appeal upheld orders compelling the discovery, holding that "It is undisputed that the bulk of the assets of Kerr's trusts is stock in Mary Kay. Thus information concerning Mary Kay's financial status and prospects is certainly relevant to Kerr's holdings. It is also relevant to Kerr's allegations that Rogers has imprudently managed the trusts, failed to diversify assets of the trusts, and self-dealt in Mary Kay to the detriment of the trusts." 200 S.W.3d at 322.

Other authorities have held that where the trustee controls a corporation or other entity, a fiduciary standard applies to the management of the entity. *Estate of Feraud* 92 Cal.App.3d 717, 723 (Cal. App. 1979).

In re Hubbell's Will, 302 N.Y. 246, 97 N.E. 2d 888, 891 (N.Y. 1951) held:

> "Where, as here, the trustees own, in their individual and representative capacities, the entire outstanding stock of a corporation, that duty extends not only to the trust estate as such but also to the operations of the corporation. See Matter of Horowitz, 297 N.Y. 252, 78 N.E.2d 598; Matter of Doelger, 279 N.Y. 646, 18 N.E.2d 42, affirming 254 App.Div. 178, 4 N.Y.S.2d 334; Matter of Auditore, 249 N.Y. 335, 164 N.E. 242, 62 A.L.R. 551; Id., 278 N.Y. 234, 15 N.E.2d 593; *Matter of Witkind*, 167 Misc. 885, 893, 4 N.Y.S.2d 933, 945; *Farmers' Loan & Trust Co. v. Pierson*, 130 Misc. 110, 119, 222 N.Y.S. 532, 544; see, also, Cahn, Estate Corporations, 86 U of Pa.L.Rev. 136, 138. Cahn states the rule in this way (loc. cit.): 'It is well established that where a trustee holds a working control of the stock in an estate corporation he is accountable in the probate court for the administration of the corporate affairs. His cestuis que trustent may require him to treat the corporate transactions as though they were his own transactions as trustee (*Farmers' Loan & Trust Co. v. Pierson*, 130 Misc. 110, 222 N.Y.S. 532; *Matter of Auditore*, 249 N.Y. 335, 164 N.E. 242, 62 A.L.R. 551).'"

Where there are issues of conflict of interest involved, the business judgment rule will not be held to apply. *Starr v. Fordham*, 648 N.E.2d 1261, 1266; *Johnson v. Witkowski*, 573 N.E.2d 513.

The court in *Murphy v. Murphy*, 2006 WL 3267789 (Mass. Super. Oct. 3, 2006) surcharged trustees who acquired corporate stock held by the trust allegedly at below fair market value. The trustees also served as directors and officers of the closely held company. The trial court cited *Johnson v. Witkowski*, 30 Mass. App. Ct. 697, 704 (1991) regarding the burdens carried by trustees who wear multiple fiduciary hats:

> "We note initially that the difficulty arises here because of the defendants' multiple roles. They were the trustees of the trust and were also stockholders, directors, and officers of a close corporation involved in the transactions in which

they stood on both sides and in which they had a self-interest. In each capacity, the defendants had fiduciary duties. Wearing more than one hat – here, at least three—requires a fiduciary to be very nimble as well as most prudent. While the fiduciary may purport to wear one hat at a particular moment, in truth, all hats are worn together at all times."

2006 WL 3267789 at *12.

The trial court explained the Bartholomew Cubbins trustee owes to her beneficiaries the same duties owed by a corporate director regarding a potential corporate opportunity: disclosure of the material facts and approval by disinterested directors or shareholders. "While these safeguards were created in the context of a closely-held corporation, this Court finds that they apply to other fiduciary obligations, including the obligation owed by a trustee to her trust beneficiaries.***She would have been 'very nimble as well as most prudent' if she had presented the proposed redemption to the disinterested co-trustee, here Peter, or to all the Trust beneficiaries, and obtained their specific approval of the proposed redemption. Failing that, she would need to bear the burden of proving to the Court that the redemptions were fair to the Trust beneficiaries." 2006 WL 3267789 at *13.

As the Court of Appeals held in *Hubbell*:

> "A trustee may not be heard to assert that the corporate form of organization compels an otherwise unjustifiable extinction of the interest of the remaindermen in instances where, by reason of his stock ownership as individual and as trustee, he could have prevented it. Under such circumstances, if an irreconcilable conflict between self-interest and fiduciary responsibility develops, the choice of the trustee is either to subordinate the former or resign; 'thought of self was to be renounced, however hard the abnegation.' *Meinhard v. Salmon, supra*, 249 N.Y. 458, 468, 164 N.E. 545, 548, 62 A.L.R. 1. As to the plaint that application of that principle results in unfairness to the husband, let it be borne in mind that he voluntarily assumed his trusteeship. He was not obliged to become a trustee, 'but, as soon as he does so, he accepts whatever are the limitations, obligations and conditions attached to the position'. *Gratz v. Claughton*, 2 Cir., 1951, 187 F.2d 46, 49.
>
> "In thus holding that a duty existed on the part of the trustees to consent to a partial liquidation or dissolution of the Corporation in order to liquidate the stock held in trust, we dispose of any contention that the fiduciary, in his individual capacity, might have vetoed or prevented appropriate action by the Corporation towards that end. He may not use the corporate charter as a shield to protect himself from censure for, as has been said, though in a different context, Matter of Witkind's Estate, supra, 167 Misc. 885, 893, 4 N.Y.S.2d 933, 945,'where as here the fiduciaries control a corporation by the help of the estate stock interest added to the stock interest held personally by one of them they are not disabled to make such accounts and are therefore under obligation to do so. There is nothing sacrosanct about a corporation. It is not an impenetrable screen behind which facts may be successfully hidden.'" 97 N.E. 2d at 894
> ***

"In short, the trustees-directors were free to choose whether to use the depreciation moneys for the purpose of acquiring the stock or for the purpose of making a ratable distribution to the stockholders. In making that choice, they were required to act with due regard to the interests of all of the beneficiaries; they were under a duty to refrain from that course of conduct which would, at the expense of other beneficiaries, benefit that beneficiary who also happened to be a trustee and director." 97 N.E. 2d at 895.

"In those situations where a corporation is wholly owned by the trust and directly holds and controls all of the corporation's assets, courts are less reluctant to ignore the corporate entity and to consider the corporation, which is usually a holding company, an adjunct of the trust." *Matter of Estate of Butterfield*, 418 Mich 241, 257-258, 341 N.W.2d 453 (1983)

Where the decisions made by management lack impartiality with respect to beneficiaries, the trustee may find that it cannot shield itself behind business judgment. Decisions to favor beneficiaries who are insiders in the company, which favor income beneficiaries over remaindermen or which concentrate on the growth of the value of company by circumscribing dividends in favor of reinvestment, may be judged by a fiduciary rather than a business judgment standard.

The Uniform Trusts Act provides in §802(g)

> "In voting shares of stock or in exercising powers of control over similar interests in other forms of enterprise, the trustee shall act in the best interests of the beneficiaries. If the trust is the sole owner of a corporation or other form of enterprise, the trustee shall elect or appoint directors or other managers who will manage the corporation or enterprise in the best interests of the beneficiaries." (Emphasis added).

The commentary to this provision states the authorities supporting such a result:

> "It is based on Restatement of Trusts (Second) Section 193 com. a. (1959), which provides that '[i]t is the duty of the trustee in voting shares of stock to use proper care to promote the interests of the beneficiary,' and that the fiduciary responsibility of a trustee in voting a control block 'is heavier than where he holds only a small fraction of the shares.' Similarly, the Department of Labor construes ERISA's duty of loyalty to make share voting a fiduciary function. See 29 C.F.R. Section 2509.94.2. When the trust owns the entirety of the shares of a corporation, the corporate assets are in effect trust assets that the trustee determines to hold in corporate form. The trustee may not use the corporate form to escape the fiduciary duties of trust law. Thus, for example, a trustee whose duty of impartiality would require the trustee to make current distributions for the support of current beneficiaries may not evade that duty by holding assets in corporate form and pleading the discretion of corporate directors to determine dividend policy. Rather, the trustee must vote for corporate

directors who will follow a dividend policy consistent with the trustee's trust-law duty of impartiality."

7. Mandatory Arbitration in Probate and Trust Disputes

Arbitration provisions have been interposed in various fiduciary surcharge situations, some resulting from provisions in the trust instrument itself, some resulting from separate agreements entered into by the fiduciary on behalf of the fiduciary estate. The courts have taken a variety of positions: granting arbitration, enforcing arbitration agreements against beneficiaries, holding that such provisions have to be strictly scrutinized in light of the beneficiary's right to present claims to a court, and in other cases severing arbitrations based on agreements entered with third parties or staying the fiduciary claims until resolution of the arbitration between the fiduciary and the agent.

In evaluating the risks resulting from alleged misconduct, some care must be taken to determine whether the issues raised by beneficiaries will be tried in a court or in arbitration.

In some cases the trustee inserts mandatory arbitration clauses in its documents, seeking to force disputes with customers into arbitration, because of the perceived efficiency and speed of arbitration, and the desire to avoid general jurisdiction courts. You may have a variety of relationships with a beneficiary or heir, including acting as a fiduciary, providing banking services, selling them insurance or brokerage services, or providing investment services outside of the fiduciary estate. Many of these relationships may be subject to contracts with arbitration provisions. For example, in *Patnik v. Citicorp Bank Trust FSB*, 412 F. Supp.2d 753 (N.D. Ohio,2005), the Court faced a variety of broker agreements entered into by the beneficiary with Smith Barney, later acquired by Citicorp. The claims of the plaintiff related to alleged investment violations and improprieties in both the securities accounts and in the trust which had provided her with the funds invested. The plaintiff apparently rested her case on the proposition that she had not signed any arbitration agreements, and failed to oppose various motions of Smith Barney and the trustee, including a motion to stay proceedings against the trust defendants and others pending arbitration of the claims relating to Smith Barney. The arbitration clauses were extremely broad, including "all claims or controversies, whether such claims or controversies arose prior, on or subsequent to the date hereof, between me and [Smith Barney] and/or any of its present or former officers, directors, or employees concerning or arising from ...any account maintained by me with [Smith Barney]." 412 F. Supp.2d at 759. Citibank successfully argued that such provision included it under the provision including within its reach "'[Salomon] Smith Barney Inc. or its direct or indirect subsidiaries and affiliates or their successors or assigns.'" *Ibid.* at 760. The court stayed all proceedings against the other defendants pending arbitration. While it appears that the plaintiff did not aggressively protect her interests in opposing the various motions, the outcome speaks to the value for fiduciaries of broad arbitration clauses in documents involving beneficiaries.

The requirement for arbitration can be significant because of the deference given to decisions by arbitrators. In *Hollern v. Wachovia Securities, Inc.*, 458 F.3d 1169, (10th Cir., 2006) a successor trustee appealed an adverse arbitration award based on an arbitration provision in the brokerage contract entered into by the prior trustee. The Court held that "Errors in an arbitration

panel's interpretation of application of the law are generally not reversible. *Dominion Video Satellite, Inc. v. Echostar Satellite L.L.C.* , 430 F.3d 1269, 1274 (10th Cir. 2005). A judicially-created exception to this rule exists, however, where arbitrators act in manifest disregard of the law. *Id.*. Manifest disregard of the law has been defined as 'willful inattentiveness to the governing law.' *Id.*. To warrant setting aside an arbitration award based on manifest disregard of the law, 'the record must show the arbitrators knew the law and explicitly disregarded it.' *Id.*" 458 F.3d at 1176. Because the arbitration provision in the brokerage agreement did not require the arbitrator's award to include factual findings or legal reasoning and none were included, the bare award did not provide a basis for demonstrating manifest disregard. The Court upheld the attorney's fees award against the trust.

In *Hogan v. Country Villa Health Services,* ___Cal. Rptr.3d___, 2007 WL 614072 (Cal. App. March 1, 2007) the court upheld a mandatory arbitration provision with a nursing home which was entered by the holder of a durable power of attorney for health care, binding the heirs of the decedent.

While arbitration of disputes is generally favored by the courts, some restrictions have been imposed. In *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005), the California Supreme Court invalidated mandatory arbitration provisions (which also waived class arbitration of disputes) in credit card agreements provided by the bank. "We do not find that all class action waivers are necessarily unconscionable. But when the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then, at least to the extent the obligation at issue is governed by California law, the waiver becomes in practice the exemption of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of another.' (Civ. Code §1668.) Under these circumstances, such waivers are unconscionable under California law and should not be enforced." 36 Cal. 4th at 163-64.

It is important to note the limitations placed on this ruling: consumer contract with small claims of money involved. The implication is that such clauses, requiring arbitration and precluding class arbitrations, might be enforceable in securities, agency and other types of agreements. Note, however, that most State have adopted section 9 of the Uniform Prudent Investor Act which provides that agents for trustees agree to submit to the jurisdiction of the courts of the State where the principal place of business of the trust is found. It is not clear whether such provisions can be used to undercut arbitration clauses in agency agreements with trustees in UPIA jurisdictions.

Subsequent cases dealing with disputes governed by the law of other States have restricted the adhesion rule stated in *Discover*. In *Provencher v. Dell, Inc.*, 409 F. Supp.2d 1196, 2006 WL 9626 (C.D. CA. 2006), the court held that Texas law governed arbitration provisions and class action waivers and that such provisions were enforceable. Since the disputes were not over small amounts of money, and since there was no claim of a scheme of fraudulent avoidance of liability on the part of Dell, the clauses were held to be enforceable in light of the general policy of the courts of enforcing arbitration provisions. In *Lipuma v. American Express Co.*, 406

F. Supp.2d 1298 (S.D. Fla. Dec. 20, 2005), the Court, ruling under New York law, upheld a class action settlement. One of the reasons for finding the settlement fair and reasonable, however, was the claim of the defendant that class actions were barred by its account documents. While the Court noted *Discover* and other cases precluding enforcement of such clauses, it pointed out that "the New York courts have consistently upheld arbitration agreements in credit card and other consumer agreements." 406 F. Supp. 2d at 1321. Hence such provisions find support in a number of courts and the general federal policy favoring arbitration contained in the Federal Arbitration Act.

"In addition to providing that any Claim shall be resolved by arbitration upon the election of the cardmember or by American Express, the arbitration provision unambiguously states: "There shall be no right or authority for any Claims to be arbitrated on a class action basis or on bases involving Claims brought in a purported representative capacity on behalf of the general public, other Cardmembers or other persons similarly situated; provided however, that the claimant's individual Claim would be subject to this Arbitration Provision. (Id.).

"The pertinent cardmember agreements provide that they are variously governed by either the laws of the State of Utah or of New York, and applicable federal law. Admittedly some arbitration agreements limiting class action rights in similar settings have not been enforced. See, e.g., *Discover Bank v. Sup. Court* (Boehr), 113 P.3d 1100, 30 Cal.Rptr.3d 76 (2005); *Powertel v. Bexley*, 743 So.2d 570, 576 (Fla. 1st DCA 1999); *State v. Berger*, 211 W.Va. 549, 567 S.E.2d 265, 278 (2002); *Leonard v. Terminix Intern. Co. L.P.*, 854 So.2d 529, 538 (Ala.2002); all cited by intervenors in their Notice of Submission of Case Authority. [D.E. 391]. However, the New York courts have consistently upheld arbitration agreements in credit card and other consumer agreements. See, e.g., *Tsadilas v. Providian Nat'l Bank*, 13 A.D.3d 190, 786 N.Y.S.2d 478 (N.Y.A.D. 1 Dept.2004); *Johnson v. Chase Manhattan Bank USA, N.A.*, 2 Misc.3d 1003, 784 N.Y.S.2d 921, 2004 WL 413213 *4-8 (2004); *Ranieri v.Bell Atlantic Mobile, Inc.*, 304 A.D.2d 353, 759 N.Y.S.2d 448 (1st Dep't 2003); *Whalen v. American Express*, 01-602754 (N.Y.Sup.2002). Courts in Utah similarly favor agreements to arbitrate. See, e.g., *Central Fla. Investments, Inc. v. Parkwest Assocs.*, 40 P.3d 599 (Utah 2002); *Chandler v. Blue Cross Blue Shield*, 833 P.2d 356 (Utah 1992).

"Federal courts have also not hesitated to enforce arbitration agreements that precluded class action relief. See, e.g., *Randolph v. Green Tree Fin. Corp.*, 244 F.3d 814, 819 (11th Cir.2001); *Jenkins v. First American Cash Advance of Georgia, LLC, et al.*, 400 F.3d 868 (11th Cir.2005); In re Currency Conversion Fee Antitrust Litig.,,265 F.Supp.2d 385 (S.D.N.Y.2003). As the undersigned has previously acknowledged, the Federal Arbitration Act ("FAA") establishes a general federal policy favoring arbitration. *Sims v. Clarendon Nat'l Ins. Co.*, 336 F.Supp.2d 1311, 1316 (S.D.Fla.2004). Section 2 of the FAA provides as follows:

"'A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.' 9 U.S.C. § 2. "Section 2 is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive

or procedural policies to the contrary." *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Co.*, 460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983). Thus, a number of federal courts have enforced arbitration provisions in credit card agreements under the FAA. See, e.g., *In re Currency Conversion Fee Litig.*, 265 F.Supp.2d 385, 400-416 (S.D.N.Y.2003); *Vigil v. Sears Nat'l Bank*, 205 F.Supp.2d 566, 568 (E.D.La.2002); *Hale v. First USA Bank, N.A.*, 2001 WL 687371 *7-8 (S.D.N.Y.2001); *Bank One, N.A. v. Coates*, 125 F.Supp.2d 819, 831-33 (S.D.Miss.2001), aff'd, 34 Fed.Appx. 964 (5th Cir.2002)." 406 F. Supp. 2d at 1321.

Hence, it is important to consider whether such clauses should be placed in agreements with fiduciaries.

The cases to date have come to no consensus on the applicability of such clauses in probate and trust contexts.

In *Bayer v. The Harris Bank, N.A. v. UBS Financial Services, Inc.*, 2004 WL 2303495 (D. Ore. Oct 12, 2004), the court enforced an arbitration agreement between a trustee and an investment manager to send the trustee's indemnity claim to arbitration. The trustee had been sued for alleged failure to diversify and brought an indemnity action against the agent. The court held that the arbitration provision had to be honored and directed the indemnity claim to be arbitrated. The main case was stayed until the arbitration between the trustee and advisor was concluded.

In *Morgan Stanley DW Inc. v. Halliday* 873 So.2d 400 (Fla. App. 2004) the court denied enforcement of an arbitration agreement entered by the trustees of a QTIP trust and an investment manager against a non-signing beneficiary The beneficiary was held not to be a third party beneficiary of the agreement. The Court on appeal affirmed, taking a strict view of the purpose of an arbitration agreement: "While it is true that the Trust assets are for the benefit of the Trust beneficiaries—as to which the Trustees here are themselves the remainder beneficiaries and will take the corpus when plaintiff passes away—that fact hardly yields the conclusion that the customer account agreement between the Trustees and Morgan Stanley was done primarily for plaintiff's benefit. More important, it does not indicate that the *arbitration clause* was done for her primary and direct benefit—as one would suppose would be the rule in order to make a non-signatory to an arbitration agreement bound by somebody else's manifestation of assent." 873 So.2d at 403. The Court concluded, "To find the requisite contract actually and expressly intended to benefit the third party, it is not sufficient to show only that one of the contracting parties unilaterally intended some benefit to the third party." *Ibid.*

One cannot metamorphose one's beneficiaries! "Maybe the attempt to metamorphose plaintiff into a 'third party beneficiary' of this arbitration agreement really masks an attempt to make the Trustees the agent for plaintiff when they entered into the customer account agreement. But only a moment's reflections should dispel that notion as well." 873 So.2d at 403.

The court rejected on policy grounds the waiver of the right to seek redress in the courts without express knowledge and consent: "As for the arbitration agreements, which involve a waiver of a person's right to access to the courts, binding a non-signatory to arbitrate under the theory of third party beneficiary is fraught with miscalculation and unfairness. For one thing,

unless a manifestation of intent by the third party beneficiary to the arbitration clause is **clear and indisputable**, the non-party's right of access may be lost by the unilateral decision of another without knowledge or consent." 873 So.2d at 404 (emphasis added).

The trial court noted that "Arbitration in this matter could result in extended litigation of the parties whereby the plaintiff would be litigating her claims in both arbitration and before this court, with the possibility of differing outcomes." 873 So.2d at 402.

Florida, like most States, has adopted the Uniform Prudent Investor Act §9, which makes agents of the trustee subject to the jurisdiction of the courts of the trust situs, F.S.A.§518.112(5). The court did not discuss the application of this section, or of the following section, §518.112(6) which provided that "In performing a delegated function, the investment agent shall be subject to the same standards as the fiduciary."

The same result obtained in *Besser v. Miller, Advest, Inc. and Carlsen*, 785 N.Y.S. 2d 625 (App. Div. 2004): "There is no evidence establishing that the parties to the brokerage agreement intended petitioner to be bound by the arbitration clause therein and no evidence that petitioner intended to be so bound."

In *Trustees of the Texas Iron Workers' Pension Trust Fund v. Larson*, ___F. Supp.2d___, 2005 WL 2416669 (S.D. Tex. 2005) the court denied arbitration where there was no evidence that the party in question had agreed to a collective bargaining agreement containing an arbitration clause.

Other courts have required beneficiaries to be bound by arbitration clauses executed by their fiduciaries on the theory that "If 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., LIP v. Ventura* , 907 So.2d 1035, 1042 (Ala. 2005). The Court held that "Because 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.*

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 Judgment §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

The Court of Appeal in Ohio in *McKee v. Merrill, Lynch, Pierce, Fenner etc.*, 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,2w 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.

If the terms of the trust had required beneficiaries to arbitrate their disputes as a condition subsequent or under an in terrorem clause, then perhaps the provision might have been enforceable. The Father of our Country is widely cited as the father of use of arbitration provisions in will disputes, providing in his will:

> "that all disputes (if unhappily they should arise) shall be decided by three impartial and intelligent men, known for their probity and good understanding; two to be chose by the disputants each having the choice of one, and the third by those two -- which three men thus chose shall, unfettered by law or legal constructions, declare their sense of the Testator's intention; and such decision is, to all intents and purposes, to be as binding on the parties as if it had been given in the Supreme Court of the United States.

Cited in Zack, "Arbitration: Step-Child of Wills and Estates," 11 The Arbitration Journal 179 (1956). For forms and a discussion of the precedents for such usage, see Nossaman and Wyatt, Trust Administration and Taxation (2d ed. 1987) §35.07[5] and Comment, "The Validity of Arbitration Provisions in Trust Instruments," 55 California Law Review 521 (1967).

It is a good thing his heirs were happy with their legacies, since this provision likely would have been treated as unenforceable precatory language. However, if George had conditioned receipt of Mount Vernon on agreement to submission of any disputes to arbitration, the provision would doubtless have been enforced, unless the will were invalidated for reasons of capacity or undue influence. Restatement (Second) of Property §§5.1, 5.2, 8.1-8.3.

Query whether resort to Section 27 of the Third Restatement, requiring the trust to be administered solely in the interests of the beneficiaries, might have led to the same result in *Schoeneberger*.