# What Every Trustee and Professional Advisor Should Know About Minimizing Fiduciary Liability and Reducing Litigation Exposure

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Part 3 of a series addressing fiduciary liability and limitation of exposure.

Acting in a fiduciary role requires a trustee to navigate a myriad of potential quandaries. Minimizing fiduciary risk is of particular interest for those who act in that role, and their advisors. Looking at the reasons for which trustees might be sued, it is possible to extract strategies aimed at reducing fiduciary risk.

This three-part article explores ten potentially perilous quandaries for trustees, and offers guidance and practical suggestions for reducing litigation exposure. Parts 1 and 2 explored the first seven of ten potentially perilous quandaries for trustees and this Part 3 explores the final three.

## THE QUANDARY – HOW TO PROTECT THE PROFESSIONAL ADVISOR/ TRUSTEE BY ENSURING PROPER CHANNELS OF COMMUNICATION

Oftentimes, it is not an action or omission of the trustee that establishes liability. Rather, the failure to *communicate* is the breach to which liability attaches. *Rollins v. Branch Bank and Trust Co. of Virginia*,[1] graphically illustrates the point.

In the *Rollins* case, two irrevocable trusts were established for the benefit of the grantor's children and grandchildren in 1977. The trusts were initially funded primarily with shares of stock in Tultex Corporation. When the trusts were created, the trustee obtained the written authority of the beneficiaries to over-concentrate the trusts with Tultex stock. The trusts remained over-concentrated with Tultex stock until 1997 when, at the direction of the beneficiaries, the trustee sold the stock. At the time of the sale, the value of the stock had fallen dramatically and was worth only one-twentieth of its highest value.

Following the sale, the beneficiaries sued the trustee, claiming that the trustee failed to diversify the trust assets, and failed to communicate with the beneficiaries concerning investment decisions.

The trust agreement contained the following language:

> Investment decisions as to the retention, sale, or purchase of any asset of the Trust fund shall likewise be decided by such living children or beneficiaries, as the case may be.

The trustee claimed that it could not be held liable for the trust's loss in value since the trust vested the power to make investment decisions exclusively in persons other than the trustee. In addition, the bank relied on Virginia statutory law, which provided:

> Whenever the instrument under which ... fiduciaries are acting...vests in...any other person...including a co-fiduciary... to the exclusion of one or more of the fiduciaries, authority to direct the making or retention of investments...the excluded fiduciary or co-fiduciary...shall not be liable...for any loss...

The Court held that the plain language of the trust instrument contradicted the beneficiaries' argument and the statute recognized the basic principle that the Court cannot hold a trustee liable for decisions that it did not and could not have made.

However, the Court held that, in order to ensure a trust's conservation, the trustee also has a duty to stay informed as to the conditions of the trust. Additionally, the trustee has a duty to fully inform beneficiaries of all facts relevant to the subject matter of the trust which come into the trustee's knowledge and which are material for the beneficiary to know for the protection of his interests. A trustee cannot rid himself of this "duty to warn."

Although the Court found that the conduct of the beneficiaries in requesting retention of the stock prohibited them from complaining about that decision, the prohibition on recovery did not excuse the trustee from liability for failing to participate in the administration of the trust.

The Court allowed the objection as it related to all claims arising from a failure to diversify funds, but overruled the objection regarding breach of fiduciary duty.

Similarly, in *In Re: Alexander McFadden. Testamentary Trust and George McFadden, Testamentary Trust*,[2] although trustees were not held liable for investment losses suffered during the financial crisis of 2008, the Court found that (among other breaches), the trustees were guilty of breach of fiduciary duty in failing to alert the beneficiaries to an ambiguity in the trust at issue that could have resulted in a termination of the trust at any point in the proceedings.

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## THE QUANDARY – HOW TO PROTECT THE PROFESSIONAL ADVISOR/TRUSTEE BY CONSIDERING ALL THE FACTS AND CIRCUMSTANCES

It is important to heed the fact that no decision a trustee makes can be made on autopilot. It is the responsibility of a trustee to make reasonable, reasoned decisions, based on a consideration of all the facts and circumstances. Even the fundamental duty to diversify cannot be discharged in a vacuum.[3]

Indeed, a decision *not* to diversify, even in the absence of a retention clause, can be reasonable if based on a careful consideration of all the facts and circumstances, as illustrated in *Matter of Hyde.*[4] In *Hyde*, three trusts were funded with large concentrations of stock in a closely held company, Finch Pruyn. Each trust agreement granted the trustees absolute discretion in managing trust assets, but contained no directions concerning the disposition of the Finch Pruyn stock. In addition to being closely-held, Finch Pruyn had an unusual capital structure.

After the trusts suffered losses, the beneficiaries brought suit against the corporate fiduciaries, claiming that the fiduciaries failed to adequately diversify the investment portfolios in the trusts, and thus violated the Prudent Investor Rule.

The Surrogate's Court dismissed the beneficiaries' suit as to all three trusts. On appeal, the New York Appellate Division addressed each trust's accounting separately. The gist of the decision is that the trustee did not breach its fiduciary duty for failure to diversify because the trustee made a reasonable determination that it was in the best interests of the beneficiaries not to diversify the Finch Pruyn stock.

The trustee examined several factors in reaching its decision, including the fact that Finch Pruyn was a closely-held corporation and there was no market for its stock; Finch Pruyn's unusual capital structure (which made it particularly unmarketable); the expected tax consequences of selling the stock; the needs of the beneficiaries (the stock paid considerable dividends); and the intent of the trust creator for the stock to remain in the family. Even so, the Court pointed out that the trustee regularly explored the market for Finch Pruyn stock and kept well informed of the company's financial condition.

The *Hyde* case is also an important reminder that, whatever the nature of trust assets, even if they might be difficult to sell such as closely held stock, that does not absolve a trustee from at least considering diversification, even though it may ultimately decide that diversification is not in the best interests of the beneficiaries.

> The trustee has a duty to fully inform beneficiaries of all facts relevant to the subject matter of the trust which come into the trustee's knowledge and which are material for the beneficiary to know for the protection of his interests.

*Merrill Lynch Trust Company v. Campbell*,[5] is another example of how deciding on a course of action after consideration of all the facts and circumstances can help protect a trustee from liability. The trustee was sued for investing too aggressively in equities that suffered losses by a beneficiary who claimed that investing for an individual of advanced age requires a significant component of fixed income investments, instead of the 90-100% equity strategy implemented.

The charitable remainder unitrust at issue provided for a 10% annual payout to the income beneficiary for life, then to her husband if he survived her, and upon the death of the second spouse, payments would be allocated among the couple's three children. Upon the death of the last of the three children, the trust would terminate, and the remainder would be allocated in equal shares among various designated charities.

The Court examined the prudent investor standard to which the trustee was subject and noted that the very terms of the trust agreement, and its obligations, shape the contours of the prudent investor's responsibilities:

> A trustee will not be liable to a beneficiary for following a specific investment strategy to the extent that the trustee acted in *reasonable* reliance on the terms of the trust. The conduct of a trustee in administering the trust is not to be determined a violation of any fiduciary duty based on hindsight knowledge of subsequently developed facts and circumstances. [Emphasis added.]

The Delaware Court of Chancery noted that the trust anticipated no less than ten beneficiaries, imposing upon the trustee a duty of impartiality to administer the trust in a manner designed to deliver reasonable income payments, while preserving the trust's corpus. Expert witness testimony attested to the fact that, preserving the trust's corpus for its 50-year expected duration with a 10% annual payment, was an "onerous challenge." The Court found that the trustee chose the equity mix based on its understanding of preserving the trust principal for its long-anticipated life, given the annual 10% payout obligation. Judging the trustee's actions in light of the circumstances at the time, and not with the benefit of hindsight, the court held that:

> ...considering the duties owed to each anticipated beneficiary and the unique coalescence of competing mandates... [the trustee's] decision to invest the Trust's assets heavily in equities [was] reasonable.

Although the record concerning the process the trustee employed to raise the equity level following the income beneficiary's request for increased payouts was "thin," the record was found to amply document the trustee's standard practices. The Court found that there was no reason to suspect that the standard practices were not followed and that the documentation that there was supported a finding that the trustee employed a deliberative process, including trust committee review. This holding highlights the importance of having regular protocols in place, which is typically standard practice when working with a corporate trustee.

## THE QUANDARY – HOW TO PROTECT THE TRUSTEE BY ENGAGING TRUSTED PROFESSIONAL ADVISORS

One important step a trustee can take to help minimize fiduciary risk is to hire trusted professional advisors who are cognizant of the responsibilities imposed on fiduciaries, and have expertise in fulfilling those responsibilities.

When friends or family members are appointed as trustees, oftentimes they are simply unaware of the myriad of duties to which they are subject. In *Mary and*

*Emanuel Rosenfeld Foundation Trust*,[6] is a classic example.

Emanuel Rosenfeld, the founder of Pep Boys, established a charitable trust in 1952, which was funded entirely with Pep Boys stock. The trust document named Mr. Rosenfeld's son Lester, his daughter Rita, Lester's son Robert, and Wachovia bank as trustees.

> A decision *not* to diversify, even in the absence of a retention clause, can be reasonable if based on a careful consideration of all the facts and circumstances.

During the mid-1990s, both Rita and Wachovia repeatedly expressed concern that the charitable trust was funded entirely with Pep Boys stock, and communicated to the other trustees that they were interested in diversifying the trust assets. Lester, who had worked for Pep Boys since 1952 and served as a board member, refused to address Rita's concerns about the trust and blatantly ignored letters sent by Wachovia stressing the need for diversification. Robert's involvement in trust issues at this time was passive and disinterested.

Wachovia actively monitored the trust's investments during the lifetime of the trust, and pointed out in its letters to the co-trustees that the value of Pep Boys stock was steadily declining between 1997 and 2000.

When Lester and Robert finally agreed to sell some of the Pep Boys stock in 2001, the stock had already declined significantly in value. In 2002, Rita filed a lawsuit against Lester, Robert, and Wachovia for breach of fiduciary duty, based on the failure to diversify the trust. Summary judgment was later granted to Wachovia, based on Wachovia's consistent monitoring and review of the trust assets, and the letters sent by Wachovia urging diversification.

The Court found that Lester's obdurate refusal to diversify resulted from his conflict over his relationship with the company, which he put before the interests of the charitable remaindermen. According to the court, Lester's son had a cavalierly negligent attitude towards his fiduciary responsibility and was motivated by concerns over how his personal fortunes would be adversely affected if he deviated from his father's position.

The Court noted that neither Lester nor Robert fully appreciated their fiduciary responsibilities – a finding which is clear from the following excerpt from Lester's deposition testimony:

> Q:Do you consider yourself a trustee of the foundation to have any duties to beneficiaries of the foundation, and by beneficiaries, I mean the charities that will be receiving...
> A:No.
>
> Q:...distribution?
> A:No.
>
> Q:You have no duty to the beneficiaries?
> A:No. I have no commitment to them, they're very appreciative of what we give them and I'm grateful for the fact that we're able to do it.
>
> Q:Now, I understand from your testimony that it didn't matter what the bank was recommending as to putting the proceeds into, you were against diversification per se, correct?
> A: Yes.

The Court rejected the claim that no losses could be assessed since the trust was worth more than its inception value. Instead, the Court looked to damages based on what the trust assets would have earned, but for the breach, and surcharged Lester and Robert nearly $600,000. They were also surcharged in the amount of the legal fees incurred by Wachovia and the charitable beneficiary – an additional $425,000.

Giving some comfort to those trustees who do determine to hire a professional investment advisor is the case of *O'Neill v. O'Neill.*[7] Pursuant to the Prudent Investor Rule, which is the law governing the investment of trust assets in virtually every jurisdiction and embodied in Uniform Prudent Investor Act promulgated in 1994, delegation of investment responsibility is permitted if the trustee uses reasonable care, skill, and caution in:

1. Selecting an agent;
2. Establishing the scope and terms of the delegation; and
3. Periodically reviewing the agent's actions.

Indeed, in most jurisdictions, a trustee who complies with these requirements is not liable for the decisions or actions of the agent to whom the function was delegated. The question is: what does an individual trustee need to do in order satisfy that standard?

In *O'Neill*, a trustee was sued by the beneficiary (his nephew) for breach of fiduciary duty in delegating the investment duties for the trust to a professional manager. The question before the Court was: how much reviewing and monitoring is required by the trustee to satisfy the mandate of the Prudent Investor Rule?

In this case, the uncle received and reviewed periodic statements for the trust (although he testified he did not scrutinize them). He received performance reports and confirmation of trades. The uncle also periodically met with the manager concerning the trust. The Court did not find it necessary that the uncle be "heavily involved" in the duties delegated in order to comply with the Prudent Investor Act. The Court determined that the actions of the uncle constituted sufficient evidence that he did not "fall asleep at the wheel."

## LESSONS LEARNED FOR MINIMIZING FIDUCIARY RISK

In light of the ten potentially perilous quandaries for trustees explored over the course of this three-part article, trustees will be well-advised to consider the following guidance in order to manage quandaries, reduce conflict and reduce litigation exposure:

- It is imperative to identify the parties to whom responsibilities are owed. Once they are identified, the duty of undivided loyalty is the bedrock of the trust relationship. Trustees must act solely in the best interest of the beneficiaries. It will be prudent to avoid even the appearance of impropriety.
- In accordance with the Prudent Investor principles, trustees must formulate an investment strategy designed to meet the particular trust's objectives, having regard to the portfolio's total expected return and all the facts and circumstances.
- In order to demonstrate compliance with the Prudent Investor Rule, not only must trustees fulfill fiduciary responsibilities, they should also document that they have done so by careful record keeping and establishing policies and procedures.
- The Power to Adjust and Unitrust Regimes are powerful tools for trustees to consider in implementing the mandate of total return and investing

in a manner that minimizes conflicts of interest among beneficiaries.

- It is important for trustees to factor in the impact of taxes on distribution determinations and investment strategy. Allocation of the tax burden can significantly impact benefits.
- Boilerplate language is not sufficient to obviate the duty to diversify. And in any event, no matter what the terms of the instrument provide, trustees must be vigilant not to abdicate their fiduciary responsibilities.
- Courts strictly construe exculpatory clauses and indemnification provisions, and blind reliance on those clauses has not been tolerated.
- Communication plays an important role in a fiduciary relationship. Trustees should maintain regular communication with the beneficiaries and keep them informed.
- Trustees should make reasonable, reasoned decisions, based on a consideration of all the facts and circumstances. Deciding on a course of action after consideration of all the facts and circumstances may help insulate a trustee from liability.
- Friends and family members who act in a fiduciary role often do not appreciate the full extent of the fiduciary responsibilities, and the potential liabilities, to which they may be subject. A professional advisor who is cognizant of the responsibilities imposed on fiduciaries, and has expertise in fulfilling those responsibilities, can provide guidance to assist in complying with the law.

### End Notes

1 56 Va. Cir. 147 (2001).

2 No. 1129 ST OF 1956, 2013 WL 8563470 (Pa. Com. Pl. Apr. 16, 2013).

3 See, for example: *In re Sky Trust*, 868 A.2d 464 (Pa. Super. 2005); *Matter of Tr. of Post*, 2018 WL 3862756 (N.J. Super. Ct. App. Div. Aug. 15, 2018).

4 845 N.Y.S.2d 833 (App. Div. 2007), appeal denied by, 881 N.E.2d 1197 (Ct. App. 2008), subsequent appeal, 876 N.Y.S.2d 196 (App. Div. 2009).

5 C.A. No. 1803-VCN (Del. Ch. Mar. 31, 2010).

6 2006 WL 3040020, aff'd in part and rev'd in part, remanded, without opinion, 953 A.2d 849 (2008).

7 169 Ohio App. 3d 852 (2006).