Recent Cases of Interest to Fiduciaries: Part 6 –Trustee Liability for Investment Losses (Part One)

Dana G. Fitzsimons, Jr.
804.775.7622 | dfitzsimons@mcguirewoods.com

Meghan L. Gehr
804.775.4714 | mgehr@mcguirewoods.com

McGuireWoods LLP
One James Center
901 East Cary Street
Richmond, Virginia 23219-4030

www.mcguirewoods.com

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Gloria Figel established a trust for the benefit of her son, Terry, and grandson, Spencer, with Wells Fargo Bank, N.A. as trustee. The trust terms gave the trustee broad powers with respect to investments, and broad powers to make distributions to Terry and Spencer. Terry made numerous requests for trust distributions to support a high lifestyle even though he had never held a job, to pay alimony to his ex-wife, for child support and tuition for Spencer, and to purchase a home he shared with Spencer. In 2007, the trustee informed Terry that he needed to reduce his budget because he was consuming trust assets at a rate of 7% per year. The trustee sent Terry detailed quarterly account statements, but Terry largely ignored the statements. The trustee allegedly invested the trust assets in equities rather than in bonds, and the beneficiaries alleged that had the trustee invested 70% of the trust portfolio in bonds or fixed income, the trust would have more than $3 million in additional funds. The trustee invested the trust assets 70% in equities and 30% in fixed income to keep up with Terry's large principal demands and to balance the interests of the current and future beneficiaries, and in 1999 and 2003 Terry requested and ratified that asset allocation. All of the assets purchased for the trust were on the trustee's buy list.

The court granted summary judgment in favor of the trustee, noting that the beneficiaries could not point to any case where a trustee was found to have breached his fiduciary duty merely because (in hindsight) the trustee invested the trust assets in a manner that did not earn as much as it could have, and did not point to any action of the trustee that was contrary to the trust terms. The court also held that Terry could not claim that he was unaware of the trustee's conduct because he had received regular account statements, and was therefore barred by his consent to the trustee's conduct.

In re: The Mark Anthony Fowler Special Needs Trust, Washington Court of Appeals Division II Case #39729-3 (February 8, 2011)

In 2000, the court established a special needs trust for Mark Anthony Fowler, with Wells Fargo Bank, N.A., as trustee, to hold the settlement proceeds from litigation following an injury. At the time the trust was created, Fowler's life expectancy was 58 years. The trustee regularly submitted its annual accountings to the court, and the court regularly approved the accountings and the trustee's compensation. In 2008, the trustee submitted its accounting for 2007–2008, which showed that the trust had suffered a 12% loss in value during the economic downturn and that the trust assets were invested 65.5% in equities, 31.5% in bonds, and 3% in cash (during the same period the trust investments outperformed the S&P 500 Index by 2.5%).

The trial court refused to approve the trustee's accounting and stated that due to the loss in the equities the trustee should move all of the trust investments into FDIC-insured accounts with diversified institutions. The trust's investment manager testified that moving all of the trust investments into insured deposits would be a mistake and risk premature depletion of the trust. A guardian *ad litem* appointed by the court agreed and concluded that the trustee had invested the trust assets prudently. Notwithstanding, the trial court ordered the trustee to move the trust assets into insured deposits.

The trustee appealed, and Fowler's guardians joined in the appeal, with no parties supporting the trial court's actions. The Washington Court of Appeals reversed the trial court on the grounds that: (1) the trial court did not find that the trustee abused its discretion or breached the trust, and therefore the trial court lacked the authority to control the trustee's exercise of its discretion; (2) the court cannot interfere with a trustee's discretion merely because the court would have exercised that discretion differently; (3) the decline in the investments was the result of a decline in the market, and not from the trustee's selection of inferior assets; (4) the balanced investment approach by the trustee was prudent; (5) beneficiaries can be disserved by undue conservatism (i.e., by investing only in FDIC-insured accounts) as well as by excessive risk-taking; and (6) the trustee was prudent in not selling at the bottom of the market and locking in losses.

***In re: Helen Rivas Trust*, 2011 NY Slip Op 50008U (Monroe County Surrogate's Court, January 5, 2011)**

Helen Rivas created a perpetual charitable trust in 1945 for the benefit of the University of Rochester with a predecessor to Bank of America, N.A., as trustee. At the same time that she created the trust, Helen also gave $2 million to the university outright. The trust provided for the distribution of income, but the court in a prior lawsuit modified the trust to pay out the greater of net income and a 5% unitrust amount annually to the university and to allow a $2.4 million principal distribution to the university. The trust terms established an Investment Advisory Committee (Advisory Committee), with two members appointed by the university and one by the trustee, and provided that the trustee was to take directions from the committee concerning investments for the trust.

In 2009, a majority of the Advisory Committee (over the dissenting vote of the member appointed by the trustee) directed the trustee to invest all of the trust assets in the university's long-term investment pool (LTIP). The terms of the contract with the LTIP gave the university sole discretion for the investment of all of the trust assets, allowed annual withdrawals up to 10% of the assets and allowed the university to select the custodian of the assets (which would be Northern Trust Company). The trustee sought a determination from the court as to whether the investment in the LTIP would be consistent with the settlor's intent and the trust terms. The attorney general appeared in the case but did not actively participate.

The court held that the investment in the LTIP would violate the settlor's intent and the trust terms because: (1) even though the trust terms directed the trustee to invest the trust assets in the manner directed by the Advisory Committee, the trust agreement as a whole made clear that the trustee would still have fiduciary duties and a role with respect to the trust investments, and the trust agreement cannot be interpreted to disregard that role; (2) Helen could have given the trust assets outright to the university along with her other gift, but chose not to do so and instead established a trust with supervision by the trustee; (3) the power of the Advisory Committee is not unlimited and cannot be used in contravention of the trust purposes; (4) the investment would remove the trustee and the committee from the investment process and move the custody of the trust assets to parties that are not trustees of the trust; (5) the investment would allow withdrawals of 10% which could impeded the goals of the trust (i.e., the perpetual existence of the trust); (6) there are concerns that the persons with power over the fund would have a conflict between their loyalties to the university and their loyalties to the settlor's goals, and a trustee must not place itself in a position of conflict; (7) the investment would be an improper delegation of the trustee's and the Advisory Committee's investment authority; and (8) the investment standard governing the LTIP — the Uniform Prudent Management of Institutional Funds Act — is a lesser standard than the Prudent Investor Act that applies to the trust.

Matter of Knox, 2010 NY Slip Op 52234U (February 24, 2010); *Matter of Knox*, 2010 NY Slip Op 52251U (November 24, 2010)

Seymour Knox II (Mr. Knox) created a trust under a trust agreement in 1957 for the benefit of his son Seymour Knox III (Seymour), with a predecessor to HSBC Bank as sole trustee. The Knox family had long been involved with the bank, and both Mr. Knox and his son Northrup headed the bank for many years. The Knox family was one of the bank's most important clients and among the founders of the modern version of the bank. Seymour and Northrup also founded the Buffalo Sabres NHL hockey franchise.

The trust provided for discretionary income and principal distributions among Seymour's children and more remote descendants on a *per stirpes* basis, with the goal of treating Seymour's children equally. The trust was funded with 5,000 shares of Woolworth stock and 5,200 shares of Marine Midland (now HSBC) stock. At the time Mr. Knox created the trust, he was on the board of directors of both Woolworth and Marine Midland and owned 13% of all Woolworth stock.

Within a year following the creation of the trust, the trustee sold 2,100 shares of Woolworth stock and purchased other equities. The trustee retained the balance of the stock at Mr. Knox's request. In 1985 the Woolworth stock made up 38.1% of the trust portfolio, which increased to 40.2% by 1996. The concentration was approved by the trustee's regional manager due to the low cost basis of the stock and "the sensitive nature of these issues on this account." In 1991, the trustee wrote to Seymour and recommended the sale of the stock, but said they would continue to hold the stock because "co-trustee" Seymour did not want the stock sold. By 1995, Woolworth was showing signs of trouble and stopped paying dividends. That year, at Seymour's request, the trust invaded principal to make up for the income lost when Woolworth stopped paying dividends, but continued holding a 33.6% concentration of the stock. There was no documentation in the file as to why the stock was retained. Seymour died in 1996. In 1997, Northrup wrote to the trustee and warned against holding Woolworth stock, and informed the trustee that all Woolworth stock in the Knox Foundation had been sold. That year, the trustee sold 5,000 shares of Woolworth stock, leaving 23,000 shares in the trust, making up a 21.1% concentration. That same year, Woolworth was removed from the trustee's "hold list." In 1998, the trustee sold another 3,000 shares. Later that year, the trustee received 20,000 shares of Venator (the successor to Woolworth) stock in an exchange. The trustee did not fully divest the trust of Woolworth stock until 1999, four years after it stopped paying dividends.

When the trust was created, it was also funded with 5,200 shares of Marine Midland stock. The trust agreement expressly authorized the retention of the Marine Midland stock, even if the asset was not otherwise authorized by law as a suitable trust investment and even if the bank was acting as trustee. Internal bank documents stated that Mr. Knox understood that the trustee had complete authority to sell the bank stock for purposes of diversification, and that Mr. Knox was not adverse to the sale but hoped other assets would be acquired rather than the bank stock sold. In 1981, Seymour informed the trustee of his preference to retain the bank stock, and the trustee retained the stock. The only documentation of the annual decision to retain the stock was a literal rubber-stamped entry in the investment diary, with no analysis in the trust files. The bank stock was finally sold in 1987.

In 1969, Mr. Knox and Seymour requested that the trustee purchase stock in Dome Petroleum and Leesona Corporation for the trust. The trustee determined these stocks were not good trust investments, but purchased them anyway on the approval of Mr. Knox and Seymour. Despite the trustee's negative conclusions about the Dome stock, it was held in an overweight position (well above 10% of the trust portfolio, and by 1981 as high as 43.4%) at Seymour's direction, whom the bank internally referred to as a "co-trustee" even though he was not actually a co-trustee. Even though Leesona was an off-list security not proper for the trust, the trustee held a concentration in Leesona as high as 30.4% of the trust portfolio on Seymour's authorization. There was no documentation in the file explaining the retention of the overweight position. The trust also retained an overweight position of Digital Equipment stock (as high as 20%) without documentation.

In September of 2006, the trustee brought an action in the Surrogate's Court to settle its accounting from 1957 to 2005 and to resign and be discharged as trustee. Seymour's children objected to the accounting and alleged that the trustee negligently retained the Venator Group (the predecessor to Woolworth) stock. The guardian *ad litem* appointed for Seymour's minor descendants also filed objections alleging that the trustee breached its duty by failing to diversify investments, violating its own internal procedures in making investments, improperly abdicating its fiduciary role to Mr. Knox and Seymour, and being engaged in an overall pattern of imprudence and negligence.

The court held that the trustee breached its fiduciary duty and was negligent in purchasing the Dome and Leesona stock at the direction of a non-trustee (at different times Mr. Knox and Seymour) when the trustee's own analysis concluded those stocks were not proper trust investments. On critical management issues, the court concluded that the trustee simply deferred to Mr. Knox and Seymour, even to the extent of allowing one or both of them to effectively override the best consideration of the sole trustee.

With respect to the Woolworth stock, the court held that the trustee should have sold the stock when it became an off-list holding in 1997 at the latest, and that the trustee offered no plausible explanation for its gross dereliction of its fiduciary duty. The court rejected the trustee's defense that the stock produced one-third of the trust's income because there was no documentation of that rationale during the administration, other stocks could have generated more income, and the stock was retained by the trustee after it stopped paying dividends. The court was also sharply critical of the trustee's distribution of principal to make up for the lost Woolworth dividends, without any analysis and simply at Seymour's request.

With respect to the bank's stock, the court held that: (1) the trust instrument exonerated the trustee for holding its own stock, but only where it exercised its discretion with respect to the stock; and (2) since there was no proof that the trustee performed any actual analysis about the prudence of holding the stock and ignored its fiduciary duties, the trustee could not be absolved of it negligence by the trust terms.

The court held that the trustee negligently managed the trust by: (1) failing to maintain documentation; (2) failing to develop an investment plan; (3) being indifferent to bank policies; (4) acquiescing to directions by a non-trustee and treating Seymour as a co-trustee; (5) failing to sell the bank stock at the inception of the trust; and (6) failing to sell 90% of the Woolworth stock at the inception of the trust and the balance of the shares by 1991.

In a supplemental decision concerning damages against the trustee, the court: (1) used a straightforward application of the *Matter of Janes* method of calculating damages; (2) awarded 9% interest compounded annually, finding that a 9% return would have been earned by the trust assets if invested properly; (3) awarded actual damages in the amount of $21,437,084; (4) declined to order the trustee to return commissions due to a lack of evidence of malevolence or dishonesty; and (5) reserved decision about the trustee's attorneys' fees.

W.A.K., II v. Wachovia Bank, N.A., 2010 U.S. Dist. LEXIS 72289 (July 19, 2010); *W.A.K., II v. Wachovia Bank*, N.A., 2010 U.S. Dist. LEXIS 79074 (August 5, 2010); *W.A.K., II v. Wachovia Bank*, N.A., 2010 U.S. Dist. LEXIS 87934 (August 25, 2010)

In *Karo v. Wachovia Bank, N.A.*, 2010 U.S. Dist. LEXIS 46929, the U.S. District Court for the Eastern District of Virginia granted summary judgment for Wachovia Bank in a suit alleging that the bank breached its fiduciary duties as trustee by retaining an overweight position of its own stock in a trust. (For our complete discussion of the decision see: http://www.mcguirewoods.com/news-resources/item.asp?item=4820).

The plaintiff's appeal was subsequently rejected by the U.S. Court of Appeals for the Fourth Circuit without a reported decision.

On August 5, 2010, the federal district court awarded payment out of the trust of the trustee's reasonable attorneys' fees and costs for its successful defense in the amount of $825,233.10. The court noted that the Virginia Uniform Trust Code allows the payment of reasonable attorneys' fees and a reasonable amount can be determined by first establishing a "lodestar figure" by multiplying the reasonable number of hours expended by a reasonable rate. The court considered the twelve "Johnson" factors set out by the Fourth Circuit in determining the lodestar amount, and reached its determination of the amount of the fee award based on the following conclusions: (1) the trustee met its burden of proving that the hourly rates are consistent with the prevailing rate in Richmond for similar work; (2) the number of attorney hours claimed were a bit excessive, and reduced the hours by 15% due to the "vigorous manner in which [the trustee's attorneys] litigated the case"; (3) the paralegal hours should be reduced by 25% for clerical tasks performed by a paralegal; (4) the trustee did not have any unsuccessful claims and enjoyed a high degree of success, so further reductions were not required; and (5) while expert fees appeared to be excessive, plaintiff introduced no persuasive evidence to support a reduction of the fee.

One of the trust beneficiaries, William A. Karo ("Drew"), had signed a letter of retention that indemnified the trustee for any liabilities, including attorneys' fees and costs, incurred by the trustee in connection with the retention of its own stock. On July 19, 2010, the court granted the trustee summary judgment and ruled that the indemnification agreement was a valid contract and, to the extent the trustee's attorneys' fees and costs were not recoverable from the trust, Drew was contractually liable for any remaining costs, expenses, and fees that the court determined were recoverable. The court rejected Drew's arguments that the indemnification lacked consideration, should be void as a matter of public policy, or allowed the trustee to "double dip" on fees.

On August 25, 2010, the court ruled that Drew was required by the indemnification agreement to pay the trustee the $35,962.04 incurred by the trustee in seeking enforcement of the indemnification agreement. The court refused to award the trustee the other fees it sought from Drew on the grounds that: (1) the trustee did not seek payment of $53,727.70 of the fees out of the trust and did not explain why those fees were omitted, and these fees exceeded the $825,233.10 approved by the court as reasonable; and (2) the court refused to award payment by Drew of any fees for the underlying action that exceeded the $825,233.10 approved by the court as reasonable.

Estate of Warden, 2010 PA Super 121 (July 9, 2010)

Under his will, Clarence Warden established a trust that was funded with 110,000 shares of stock in Mr. Warden's company, Superior Tube Company, with a value of $1.5 million at the time of Mr. Warden's death in 1951. The trust terms provided that the trustees were not liable for any actions taken in good faith. Mr. Warden expressed a preference for a focus on long-term performance with respect to trust investments, and restricted the sale of the company unless all trustees consented to the sale and the sales price was not below the book value of the stock.

In 1987, Mr. Warden's grandson successful petitioned the court to be appointed as successor trustee of the trust, to serve along with Wachovia Bank, N.A. No beneficiaries objected to the appointment. Through stock exchanges and name changes, by 1996 the trust held stock in a successor company called Superior Group, Inc. (SGI).

Mr. Warden's great-grandchildren, Charles and Genevieve, who held a 12.5% interest in the trust income, filed objections to the trustees' accountings and sought to surcharge their father and Wachovia Bank as co-trustees. The other beneficiaries did not file objections. At the time the beneficiaries filed the suit, the value of the SGI stock had increased from $1.5 million at Mr. Warden's death to at least $189 million. The beneficiaries filed the suit after attending a family meeting where they learned of an SGI operating loss of $66 million sustained from 2000 through 2003 that would result in a 50% reduction in their dividend payments.

Following a 13-day trial, the trial court overruled the objections, and the beneficiaries appealed.

On appeal, the Pennsylvania Superior Court affirmed the trial court on the grounds that: (1) the higher standard of care for a corporate fiduciary does not apply where the trust instrument explicitly mandates a different standard of care such as the good faith standard; (2) because Mr. Warden indicated a good faith standard in the trust instrument, the trustees only breach their duty if they do not act in good faith, which means if they intentionally acted with a dishonest state of mind; (3) the allegations that Wachovia failed to follow its policies, attend SGI board meetings, review financial statements, or meet with the co-trustee did not rise to the level of intentionally dishonest behavior; (4) because the trust terms required the consent of all co-trustees to the sale of SGI stock, and did not provide a mechanism for breaking a tie between Wachovia and the co-trustee, Wachovia did not have a duty to compel the co-trustee to sell the SGI stock; (5) the trustees were authorized by the trust terms to hold assets even if they did not generate returns; (6) a trust investment may fluctuate in value in a short-term time period over the administration of a trust, but a short-term decline in value is not a loss where the overall long-term performance of the stock shows an increase in value; (7) here, the asset increased from $1.5 million to $189 million, and the beneficiaries' focus on the alleged $300 million loss in value between the 1990s and 2003 was inappropriate; (8) the beneficiaries' claims were barred by laches because their grandmother never objected to the trustees' actions, no other beneficiaries objected to the administration prior to 2004, the beneficiaries did not demand an accounting until four years after succeeding to their grandmother's interest in the trust, and they were aware of the high concentration of SGI stock 13 years before becoming beneficiaries and four years after becoming beneficiaries before requesting an accounting; therefore, the beneficiaries had an affirmative duty to inquire and bring their claims sooner.

Matter of Hunter, 2010 NY Slip Op 50548U (March 31, 2010)

Upon her death in 1973, Blanche Hunter created a trust under her will that provided her granddaughter Pamela with income for life and granted Pamela a power of appointment over the trust assets at her death. Blanche named James W. Cook and a predecessor to JPMorgan Chase Bank as co-trustees. The trust was originally funded with 13,035 shares of Kodak stock. In 1980, the trust received additional Kodak stock from another trust created by Blanche that had terminated.

The individual co-trustee died in 1996, and thereafter the bank brought an action to judicially settle its accounts as trustee since 1973. Pamela waived any objections to the accounts and the bank's accounts were judicially settled and approved in 1998. Thereafter, Pamela appealed and sought to set aside and vacate her waiver of objections. In 2002, Pamela prevailed on her claim to set aside the waiver, and she was allowed to file objections to the bank's accounts arising out of the bank's retention of a concentration of Kodak stock in the trust and the sharp decline in the value of the stock.

Pamela died during the course of the litigation and the bank filed a supplemental account. Pamela had exercised her power of appointment in favor of her mother and Pamona College, who filed objections to the bank's account. The state attorney general also filed objections to the account. All of the objections focused primarily on the retention of a concentration of Kodak stock in the trust.

The court noted that two different legal standards applied to the retention of an almost 100% concentration of Kodak stock. For years prior to 1995, the prudent person rule applied and did not impose an absolute duty to diversify investments. After 1995, the prudent investor rule did impose an affirmative duty to diversify investments. The court also noted the higher standard of care for a professional fiduciary. The plaintiffs alleged that the bank breached its fiduciary duty by failing to sell 95% of the Kodak stock by July of 1987, whereas the bank claimed that the date alleged by the plaintiffs was based on a spike in the value of the stock and that the entire suit was impermissibly based on investment hindsight.

Following trial, the court concluded that the bank's conduct violated its fiduciary duties under any applicable legal standard for the following reasons: (1) the bank had a policy of diversifying investments that it failed to follow, along with other internal policies; (2) the bank met with Pamela only three times over 20 years, paid limited attention to her needs, and no attention to the needs of any remainder beneficiaries; (3) the bank had no written investment plan for the trust other than an informal aspiration to sell some Kodak stock someday at a good price; (4) the bank did not analyze the quality of the stock; (5) the bank's annual investment review lasted only a few minutes; (5) the court rejected the bank's argument that the concentration should be viewed in light of Pamela's nontrust assets; (6) the bank did not monitor the stock; and (7) the bank did not consider the risk of holding a 100% concentration of Kodak stock.

The court held that by the summer of 1987, a prudent trustee would have sold 95% of the Kodak stock, and it awarded damages against the trustee for the lost capital to the trust under the method set forth in *Matter of Janes*. The court rejected the plaintiff's request for a higher market measure of damages due to a lack of proof of deliberate self-dealing or fraud. As a result of the 20-year pattern of neglect, the court awarded the plaintiffs compounded interest on the damage award and reduced the bank's compensation to the rate allowed to an individual, rather than a professional, fiduciary.