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The Black Swans (and other Clichés) Have Come Home to Roost
Trustee Liability in a Sigma Seven World
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The reign of Modern Portfolio Theory seems to have reached an inflection point, with Alan Greenspan recanting his belief in the ability of the market to manage risk amid the worst crash since the Great Depression. While the message has not reached the editorial pages of the Wall Street Journal (which still sees the invisible hand diligently at work), the rest of the world has suddenly recalled the insights of Peter Drucker on the fact that American corporate managers often have goals at variance with those of shareholders. Management follows incentives designed to bolster the financial and reputational aspiration of management, with boards of directors looking to the corporate leadership who appointed them, rather than the voiceless shareholders. The unintended consequences of short-term performance goals and golden parachutes are now clear to anyone reading the news reports in the Journal: managers took unacceptable risks because they were insulated by quarterly incentives, bolstered by friendly directors happy to serve with masters of the universe perspicacious enough to hire them as directors, and because they were able to bail out when risks became reality while the shareholders in economy class crashed with the enterprise.

Those of us who litigated through the Savings and Loan debacle see the same familiar patters: S&L's lusted after the ability to move from home mortgages with limited profit potential and so invoked the deregulatory animal spirits in Congress to allow them to compete fully. Loaded with low cost deposits, any warm blooded, well-dressed and articulate businessman could launch or take over an S&L, recruit inexperienced people to staff lending, and provide incentives for them to compete in crowded markets for construction loans, project development, windmill farms and any other current fancy. Risk was not an issue, and regulators were distained as government hacks frustrating the genius of the marketplace, and forced to sit on the sidelines.

As discussed frequently in past years, some carping critics believed that Modern Portfolio Theory and tenets of diversification were not grounded in reality. "The random walk model thus explains quite well the way typical returns in the stock market change with time and with time scale. However, it does not explain the large fluctuations that are not 'typical,'" Didier Sornette, Why Stock Markets Crash at 38 (Princeton 2003).

"Evidence suggests that distributions of security returns might not be normal, with markets exhibiting more extreme events than would be consistent with a bell curve distribution. *** If extreme price changes occur substantially more frequently than predicted by a normal distribution, some extremely important events fail to influence conclusions generated from quantitative analysis. In fact, investors may care more about extraordinary situations, such as the 1987 stock market crash, than about outcomes represented by the heart of the distribution." D. Swensen, Pioneering Portfolio Management at 106; see also Benoit Mandelbrot, The (Mis)Behavior of Markets at 11 and 84-88.

Now we are in a series of events whose standard deviations would appear highly improbable under the assumptions of Modern Portfolio Theory. This is a repeat of the problems

discovered by Long Term Capital Management, and explained in great detail in Richard Bookstaber's "A Demon of Our Own Design," (John Wiley & Sons 2007). Investors burned by the liquidation of fixed income arbitrages, months later refused to enter the market when LTCM had to sell assets after Russia defaulted. That crash was limited by quick government action, and by the relatively small segment of financial assets at risk. Now, we face the consequences of a party where everyone drank the cool aid.

As Bookstaber described the consequences of quant models with serious reality problems, he foreshadowed the current crisis:

"During a market shock, the liquidity suppliers –the market makers, broker/dealers, and bargain hunters in the trading community – will recognize the risk of a cascade of liquidity demand and be reticent to be the first ones to take on supply. Indeed, some of the liquidity suppliers may actually find themselves in the position of demanding liquidity.

"The cycle would become a market crisis as the drop in the market price led to similar needs to liquidate at other firms. The flood of liquidation would accentuate the price drop at every turn. The point of no return would come when the effect of liquidation elicited greater demand for margin for the remaining fund position than the amount of cash it could raise from the liquidation. That is, suppose that to raise $10 million to meet a 10 percent margin requirement, the fund must offer down the prices to an amount that causes the prices of its remaining positions to decline by more than $10 million. The fund then faces yet another call to meet the resulting mark-to-market loss. It is caught in an ever-widening downward spiral and cannot satisfy its creditors' or investors' demands no matter how aggressively it sells. Indeed, the very need for aggressiveness in liquidation becomes the root of the problem." *Op cit* at 94-95. Nassim Taleb explains the same crash in terms of Black Swans, the supposedly unforeseen events which are not accounted for in the standard Gaussian bell shaped curves, because they are defined away by the assumptions used to create the model. The Black Swan, at 281-285.

Despite Warren Buffet's dictum about not investing in something you don't understand, many managers were dazzled by quants with black box programs which supposedly eliminated risk. Faced with the experience of 1982 when defaults by foreign governments and Mr. Volker's efforts to crush inflation, and the crash in October of 1987 (a crash which represented 20 standard deviations from the supposedly uniform distribution of securities prices—N. Taleb, The Black Swan at 276) and the 1998 crash which took down Long Term Capital, management yawned. When risk became reality, the investors ordinarily fighting to pick up diamonds in the wreckage suddenly were concerned that the layers of hedges, swaps and other devices of supposed financial genius could leave them like Lehman Brothers. They refused to bid, despite carping by columnists that the probabilities they faced were sigma seven events, roughly 1 chance in 13 billion. (Barron's, October 27, 2008 at 25) We have swung from distain for supposedly quantified risk to paralysis resulting from the realization that risk happens.

The collapse of the market also demonstrated the shortcomings of standard asset diversifications. Relying on the Beta or cross correlations among different asset classes proved unavailing, as most investment classes suddenly correlated in the face of the liquidity crisis and the bankruptcy of Lehman. However, allocations into government bonds proved a worthwhile

procedure, since bonds outperformed equities over two rolling ten-year periods. The sudden correlations among domestic and foreign equities and REIT's raise some defenses for trustees faced with losses. Where real estate had a correlation of .46 with domestic large cap stocks over the period from 1991 through 2008, the correlation jumped to .83 in 2008. Large foreign stocks with an historic correlation of .73 with large domestic stocks, converged to .91. Midcaps and small caps moved to correlations of .98 and .96 with large caps during 2008. MainStreet Advisors, Correlation Coefficients of Asset Classes in 2008. Where the failure to diversify was among equities/REIT's, the benchmarks would have crashed anyway, providing an argument for reducing damages.

The recent correlations among asset classes raise serious problems for investments going forward—what is an appropriate asset allocation strategy. The bubble in equities and venture capital and hedge funds have now been replaced with a bubble in federal instruments. When short-term Treasuries pay virtually the same amount at long-term instruments, it is very difficult to structure safe portfolios or to make predictions as to the performance of various allocations. China's use of portions of its two trillion dollars in reserve currencies to shore up its flagging internal economy and to buy positions in commodities, including oil fields and mines, from Rio Tinto and Russian oil companies, points to pressures on future interest rates, just as the US bail-out deficits point to future imbalances. The Treasuries are currently viewed as the worst bonds, except for all the others in the world—but this Churchillian view may erode quickly if deficits domestically and liquidation by foreign bondholders accelerates. China may be less afraid of hurting the value of its Treasuries than its need to quell local unrest and to develop its middle class to the point where exports are less crucial to its future. Long-term, low yielding bond portfolios are ripe for correction if demand shifts or our economy fails to respond to stimulus.

These have not been halcyon days for trustees. The bashing of banks and their employees is a favorite ploy for congressmen anxious to distract attention from their own role in the crash. It is likely to continue, raising the risk that judges and juries will follow suit.

Arbitration

There have been a number of bright areas for trustees, particularly in the area of arbitration, with the Supreme Court limiting the grounds for modification of awards under the Federal Arbitration Act, *Hall Street Associates, LLC v. Mattel, Inc*, ____US___, 128 S.Ct. 1396 (2008). The California Supreme Court in *Schwatz v. Allen Matkin Leck Gamble & Mallory,* 45 Cal. 4th 557 (2009) ruled in favor of contractual arbitration with no right of appeal, in spite of state law otherwise requiring an attorney to offer mandatory arbitration with right to a trial de novo. Cal. Bus. & Prof. c. §6200 *et. seq.*

Standard of Review where a conflict of interest is "structural"

The Supreme Court has also ruled on the standard of review (deferential or *de novo*) with regard to the conflict of ERISA administrators in reviewing claims for benefits, allowing a deferential standard in most cases, but allowing the conflict to be a factor in determining whether the conflict influenced the decision to deny or limit benefits, *Metropolitan Life Insurance Co. v. Glenn*, 128 S. Ct.2343 (2008) . *See Pegram v. Herdrich*, 530 US 211 (2000), ERISA trustee

administering health plans, may have two hats, but wears only one at a time. The court founds no intent of congress to place HMO's in a fiduciary situation where they would be forced to defend themselves on essentially malpractice grounds. A conflict which in other circumstances might raise a presumption of a breach of fiduciary duty, is now held to be a "structural conflict" which is merely one factor to consider in evaluating the conduct of the ERISA trustee. Courts dealing with conflicts which were known and approved by the settlor have frequently held that presumptions of misconduct should not apply.

The Ninth Circuit ruled in January of 2009 on claims brought regarding structural conflicts of interest in administration of medical benefits in an ERISA plan, *Nolan v. Heald College*, ___F.3d___, 2009 WL 69238 ((9th Cir. January 13, 2009). The Court followed MetLife:

"Where a plan administrator operates under a conflict of interest –in this case a structural conflict—a court must weigh the conflict '"*as a factor* in determining whether there is an abuse of discretion."' *MetLife*, 128 S. Ct. at 2348….As noted in *Abatie [vs. Alta Health & Life Ins. Co.*, 458 f. 3d 955 (9th Cir. 2006)], consideration of the conflict can 'affect judicial review,' and a court is required to consider the conflict whenever it exists, and to temper the abuse of discretion standard with **skepticism 'commensurate' with the conflict.** 458 F. 3d at 959, 965, 969. …Accordingly, while the abuse of discretion standard generally applies to cases where plan administrators have discretionary authority to determine eligibility for benefits, the precise standard in cases where the plan administrator is also burdened by a conflict of interest is only discernable by carefully considering the conflict of interest, including evidence outside of the administrative record that bears upon it." 2009 WL 69238 at *4.(**emphasis** added)

The Court reversed a summary judgment ruling in favor of the trustee, concluding that "We hold that the district court erred in failing to view the evidence of bias, which the district court considered but was not part of the administrative record, through the lens of the traditional rules of summary judgment. The evidence permitted inferences of bias that could have materially affected the abuse of discretion standard review in this case." 2009 WL 69238 at *6.

This review standard is likely to make its way from the federal courts dealing with ERISA into bread and butter cases where federal and State judges are reviewing the discretion of common law trustees, allowing discovery and introduction of evidence regarding the scope of the conflict, in addition to questions whether the conflict was waived by the settlor. Skepticism commensurate with the conflict thus gives beneficiaries grounds for inquiring into the impact of the conflict on the actual decisions made by the trustee, in an effort to move closer to the presumptions or inferences of breach found in many states and statutes.

Litigation coming to a courtroom near you

Class Actions by bank employees under their pension plan

One disturbing trend likely to be faced by many corporate trustees is the progress of an ERISA case involving the stock of a bank held in its own ERISA plan. Given the collapse of trustee stock prices, this is a serious risk potential, particularly as trustees shed employees to

make merged entities efficient or downsize to meet reduced demand. Those employees may look to the model in *Shirk* for a way to recover the losses in their retirement plans.

Shirk v. Fifth Third Bancorp, 2007 WL 1100429 (S.D. Ohio, April 10, 2007) dealt with a class action under ERISA alleging breaches of fiduciary duty in the management of the bank's profit sharing plan, including the retention of its own stock as a plan investment. The allegations dealt with the consequences of federal banking regulators and SEC investigations whether its rapid growth had outpaced its internal controls and processes, causing the stock to suffer a 23% drop in price. The court denied a variety of motions to dismiss, including allegations of a conflict of interest on the part of company officials who had a duty to monitor the plan fiduciaries, who allowed the company's stock to be held in the profit sharing plan despite supposed knowledge of inadequate internal controls. The conflict allegation was based on the supposed bonus compensation structure of the monitoring officers which was tied to "pre-set growth targets." The Court concluded that "where the interests of the individual Defendants, as corporate officers, to protect the company and their own assets, conflicted with their interests to protect the Plan, allegations that the individual Defendants took no ameliorating steps such as appointing an independent fiduciary or seeking independent advice sufficiently states a claim at this stage of the case for breach of the duty to avoid conflicts of interest." 2007 WL 1100429 at *18. The Court certified the case for class action status, *Shirk v. Fifth Third Bancorp*, 2008 WL 4425535 (September 28, 2008).

Trust Distribution Rate

The Court in *Laubner v. JPMorgan Chase Bank, N.A.*, 898 N.E. 2d 744, 2008 WL 5006542 (Ill. App. 2008) dealt with trusts which involved annual distributions based on 3.5% of the fair market value of trust assets. This is one of the few cases discussing the prudence of distribution rates, *see McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001), aff. and mod. *McNeil v. McNeil,* 798 A.2d 503 (Del. 2002). Many trustees in recent years have calculated the rate of distributions which could be made without posing risk to principal, with many calculations pointing to distributions in the area of 300 to 350 basis points.

The trusts had discretionary distribution standards based on "proper care, support, maintenance or education of said daughter and such daughter's issue and shall add to the principal from time to time any balance of net income not so applied." 2008 WL 5006542 at *2.

Some beneficiaries pointed to the GST tax which could be imposed on the non-exempt trusts, and proposed that "the distributions from the nonexempt trusts be calculated to liquidate the nonexempt trusts over plaintiffs' life expectancies. 2008 WL 5006542 at *2. Plaintiffs filed a petition requesting to change the distribution rate for **all** trust to 5% of the fair market value of the combined trust assets, but that distributions be made only from the nonexempt trusts, and providing that on the death of the individual co-trustee the plaintiffs be appointed co-trustees of their own trusts with the power to replace the corporate trustee. After a motion to dismiss was filed, the plaintiffs filed a new claim alleging hostility by the individual trustee and seeking her removal and their appointment as successor co-trustees of their own trusts.

"Plaintiffs further alleged that both trustees breached their fiduciary duty by (1) showing a preference for the remainder beneficiaries by preserving the principal rather than focusing on plaintiffs' comfortable maintenance, (2) adopting arbitrary distribution standards, and (3) wasting the assets of the trusts by unnecessarily subjecting plaintiffs' descendants to generation-skipping taxes." 2008 WL 5006542 at *3. The Court, faced with opposition by the trustees and the guardian ad litem, dismissed for failure to allege a basis for removing the individual co-trustee or modifying the distribution scheme.

The court reviewed the distribution rate of 3.5% under the abuse of discretion standard, fining that the trustees were not acting in a "wholly unreasonable and arbitrary" manner "because they have sought to protect the principal of the trust, especially where they continue to distribute the substantial sum of $11,500 per month to each plaintiff, not including educational and living expenses for plaintiffs' children." 2008 WL 5006542 at 5. The fact that undistributed income was added to principal led the court to conclude that the settlor must have envisioned that "said excess would therefore be used to grow the principal of the trust." 2008 WL 5006542 at *6. The court concluded that the power to invade did not result in the conclusion that the trustees were breaching their duties. It concluded that the trustees had not breached their duties by favoring the remaindermen over the plaintiffs. It found that "the cotrustees here merely adopted a conservative and responsible distribution plan that incidentally benefits the remaindermen by protecting the principal. We note it can just as well be said that protecting the principal benefits the plaintiffs; cost of living is sure to rise, and plaintiffs themselves state they expect to live another 30 years. The cotrustees are not acting partially by protecting the principal of the trust." *Ibid.*

The plaintiffs had argued that the trustees had failed their duty to meet with the beneficiaries to establish the propriety of the $11,500 monthly distributions, citing Restatement Third of Trusts §50, Com. e(1) at 271 (2003). Some Courts have found liability where the trustee could not demonstrate that it investigated the risk and return requirements of the beneficiary. *See e.g. Meyer v. Berkshire Life Insurance Company*, 250 F.Supp.2d 544 (D. Md. 2003), *aff'd*, 372 F.3d 261 (4th Cir. 2004); *In re Scheidmantel*, 868 A.2d 464 (Sup. Ct. 2005).

The court dismissed this argument: "However, no requirement exists that trustees meet in person with beneficiaries." *Ibid.* Truly this is wonderful language, if indeed some other court would find that personally avoiding contact with beneficiaries is consonant with fiduciary duties under the Prudent Investor Act and the Restatement. To cover this assertion, the Court backstopped itself by finding that "plaintiffs have not set forth any facts to show *why* $11,500 per month is not enough to sustain their respective lifestyles in a manner that is 'comfortable.' Plaintiffs make no allegations of debt..., steep mortgage payments, or any other expense that we can imagine that would result in $11,500 per month being insufficient." 2008 WL 5006 542 at *7. Clearly the imagination of state court judges is untouched by the endless cries of beneficiaries for more gruel which is the common experience of trust officers, particularly since it assumes at each of the children has identical needs. Parkinson's law holds no sway in Illinois.

The court dealt with the claim of waste based on the possible GST tax which would be applied to the non-exempt trusts, citing a failure to plead "sufficient facts to show the cotrustees are committing waste by failing to deplete the nonexempt trust." "However, plaintiffs predict

they will each live another 30 years. The tax laws might be different at that time. The cost of living may have risen. Plaintiffs might require expensive end-of-life care. It seems the trustees are acting prudently at this state, planning ahead for the aforementioned concerns rather than depleting the trust at a steady rate." *Ibid.*

The court brushed aside various failures to respond to letters or invite certain plaintiffs to family weddings as not sufficient to show hostility. "to remove the trustee, the hostility must be shown to interfere with the beneficial administration of the trust....Such hostility is just one factor to consider where the 'hostilities of the parties combine with other circumstances to render removal of the trustee essential to the interests of the beneficiary and the execution of the trust.'" Citing *Rennacker v. Rennacker*, 509 N.E. 2d 798,800(Ill. App. 1987). 2008 WL 5006542 at *8.

The court held that absent proof that the plaintiffs' actions had provided a benefit to the trust, the trial court had appropriately refused to award them their fees from the trust. 2008 WL 5006542 at *9.

Suits against Mutual Funds for Undisclosed Risky Investment Strategies

The Court in *In re State Street Bank and Trust Co. Erisa Litigation*, 579 F. Supp. 2d 512 ((S.D. N. Y. 2008) ruled on motions to dismiss in favor of damages claims brought on behalf of an ERISA plan by Prudential Retirement Insurance as the fiduciary of over two hundred retirement plans to recover losses from several bond funds offered by State Street, which allegedly utilized "overly risk investment strategies, including 'undisclosed, highly leveraged positions in mortgage-based financial derivatives,' ...and by concentrating the holdings of the funds in such assets 'exposed the ...Funds to an inappropriate level of risk,' contrary to State Street's representations that the Funds were 'enhanced bond index' funds that sought 'stable, predictable returns' slightly above an index consisting of investment-grade U.S. Government and corporate bonds.'" 2008 WL 4414662 at *1.

Prudential had taken the unusual step of lending "a participating plan an 'up-front payment' in an amount that to some extent compensated a plan for losses from its investment in the State Street Funds...in exchange for the plan's authorization for Prudential to commence litigation against State Street on its behalf." *Ibid.*

This strategy emerges from the risks of being a co-defendant with the third-party manager and perhaps facing the risks that it might be denied indemnity rights, *see e.g . Lesavoy v. Lane* 2008 WL 2704393 (S.D. N.Y. 2008); *Haddock v. Nationwide Financial Services, Inc.* 570 F. Supp.2d 335 (D. Conn. 2008). An investment manager might be sued for breach of duties in supervising agents or for aiding an abetting another party in breach of a fiduciary duty. *e.g. Kottler v. Deutshe Bank, A.G.* 2009 WL 55885 (S.D. N.Y. January 9, 2009).

Hence Prudential's strategy pre-empted the plans from suing Prudential and allowed it the chance to recover the losses from the mutual fund, thus providing it with the funds to repay its loans to the plans. Pretty expensive, but perhaps less expensive and more fun to be a plaintiff rather than a defendant in a class action. The Court held that the "collateral source rule" permitted the plans to recover damages even though they had received some compensation from

a third party. 2008 WL 4414662 at *3. While the court dismissed various injunctive relief claims, it allowed claims for damages to proceed pursuant to section 409(a) and 502(a)(2) of ERISA. 2008 WL 4414662 at *7.

Uncharitable Conduct?

Trustees dealing with charitable entities in recent years have discovered that such services can be both risky and expensive when things go wrong. *Baker Botts, L.L.P and Wells Fargo Bank Texas, N.A. v. Cailloux,* 224 S.W. 3d. 723 (Tex. App., 2007) ended well for the bank involved, but it was an experience most institutions would wish to avoid. There are a number of recent cases involving charitable institutions or bequests which highlight the expenses and risks involved. *In re Banning v. Court of Probate*, 2008 WL 5274164 (Conn. Super. December 1, 2008) The court in *Banning* held that St. Vincent DePaul of Hartford had standing to object to distribution by trustee to the local Archbishop rather than directly to the charity whose purposes were described in the trust. The court noted that a permissible charitable trust could be limited to a defined group of beneficiaries such as the "worthy, deserving, poor, white, American Protestant, Democratic widows and orphans residing in the town of Bridgeport," citing *Beardsley v. Selectman of Bridgeport,* 491 A. 557 (CN. 1885)). The Court found that "the Probate Court ordered that the Archbishop may dispense the trust funds to any charity that performs a mission similar to the appellant's. this order effectively deprives the appellant of funds that it arguably was entitled to under the Banning Trust." 2008 WL 5274164 at *5.

Robertson v. Princeton University, Mercer County Chancery Division No C-99-02 was settled in December after expenditure of over $80,000,000 in fees and expenses, with Princeton agreeing to payment of $90 million over ten years to The Banbury Fund for reimbursement of its approximately $40 million in litigation expenses (payable during 2009 through 2011) and an additional $50 million payable in increments from 2012 through 2019, to the Banbury Fund to encourage students at one or more colleges and universities to prepare for careers in government service. The existing endowment, which had grown from $35 million in 1961 to approximately $900 million in June, prior to the market crash, will be wholly managed by Princeton, rather than paid to the Robertson Foundation. The initial attempt by the plaintiffs to strip the endowment from Princeton failed, with the Court issuing several partial summary judgment motions and denying others in October of 2007. Thereafter, the litigation focused on various expenditures and claims dealing with the allocation of expenses between the graduate program at the Woodrow Wilson School and other University expenses. Many of these claims appear similar to disputes arising in 1991 and thereafter, with federal agencies questioning the use of Department of Defense and other federal agency grants to major research universities, leading to Office of Management of the Budget regulations on shared overhead and use of research funds.

Faced with a substantial trial in early 2009, and litigation expenses estimated at $20 million each, the parties settled.

For other interesting and expensive charitable romps, see *Thomas and Agnes Carvel Foundation v. Carvel*, 2008 WL 4482703 (Del. Ch. September 23, 2008) and *Carvel v. Griffin*, __F.Supp.2d___, 2008 WL 4922432 (D. Del. November 18, 2008).

SLUSA cases

The Seventh Circuit affirmed the dismissal of a class action dealing with alleged bribes to brokers in *Kurtz v. Fidelity Management & Research Co.*, ___F.3d ___, 2009 WL 426053 (7th Cir. 2009).

The Court in *Kutten v. Bank of America*, 2008 WL 4838152 (E.D. Mo. 2008) awarded fees to the defendant under FRCP 41(d), where the court found that the "plaintiffs and their attorneys have prosecuted this case with nothing short of abandon." 2008 WL 4838152 at *3. "It appears that Plaintiffs' attorneys have not been deterred by the rulings of this Court or other courts condemning their forum shopping and other vexatious litigation tactics. They do not deny that they have filed or assisted in filing two new actions based on the same conduct claimed wrongful in the numerous actions previously dismissed." *Ibid.* "The instant case presents an example of when awarding fees and costs is most appropriate. Plaintiffs and their counsel have pursued multiple lawsuits, propounded voluminous discovery, and engaged in blatant forum shopping. Neither the admonitions of this Court or other courts have slowed Plaintiffs' counsel's dilatory ways. An award of fees and costs is not only appropriate, it may be the only way to convince Plaintiffs and counsel o end their pattern of forum shopping and vexatious litigation." 2008 WL 4838152 at * 4.
Richtenburg v. Wells Fargo Bank, 2008 WL 2232660 (Cal. App. 2008) denied a motion for preliminary injunction to bar trustee from charging various fees for preparation of fiduciary tax returns. A motion to dismiss an amended complaint was granted under SLUSA. A motion for reconsideration is pending.

Kurz v. Fidelity Management, 2008 WL 2397582 (S.D. Ill. June 10, 2008) dismissal under SLUSA.

Has Somebody Made Off with the Money?

When the market crashed and liquidity disappeared, Ponzi schemes could no longer function effectively, leading to the exposure of a number of major sources of potential liability to banks and other supposedly innocent bystanders.

Liability for banks and other institutions within subpoena distance of Ponzi schemes can be evaluated under a number of headings: aiding and abetting liability, Uniform Fiduciary Act liability, liability for failure to supervise investment agents of trusts under section 9 of the Uniform Prudent Investor Act, and failure to investigate investment managers made available to customers.

Aiding and Abetting Liability

In evaluating the liability of fiduciaries resulting from an investor's Ponzi scheme, it may be useful to reflect on this Sterling example of a fiduciary in Texas. The Supreme Court of Texas in *Sterling Trust Co. v. Adderley*, 168 S.W. 3d 835, (Tex. 2005), reversed a court of appeals decision affirming a jury verdict of $6,000,000 against a bank which acted as the custodian for retirement accounts which had been victimized in a Ponzi scheme. The Court of Appeal, 119

S.W. 3d 312 (Tex. App. 2003), had affirmed the finding of liability of the jury, but reversed the award of punitive damages. The plaintiffs had elected to recover actual damages on the theory of aiding and abetting a breach of trust by the plan fiduciary, and the appellate court had held that once an election had been made as to alternative damage awards, the trial court "reversibly erred in tacking the jury's punitive damages award for malicious breach of fiduciary duty onto the actual damages award for Sterling's [aiding and abetting] violations." 119 S.W. 3d at 324.

The Supreme Court acknowledged that:

> "the investors provided evidence that Sterling's failure to comply with several of its own internal procedures facilitated Cornelius' pyramid scheme and allowed Cornelius to hide the nature of his scheme from the investors. For example, the investors showed that, although Sterling's policies prohibited it from holding promissory notes that were in default, it nevertheless held such notes. The investors also provided evidence that Sterling failed to obtain many of the Avalon stock certificates and original promissory notes; ordinarily, Sterling employees could not enter transactions into Sterling's computer system without such documents,. When lower-level Sterling employees alerted management to the lack of such documents, they were told that Sterling had made an agreement allowing Avalon to retain those documents. There was also evidence that Sterling failed to obtain copies of the security agreements for the promissory notes that purported to be secured by real estate, even though Sterling's internal procedures required it to keep such documents on file. In addition, the investors provided evidence that Sterling was aware that Cornelius was commingling investors' funds by having one or more of the Avalon companies make payments on notes for which another Avalon company was indebted, and that at least of one Sterling's internal memos questioned this practice. Finally, the investors demonstrated that Cornelius did not pay the principal balance on a number of notes as they became due, but instead transferred the investors' money into new investment vehicles in other Avalon entities. There was evidence that Sterling allowed Cornelius to unilaterally make such transfers despite its own policy requiring documentation of investor approval for such new investments."

168 S.W. 3d at 838-39.

The claim on which the plaintiffs prevailed was based on an alleged violation of the Texas Securities Act, which contains an aider and abetting provision, which holds an aider liable "who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer or issuer of a security. TRCSA art. 581-33F(1)-(2). (emphasis added.) The Supreme Court held that when the legislature added the "reckless disregard" standard, it must have intended to require a scienter standard involving a subjective awareness of the wrongful conduct that was materially assisted, since it included a provision that the statute "may be construed and implemented to effectuate its general purpose to maximize coordination with federal and other states' law and administration." TRCSA art. 581-10-1A. The Supreme Court rejected reliance on *Goldstein v. Mortenson*, 113 S.W. 3d 769, 777 (Tex. App.

2003) which held that reckless disregard could be proven by a "failure to conduct minimal investigation and inquiry."

The Supreme Court concluded that "We therefore hold that the TSA's 'reckless disregard for the truth or the law' standard means that an alleged aider can only be held liable if it rendered assistance 'in the face of a perceived risk' that its assistance would facilitate untruthful or illegal activity by the primary violator....In order to perceive such a risk, the alleged aider must possess a '""general awareness that his role was part of an overall activity that is improper."' *Gould*, 535 F.2d at 780." 168 S.W. 3d at 842. The Court went on to find that the jury's finding that Sterling "'did not know and in the exercise of reasonable care could not have known of the untruth or omission' is not dispositive on the question of whether Sterling had knowledge of the underlying wrongdoing." 168 S.W.3d at 846. The Court also ruled that instruction to the jury on breach of fiduciary duty were defective because they did not take account of the document signed by all account holders that "Sterling Trust has no responsibility to question any investment directions given by the individual regardless of the nature of the investment" and that "Sterling Trust is in no way responsible for providing investment advice." The Court concluded, "Because the question of breach of fiduciary duty did not account for these contractual modifications, it was overly broad and rendered the question defective." 168 S.W. 3d at 847. The Court remanded the case to the trial court for further proceedings consistent with this opinion.

The banker for a entity alleged to have been involved in a Ponzi scheme obtained summary judgment in *Ulrich v. Woodforest National Bank*, 2007 WL 4532800 (December 20, 2007). The plaintiffs had sought to assert aiding and abetting liability based on a variety of claims, such as the alleged failure of the bank to follow the warnings in the OCC's "Red Flags in Board Reports: A Guide to Directors." 2007 WL 4532800 at *4, allegedly engaging in back to back loan transactions which supposedly "enabled the diversion of investors' funds to fraudulent uses" as well as the bank's "investment vehicles," and the failure to file Suspicious Activity Reports. *Ibid.*

The court dismissed some of these claims as based solely on conclusory statements, holding that such statements "are insufficient to defeat summary judgment." "The affidavit does not otherwise contain underlying facts to support his conclusion that WNB was aware that the Interamericas Group was engaged in illegal activities. Morrow's further conclusion that WNB aided fraud by entering into back to back and participation loans which enabled the diversion of investors' funds to fraudulent uses by Interamericas Group as well as WNB investment vehicles used to attract investor funds is also unsupported by underlying facts. He provides no underlying facts to show how the back to back and participation loans were knowingly part of any scheme by MNB to aid in the Interamericas Group's fraudulent activity." 2007 WL 4532800 at *5 . The court on appeal upheld summary judgment in favor of the bank holding that "A party produces less than a scintilla of evidence when the evidence is 'so weak as to do no more that create a mere surmise of suspicion' of fact.' *Ibid.*

In *Cote v. Texcan Ventures II*, 271 S.W. 3d 450 (Tex. App. 2008) the court rejected efforts to impose constructive trusts on proceeds which other victims had received before the collapse of the scheme. The trial court had concluded that "appellees and appellants were equally situated as victims of West's scheme, appellees were not unjustly enriched by receiving the

funds, and equity, in the form of a constructive trust, should not intervene in the dispute. 271 S.W. 3d at 453. The court noted that a constructive trust was available for a transferee who paid not consideration and who has "notice of the existence of the trust at the time of the transfer. *Ibid.* The trial court had found that appellees "believed the funds were a partial repayment of the investments they had made with West. Therefore, appellees did not have notice the funds might be subject to a constructive trust." *Ibid.*

Uniform Fiduciaries Act

Hendren v. Farmers State Bank, S.B. ___S.W. 3d___, 2008 WL 4702067 provides a useful analysis of UFA principles in holding that the bank did not act in bad faith or with actual knowledge of inappropriate transfers by a fiduciary when it honored a check of the fiduciary. This is good case to look at if you are facing such claims. As in most UFA statutes, liability in Missouri is based on notice that the fiduciary with the account at the institution is committing a breach of duty as a fiduciary, and the institution acts with "actual knowledge of such breach or with knowledge of such facts that his actions in taking the instrument amounts to bad faith." 2008 WL 4702067 at *1.

"'The relation of a bank to a trustee-depositor is that of a creditor and debtor.' *Gen. Ins. Co. of Am.* [*vs Commerce Bank of St. Charles*], 505 S. W. 2d. 454, at 458. 'The bank's obligation [is] to the trustee, to honor his checks when drawn to form.' *Id.* "It owes no duty to the trust estate save to refrain from participating in misappropriation of the funds.'" 2008 WL 4702067 at *2.

The Court held that "'Such circumstances do not impose upon the bank the duty or give it the right to institute any inquiry into the conduct of its customer, in order to protect those for whom the customer may hold the fund, but between whom and the bank there is not privity.'" The Court concluded that "'[M]ere negligence on the part of the depository bank is not sufficient to hold it liable to the principal if the fiduciary in fact misappropriated the fund.' *Trenton Trust Co. v. Western Sur. Co.*, 599 S.W. 2d 481, 490 (Mo. Banc 1980)." *Ibid.* "A bank may not be found to possess 'actual knowledge' of a breach of trust merely because 'at some state of the handling of the fiduciary account it could, by inspection of public records or by piecing together all the fact known by different employees of the bank, become aware of a breach of Trust." 2008 WL 4702067 at *3.

"'Evil motive is not the gauge; it is whether it is 'commercially' unjustifiable for the (bank) to disregard or refuse to learn facts readily available.' …'The facts and circumstances must be so cogent and obvious that to remain passive would amount to a deliberate desire to evade knowledge because of a belief or fear that inquiry would disclose a defect in the transaction.'" *Ibid.*

"Bad faith or dishonesty, unlike negligence, involves willful facts or omissions…'The mere failure to make inquiry, even though there be suspicious circumstances, does not constitute bad faith, unless failure is due to the deliberate desire to evade knowledge because of a belief or fear that inquiry would disclose a vice or defect in the transaction, that is to say, where there is an intentional closing of the eyes or stopping of the ears.'" 2008 WL 4702067 at *4. The Court concluded that "the evidence does not demonstrate that the Bank vice president had express

factual information as to misappropriations at the exact moment of the transfer from the estate account to [fiduciary's] personal account." 2008 WL 4702067 at *5.

Summary judgment was denied as to several deposits as to which the bank had no records of the disposition. "The Bank acknowledges that the funds were not tendered to the Bank to keep, as in payment of a debt owed to the Bank. That being the case, the burden is on the Bank to protect itself from the presumption that the Bank improperly benefited from the funds." That portion of the case was remanded to permit the bank to attempt to rebut the presumption arising from the lack of records.

See also State vs. Rhinebolt, 2008 WL 5058805 (Oh. App. November 26, 2008).

Compare this result, giving the bank the benefit of almost every doubt, with *Lerner v. Fleet Bank, NA, Sterling Nat. Bank and Republic Nat. Bank of New York*, 459 F.3d 273 (2nd. Cir 2006), where the Court denied motions to dismiss aiding and abetting claims against banks in which an attorney placed funds in purported attorney trust accounts as part of an alleged Ponzi scheme. The complaint alleged that the banks had notice that the attorney had issued checks for which there were insufficient funds, putting them on notice of potential misuse of attorney trust accounts. The court held that "By ignoring evidence of [attorney's] misconduct and allowing him to continue to use … accounts, [defendant bank] allowed itself to become a conduit for Schick's activities. Like the defendant held liable in *Bischoff [ex rel. Schneider v. Yorkville Bank*, 218 N.Y. 106, 112 N.E. 759 (1916)] 'by supinely paying, under the facts here, …the subsequent checks of 9the trustee0, it became privy to the misapplication." *Bischoff*, 218 N.Y. at 114, 112 N.E. at 762; *see also Grace [ex rel Fox v. Corn Exch. Bank and Trust Co.* 287 N.Y. 94, 38 N.E. 2d 449 (1941)] 'By ignoring these facts and their necessary implications, the bank became a guilty participant in the trustee's embezzlement of trust funds deposited in the trust account in the bank and from that date it became liable as a joint wrongdoer for all moneys which the trustee embezzled.'" 459 F. 3d at 290.

The court noted that "'Facts sufficient to cause a reasonably prudent person to suspect that trust funds are being misappropriated will trigger [such] a duty of inquiry on the part of a depositary bank, and the bank's failure to conduct a reasonable inquiry when the obligations arises will result in the bank being charged with such knowledge as inquiry would have disclosed.'" It held, however that "small overdrafts" would be insufficient to trigger a duty of inquiry, while "chronic insufficiency of funds" may impose such a duty. 459 F. 3d at 288.

If one is a fiduciary rather than a depository institution, the duty to be vigilant is quite harsh. In *Woolard v. Woolard*, 547 F. 3d 755 (7th Cir. 2008), the court upheld liability against a trustee which had improperly disbursed funds for a minor to his parent. At issue was a $300,000 distribution by the trustee which allegedly was given away to a charity by the father. "it is particularly telling that Defendant disbursed over $300,000 to plaintiff's father through a series of distributions in one six-month period when Plaintiff was seventeen years old. Beyond lacking any documentation of how this money was actually used, Defendant has no evidence, even his own testimony, specifically identifying the intended purposes of these distributions.

"'The law requires that a trustee must act in good faith in the management of all matters relating to the trust, and employ such vigilance, sagacity and diligence as prudent men of

intelligence ordinarily employee in their own affairs.' *Suffolk v. Leiter*, 261 Ill. App 82 (1931. By having, in his own words, 'no idea what they were doing with the money,' Defendant was not appropriately vigilant; by not asking for any certification that the money was being spent in an appropriate manner, Defendant breached his obligations to be diligent. It is hard to imagine Defendant would have been so relaxed and disinterested were his own money involved. Indeed, now that his own money is involved, Defendant is interested enough to appeal his case to this Court."547 F. 3d at 762.

Duty to Diversify: Special Circumstances

The Uniform Prudent Investor Act §3 provides that "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."

The comment to Section 3 notes that "Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an underdiversified block of low basis securities, the tax costs of recognizing the gain may out-weight the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify."

Restatement (Third) of Trusts §90(b) provides "In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."

Restatement (Third) of Trusts §92 provides in Comment a, "In some circumstances, for example, tax considerations (looking to the tax positions of both the trust and the beneficiaries) may tend to suggest retention of inception assets, and in others these considerations may tend to suggest that conversion be made promptly... In addition, the trustee's decision to retain or dispose of certain assets may properly be influenced, even without trust terms expressly bearing on the decision, by the property's special relationship to some objective of the settlor that may be inferred from the circumstances, or by some special interest or value the property may have as a part of the trust estate or that it may have, consistent with trust's purposes and the trustee's duty of impartiality, to some or all of the beneficiaries. Examples of such property might be land used in a family farming operation, the assets or shares of a family business, or stockholdings that represent or influence control of a closely or publicly held corporation."

In re Hyde, 44 A.D. 3d 1195, 845 N.Y.S.2d 833(N.Y.A.D.,2007), *app. den* 881 N.E. 2d 1197) (N.Y. 2008) involved challenges to the accountings of three trusts which held non-voting shares of a closely held company, Finch Pruyn. The accountings were all for periods in excess of 20 years, beginning in the early 1980's. Glen Falls National Bank and Trust and Banknorth, N.A. were trustees of respective trusts, along with individual co-trustees. The trustees were granted "absolute discretion" in managing the trust assets. However there was no retention language in the trusts. The accounting period included time periods when the "prudent person" rule applied; after 1995 New York's Uniform Prudent Investor Act applied, including the duty to diversify unless it was prudent not to do so. EPTL 11-2.3[b][3][C]: "to diversify assets unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking

into account the purposes and terms and provisions of the governing instrument." On appeal, the court found that "The diversification mandate of the new rule was generally consistent with the diversification standards already developed by the court under the prudent person rule." 845 N.Y.S.2d at 836.

The voting stock had restrictions which would restrict the voting stock shareholders to one cent per share in a liquidation. The non-voting stock got the balance of the value of the company in a liquidation. "This capital structure engendered a state of 'gridlock,' which may have been intended by Finch Pruyn's founders in order to sustain Finch Pruyn as a family business." 845 N.Y.S. 2d at 837. Both sets of shares provided substantial dividends.

There was no market for the shares, except for the company itself, which refused to buy most tendered shares, and only at book value. "Representatives from GFNBT held meetings with various financial advisors, including investment bankers and brokerage houses, and determined that a fair price for the stock could only be obtained via a sale of the entire company." *Ibid.* The court concluded that shares could have been sold only at "speculative" prices during the period of the account. The beneficiaries filed objections which included allegations that the trustees had breached their duty by failing to diversify.

In one of the three trusts, Great Falls had not been informed until 2004 that it was a successor trustee. While the court suggested that it might be charged with imprudence for neglecting to discovery its appointment, the court found that the failure to diversify the stock was prudent under the circumstances.

The court looked to the steps which the trustees took into consideration in evaluating the decision to diversify: "consideration of other factors, such as the general economic situation of the trust assets, the expected tax consequences of investment decisions and the needs of the beneficiaries," citing the standard of care elements of New York's Prudent Investor Act. Glen Falls also concluded that "the needs of the beneficiaries militated against diversification. The Finch Pruyn stock paid out considerable dividends such that selling the shares at a discounted price, for the sake of diversification, may have been imprudent." 845 N.Y.S.2d at 848.

The Court on appeal noted that "Most importantly, there is **an indication** that the settlors of the trust wanted the ownership of Finch Pruyn to remain in the family and the trusts were used a vehicles to achieve such a result. GFNBT partially based its determination not to diversify on the family nature of the corporation, a material consideration according to the legislative history of PTL 11.2.3. " 845 N.Y.S. 2d at 838. This conclusion stemmed from the restrictions on the two classes of stock, rather from any terms of the trust. As noted above, the Restatement provides flexibility in determining settlor intent where the trust terms do not provide explicit guidance, where such intent may be "inferred from the circumstances." Restatement (Third) of Trusts §92, com. a. Without citing this provision, the Appellate Division did just that.

With respect to the trust in which Banknorth served as a co-trustee, the court noted testimony that a member of the Pruyn family had offered to repurchase trust shares "at a heavily discounted price. Following receipt of this letter, Banknorth reasonably determined that it was not in the best interests of the beneficiaries to sell the stock at a discounted price merely for the

sake of diversification." *Ibid.* The court noted the continued review of the company and the potential market for the sale of shares of the stock in supporting its conclusion that Banknorth had properly met its duty of prudence in retaining the concentrated position. 845 N.Y.S. 2d at 839.

In *Nelson v. First National Bank and Trust Co. of Williston*, 543 F.3d 432 (8th Cir. 2008) the court held that a trustee had not breached its duties under North Dakota's Prudent Investor Rule by delaying sale of stock held in the trust for two weeks following the death of the settlor in June of 2006. The trust had a provision which stated that "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." The beneficiaries exercised a power to remove the trustee after the grantor's death, and directed that the assets be transferred to a successor trustee which promptly sold 600,000 shares of Medtronic stock in a single day in November 2006. The beneficiaries claimed that the First National acted in bad faith by delaying transfer while it tried to convince the beneficiaries to change their minds, and then retained $180,000 of trust assets while transferring the rest to the successor. The Court held that the claim that the stock should have been liquidated in the first two weeks was unaffected by conduct **after** that time. 543 F.3d at 436. It held that "A failure to act,, like an act, may be in good faith or bad faith, just as it may be negligent or prudent. There is no evidence that First National proceeded dishonestly or with corrupt of selfish motives in respect to this particular inaction. See Perry on Trusts §511." *Ibid.* [keep that ancient set of Perry on hand for times like this]

The good faith test was met by showing that the trust had adequate assets to pay estate taxes due in nine months based on the market price of the stock during the first two weeks of post-death administration. "It was not unreasonable for the trustee, giving weight to [settlor's] investment authorization, to retain the Medronic stock so long as it did not interfere with the trustee's ability to meet its tax obligation." 543 F.3d at 437.

"It is undisputed that First national monitored the stock price daily to ensure that it did not drop so low as to interfere with the trust's ability to pay the taxes and there were plenty of proceeds from U.S. Bank's sale of the Medtronics stock to pay the taxes when due. Rather, the damages sought by the plaintiffs are with respect to the assets left over for their use and enjoyment after the estate taxes were paid. These alleged damages are attributable to market risk and a lack of diversification in the period after Leonard's death, if not to the decision of the plaintiffs or U.S. Bank to sell nearly 600,000 shares of Medtronic stock on a single day in November 2006." *Ibid.*

The case points to the value of procedural prudence in monitoring concentrated positions, even in the early stages of administration following the death of the life beneficiary. Good faith can be a adequate defense when given standard retention provisions like that found in this trust. One should also be prepared to face consequences from urging positions which some court may use to chide the losing side.

In the *Matter of Bloomingdale*, 853 N.Y.S.2d 92 (N.Y.A.D. 2008) the court dealt with objections to a final accounting based on "retention of high concentrations of certain stocks as a

failure to diversify under EPTL 11-2.3" 853 N.Y.S.2d at 94. The court dismissed the objection for the period beginning in 2001 when the beneficiaries became co-trustees, holding that "Where a fiduciary has the means to know of a cofiduciary's acts, and has assented or acquiesced in them, the fiduciary is bound by those acts and jointly liable for them. ...Equity will not permit a knowing cofiduciary to maintain a suit against another cofiduciary for a breach of their joint obligations." *Ibid.* One of the beneficiaries had a MBA and a PhD and was an assistant professor of marketing, while his brother had a bachelor's degree in business administration with a major in finance. The court noted that when they became co-trustees they became "obligated to familiarize themselves with the prudent investor rule and cannot maintain their objections against Cohen for the period during which they were cotrustees." *Ibid.*

However, the appellate division concluded that the trustee's motion for summary judgment on the objections for the earlier period when the objectors were mere beneficiaries was properly denied by the trial judge. The court on appeal noted that to find ratification, "the beneficiary must have been 'fully apprised of the effect of the acts ratified, and of his or her legal rights in the matter' *** Furthermore, consent will not be presumed from mere silence." 853 N.Y.S.2d at 95.

In *Hartman v. Walker*, 73 Va. Cir. 245, 2007 VA. Cir. LEXIS 212 (Va.Cir. Apr. 5, 2007), the court denied a demurrer to objections by an income beneficiary that the trustee had failed to make the trust property productive by responding to an offer from a third party to purchase unproductive land held in a partnership and company owned by the trust, as well as objections alleging the trustees' "failure to diversify the investments of the Hartman Trust and their lack of impartiality towards the various Trust beneficiaries" under Virginia's Prudent Investor Act. The court held that grants of the power in the dispositive instrument to invest in the trustee's "sole discretion" did not constitute a basis for an express manifestation that the provisions of the UPIA were waived by the settlor.

The Court pointed to the procedural steps which a trustee is obligated to undertake in making decisions on diversification: "Similarly, while the acts do not mandate diversification of assets, they do provide a series of factors to be considered in determining whether the assets of a particular trust should be diversified and how assets should be managed." 73 Va. Cir. at 250. The court noted that the alleged failure to inform the beneficiaries of offers to purchase unproductive land from the entities "may have prevented a full determination of whether, because of 'special circumstances, Va. Code Ann. §26-45.5, the purposes of the Trust are better served by maintaining the unproductive property; as such, they may have breached their duty to Mr. Hartman." *Ibid.*

Despite the broad authorization to invest, the court distinguished the existence of the power from the prudence of its exercise: "Thus, while the Will does grant the Co-Trustees significant authority to oversee the Trust, given that '[t]he authority to undertake a specific action and the proper exercise of that authority are distinct considerations,' *Ward v. NationsBank of Va.*, 256 Va. 427, 436, 507 S.E. 2d 616 (1998), and noting the fact-specific inquiry necessitated by the Prudent Investor Act and the [Uniform Principle and Interest Act], the defendants' demurrer at to Counts I and II will be overruled." *Ibid.*

The Supreme Court of Georgia affirmed a trial court denial of surcharge for failure to diversify in a trust with permissive retention language in *Ludwig v. Ludwig*, 642 S.E.2d 638 (Ga. 2007). The plaintiffs had complained about the refusal of the trustee to make distributions in light of "appellants' need for money in response to debts they have accumulated. The evidence establishes that one appellant, an attorney, has received more sums from the trust than the remaining eight grandchildren; the other appellant, a member of the United States armed forces, has received more sums than two other grandchildren." 642 S.E. 2d at 640. The court affirmed the denial of surcharge for abuse of such discretion.

The trust had a permissive retention provision with respect to original assets, which could be retained "without regard to principles of diversification." The court concluded that "appellees have received professional advice regarding the trust's assets," and that "appellees retained certain assets for tax reasons appellants have failed to show were unreasonable," and further that "appellants adduced no evidence to support appellant Daniel Ludwig's opinion that appellees' retention of certain stock violated their duty under OCGA §53-12-287(b) to act in a prudent manner."

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.

Damages for Breaches of Fiduciary Duties

The *Schwegmann* 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.

At trial after remand, "plaintiff's expert estimated that had the trust's cash assets of gifts and dividends had [sic] diversified its holdings and invested in stocks, bonds, and U.S. Treasury Bills, the trust's assets would have been $5,147,073.00. This court finds that the plaintiff's accountings sufficiently take into account what a moderate investment of funds would have generated for Brown's trust." *Brown v. Schwegmann*, 958 So.2d 721, 723 (La. App. 2007). The court held that the expert's calculations took into consideration: "Brown's age; whether Brown needed access to the cash and dividends in the trust for living expenses or whether the funds

were more of a long-term investment; Brown's risk tolerance; and Brown's overall financial picture." 958 S.2d at 724. The expert used the Vanguard Index 500 and Vanguard Short-Term index funds as the basis for his return calculation. In light of the trial court's finding that the plaintiff's expert was more credible, the decision was affirmed on appeal. 958 So. 2d at 725.

The Supreme Court of New Hampshire affirmed the granting of damages in a case involving misappropriation of guardianship assets in *Guardianship of Dorson*, 934 A. 2d 545 (N.H. 2007). The fiduciary's surety objected to the imposition of interest on the amounts taken from the date of the transfer, claiming this was inappropriate prejudgment interest. The Court cited an earlier opinion in which damages included interest lost when funds were improperly taken from an interest bearing account, *In re Estate of Ward*, 523 A. 2d 28: "'When [the executor] withdrew those funds he also withdrew the ability of the money earn interest. By misappropriating the $116,820, [the executor] also misappropriated the interest thereon. Thus, the lost interest was just as much a debt as the actual funds.'" 934 A. 2d at 548.

The Court found that "'A surcharge is the equitable penalty imposed when a trustee fails to exercise the requisite standard of care and the trust suffers thereby.' *In re Scheidmantel*, 868 A. 2d 464, 492-93 (Pa. Super. Ct. 2005). It 'is the penalty for failure to exercise common prudence, common skill and common caution in the performance of the fiduciary's duty and is imposed to compensate beneficiaries for loss caused by the fiduciary's want of due care.'...Equitable remedies are particularly within the sound discretion of the trial court.***

"Contrary to Peerless' assertions, when crafting a remedy for a trustee's breach of trust and breach of loyalty, '[t]he court is not confined to a limited list of remedies but rather will mold the relief to protect the rights of the beneficiary according to the situation involved.'" Citing Boget, Trusts and Trustees, §861 at 4 (2d ed. 1995). The court allowed consequential and punitive damages "'where malice or fraud is involved.' ...The court may 'adapt ...its decree...to fit the nature and gravity of the breach and the consequences to the beneficiaries and trustee...' Equity 'does not always grant the same kind of relief for the same kind of wrongdoing; its object is not merely to prevent loss to the trust estate or wrongful gain by the trustee.' ... Rather, one of the purposes of relief may be to deter other trustees from acting similarly in the future.'" 934 A. 2d at 549, citing Bogert, §543(V), at 441-442.

"'When a breach of trust occurs, the beneficiary of the trust is entitled to be put in the position he would have been if no breach of fiduciary duty had been committed.' *Berish v. Bornstein*, 437 Mass. 252, 770 N.E. 2d 961, 977 (2002)...see *Matter of Wills of Jacobs*, 91 N.D. App. 138, 370 S.E. 2d 860, 865 ('damages for breach of trust are designed to restore the trust to the same position it would have been had no breach occurred')...Other remedies including holding the trustee liable for 'any loss or depreciation in the value of the trust estate resulting from the breach of trust' or requiring the trustee to disgorge any profit that the trustee made through the breach of trust. Restatement (Second) of Trusts, *supra* §205." 934 A. 2d at 549.

The court expressly authorized appreciation damages "'representing the appreciated value of the property at the time of the beneficiary's suit or judgment thereon rather than its value at the time of misappropriation.' Bogert & Bogert, *supra*, §543 (V), at 446; see also

Restatement (Second) of Trusts, *supra*, §208; Restatement (Third) of Trusts Prudent Investor Rule 208 (1992)." 934 A. 2d at 550.

The court cited *Flagship Bank v. Reinman, Harrell, Silberhorn, Moule & Graham, P.A.*, 503 So.2d 913, 916 (Fla App. 1987), where the trustee of a land trust had improperly failed to protect the trust property from a tax sale, the beneficiaries were entitled to damages "'equalling the fair market value of the retain and lost property at the time of trial.' As the court explained, 'By applying the fair market value of the retained and lost property at the time of trial, the trial judge awarded damages to the beneficial interest holders which placed them in a position very similar to that which they would have been in had the promoters not fraudulently retained the property.'" *Ibid.*

In *DeMille v. Citizens Business Bank*, 2007 WL 3276774 (Cal. App. Nov. 7, 2007), the court affirmed the award of double damages where the fiduciary allegedly took estate property for his own use. Beneficiaries The John Birch Society and the Yosemite Fund had supported the recovery. Double damages were denied in *Taubman v. U.S. Bank*, 2007 WL 3087874 (Cal. App. October 24, 2007), despite an award of damages of $8.8 million of actual damages for self-dealing transactions, because of a lack of finding of "bad faith" required for a double damage award under Cal. Prob. Code §859.

The Surrogate in *In re Chase Manhattan Bank*, 847 N.Y.S. 2d 900 (NY Surr. 2007), the court denied application of compounded statutory interest where only negligence was involved, limited interest "to the rate which was earned by the trust itself during the time frame in question" in order to place "the charities where they would have been if the bank had acted appropriately...." 2007 WL 2318392 *2.

The Court rejected damages for a court approved sale in *Clay v. Monroe*, 658 S.E. 2d 532 (N.C. App. 2008), citing the approval of the probate judge and confirmation by the court clerk, relying on expert testimony as to the value of property sold without an appraisal. The court noted that the approval process was designed in part "to protect the fiduciary from venality of heirs who did not see fit to participate in the ward's care during his or her life, but who later emerge and attack the guardian's work after the ward's death in an effort to increase their inheritance." 658 S.E. 2d at 536.

Exxon Shipping Co. v. Baker, 128 S. Ct. 2605, 2008 WL 2511219 (2008) deals with narrow issue of punitive damages on maritime law upheld on 4 to 4 vote; analogizing to *Amiable Nancy* dealing with privateers. Punitives multiple where conduct not designed to augment profit and the negligence in question is "profitless to the tortfeasor." Inconclusive data on "shadow on settlements" but court seems concerned about "stark unpredictability" and "inherent uncertainty" of outcomes when a multiple of actual damages might be awarded. Rejects a three to one punitives to actual on these facts, finding 1 to 1 was appropriate. We will see these issues when a full panel deals with punitives outside this narrow context.

Ethical Issues for Fiduciaries

The expansion of financial institutions into multiple areas of wealth management has raised a number of issues regarding the extent of fiduciary and ethical duties of express trustees

and their corporate affiliates. For example, in *French v. Wachovia Bank*, 2007 WL 895820 (E. D. Wis. March 21, 2007), *stay dismissed*, 2007 WL 3125277 (E.D. Wis. October 27, 2007), the trustee was sued for alleged self-dealing in replacing a life insurance policy in a trust with an purportedly inferior one from an affiliated life insurance company. The claim for breach of Wis. St. §100.18 dealing with allegedly untrue, deceptive or misleading information in the sale of certain insurance policies was sent to arbitration, and the breach of fiduciary duty claim was stayed. The plaintiff then dismissed the cause of action and the stay was dismissed, so that the claim of self-dealing was allowed to go forward.

Dealing with liability claims raised against express trustees as well as affiliated entities in the insurance, brokerage, investment management, real estate services is extremely complex, given the interplay of state and federal laws and regulations governing financial institutions, as well as common law fiduciary principles. Those common law principles have been hammered out in a huge variety of situations, dealing with corporate fiduciaries as well as common folk draped with ethical and fiduciary mantels. Except where waived by statutory or regulatory exemptions, the general principles of fiduciary duty can be applied from very different contexts.

In *Estate of Wallens*, 877 N.E. 2d 960 (N.Y. 2007), New York's highest court imposed conflict of interest restrictions on a trustee. "'This is a sensitive and "inflexible" rule of fidelity, barring not only blatant self-dealing, but also requiring avoidance of situations in which a fiduciary's personal interest possibly conflicts with the interest of those owed a fiduciary duty.' (*Birnbaum* [*v. Birnbaum*, 73 N.Y. 2d 461] at 466, 541 N.Y.S.2d 746, 539 N.E. 2d 574...)."

The trustee had been obligated in a divorce settlement to provide for private elementary and secondary school tuition and medical expenses for his minor child. The trustee began to use trust funds for school tuition and medical expenses, however it was not until his child went to college that he sought court authorization for the invasions. The Court of Appeals noted that such disbursement were in general authorized by the terms of the trust, however, "even when the trust instrument vests the trustee with broad discretion to make decisions regarding the distribution of trust funds, a trustee is still required to act reasonably and in good faith in attempting to carry out the terms of the trust. ...Although father sought and obtained court approval to access the trust for Maggie's college expenses, he did not secure judicial approval to use trust assets to pay his obligation regarding her secondary school tuition, and certain medical expenses. Thus, we remit the matter to Surrogate's Court for a hearing to determine whether the expenditures were authorized in good faith and in furtherance of the beneficiary's interests." 877 N.E. 2d at 963.

In *Matter of Revocable Trust of Margolis*, 731 N.W. 2d. 539 , (Minn. App. 2007), the court followed *Wallens* in finding potential liability for a trustee who used funds from a trust established by his wife to pay for her nursing home care, in the face of a Minnesota statute which barred such use of trust funds to discharge "*any* legal support or other obligations of the trustee to *any* person." 731 N.W. 2d at 544. This was a second marriage, with the trustee having children from a prior marriage. Hence there was a conflict in using the spouse's trust funds to discharge the trustee's obligation to provide support to his wife. The Court found that "the record indicates that respondent co-mingled trust funds with his own funds, failed to keep the beneficiaries reasonably informed of material facts, refused to respond to appellant's requests for information, failed to maintain an accurate accounting of his management of the trust funds, and failed to

inform appellant that he was to serve as a successor trustee after Naomi became incapacitated, even though the trust expressly calls for that appointment." 731 N.W. 2d at 546. The case was remanded for findings on the breach of trust. It also discussed the shifting of the burden of proof regarding tracing of the proceeds of a trust asset, finding that "the presumption takes effect only after it is shown that the property in question was an asset of the trust at the trust's inception. Here, the district court found that appellant did not meet his evidentiary burden to show that the CD was a trust asset." 731 N.W. 2d at 548.

In *Application of Mel S.*, 838 N.Y.S. 2d 373 (Sup. Ct. 2007), the court imposed the ethical duty to avoid conflicts on a guardian, despite the lack of express statutory requirement for a guardian to observe such duties. The court held that the "guardian breached her fiduciary duty by using assets of the guardianship estate for her own personal advantage, namely renovations to real property owned by her and purchase of a van. That is a breach of fiduciary duty." 838 N.Y.S. 2d at 375. The court cited as authority cases involving executors.

"True, the cased cited above involve executors and administrators, but there is no difference between the fiduciary duty of an executor or administrator and those of a guardian. They are all fiduciaries...There is no logical reason why a guardian's accounting involving breach of the duty of loyalty should be any different than an accounting by any other type of fiduciary." *Ibid.* The court denied a jury trial under settled equitable principles.

In *First Union National Bank v. Turney*, 824 So. 2d 172 (Fla. App 2001), *rev. den.* 828 So.2d 385 (Fla., 2002) the court dealt with the duty of a trustee to disclose material facts, citing as authority the ethical duties of attorneys, who share the same ethical duties. "'[T]he beneficiary is always entitled to such information as is reasonably necessary to enable him to enforce his rights under the trust or to prevent or redress a breach of trust.' Restatement (Second) of Trusts §173, cmt. c. (1959). A trustee's intentional breach of the duty to supply the information is a fraud. A similar rule applies to lawyers, who are also fiduciaries:

> "If the lawyer's conduct of the matter gives the client a substantial malpractice claim against the lawyer, the lawyer must disclose that to the client. For example, a lawyer who fails to file suit for a client within the limitations period must so inform the client, pointing out the possibility of a malpractice suit and the resulting conflict of interest that may require the lawyer to withdraw.
>
> "Restatement (Third) of Law Governing Lawyers §20 cmt. c. (1998). No lawyer guilty of malpractice nor any trustee aware of a conflict with its beneficiary can, in order to defeat a claim for redress, conspire with (other) counsel to keep the client or beneficiary in the dark, under cover of the attorney-client privilege."

824 So.2d at 190.

Even where the terms of the trust may attempt to limit a fiduciary duty, such as the obligation to disclose material facts, the courts may nonetheless apply such duty to the fiduciary. In *Matter of Gustafson Revocable Living Trust*, 2007 WL 4248561 (Mich. App. Dec. 4, 2007),

the court ordered a trustee to account to a beneficiary and provide a copy of the relevant portions of the trust, despite language in the trust eliminating a duty to account to income beneficiaries. The Court held that "'a trust provision relieving the trustee of the duty to keep formal accounts does not abrogate the statutory duty to account to the beneficiaries in the probate court.' *In re Childress Trust*, 194 Mich. App. 319, 327028; 486 N.W. 2d 141 (1992)." 2007 WL4248561 at *2. The *Childress* court had held that "Although the terms of the trust may regulate the amount of information that the trustee must give and the frequency with which it must be given, the beneficiary is always entitled to such information as is reasonably necessary to enable him to enforce his rights under the trust or to prevent or redress a breach of trust. 1 Restatement Trusts, 2d, §173, comment c, p 378." 486 N.W. 2d at 145-46.

The trial court had refused to remove the trustee, despite the refusal to provide information. On appeal, this was reversed:

"Our Supreme Court has opined that 'a trustee must show the utmost good faith. He must exercise in the execution of the trust the degree of care and diligence which a man of ordinary prudence would exercise in the management of his own affairs'... Prudence is defined as 'acting with care, diligence, "integrity, fidelity and sound business judgment."...Both Robert and respondent breached their duties to petitioner by failing to provide her with an accounting and with relevant information about the trust. The probate court abused its discretion by failing to remove the trustee and successor trustee. *Comerica Bank* [*v. City of Adrian*, 179 Mich App. 712, 446 N.W. 2d 553 (1989)]at 729." 2007 WL 4248561 *4.

A similar result was had in *Matter of Kornrich*, 854 N.Y.S. 2d 293, (Sur. 2008) where the trustee claimed the trust language excused him from accounting during the term of the trust: "There is a basic reason that such a provision cannot be enforced, namely that accountability is an essential element of all fiduciary relationships which cannot be waived." 854 N.Y.S. 2d at 295.

In dealing with a power of attorney, the court in *Matter of Mueller*, 853 N.Y.S.2d 245 (Sur. 2008) held that EPTL 11.1.7 "prohibits a testator from exonerating a fiduciary from the duty of exercising reasonable care, diligence and prudence....the statute was the result of the legislature's concern with an increase in the practice of vesting fiduciaries with unlimited powers and a minimum of obligations which posed a risk to the persons interested in an estate and could serve to defeat the primary duties of ordinary care, diligence and prudence and of absolute impartiality which are the very essence of a trust." 853 N.Y.S. 2d at 249-250.

See also McNeil v. McNeil, 798 A.2d 503 (Del. 2002) where the court held that a grant of wide discretion did not waive their fiduciary duties of disclosure and impartiality: "Statements of this type are generally viewed as a definition of the trustees' powers, not as exculpatory of the liability of the trustee. *See* George Gleeason Bogert, The Law of Trusts and Trustees, §542 (1993)...Further, Article III(e) of the Lois Trust specifies, 'Decisions by the committee [of trustees]..[are] not subject to review by any court.' Courts, however, flatly refuse to enforce provisions relieving a trustee of all liability. *Id.* " 798 A.2d at 509.

The essential duties of a trustee are set forth not only in the Restatements, but also in the Uniform Prudent Investor Act and Uniform Trust Code. Hence the duty of disclosure formerly covered by Restatement (Second) of Trusts §173 is now governed by Restatement (Third) of Trusts §82 and Uniform Trust Code §813. The Restatement (Third) of Trusts has renumbered and revised many key provisions, which can be found on-line at the NCCUSL website.

The duty of loyalty in Restatement (Second) of Trusts §170 is now found in Restatement (Third) of Trusts §§78 and 27, as well as §802 of the Trust Code and §5 of the Prudent Investor Act.

The duty of impartiality found in Restatement (Second) of Trusts §183 is now Restatement (Third) of Trusts §79, Prudent Investor Act §6, and Trust Code §803.

Insurance Claims

Claims against insurance brokers have risen in recent years, with enforcement actions by State officials, including the Insurance Commissioner of California in *Matter of Allianz Life Insurance Co. of North America,* File No. VA 1152-AP. The Commissioner alleged breaches of CIC §790.03(a) with respect to sales of annuities to elderly clients which allegedly were unsuitable for the needs of the purchasers. The matter was settled with Allianz entering a Stipulation and Waiver on December 28, 2007, agreeing to various Annuity Suitability Systems, Standards and Procedures and paying $3million in monetary penalties to the Department, $300,000 in attorneys fees and costs, and a payment over five years of $3,750,000 to the Life and Annuity Consumer Protection Fund and a $3million investment in the California Organized Investment Network.

The Supreme Court of Delaware in *Wall-Mart Stores, Inc. v. AIG Life Insurance Co.*, 901 A.2d 106 (Del. 2006), refused to dismiss allegations of equitable fraud involving the tax consequences and risks involved in various corporate owned life insurance (COLI) policies issued to Wal-Mart. The IRS contested the deductions taken and the purchaser sued for damages, raising a variety of claims. The Court on appeal upheld dismissal of a number of such claims, but allowed the equitable fraud claims to proceed. This was not a judgment on the validity of the allegations, but merely that (on the basis of a "well pleaded" complaint), the case could go forward to allow each side to develop the evidentiary and legal bases for supporting or attacking the allegations either in motions or at trial. Discovery is continuing.

The Court dismissed claims that the brokers and insurance companies were fiduciaries. [note that California takes a different view on the fiduciary duties of insurance carriers]. The Supreme Court held that "Agents are fiduciaries when they are authorized to 'alter the legal relations between the principal and third persons…'" 901 A. 2d at 113. It found that the brokers and insurance companies did not make such independent decisions and hence were not fiduciaries, citing Restatement (Second) Agency §12 (1958). "The Court is mindful of the fact that normal business dealings such as that of an insurance broker and its client) can sometimes take on certain aspects of a fiduciary relationship, as, for example, where the broker agrees to act as agent for the customer with power to bind the customer contractually. At the same time,

however,…it is vitally important that the exacting standards of fiduciary duties not be extended to quotidian commercial relationships…" 901 A. 2d at 114.

The Court held that the relationship went beyond normal commercial transactions, finding that there was "no alignment of interests between Wal-Mart and the broker-defendants," that there were no facts alleged that the broker-defendants "exerted control or dominance over Wal-Mart," and that there were no allegations of "self-dealing." It concluded that the "relationship that is alleged to have existed between Wal-Mart and the broker-dealers was merely a normal, arm's-length business relationship." 901 A. 2d at 114.

However the court found that the complaint had made sufficient allegations that statements made in the process of selling the COLI policies were sufficient to support a claim of equitable fraud. "Equitable fraud differs from common law fraud in one respect – the defendant need not know that the representation is false. Although an **expression of opinion** cannot form the basis of a fraud claim, 'the mere fact that a material statement is in the form of an opinion, or of an estimate, is not necessarily conclusive as to whether it must be treated as such…'" 901 A. 2d at 115 (emphasis added).

The Court held, citing Restatement (Second) Torts §545 (1977), com. C:

"Even though the language of a representation concerns only legal consequences and is in the form of an expression of opinion, it may, as in the case of any other statement of opinion, carry with it by **implication the assertion that the facts known to the maker are not incompatible with his opinion or that he does know facts that justify him in forming it….** <u>When the recipient does not know the facts, he may justifiably rely upon these implied assertions and recover on the basis of a misrepresentation of implied fact.</u>" *Ibid.* (emphasis added).

The Court stated: "Similarly, a statement that is 'facially true...may constitute an actionable misrepresentation if it causes a false impression as to the true state of affairs, and the actor fails to provide qualifying information to cure the mistaken belief.'" 901 A.2d at 115.

The Court upheld against a motion to dismissal allegations that defendants allegedly "misrepresented the viability of the COLI plans by failing to inform Wal-Mart that the plans deviated from industry standards, and that those deviations had prompted regulators to question or disapprove similar plans. These are misrepresentations of implied fact – implied in light of appellees' representations that the COLI plans were 'designed' or 'intended' to comply with the requirements of IRC §§7702 and 264. In addition, a Broker allegedly advised Wal-Mart that its maximum exposure under a 'worst case' scenario would be $283,000. That statement may be classified as an 'estimate' or 'opinion,' since no one can provide absolute assurance as to future events. Nonetheless, **it is the type of opinion that suggests the reasonable belief that it was based on facts known to the maker. Thus, such a statement can form the basis for an equitable fraud claim as well."** 901 A. 2d at 1116 (emphasis added).

The expansion of financial institutions into multiple areas of wealth management has raised a number of issues regarding the extent of fiduciary and ethical duties of express trustees and their corporate affiliates. For example, in *French v. Wachovia Bank*, 2007 WL 895820 (E. D.

Wis. March 21, 2007), *stay dismissed*, 2007 WL 3125277 (E.D. Wis. October 27, 2007), the trustee was sued for alleged self-dealing in replacing a life insurance policy in a trust with an purportedly inferior one from an affiliated life insurance company and its brokerage affiliate. Plaintiff sought class action status. The Court described the claims as follows:

"According to the Complaint, Wachovia Bank breached its fiduciary duty of loyalty by engaging in impermissible self-dealing when managing the French Trust. Specifically, the Plaintiffs claim that Wachovia Bank had an obligation to first obtain a waiver of conflict from James French before purchasing insurance from its affiliates. The Plaintiffs also allege that Wachovia Bank violated its fiduciary duty because the purchase of the John Hancock policies was not a reasonable and prudent business practice. And finally, the Plaintiffs allege that Wachovia Bank, "directly or indirectly through its affiliate," violated section 100.18 of the Wisconsin Statutes by using false or misleading information to induce the Plaintiffs to approve the purchase of the John Hancock policies." 2007 WL 895820 at *1. The brokerage affiliate was alleged to have "conducted the alleged deception by providing [beneficiary] illustrations about the value of the John Hancock policies that were misleading." *Ibid.* at *2.

The claim against the brokerage affiliate was initially sent to arbitration, and the breach of fiduciary duty claim was stayed. The plaintiff then dismissed the statutory cause of action to escape arbitration, and the stay was dismissed, so that the claim of breach of fiduciary duty was allowed to go forward. However, the plaintiff allegedly stated in an email that it "had not 'abandoned' or 'waived' the arbitrable claim," 2008 WL 2439717 (E.D. Wis. June 16, 2008) at *1 and Wachovia moved for arbitration on the main claims, filing an appeal when the trial court rejected its motion. Hence it will be some time before the claims of misrepresentation and breach of trust are tried. This should not give any trustee or affiliated insurance broker comfort with blood in the water cruised by class action lawyers.

Dealing with liability claims raised against express trustees as well as affiliated entities in the insurance, brokerage, investment management, real estate services is extremely complex, given the interplay of state and federal laws and regulations governing financial institutions, as well as common law fiduciary principles. Those common law principles have been hammered out in a huge variety of situations, dealing with corporate fiduciaries as well as common folk draped with ethical and fiduciary mantels. Except where waived by statutory or regulatory exemptions, the general principles of fiduciary duty can be applied from very different contexts.

Damages in a falling market

Restatement Third of Trust, Prudent Investor Rule (1992) §209 at 156-157:

"Liability for Breach of Trust by Failing to Sell Trust Property

"(1) If the trustee fails to sell trust property that the trustee has a duty to sell, the beneficiaries may charge the trustee with the amount of proceeds that would have been received had the trustee properly sold the property, ordinarily with an appropriate additional amount to compensate for loss of return on those proceeds."

"Comment b. If the property has depreciated in value, the beneficiaries can require the trustee to pay the amount that would have been received, together with an appropriate return thereon, had the trustee sold the property in accordance with the duty of sale. In that event the unsold property will belong to the trustee individually, subject to a lien to secure the beneficiaries' claim." Ibid at 157

Illustrations
At158:

"Recoveries for interest or total return (on which see §227, Comment e) are generally to be compounded on a reasonable basis.

"If the trustee fails to sell trust property that the trustee is under a duty to sell, and the property subsequently so appreciates in value that no loss results, the trustee is subject to no pecuniary liability. **Nor is the trustee subject to liability, when there is a total return measure of loss, although the property that should have been sold depreciates in value, if appropriately comparable investments so decline in value that the beneficiaries have suffered no loss. See §§205 and 211."** (emphasis added).

In *California Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036 (9th Cir. 2001) the court affirmed a finding that the investment advisor to a pension trust imprudently invested too large a portion of the assets in inverse floaters, a derivative security based on CMO's. The trial court had calculated damages based on what the trust would have earned if the excess investments in inverse floaters had in fact been invested in appropriate fixed income securities, calculating a benchmark yield for measuring damages. The Court on appeal advised:

> "However, to the extent that the district court may wish to rely upon the benchmark yield in its recalculation of damages, such reliance would be appropriate. It would be extremely difficult to arrive at even an approximate calculation of the yields which reasonably could have been expected from different portions of the portfolio assuming appropriate investment. When precise calculations are impractical, trial courts are permitted significant leeway in calculating a reasonable approximation of the damages suffered. *See Sutton v. Earles*, 26 F. 3d 903, 918 (9th Cir. 1994)."

259 F.3d at 1047.

See Guthy-Renkar Corp. v. Bernstein, 39 Fed. Appx. 584, 587, 2002 WL 826231 (9th Cir. 2002) (damages based on reasonable approximation in breach of contract case, citing *Ironworkers, supra.*).

Restatement, Third, of Trusts § 211 provides that

> "If the duty was to acquire any property constituting a proper investment for the trust, charge the trustee with the amount of the funds the trustee failed properly to invest, adjusted for the amount of the total return, **positive or negative**, that would have accrued to the trust estate had the funds been invested in a timely fashion, this return to be based on a total return experience for suitable investments of generally comparable trusts." (emphasis added)

The Reporter's notes to §211 notes the variety of measures of damages which could be applied when an improper investment scheme causes the trust to lose what it should have earned:

> "This approach can be carried out by referring the to performance of all or a relevant portion of the proper investments of the trust in question, to the performance of all or part of the portfolios of comparable trusts, or to the performance of **some suitable securities index or other benchmark portfolio**." (Emphasis added

Restatement, Third of Trusts, §211, Reporter's notes at 168.

The flexibility of the equity court to fashion a measure appropriate to the circumstances is emphasized in the new investment provisions of the Restatement. Comment f to §211 notes:

> "If the period during which the trustee has failed to make investments is not significantly prolonged, at least if the trustee is not guilty of bad faith or other serious misconduct, it would ordinarily be an appropriate exercise of equitable discretion to measure the performance of proper trust investments only by applying a suitable rate of interest, based on the income yields of investments of generally comparable trusts. In such a case the court would not look to a total return figure; that is, damages would not take account of capital gain or appreciation, nor of losses in value, that might have resulted in a suitable trust portfolio from general changes in stock and bond values in the security market. This approach would be particularly justified in such cases if a recovery based on some representative measure of total return performance of trusts appears highly speculative." (Emphasis added).

Section 205 Restatement Third of Trusts, Prudent Investor Rule, at 154-155

205(b) provides that the breaching trustee may be "chargeable with the amount required to restore the values of the trust estate and trust distributions to what they would have been if the trust had been properly administered." at 155.

Comment "Thus, the recovery for an improper investment by a trustee would ordinarily e the difference between (1) the value of the investment and its income and other product **at the time of surcharge** and (2) the amount of the funds expended in making the investment, increased **(or**

decreased) by the amount of the total return **(or negative total return)** that would have accrued to the trust and its beneficiaries if the funds had been property invested." (emphasis added).

Note that the courts have leeway to pick the time for the measure of damages. When the trustee breaches his duty to sell trust assets which become inappropriate because of a change in circumstance, a need to diversify trust assets, or other factors making the continued investment inappropriate, the measure of damages may be more difficult to ascertain. In *Brougham v. Swarva*, 661 P.2d 138 (Wash. Ct. App 1983), the court used the highest value of the assets during the intervening period. When the trustee is not guilty of some breach of loyalty in retaining the assets, courts will attempt to find a measure of damages which reflects the general duty of the trustee to dispose of those assets within a reasonable period of time. Therefore, rather than pick the highest value of those assets during the period in which a sale was to be made, the court may fix damages based on the average price of the assets during the period in question. *Steiner v. Hawaiian Trust Co.*, 393 P.2d 96 (Hawaii 1964); Frachter, 3 *Scott on Trusts* §209 at 1692-1695. In *Schug v. Michael*, 245 N.W.2d 587 (Minn. 1976), the court based damages for conversion by the trustee on the highest value within a reasonable time the beneficiary had knowledge of their conversion. The Third Restatement has utilized the value at the time of the decree as the appropriate measure. Restatement (Third) of Trusts §208.

No "Peak of the Market" Damages

The Court of Appeals in Ohio, in an unreported decision, *Pickerel v. Huntington National Bank*, 2002 WL 416970 (Ohio App. , 2002), relied on a 1955 Ohio Supreme Court decision to reject "peak of the market" damages where the trustee allowed an 11% concentration in The Limited stock to rise to 55% of the portfolio before plummeting.

The trust company's internal policy manual held that a trust could hold no more than 10% of the portfolio in any one stock. The trust, in 1981, held 11% of its assets in The Limited. The stock split on five occasions in subsequent years. The trustee sold shares at various times, but by 1992, the shares in The Limited represented 66.6% of the portfolio, based on $28.88 per share. By September of 1996, the price had fallen to $19.12 per share. The trial court granted summary judgment for the trustee because the beneficiaries had failed to raise an issue of fact to the trust company's assertion that no damages had been sustained.. The appellate court rejected damages based on the 1992 high water mark.

> "Appellee asserts that under appellant's theory of damages, almost a decade of phenomenal growth in Limited stock, during which time the trust held well over ten percent of its assets in Limited stock, and then assert breach based on the failure to diversify once the stock began to decline in value." 2002 WL 416970 at 3.

The Court, affirming the trial court's denial of damages based on a failure to prove damages, relied on *In re Estate of Bentley*, 163 Ohio. St. 568, 127 N.E. 2d 749 (Oh. 1955), dealing with liability of an executor:

> "Ordinarily, where a fiduciary is entrusted with securities and has the power of sale, in the absence of fraud or bad faith he can not be charged with any loss if he failed to make a sale at the peak of the market. The absurdity of any contrary rule is at once apparent. If

> the market was lower at the time the securities were sold, and the fiduciary was to be charged with the loss for not selling them at an earlier date, it would logically follow that, if he had sold them at the earlier date and the market had advanced, he would be held liable for not having held the securities and thus realized the gain." 2002 WL 416970.

The court noted that The Limited outperformed the S&P 500 by 100%, and that if it had been maintained at 10%, "distribution to the beneficiaries would have been reduced to roughly $362,000 compared to the pretax proceeds actually earned by Hunting of roughly $1.24 million (for a difference of roughly $879,000.)." *Ibid.* Citing Restatement (Second) of Trusts §209(1) and com. b., the court concluded that "the unrefutted evidence is that the trust, as a whole, benefited from the holdings in Limited stock."

The appellate division in the case of *In re Chase Manhattan Bank*, 809 N.Y.S. 2d 360 (A.D. 2006), *leave to appeal den.* 813 N.Y.S. 2d 689 (A.D. 2006) rejected a finding of liability where the stock had reached a peak, but fallen 22%. 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 for a sale. It rejected liability based on "hindsight." 809 N.Y.S. 2d at 364. The Court held:

> "Indeed, the evidence establishes that the trustee would have acted imprudently had it sold the stock on January 31, 1974. The stock had outperformed the Standard and Poor's 500 Index by nearly 3 to 1 up to January 1973. Although the value of the stock fell from $148 on January 12, 1973 to $115 on January 11, 1974, it was still above its January 14, 172 price of $97. In fact, the Valueline reports on Kodak stock indicated a Beta of .71 to 1.02 between January 14, 1972 and January 11, 1974 with a safety rating of one and 12-month performance ratings of two and three. 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 extensive retention clause."
>
> 809 N.Y.S. 2d at 364-365.

The New York Court of Appeals denied review of this decision.

Duty regarding estate planning

In *Matter of Galloway Trusts,* Court File No C5-04-200042 (Minn. trial court decision, 2007), the Court held that a trustee had no duty to advise a widow to consider planning her assets into a family limited partnership.

The court in the trust matter held that "The creation of an FLP, an aggressive tax-avoidance device, goes well beyond the duties of a fiduciary, however sophisticated it is. Such a device makes it difficult, if not impossible, for the fiduciary to maintain control of the assets for the benefit of the income (i.e. primary) beneficiary and at the same time to give up control in order to drive tax discounts. *If* an FLP were appropriate here –and it was not—its creation was not in the bailiwick of a trust company, and US Bank did not breach its fiduciary duty to the Galloway family in not taking actions to induce Janice Galloway into casting up her taxable wealth in that form." Findings of Fact at 3.

The extensive findings, plus a memorandum decision by the judge, went into great detail as to various estate planning alternatives. The Court did reference the decision in *Hatleberg v. Norwest Bank Wisconsin*, 700 N.W. 2d 15 (Wis. 2005), where the Wisconsin Supreme Court found that ordinarily the trustee would not have a duty to review the trust for tax flaws unless it had contractually agreed to do so 700 N.W. 2d 15. However, the trustee must 'warn [the grantor] regarding easily identifiable impediments or pitfalls' that would thwart the grantor's intent." 700 N.W. 2d at 22.

> "here the trust instrument contained no language requiring the trustee to review it for effectiveness. In view of the fact that Wells Fargo did not draft the trust, we have serious reservations about Hatleberg's invitation to impose liability for failing to ensure that the trust worked for its intended tax avoidance purpose." 700 N.W. 2d at 23.

The Court concluded: "We are reluctant to impose liability on a trustee for not discovering and correcting a **defect in a trust resulting from negligence by an unaffiliated drafter, unless the responsibility was assumed by contract.**" 700 N.W. 2d at 23. (emphasis added).

In *First Farmers Bank and Trust Co. v. Whorley*, 891 N.E. 2d 604 (Ind. App. 2008), a guardian changed the management of a farm which was the largest asset of a estate, from a modified share crop arrangement to a cash rent, resulting in the loss of a Special Use Valuation resulting in $537,474 in additional estate taxes. The Court looked to a recent Indiana Supreme Court decision, *In re Guardianship of E.N.*, 877 N.E. 2d 795 (Ind. 2007), noting that "the court acknowledged that the statute's principal focus is on minimizing estate and inheritance taxes. [877 N.E. 2d] at 800. thus, based on our supreme court's recent pronouncement in this area, it is clear that a guardian's duties include estate planning for its protected person, while mindful of the best interests of his ward, spouse or family." 891 N.E. 2d at 613. The court reversed a summary judgment in favor of the guardian.

In *Savu v. Suntrust Bank*, 668 S.E.2d. 276 (Ga. App. 2008), the court upheld summary judgment in favor of an executor against claims that it should have sued the settlor's attorney for malpractice because of alleged estate planning errors. The court held that the fact that the bank had recommended the attorney to the settlors, resulting in an estate plan which named the bank as executor, which then hired the attorney to represent it in its fiduciary capacity, did not raise a conflict nor did it result in a breach of fiduciary duty. Development officers can breathe a sigh of relief. There was testimony that the attorney had not recommended the bank as an executor, but rather that the attorney had testified without contradiction that settlor "herself made the decision." 668 S.E. 2d at 688. "SunTrust's standard practice of employing the attorney who drafted a will to provide legal services in administration of the estate is supported by numerous practical considerations, e.g. such attorney has familiarity with the estate and is presumably the attorney whom the testator would select. Therefore, this is a pervasive practice endorsed by a 'Statement of General Policies' adopted by the Trust Division of the American Bankers Association and the American Bar Association. It is not prohibited by any ethics rule in Georgia. We do not, however, disagree that the practice raises ethical concerns where it is part of a

reciprocal arrangement through which the will draftsman names the bank as estate executor, and the bank then names the will draftsman as estate attorney **at a higher fee than that obtainable through negotiation with other qualified lawyers.** But the evidence here shows without dispute that the Riches selected SunTrust as fiduciary in their wills; that the wills named Sally and Clayton rich as co-executors and gave them or their daughters power to remove SunTrust; and that after Sally Rich's death, Clayton Rich at lease tacitly approved both the selection of Morrison as estate attorney and his fees." (emphasis added). 668 S.E. 2d at 689. The court rejected a claim that the bank had breached its duty by failing to sue the estate planning attorney for failing to "advise the Riches about use of a family limited partnership as an estate tax savings strategy." *Ibid.* The court held that summary judgment had been proper based on testimony that the decedents had rejected proposals of family limited partnerships when suggested to them. 668 S.E. 2d at 690. The Court rejected claims that the bank itself should have advised use of a family limited partnership, "the bank referred them to rust and estate counsel to determine the specific strategies to be employed. Clearly, therefore, SunTrust did not undertake to advise the Riches on specific strategies and the Riches could not have reasonably relied on SunTrust for such advice." The Court distinguished *Merrick v. Mercantile-Safe Deposit & Trust Co.*, 855 F. 2d 1095 (4th Cir. 1988) where the trust companies had provided estate planning advice to the testatrix in consideration of being named the fiduciary under her will and testamentary trusts. 668 S.E. 2d at 283.

Attorneys Fees

Matter of Galloway Trusts, Court File No C5-04-200042, in Galloway the trustee had been removed following the death of the widow, and another corporate trustee appointed to close out the trusts. US Bank had sought to reserve assets to pay for its defense in the event it prevailed, and the court ultimately directed the successor trustee to retain $750,000 for such purpose. The multiple trusts were then terminated and the assets distributed to the beneficiaries.

Following the surcharge trial, the trustee requested is attorneys fees. The plaintiffs objecting on the grounds that USBank was no longer a trustee, and hence had no right to fees. They also argued that since some trusts had been distributed, recovery could not be had from the beneficiaries. In November of 2007, the court rejected these defenses and awarded fees to the former trustee. Attorneys fees of $1,618,828 were approved, along with expert witness fees of $271,817. Other costs of $91,883 were also approved. The Court concluded: "In addition to the $700,000 already paid to U.S. bank from the Court-established reserve fund, Objectors shall direct the current trustee of the Galloway family trusts to pay to U.S.Bank $1,287,524.14, which is the remaining total of all attorneys' fees, experts' fees, non-expert costs and disbursements. Alternatively, Objectors may pay such amount individually or from any of their other trusts."

The trial judge filed a memorandum explaining the basis for the fee recovery. "From the outset, this case has been plagued by a lack of organization and focus by Objectors' attorneys. As it progressed, it also became apparent that many of the tacks taken by these attorneys were designed to frustrate such routine issues as discovery, scheduling, even selection of a mediator. Some of these difficulties were brought contemporaneously to the Court's attention by virtue of the numerous motions argued. However, the motions argued were simply the **tip of the iceberg**:

the billings reflect many more matters that should have been handled in a more straight-forward and efficient manner." (emphasis added)

The dispute over fees was subsequently settled.

In *Kasperbauer v. Fairfield*, 170 Cal. App. 4th 785 (2009) the court held that a trustee who distributed assets to beneficiaries had an equitable lien on the assets distributed to the beneficiaries based on extrinsic mistake, to support an order to return a portion of the assets to compensate the trustees attorneys. This was done despite pendency of objections to the accounting; however the court held that the award could be modified depending on the outcome of the objections. The Court on February 24, 2009 modified its opinion, after objection by a public spirited partner of the author, to base the right to such a lien on Restatement Second of Trusts section 249, which provides that "If the trustee is entitled to indemnity out of the trust estate for expenses incurred in the administration of the trust and conveys the trust estate to the beneficiary without deducting the amount to which he is entitled as indemnity, he is entitled to indemnity from the beneficiary personally to the extent of the property so conveyed, unless he manifested an intention to forego his claim to indemnity, or unless the beneficiary has so changed his position that it is inequitable to compel him to indemnify the trustee." The court followed §246 based on California's statutory adoption of the common law where there is no contrary statute, Cal. Prob. C. §15002.

U.S. Bank also prevailed in *Cundall v. U.S. Bank*, 882 N.E.2d 481, (Ohio App., 2007), *rev. granted* 118 Ohio St. 3d 1432, 887 N.E.2d 1201 (Ohio, 2008). The case involved claims of breaches of trust of several related trusts against both an individual trustee and the corporate trustee. Some of the matters dated back to 1983, when the plaintiffs allege they were coerced by the individual trustee into agreeing to sell shares of a closely held business from their trusts at inadequate prices. In 2005, the shares of the company were sold for approximately $340 million. There were also claims that a trust for the plaintiffs' family had been improperly managed. The individual trustee died in 2005 after the sale. The trial court dismissed the action, but was reversed on appeal as to the individual trustee in a very colorful opinion.

The Court upheld the dismissal of the claim of the corporate trustee, holding that the statute of limitation had begun to run when the trustee was removed pursuant to a power in the trust in 1996. The court held, "We believe that if the Cundalls had exercised reasonable diligence, they would have discovered any alleged fraud that U.S. Bank had perpetrated on them. In 1984, they knew that CIC had purchased Miller's shares at a much higher price. They also knew that U.S. Bank was CIC's commercial banker.

The case has been argued on the issue of statute of limitations, and is awaiting a decision by the Ohio Supreme Court.

Pederson v Wells Fargo Bank, 757 NW 2d 740 Rule 11 fees in favor of bank. De novo review of mixed question of fact and law.

J.P. Morgan Trust Co. v. Siegel 965 So. 2d 1193 (Fla. App. 2007). Trustee required to repay attorneys fees after beneficiaries responded to interrogatories, providing notice of a dispute regarding conduct of the trustees. Because of conflict, trustee should have gotten court order

before paying its litigation fees. Discussion of development of Florida law prior to adoption of Section 737.403(e) Fla. St. in 2003.

Kerr v. UMB Bank, NA, ___F. Supp. 3d___, 2008 WL 822055 (W.D. Okla. March 26, 2008). Discretion of court to award fees to prevailing trustee, citing Restatement Third of Trusts §88, com. d. (2007), even where no evidence that plaintiffs acted unreasonably.

Jain v JPMorgan Securities, Inc., 177 P.3d 177 (Wash. App. 2008) discussion "ABA Rule" regarding award of attorneys fees as consequential damages.

*Walker v. Northern Trust Co.*___F. Supp. 3d.___, 2008 WL 191182 (N.D. Ill. Jan. 22, 2008) award of attorneys fees to prevailing trustee.

Kiatkowski v. Drews, Frost, Seattle First National Bank, 176 P.3d 510 (Wash. App. 2008), award of fees to trustee incurred in motion to enforce settlement agreement (despite waiver of attorneys fees as part of the settlement).

Exarhos v. Exarhos, 158 Cal. App. 4th 938, 70 Cal. Rptr. 486 (Cal. App. 2008), award of attorneys fees when California Bank and Trust prevails in claim brought by plaintiff to establish accounts should have been distributed to him under estate plan and claimed accounts negligently managed. Plaintiff subject to attorneys fees provision in account agreement signed by decedent when bank prevailed.

Losser v. Bradstreet, 183 P3d 758 (Idaho 2008), party who successfully defeated probate of holographic will could not recover attorneys fees against proponent of the will in separate action against the proponent; attorneys fees not an element of damages for tort of interference with expectancy of inheritance, since plaintiff was not deprived of an inheritance (since he won). "We are unwilling to...eviscerate our long-standing rule that attorney fees for tortuous conduct are not recoverable in the absence of a statute conferring such a right." 183 P.3d at 764. Court dodges issue of whether it will recognize tortuous interference.

Removal of Fiduciary

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*, 828 N.Y.S. 2d. 689,(N.Y. A. D. 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.**" 828 N.Y.S. 2d at 1193(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).

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.

The Massachusetts Supreme Court upheld the removal of trustees under a charitable trust in *Matter of the Trust under the Will of Lotta M. Crabtree*, 865 N.E. 2d 1119 (Mass 2007). The Court held that "Two of the breaches of fiduciary duty found by the judge, alone or in combination, are sufficient to justify removal: the breach of fiduciary duty inherent in the misuse of the agricultural fund trust (both by using the agricultural fund trust account to pay trustees' fees for all of the trusts, and by using that account as an operating account for the other trusts), and the breach of fiduciary duty inherent in the unauthorized and undisclosed creation and maintenance of an endowment, the operation of which was not countenanced by the will." 865 N.E. 2d at 1128.

The court held that "We recognize that a successor trustee is not strictly liable for the acts of a predecessor. However, 'the successor trustee has a positive duty, upon taking over the trust estate, to see that the predecessor has properly accounted for the whole of it.' Loring, A

Trustee's Handbook §7.2.4 at 500 (C.E. Rounds ed. 2007). Historical practices does not excuse a present failure of diligence. Nor can we say that the Attorney General had no objection to the trustees' method of accounting where the judge found that these impermissible accounting practices are not obvious from the accounts filed and not disclosed until the present litigation." 865 N.E. 2d at 1129.

"The trustees were required by the terms of the will to distribute the income earned from the agricultural fund trust semiannually. By establishing the endowment, the trustees essentially converted trust income into a parallel pool of principal, only a small part of which was actually paid out to needy students. Where or not this was 'a good idea,' as the trustees claim, it was not countenanced under the Crabtree will. In the absence of a court order, it is the terms set out by Crabtree that must dictate the distribution of income from her estate. 865 N.E. 2d at 1132.

The Court also approved the reduction of the trustee fees paid to the removed trustees on the grounds that such fees were excessive, using $100 per hour as a criteria for certain services, and looking to fee schedules from eight other Boston-area trust management entities. The selection of a fee amount at the low end of this range of comparable fee structures "was not unreasonable-does not evidence an abuse of discretion." 865 N.E. 2d at 1133.

ADR

The Supreme Court has now ruled in *Hall Street Associates, LLC v. Mattel, Inc*, ____US___, 128 S.Ct. 1396 (2008) that the grounds stated in the Federal Arbitration Act for enforcement of an arbitration award are exclusive, and cannot be altered by the parties to seek a general review for the arbitrator's legal error. It held that the FAA sections 10 and 11 "address egregious departures from the parties' agreed-upon arbitration: 'corruption,' 'fraud,' 'evident partiality,' 'misconduct,' 'misbehavior,' 'exceed[ing] ...powers,' 'evident material miscalculation,' 'evident material mistake,' 'award[a] upon a matter not submitted'...Given this emphasis on extreme arbitral conduct, the old rule of *ejusdem generis* has n implicit lesson to teach here. Under that rule, when a statute sets out a series of specific items ending with a general term, that general term is confided to covering subjects comparable to the specifics it follows. Since a general term included in the text is normally so limited, then surely a statute with no textual hook for expansion **cannot authorize** contracting parties to supplement review for specific instance of outrageous conduct with review for **just any legal error. 'Fraud' and a mistake of law are not cut from the same cloth."** (emphasis added). 128 S.Ct. at 1404. The case was remanded, however, to determine whether the matter should have been reviewed as an exercise of the trial court's power to manage its case under FRCP 16. The arbitration had been created by the court after it had rendered its decision on a breach of contract action, with the parties asking that the question of damages be separately arbitrated. Since the arbitration was established by the court's order, the question arose in the course of the resulting appeals whether the trial court's case management powers might trump the FAA's review restrictions.

The Supreme Court held that the FAA should be interpreted in favor of "a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway. Any other reading opens the door to the full-bore legal and

evidentiary appeals that can 'rende[r] information arbitration merely a prelude to a more cumbersome and time-consuming judicial review process…'" 128 S.Ct. at 1405.

Hence, in federal court the limited review of arbitration awards only for "manifest disregard" may be more restrictively read to include only the types of conduct contained in paragraphs 10 and 11 of the FAA.

Schatz v. Allen Matkins, 45 Cal. 4th 557 (2009) attorney arbitration provision in fee agreement entered prior to the dispute requires arbitration under its terms (no appeal), displacing mediation provision under California law which would ordinarily allow mediation of the dispute and appeal.

Statute of Limitations Cases

In *Cundall v. U.S. Bank, N.A.*, 882 N.E. 2d 481, (Ohio App, 2007) the court dealt with claims of breach of trust, dismissing the claims against US Bank on statute of limitations grounds holding that the four year statute was triggered when the corporate trustee was removed. The Court dealt with claims involved in the purchase of the beneficiaries' shares in a closely held company at an inadequate price as a result of alleged improper pressure and threats by the individual trustee. The Court found that beneficiaries had been aware of a subsequent purchase of shares at a higher price in 1984. The court held that the statute of limitations had not run,, despite the passage of over twenty years from knowledge of the allegedly inadequate price and improper pressure, based on the fact that the trustee had served until his death. The Supreme Court of Ohio granted review of the decision relating to statute of limitations regarding the individual trustee, with oral argument to take place in January of 2009.

In *Spitzer v. Ben*, 866 N.Y.S. 2d 464 (N.Y. A.D. 2008) held that a claim involving a charitable trust was not time-barred based on case law holding that the three-year statute of limitations was tolled "until the fiduciary has openly repudiated his or her obligation or the relationship has been otherwise terminated," holding that this tolling applied to the benefit of the attorney general. 866 N.Y.S.2d at 465-66.

In *August v. U.S. Bancorp*, 190 P. 3d 86 (Wash. App. 2008), the Court denied summary judgment for the defendant trustee based on grounds that there were disputed questions of fact regarding whether the beneficiary had failed to use reasonable diligence in discovering various alleged breaches of trust involving alleged failures to use investments to diminish tax liability, to determine the needs of beneficiaries, to evaluate low-quality and low-yield funds, and to roll an annuity into a subtrust to avoid adverse tax consequences. The beneficiary argued that he had asked for a distribution of funds to investigate, but the Bank refused such funds. He then argued that he did not discover documents which disclosed several material aspects of his claims until several years later. The beneficiary claimed fraudulent concealment, based on his unsophisticated financial understanding, the trustee's alleged failure to disclose material facts and various "missing or misleading statements." Against the claim that the failure to provide information does not establish fraudulent concealment, the Court held that because of the fiduciary duty to disclose, questions of fraudulent concealment and the factual issues whether the beneficiary knew or should have known the elements of his cause of action, summary

judgment should be denied. 190 P.3d at 96. Review is being sought in the Washington Supreme Court.

In *Noggle v. Bank of America N.T.S.A.* 70 Cal. App. 4th 853 (Cal. App. 1999), the court held that allegations of investment breaches were barred, except for the three year period prior to the filing of the complaint, where the accountings provided to the beneficiaries would have allowed them to determine that the assets had not grown over the years because of investment in fixed income securities. 70 Cal. App. 4th at 861.

Core Jurisdiction

Core jurisdiction in bankruptcy, *In re CBI Holding Co. Inc. v. Ernst & Young*, ___F.3d___, 2008 WL 2405702 (C.A. 2d 2008). Not following the 9th Circuit on open question of status of creditor claims/counterclaims.

Diversity Jurisdiction

Andrews v. Modell—2008 WL 4949778 Court dismisses case for lack of diversity. "Not wishing to draw comparisons with Alexander the Great or Henry V—an because Mr. Modell's arguments regarding diversity of citizenship are more easily disposed of – the Court shall pass this issue and turn to whether [new trustee's] citizenship should be disregarded for purposes of the diversity statute." 2008 WL 4949778 at *4. The court found that the appointment of new trustee, whose residence would defeat diversity jurisdiction, had sufficient power and duties so that she was not a "naked trustee" whose citizenship could be ignored for purposes of diversity jurisdiction. jurisdiction.

Butler v. Kosin 2009 WL 210 721 IRS removes from probate action to federal, remanded.

In *United States v. Lewis,* 2008 WL 2986410 (W.D. La. August 4, 2008) the Court found it was "called upon to venture forth, in the words of William Shatner, where no one has gone before." 2008 WL 2986410 at *3. The IRS had removed a controversy to federal court. The court examined cross motions for summary judgment and held in favor of the beneficiaries regarding the validity of a trust whose distributive provisions were modified following the death of the settlor.

In *McCann v. The George W. Newman Irrevocable Trust,* 2007 WL 1352832 (D. N.J. May 7, 2007) the court faced a law school exam set of facts regarding the domicile of a deceased party. The trust had been created to hold a parcel of land for development. The settlor's development company which was to develop the property into a commercial and transportation center, got into disputes with McCann, the president of the development company, later known as Secaucus Connection. Two of the trustees agreed to settle the dispute by granting an equity interest in the property to McCann. The third trustee sued to enjoin his co-trustees from entering into the proposed agreement and grant of an equity interest. McCann then died. An action was filed in federal court under diversity. The court in this order denied a motion to dismiss, finding that McCann had changed his domicile by moving to New Hampshire prior to his death.

While he sold his home in New Jersey, he retained an apartment there after the purchase of a New Hampshire home. He did not use the apartment in the month before his death and visited New Jersey only four times between November 2001 and his death in February of 2002. He had registered to vote in New Hampshire, but never voted prior to his death. He obtained a New Hampshire driver's license, but also renewed his New Jersey license. His bank accounts had been transferred to New Hampshire, but he retained a brokerage account in New Jersey. The income tax return filed after his death listed him as a New Hampshire resident. However, his wife's application for continued health insurance listed him as a New Jersey resident. His funeral was in New Jersey, but he was buried in New Hampshire. A true law school exam question. The trial court had dismissed, but was reversed by the 3rd Circuit, 458 F.3d 281 (3rd Cir. 2006).

On remand, the court held that it must consider "declarations, exercise of political rights, payment of personal taxes, house of residence, and place of business." *Krasnov v. Dinan*, 465 F.2d 1298, 1301 (3d Cir. 1972)Additionally the court looked to issues raised by the Third Circuit in reversing the initial decision, allowing consideration of "location of brokerage and bank accounts, location of spouse and family, membership in unions and other organizations, and driver's license and vehicle registration." 458 F. 3d 286. 2007 WL 1352832 at 3. The Court held that two steps were necessary for an instantaneous change of domicile: "the individual must (1) take up residence at the new domicile and (2) intend to remain there." The court noted that the decedent had severed many personal ties, such as breaking ties with his minister and place of worship, changing physician and changing his family's holiday tradition of spending Christmas in Short Hills. Faced with a New Jersey brokerage and driver's license, the court ruled that "to change domicile, an individual need not break all ties with his previous domicile – to do so would be to effectively eviscerate the rule that an individual can establish a new domicile instantly." 2007 WL 1352832 at 4.

The court denied the motion to dismiss for lack of jurisdiction. It then granted a motion to dismiss under FRCP 12(b)(6) based on affidavits which showed that the trustees in question had resigned their positions, thus mooting the action against the trustees, since they could not be compelled to take the actions as trustees required in the complaint. The court noted that only limited evidence could be considered in a 12(b)(6) motion in order to "protect plaintiffs against, in effect, summary judgment by ambush" citing *Bostic v. AT&T of the Virgin Islands*, 166 F. Supp. 2d 350, 354-55 (D. V. I. 2001). 2007 WL 1352832 at 5.

Expenses of Last Illness: postdeath obligations

Trust Created by Hansen, Wells Fargo Bank N.A. v. Estate of Ruth Mansfield, 739 N.W. 2d 170 (Neb. 2007) duty to pay expenses of last illness, citing Restatement Third of Trusts §50, comment d(5). 739 N.W. 2d at 181.

Liability of Successor Trustee

The Court in *Betts v. City National Bank,* 156 Cal. App. 4th 222 (Cal. App. 2007) examined the impact of exculpatory clauses on the liability of successor trustees for the acts of predecessors in the context of a ruling on an in terrorem clause. *See also Wayne Savings Community Bank v. Gardner*, 2008 WL 4901700 (Oh. App. November 17, 2008).

The Court in *matter of Mueller,* 853 N.Y.S. 2d 245 (Surr. 2008) dealt with an overly expansive exculpatory clause in a Power of Attorney.