Recent Cases of Interest to Fiduciaries: Part 7 – Trustee Liability for Investment Losses (Part Two)

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Gallagher v. Keybank, N.A., 2011 U.S. Dist. LEXIS 107361 (N.D. New York, September 22, 2011)

Patricia Gallagher is the settlor and a beneficiary of a charitable remainder trust created on June 8, 2001, with Keybank as trustee. The trust was intended to qualify as a charitable remainder annuity trust (CRAT). The trust was funded in March of 2002 with 4,500 shares of Wyeth stock with a value of $300,000 at $65 per share. Keybank later determined that the trust did not qualify as a CRAT as originally drafted and notified the drafting attorneys in May or June of 2002. The drafting attorneys then prepared an amendment to the trust that was signed by both Patricia and Keybank by July of 2002.

By the time the trust was amended, the Wyeth stock had dropped to $49 per share, and thereafter dropped further. The stock represented 85% of the trust assets until July of 2003. By October of 2008, the value of the trust had fallen to only $66,000.

Patricia sued in state court to surcharge Keybank for the investment losses, alleging breach of contract, breach of fiduciary duty, negligence and breach of trust, and seeking $216,000 in damages. Keybank removed the suit to the federal court for the Northern District of New York and brought a third-party complaint for negligence and indemnification against the lawyers who drafted the trust. Keybank claimed that the drafting attorneys' failure to properly draft the trust as a qualifying CRAT prevented Keybank from selling the Wyeth stock in a timely manner (presumably because of the taxable gain from the sale where the trust did not qualify as tax-exempt). The drafting attorneys moved to dismiss the claims against them and Keybank moved to amend their third-party complaint to drop the negligence and indemnification claims and instead seek contribution from the drafting attorneys.

The court dismissed all of the claims against the drafting attorneys and refused to allow Keybank to amend its third-party complaint, on the grounds that: (1) Keybank failed to allege privity with the attorneys to support the negligence claim; (2) Keybank failed to allege any facts to support a finding of express or implied indemnification owed by the drafting attorneys; and (3) under New York law, contribution is only available where the claim sounds in tort unless there is some independent legal duty, and here the claim was purely economic and based on a contract with no independent legal duty owed by the attorneys to Keybank.

Reed v. Regions Bank, 2011 Ala. LEXIS 138 (September 9, 2011)

In 1982, Elizabeth Walter created separate trusts for her daughters with one of her daughters as trustee. In 1983, Regions Bank became custodian for the trusts. In 1994, Regions Bank became investment advisor for the trusts.

In November 2008, the trustee fired Regions Bank as custodian and investment advisor and filed suit. The trustee and the beneficiaries sued Regions Bank and three affiliated companies — Morgan Asset Management, Inc., Morgan Keegan & Company, Inc., and Regions Financial Corporation — alleging that the companies acted in concert under the trade name of "Regions Morgan Keegan Trust" and all participated in the trust investment activities (collectively, "Regions"). The plaintiffs' causes of action included breach of fiduciary duties, negligence, wantonness, fraud, reckless or negligent misrepresentation, suppression, deceit, common-law indemnity, violation of the Alabama Securities Act, conspiracy to deceive and defraud, and breach of certain Alabama statutory duties.

The plaintiffs alleged that Regions: (1) extensively invested the trust assets in its own affiliated funds; (2) knew the funds were high risk, unsuitable for the trusts, and illiquid, and many backed by subprime mortgages; (3) failed to disclose the defects in the funds, misrepresented the risk in the funds, made other material misrepresentations, and omitted material facts; (4) only retained its appointment as investment advisor as a result of the plaintiffs' reliance on its misrepresentations; (5) following decreases in the funds in 2007, assured the plaintiffs that the funds were solid investments, the value would soon stabilize, lost value would be recovered and the decline was a temporary market reaction; (6) suppressed negative information about the funds; (7) induced the plaintiffs to retain the funds to their detriment; (8) sold their own holdings in the funds while retaining the trust investments in the funds; and (9) failed to warn the trustee of any problems with the funds.

The affiliated companies moved to dismiss the claims against them on the grounds that the claims were derivative in nature, not asserted in compliance with court rules, and should be dismissed. The trial court refused to dismiss the claims and the affiliated companies sought a writ of mandamus from the Supreme Court of Alabama.

A divided Alabama Supreme Court, with two dissents, granted the petition, issued the writ, and dismissed the claims on grounds that the claims were derivative claims that belonged to the investment funds themselves and not to the trusts as individual investors in the those funds. The court concluded that the plaintiffs failed to allege any injury distinct from the injury to the funds themselves, even though the plaintiffs did not allege that their losses resulted from the mismanagement of the funds themselves and notwithstanding the several distinct legal theories under which the plaintiffs sought relief.

The court set these distinctions aside, and reduced and characterized the plaintiffs' allegations to what the court called simply a claim for reduction in the value of the investment funds due to the mismanagement of the funds. The court then concluded that the claims (as reduced and characterized by the court) were for an injury to the corporation as a whole and as such should be characterized as derivative claims. The court set aside the plaintiffs' numerous distinctions between their claims and the company's claims and focused on the common financial harm from the loss in value of the funds. The court also rejected the distinction that the company would not have standing to bring claims related to the trusts. The court relied on the test under Maryland law (the funds were governed by Maryland law) that the injury must be distinct from the injury suffered by the company in order to avoid derivative treatment, and refused to find anything distinct about the injury suffered by the trusts.

As a result of its conclusion that the plaintiffs' claims were derivative, the court found that the plaintiffs failed to comply with the applicable state statute governing derivative claims and therefore the circuit court lacked subject matter jurisdiction. Accordingly the court ordered the circuit court to dismiss the action as to the related companies.

Two justices dissented and issued separate dissenting opinions on the grounds that: (1) the law imposes duties on investment advisors that run to the individual investor that are distinct from shareholder claims; (2) the investor's loss, unlike the fund's loss, is traceable to fraudulent investment advice and distinct from a shareholder that invests in assets independently and without fraudulent investment advice; (3) the court improperly failed to apply controlling Maryland cases; (4) the fund did not have standing to bring the trust claims; (5) the plaintiffs' claims were not claims about the mismanagement of the fund itself, but were rather about fraud and other breaches in connection with investment advice, and a different injury with a distinct cause of action from a shareholder claim; (6) courts in other jurisdictions have recognized the distinction between claims of fraudulent inducement to invest and derivative claims for losses suffered by the fund when mismanaged; (7) the purposes of a mutual fund and a trust are not the same, and therefore the duties owed are distinct and the trust claims should not be characterized as derivative claims.

Matter of Lasdon, 2011 NY Slip Op 51710U (New York County Surrogate's Court, August 23, 2011)

Under his will, Stanley Lasdon created trusts for the benefit of his grandsons Michael and Daniel. Mr. Lasdon's wife, Gene; daughter, Susan (the mother of Michael and Daniel); and son, Jeffrey, were named as co-trustees. Gene died in 2006. Michael's trust was to terminate when Michael turned 35, on August 20, 2004. Daniel's trust was to terminate when Daniel turned 35, on March 2, 2007. Susan as co-trustee sought to distribute the trust assets, but Jeffrey refused to authorize the termination of the trusts until March 4, 2008, after Michael and Daniel brought suit against Jeffrey. The trust assets consisted primarily of substantial holdings in Pfizer stock. The stock declined in value prior to finally being distributed to the beneficiaries, and the beneficiaries sued to surcharge Jeffrey for the loss in value. The New York County Surrogate's Court granted summary judgment in favor of the beneficiaries on their surcharge claim, but the court reserved decision on the calculation of the amount of the damages.

The parties stipulated to the dates on which distribution of the stock should have been made, the value of the stock on that date, and the value of the stock on the date actually distributed, but disagreed on other aspects of the calculation of the damages to be awarded to the beneficiaries.

The trial court ruled as follows with respect to the calculation of damages: (1) the surcharge award should not be reduced by the capital gains that have been incurred by the beneficiaries upon timely receipt and then sale of the stock, since the case was not about a trustee's failure to timely sell the stock, and the beneficiaries could have opted to retain the stock and receive a step up in basis at their deaths; (2) there is no reason to depart from the "anti-netting" rule that prevents a trustee from offsetting the loss in the stock with gains in other assets retained by the trustee, and a trustee who has breached his duties cannot use to his own advantage the investment "fruits" that belong to the beneficiaries; (3) the change to total return investing under the Uniform Prudent Investor Act does not require a change to the anti-netting rule, since this is not a case about prudent or imprudent investments but rather a case where the trustee's conduct made the trustee a guarantor of investment performance by withholding distributions; (4) an award of compound interest at a rate of 6% is appropriate to make the beneficiaries whole for the lost opportunity to do with the property as they wished; and (5) Jeffrey's reasonable attorneys' fees and costs are chargeable to the trusts up to the point that jurisdiction over all of the necessary parties was obtained by the court in the accounting action (i.e., the costs of preparing the accountings, which were for the benefit of the trust, but not the costs of defending the trustee in the surcharge action), but the amount of the fees are to be reduced by 25% for being somewhat excessive, leaving a proper charge to the trusts for attorneys' fees in the amount of $70,258.

Parris v. Regions Bank, 2011 U.S. Dist. LEXIS 92167 (W.D. Tennessee, August 17, 2011)

William Parris served as co-trustee of the Sara G. Parris Grantor Trust. Union Planters National Bank of Memphis served as co-trustee until it merged with Regions Bank in 2004, at which time Regions Bank became co-trustee with Parris.

Parris brought claims against Regions Bank for breach of trust, negligence, violation of the Prudent Investor Act, and violation of the Tennessee Consumer Protection Act, alleging that: (1) Regions recommended that the trust invest in a "proprietary junk bond fund" called the Regions Morgan Keegan Inc. High Income Fund; (2) committed inappropriate self-dealing as part of its plan to increase the holdings of its trust customers in affiliated junk bond funds; (3) failed to disclose material facts including the fund's risks and fees; and (4) invested 72% of the trust's assets in the fund, and failed to diversify the investment or protect the trust assets despite problems with the fund (including holdings in subprime debt obligations) and other "storm warnings" about the volatility of the investments. Parris sought compensatory damages against Regions in the amount of $92,000 and punitive damages of $500,000.

Regions moved for summary judgment dismissing the claims, which the court rejected. The court held that summary judgment was not appropriate due to the running of the one-year statute of limitations under the Alabama Uniform Trust Code because Regions did not proffer evidence that would require a jury to conclude that Parris had inquiry notice of the claims against Regions more than one year before he brought the suit. The letter sent by Regions to Parris informing him of the investment in the fund, which Parris signed, provided few details about the fund, and stated only that the fund would earn more income than current trust investments. The court held that the letter alone was not adequate to justify summary judgment based on the running of the one-year limitations period where the letter provided no information about the fund, was sent on Union Planters and not Regions letterhead and thereby concealed Regions' relationship to the fund, and was not otherwise adequate to give rise to inquiry notice that would start the limitations period.

In a footnote, the court commented that to the extent Regions relied on the trust account statements sent to Parris, Regions failed to explain how the statements could put Parris on inquiry notice about a possible claim for breach of trust. The court noted that while the trust account statements, combined with other facts not in the record, might show inquiry notice, the court could not reach such a conclusion based on the statements alone or the facts in the record at the summary judgment stage.

The court rejected Regions' other arguments as follows: (1) the claims were not barred by ratification as a result of Parris's acceptance of dividends from the fund, receipt of account statements, or approval of the initial purchase of the fund, because Regions could not conclusively show that Parris had all the facts necessary to form an opinion about the investment in the fund; (2) the claims were not barred by consent, acquiescence, waiver, laches, or estoppel because Regions made only a conclusory argument without supporting factual evidence in the record; (3) the Consumer Protection Act claims were adequately pled by incorporating all of the factual allegations in the complaint by reference; and (4) Parris had standing to bring the claims against Regions Bank, notwithstanding the Probate Court of Jefferson County, Alabama's appointment of a trustee *ad litem* to pursue claims on behalf of Regions' trust accounts in various class actions pending before the court.

Matter of Hyde, 2011 NY Slip Op 21195 (Warren County Surrogate's Court, May 20, 2011)

Charlotte Hyde and Nell Cunningham were the daughters of Samuel Pruyn, who founded Finch Pruyn, a large manufacturer in Glenn Falls, New York. Charlotte and Nell created trusts that were funded with large concentrations of Finch Pruyn stock. Following a downturn in the paper market, the trust beneficiaries filed objections to the trust accountings filed by Glens Falls National Bank and Trust Company and an individual co-trustee for the Hyde trusts, and an accounting for the same 20-year period filed by Banknorth, N.A. and an individual co-trustee for the Cunningham trust, alleging breach of fiduciary duty and seeking surcharge for failure to diversify the trust investments. The trustees prevailed in the litigation. (A summary of the case appears in our spring 2008 FAS Release available here: http://www.mcguirewoods.com/news-resources/item.asp?item=3072).

Prior to the trial, one family of trust beneficiaries, the Renz family, withdrew their objections to the accountings and acknowledged in writing that they would not share in any surcharge award to the Whitney family (that pursued the litigation against the trustees) under the common law *pro tanto* doctrine.

After the trial and the decision in favor of the trustees, the Renz family moved to have the attorneys' fees incurred by the trustees in their successful defense allocated to the Whitney family's interest in the trusts, and not to the trust principal which would diminish the shares of the Renz family. The trial court denied the motion and the appellate division affirmed. The court of appeals granted leave to appeal and reversed and remanded the case to the trial court to allocate the attorneys' fees and expenses based on numerous criteria set out by the court of appeals.

With respect to the attorneys' fees and costs incurred by the trustee in connection with the Article Ninth Trust, which was held 60% for the Renz family and 40% for the Whitney family, the trial court allocated the fees incurred prior to the Renz family's withdrawal of its objections to the trust corpus, and allocated the balance of the fees and costs one-half to the Whitney shares, and one-half to the trust corpus, on the grounds that: (1) the Renz family received some benefit from the diversification of investment caused by the litigation; (2) the Whitneys brought the suit in good faith, with factual support, and not as a vehicle for retaliation against other family members; and (3) the Whitneys had a significant economic interest in the litigation.

With respect to the attorneys' fees and costs incurred by the trustee in connection with the Article Seventh Trust that was solely for the benefit of the Whitneys, the trial court allocated the fees to the trust corpus.

With respect to the Cunningham trust, the trial court allocated the attorneys' fees and costs incurred by the trustee to corpus, in which the Renz family had a one-twelfth interest, on the grounds that: (1) the objections were filed by the father of the current beneficiaries who had died before the litigation was completed; (2) the Whitney children were merely substituted as parties, and under the *pro tanto* doctrine would not have received the benefits of any successful recovery against the trustee; (3) accordingly, the Whitney children should not be punished for the actions of their father; and (4) the impact on the Renz family was *de minimus* since they held only a small share in this trust.

Guest v. Frazier, 2011 Cal. App. Unpub. LEXIS 2106 (March 22, 2011)

In 1997, Anthony and Lottie Guest executed a revocable family trust. Following the death of the survivor of them in 2005, their daughter, Gloria, became trustee. The trust terms provided for outright distribution of 62.5% of the residuary trust assets to Gloria and 37.5% to her brother, Richard. Richard and Gloria agreed that Gloria would manage Richard's share of the trust assets and pay him a monthly stipend. Richard suffered from multiple sclerosis and depended on the stipend to pay for his living expenses.

In 2006, Gloria sold real property and invested 97.5% of the trust assets in a mutual fund that consisted almost entirely of junk bonds. In 2007, she removed 60% of the fund shares and placed them in her own separate account.

In May of 2008, Richard's attorney wrote to Gloria and demanded that she immediately distribute Richard's share of the trust assets outright to Richard and prepare an accounting. Gloria, through counsel, refused to distribute assets and invoked a trust term that granted her certain powers with respect to the interest of a beneficiary who is mentally or physically unable to manage financial affairs. That same month, Gloria transferred $51,400 out of the trust account to herself, leaving $196,100 in the account. In August of 2008, Gloria received an evaluation from Richard's psychologist, who concluded that Richard could handle his own financial affairs, but she still refused to distribute the trust assets.

In September of 2008, Richard sued to remove and replace Gloria as trustee, and the court appointed a successor trustee and ordered Gloria to turn over the assets and account for the trust. The successor trustee sold the fund shares, but by that time the value had dropped with a resulting loss to the trust in the amount of $71,972.73. Gloria filed her account in June of 2009, and Richard filed objections and sought to surcharge Gloria for breach of trust, termination of trust, and attorneys' fees. Richard alleged inconsistencies in the account, and alleged that Gloria withdrew more than her share of the trust assets and failed to report personal property, keep proper records, file proper tax returns, or diversify investments.

The trial court ruled in Richard's favor, awarded Richard $82,000 in attorneys' fees and costs, and surcharged Gloria an additional $70,000 for loss in the trust account. The court found that Gloria breached her duties by investing the trust assets in junk bonds and refusing to distribute the trust assets, and denied payment of her fees on the basis that she defended her actions in bad faith. Gloria appealed.

On appeal the California court of appeals affirmed the trial court on the grounds that: (1) the boilerplate language in the trust agreement does not rise to the level of waiving the Prudent Investor Rule, which Gloria violated by investing Richard's entire share of the trust assets in the junk bond fund; (2) Gloria breached her duty by refusing to distribute the trust assets, especially in view of the trial court's finding that Gloria refused to distribute in retaliation for Richard's hiring counsel and demanding distribution; (3) the trial court inherently, if not explicitly, found that Gloria did not have reasonable or probable cause to defend her actions by finding that she acted in bad faith; and (4) Gloria did not prevail on appeal and is not entitled to have her attorneys' fees paid out of the trust.

***Museum Associates v. Schiff*, 2011 Cal. App. Unpub. LEXIS 1752 (March 10, 2011)**

A charitable remainder annuity trust was created by court order in 1984. The CRAT paid a 6% annuity to Susan Cole for her lifetime with the remainder passing to the Los Angeles County Museum of Art (LACMA) for the purchase of Japanese and Chinese art. The trust was funded with approximately $1.3 million. Michael Schiff became successor trustee in 2001, at which time Susan was expected to live another 26 years.

Beginning in 2001, the trustee prepared annual letters to LACMA. The letters sent in 2001, 2002, and 2003 disclosed the value of the trust assets and described the trust assets generally. The 2002 and 2003 letters enclosed a management contract for the trust's investment in "FMI LLC" and represented that the investment would provide 12.54% return. The 2004 letter informed LACMA that it was necessary to renegotiate the FMI investment by taking an assignment of a promissory note from DollarWorks, Inc. to the trust in the amount of $650,000, secured by 157,500 shares of DollarWorks stock.

In 2006, Susan renounced her interest in the trust. LACMA then sought information about the trust assets, and in 2007 petitioned for surcharge against the trustee for imprudent investment of the trust assets in FMI and DollarWorks. LACMA only received interest payments on the $650,000 promissory note until October 2007, and received less than $80,000 in total payments on the promissory note. The trial court surcharged the trustee in the amount of $532,701, plus prejudgment interest. The trial court rejected the trustee's claim that his letters were sufficient to trigger the commencement of the statute of limitations on LACMA's claims. The trustee appealed.

On appeal, the California Court of Appeals affirmed the trial court and held that the letters lacked sufficient information to give rise to a duty on the part of LACMA to inquire about claims, and therefore were not adequate to start the running of the statute of limitations period.

Scanlan v. Eisenberg, 2011 U.S. Dist. LEXIS 24681 (N.D. Illinois, March 9, 2011)

Martin Bucksbaum, along with his brother Matthew, founded General Growth Properties, Inc., one of the largest publicly traded real estate investment trusts in the country. Martin established a series of trusts for his daughter, Mary, and her descendants. The trusts were drafted by attorneys for the Bucksbaum brothers, who also represented the Bucksbaum brothers in the founding and management of General Growth and its affiliates. The original trustees of the trusts were eventually replaced by General Trust Company (the Trust Company), a corporation formed and largely owned by one of the attorneys. Two of the attorneys control the Trust Company.

Two minor trust beneficiaries, by Mary as next friend, brought suit against the Trust Company as trustee seeking more than $200 million in damages, and alleging that the Trust Company (1) purchased shares of stock in General Growth despite an overconcentration in the investment; (2) extended $90 million in unsecured below-market loans to General Growth corporate insiders; and (3) failed to inform the beneficiaries of the transactions in advance. The beneficiaries also sued the attorneys and their law firm. All of the defendants moved to dismiss the claims.

The court found that the allegations that the Trust Company purchased the General Growth stock to stabilize the stock price by showing the market that the family was still buying the stock, and that only the trust participated in the stabilization purchases, were adequate to state a claim against the Trust Company for breach of the duties of prudence and loyalty because (1) the purpose of the investment (to stop a loss rather than to make money) was unusual and (2) a reasonable inference from the allegations is that the Trust Company exposed the trust to an unreasonable risk of loss for the purpose of benefitting non-beneficiaries (i.e., other trusts and the defendants themselves).

The court also held that: (1) the allegations that the Trust Company made loans at the LIBOR rate were sufficient to state a claim against the Trust Company in connection with the loans since the LIBOR rate is normally lower than the rate for unsecured loans to individuals; and (2) the allegation that the Trust Company failed to inform the beneficiaries about the purchases and loans in advance was adequate to state a claim for breach of the duty to provide the beneficiaries with the information needed to protect their interest in the trust, and that a trier of fact could find that those matters should have been disclosed to the beneficiaries in advance.

The court affirmed the position of *Scott and Ascher on Trusts* and held that the beneficiaries stated a plausible claim against the attorneys, in their capacities as corporate officers of the Trust Company, for personal liability for participation in the breach of trust by the Trust Company.

The attorneys and their firm, in their capacity as counsel for the Trust Company, moved to dismiss the claims that they were liable to the beneficiaries for aiding and abetting the Trust Company in a breach of trust. Although the court noted that there was no Illinois decision on point, the court held that an attorney can be held liable for aiding and abetting his client in a breach of trust, and allowed the claims to go forward.

The beneficiaries also sued the attorneys derivatively on behalf of the Trust Company for legal malpractice, which the court allowed to go forward on the basis that the claim amounted to a trust derivative claim and the trust beneficiaries can bring a claim on behalf of a trust where the trustee refuses to perform its duty to do so.

The court dismissed the claims for punitive damages against the attorneys to the extent the claims were based on legal advice under an applicable Illinois statute, but allowed the claim for punitive damages to go forward against the attorneys in their capacity as officers and directors of the Trust Company.