Banking on Trust Departments: Avoiding Pitfalls to Minimize Liability

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Trust services have long represented a means of generating income, diversifying a bank's business and providing elite services to high-value customers. As professional trustees, banks must establish and implement appropriate controls. In addition, their employees must follow appropriate procedures, and understand and implement the specific requirements of each individual trust. Unfortunately, however, even the most sophisticated trustees may face a variety of potential pitfalls, which, if not avoided, can result in litigation and potentially large losses. Such events can render an otherwise profitable business, unprofitable, resulting in tensions and conflicts with the high-value customers the bank coveted with the provision of trust services.

For example, in May 2015, a Missouri jury awarded an individual beneficiary and co-trustee $78 million, including $32.1 million in punitive damages, in a suit against Wells Fargo for the bank's failure to fully disclose financial transactions in two family trusts.[1] The judge also later ordered Wells Fargo to pay the trusts $17.8 million as a result of its breach of duties to the trust beneficiaries.[2] Similarly, in Pennsylvania, two plaintiff beneficiaries are suing PNC Bank and two individual co-trustees, asserting that they breached fiduciary duties and seeking over $400 million in damages.[3] While these high-profile cases are generating headlines due to the large amounts at issue and the personalities involved, similar disputes arise on a routine basis. These recent cases, and there are many other examples which could be cited, highlight the critical need for trustees to have strong policies and procedures in place to avoid common trust pitfalls and to be vigilant in complying with those procedures and practices. This protocol is especially important for large bank trust departments,

which often serve as fiduciaries over trusts with very substantial assets. It is, of course, fundamental that all trustees, irrespective of the size or scope of the trust, must be faithful to the terms of the trust instrument and comply with duties imposed by common and statutory law.[4] Our focus here, however, is on three common scenarios that can create exposure for trustees (and their professional liability insurers) in virtually any jurisdiction or circumstance.

Three Common Trustee Risks That Can Lead to Trustee Liability

Risk #1: Failure to Prudently and Impartially Administer the Trust

As a general matter, trustees must prudently administer the trust in accordance with the terms of the trust instruments to the extent possible, legal, and with respect to public policy. However, it is difficult, if not impossible, to draft a trust instrument capable of predicting every circumstance that may arise during the lifetime of the trust. Where the trust instrument is silent or where provisions conflict, the trustee should follow the applicable statutory standards. In a Uniform Trust Code ("UTC") or Uniform Prudent Investor Act ("UPIA") state, a "whole portfolio" approach should be applied to investments, meaning that the trustee must maintain a level of diversification and risk

[1] Y. Peter Kang, *Wells Fargo Hit with $78M Verdict Over Mismanaged Trusts,* LAW360 (May 12, 2015, 8:53 PM), http://www.law360.com/articles/655147/wells-fargo-hit-with-78m-verdict-over-mismanaged-trusts.

[2] *Judge: Wells Fargo must pay woman $17.8 million*, KCCI Des Moines, (Oct. 10, 2015, 10:03 AM), http://www.kcci.com/news/judge-wells-fargo-must-pay-woman-178-million/35617538.

[3] Rich Lord, "Scaife received nearly $450M from trust over last 20 years," http://www.post-gazette.com/local/city/2015/05/01/Richard-Mellon-Scaife-got-405-million-from-trust-fund/stories/201505010244.

[4] The technical aspects of trustee duties and liabilities are beyond the scope of this article. Generally, the trust instrument is the primary source of governing authority for a trustee. Where the trust instrument does not provide sufficient guidance, state statutes such as the Uniform Trust Code ("UTC") and the Uniform Prudent Investor Act ("UPIA") may control. In the banking sector, the FDIC's Trust Examination Manual also may serve as a useful guidance instrument for trust concepts, principles, and law.

that a reasonably prudent investor would utilize in dealing with her own property, considering the purposes, terms, distribution requirements, and other circumstances of the trust.[5] Whether a specific investment was prudent generally is evaluated at the time that the investment was made, not in hindsight after its success or failure is known.[6] Because the standard of prudence is relative, to the extent that the trustee has sophisticated skills, she must utilize those skills to the extent that she would with her own property.[7]

Inevitably, where a trustee plays an active role in administering a trust, she will be required to exercise discretion. The standard of discretion may be specified in the trust instrument. If it is not specified, the UTC and UPIA may help guide the trustee's choices. For example, in the context of investment, the UPIA directs trustees to consider such factors as economic conditions, the expected tax consequences of the investment, the role of the investment in the overall portfolio, and the need for liquidity or income.[8] The UTC provides that a trustee shall exercise her discretionary powers "in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.[9]"

In one case, a New York court found that a large bank serving as trustee violated the state's Prudent Investor Act by maintaining a concentration of only one company's stock in a trust for 20 years while the value of the stock declined precipitously.[10] The court noted that a prudent investor would have sold at least 95% of the stock during that time.[11] The court imposed a surcharge on the bank along with statutory interest, compounded annually, on the value of the shares from the date from which they should have been sold.[12] In another case, a Washington court held that a bank trustee was liable for loss as a result of failure to diversify assets by holding only tax-exempt, fixed-income municipal bonds.[13] The court reasoned that a prudent investor would have diversified between tax-exempt and equity securities.[14]

It is also fundamental that a trustee must administer the trust impartially. While a trustee must act in accordance with the

terms of the trust instrument, he also must be able to identify all beneficiaries of the trust to whom he owes a duty and act in their best interests.[15] This does not mean that a trustee must give equal regard to all beneficiaries. Rather, he must give due regard to each beneficiary's respective interest.[16]

In *McNeil v. Bennett*, for example, a court concluded that a large bank and other trustees breached their duties in overseeing a $300 million trust and ordered a surcharge against the trustees on commissions earned over a period of nearly ten years.[17] The plaintiff, the eldest income beneficiary of a trust created by his father for him and his siblings, contended that, among other issues, the trustees failed to give impartial consideration to his interests by providing his three siblings materially greater access to information and influence over trust decisions.[18] The trial court had noted that the trustees deliberately excluded the plaintiff from a letter which discussed how the family trusts operated, including an explanation of the trust instruments.[19] The trial court also cited evidence that the trustees regularly met with the plaintiff's mother and siblings outside the presence of the plaintiff and discussed issues affecting the trusts.[20] The appellate court affirmed the trial court's conclusion that the trustees breached their fiduciary duties by failing to give impartial consideration to the plaintiff's interests.[21]

Risk #2: Failure to Avoid Conflicts of Interest and Self-Dealing

Generally, a trustee should not profit from administering the trust, except to the extent that the trust instrument provides for

[5] Unif. Trust Code § 804; Unif. Prudent Inv'r Act § 2(b) (Unif. Law Comm'n 1994) ("A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust.").

[6] Unif. Prudent Inv'r Act § 8 ("Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.").

[7] Unif. Prudent Inv'r Act § 2, Comment ("Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs").

[8] Unif. Prudent Inv'r Act § 2(c)(1-8).

[9] Unif. Trust Code § 814(a).

[10] *In re Hunter,* 100 A.D.3d 996, 997, 955 N.Y.S.2d 163, 165 (2012), as revised (Apr. 24, 2013).

[11] *In re Hunter,* 100 A.D.3d. at 997.

[12] *In re JP Morgan Chase Bank,* 27 Misc. 3d 1205(A), 910 N.Y.S.2d 405 (Sur. 2010) aff'd sub nom. *In re Hunter,* 100 A.D.3d 996, 955 N.Y.S.2d 163 (2012), as revised (Apr. 24, 2013).

[13] *Baker Boyer Nat. Bank v. Garver,* 43 Wash. App. 673, 681, 719 P.2d 583, 589 (1986).

[14] *Baker Boyer Nat. Bank,* 43 Wash. App. at 686, 719 P.2d at 591.

[15] Unif. Trust Code § 803 ("If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests.").

[16] *Id.*

[17] *McNeil v. McNeil,* 798 A.2d 503, 510 (Del. 2002).

[18] *McNeil,* 798 A.2d at 510 (Del. 2002).

[19] *McNeil v. Bennett,* 792 A.2d 190, 212 (Del. Ch. 2001) aff'd in part, rev'd in part sub nom. McNeil v. McNeil, 798 A.2d 503 (Del. 2002).

[20] *Bennett,* 792 A.2d at 199.

[21] *McNeil,* 798 A.2d at 510.

payment of reasonable compensation to the trustee.[22] A trustee must not "self-deal" except as authorized by the trust instrument, the beneficiaries, or a court.[23] A trustee also owes a "duty of loyalty" and must avoid conflicts of interest. Moreover, the trustee is required to broadly disclose such conflicts when they arise in order to permit the beneficiaries to determine whether to ratify the conduct in question.[24]

Duty of loyalty issues arise typically in dealing with trust property.[25] For example, a Kentucky court found a breach of fiduciary duty where a bank trustee sold trust-owned real estate to a corporation that was a significant bank customer and which was owned by an individual who joined the bank's board of directors shortly before the sales transaction.[26]

Duty of loyalty issues also may arise through investment decisions made by the trustee. In *First Alabama Bank of Huntsville, N.A. v. Spragins*, the court held that where a bank invested 70-75% of the trust property in its own shares, the bank breached its duty of loyalty.[27] Similarly, JPMorgan recently settled a lawsuit alleging that it caused trusts to lose about $13 million from its decisions to purchase more than 177 investment products, mostly from itself.[28]

Trustees must be especially scrupulous in avoiding favoring one trust over another, as such conduct also may be deemed a breach of the duty of loyalty. For example, in *Wiggins v. PNC Bank, Kentucky, Inc.*, the bank acted as a trustee of two trusts with different grantors and different remaindermen, but the same lifetime beneficiary.[29] The court held that the bank had a conflict of interest when faced with the choice of whether to invade the corpus of one of the trusts to provide for the lifetime beneficiary.[30]

Particularly with professional trustees, a potential exposure involves the client's perception that the professional can perform the tasks of an accountant, a tax advisor, an investor, and/or an attorney. Historically, trust law precluded delegation of investment and management functions. The current trend, however, has been to allow such delegation as appropriate for the trust.[31] Nevertheless, trustees must be cognizant that the delegation of such duties does not create actual or apparent conflicts of interests.

Risk #3: Failure to Effectively Communicate with Beneficiaries

Professional, institutional trustees, perhaps even more than a trustee who shares a close personal relationship with the trust beneficiaries, must be careful to keep trust beneficiaries fully and timely informed. Effective communication not only allows the beneficiaries to ratify any potentially problematic transactions, but it also serves the practical function of creating trust between the fiduciary and the beneficiaries. Following this protocol is essential to a successful working relationship.

In addition, thorough and accurate documentation is imperative. Trustees should assume that their actions will ultimately be scrutinized, and accurate and complete records will allow the trustee to defend him or herself in the event that a dispute arises. For example, the UTC imposes an affirmative duty to keep qualified beneficiaries of a trust reasonably informed of the administration of the trust and of the material facts necessary for them to protect their interests.[32] This duty includes responding promptly to requests for information, supplying beneficiaries with a copy of the trust instrument upon request, and sending reports of the trust property, income, and liabilities to distributees or permissible distributees.[33] A trustee also must account for trust property timely and accurately, maintain adequate records and carefully designate trust assets as separate from the trustee's own property.[34]

In one case, a bank acting as trustee invested all of the trust's assets in one company's stock, believing that investment to be sound on the basis of reports by market analysts. However, the bank's investment officer could not produce any copies of any reports by such analysts at trial. Based on a "pattern of neglect," the court awarded 20 years of lost capital and statutory interest on that amount.[35] Timely, accurate reports to beneficiaries and thorough record keeping probably could have helped to prevent the liability.

Establishing and Adhering to Sound Procedures and Controls Is Key to Avoiding or Minimizing Liability

Ideally, trustees will all make prudent investments, impartially administer the trust, avoid conflicts of interest, keep thorough records, and communicate with the trust beneficiaries. Adhering

[22] Unif. Trust Code § 802(h).
[23] Unif. Trust Code § 802(b).
[24] Unif. Trust Code § 802(a) ("A trustee shall administer the trust solely in the interests of the beneficiaries"); Unif. Trust Code § 1009 ("A trustee is not liable to a beneficiary for breach of trust if the beneficiary consented to the conduct constituting the breach, released the trustee from liability for the breach, or ratified the transaction constituting the breach, unless: (1) the consent, release, or ratification of the beneficiary was induced by improper conduct of the trustee; or (2) at the time of the consent, release, or ratification, the beneficiary did not know of the beneficiary's rights or of the material facts relating to the breach.").
[25] Unif. Trust Code § 802, Comment ("Most but not all violations of the duty of loyalty concern transactions involving the trust property").
[26] *Thomas v. Turner*, 736 S.W.2d 343, 345 (Ky. Ct. App. 1987).
[27] 515 So. 2d 962, 964 (Ala. 1987).
[28] *JPMorgan Chase Settles Suit over Christ Church Trust Accounts*, Indianapolis Business Journal (Sept. 3, 2015), http://www.ibj.com/articles/54720-jpmorgan-chase-settles-suit-over-christ-church-trust-accounts
[29] 988 S.W.2d 498 (Ky. Ct. App. 1998).
[30] *Id.* at 502.
[31] Unif. Prudent Inv'r Act § 9.
[32] Unif. Trust Code § 813(a).
[33] Unif. Trust Code § 813(c).
[34] Unif. Trust Code § 810.
[35] *In re JP Morgan Chase Bank*, 27 Misc. 3d 1205(A), 910 N.Y.S.2d 405 (Sur. 2010) aff'd sub nom. In re Hunter, 100 A.D.3d 996, 955 N.Y.S.2d 163 (2012), as revised (Apr. 24, 2013).

to such practices is critical and bank trust departments should implement procedures and internal controls to ensure that these practices are understood and followed.

One useful resource for trustees seeking to establish or refine procedures and controls is the FDIC *Trust Examination Manual,*[36] which provides concrete examples of documents that a trustee should maintain, including evidence of appointment, supporting documentation for actions taken by the trustee, trust committee meeting minutes, accountings, documents acknowledging the receipt of assets, and many other types of records.[37] The *Manual* also provides guidance on maintaining an administrative file, a tickler system, and other records registers and logs.[38] Thus, although trust examinations are governed by policy and not regulation, consulting the FDIC materials may be useful in connection with establishing and maintaining proper internal procedures and controls for trust administration.[39]

Insurance Products Can Protect Trustees and Minimize Exposure to the Institution

The practices outlined herein provide general guidance to help mitigate risk exposure, but even when these practices are followed, trustees often find themselves at the center of disputes, which routinely result in litigation. This scenario often develops when a trust suffers a large loss in assets, due to failed investments or otherwise. Trust beneficiaries will seek to blame trustees, particularly institutional trustees with deep pockets, rightly or wrongly, to offset trust losses. And, personal or familial animosity between or among trust beneficiaries can exacerbate these types of disputes and make resulting litigation relatively more adversarial and protracted than disputes involving solely commercial parties. Indeed, recent CNA claim experience suggests an increase in trust-related disputes and claims activity.[40] This increase may be attributed to a variety of factors, including increased assets under management, recent downturns in the investment markets, high profile cases such as those discussed above, more well-educated beneficiaries, and/or more aggressive plaintiff's lawyers. It is, thus, more important than

ever that banks have in place insurance products appropriately tailored to all of the various risks they face, including losses arising out of errors and omissions in their trust services.

Professional Liability Errors & Omissions (E&O) insurance can cover various types of potential exposures that are not typically covered under the terms of general liability insurance policies. Subject to the terms of conditions of the specific policy, E&O insurance generally provides coverage for negligence or mistakes that cause financial harm in connection with the rendering of professional services by the insured. Such policies typically cover both the obligation to pay damages for covered claims, as well as the costs of defending against such claims. Bankers' Professional Liability policies may cover economic losses resulting from mistakes committed in connection with the bank's provision of financial services, including errors or omissions made by bank trust departments.

Preparedness and prevention are key areas of concern for trust departments. The time and resources devoted to identifying the pitfalls that trustees face and how such losses may be avoided is time and money well spent. As a starting point, we have identified broad areas of potential risk and highlighted practices that trustees can follow to attempt to avoid and mitigate trustee liability risks. However, given the nature of the trust business, the uncertainties of the markets and the litigiousness of our society, banks should consult their agents, brokers and insurers to discuss the various insurance products and resources available to help insulate them from trust service exposures.

[36] FDIC Trust Examination Manual, Section 2, available at https://www.fdic.gov/regulations/examinations/trustmanual/section_2/fdic_section_2-internal_controls_and_auditing.html#operintcontrol_principal_and_income.
[37] *Id.* at Section 2(G)(2).
[38] *Id.* at Section 2(F).
[39] *See* https://www.fdic.gov/regulations/resources/director/presentations/Regulatory-Exam-Process.pdf.
[40] January, 2010 to June, 2015 claims data.

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