

5 Litigation Tips for Defending Professional Trustees Under the Prudent Investor Act

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Given the recent volatility in the stock market, it has become commonplace for investors to try to hold their brokers responsible for market losses. Recently, beneficiaries of trusts have gotten into the act against professional trustees, particularly banks and trust companies, using a relatively new weapon -- the Prudent Investor Act.

The Prudent Investor Act requires a trustee to exercise the same reasonable care, skill and caution in making and implementing investment decisions that a prudent investor would, taking into account not only the terms of the trust document but also a myriad of other factors. These include general economic conditions, risks of inflation and deflation, and the estimated duration of the relationship. This standard is heightened for banks and trust companies, which are also required to exercise the discretion and intelligence of those having special investment skills. In many ways, it is more difficult to defend a trustee under the Prudent Investor Act than it is a stockbroker against a retail brokerage claim, due to the many considerations that a trustee must take into account. This article discusses some recent decisions finding the trustee liable under the Prudent Investor Act, and five key factors on which litigators should focus in defending against such claims.



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BACKGROUND: THE PRUDENT INVESTOR ACT

Although varying somewhat from state to state, the Prudent Investor Act generally provides, in pertinent part, as follows:

"(a) Prudent investor rule

A trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard defined by this section . . .

(b) Prudent Investor Standard

(1) The prudent investor rule *requires a standard of conduct, not outcome or performance*. Compliance with the prudent investor rule *is determined in light of facts and circumstances prevailing at the time of the decision or action of the trustee*. A trustee is *not liable to a beneficiary to the extent the trustee acted in substantial compliance with the prudent investor standard or in reasonable reliance on the express terms and provisions of the governing instrument*.

(2) A trustee shall exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio . . .

(3) The prudent investor standard requires a trustee:

(A) To pursue an overall investment strategy to enable the trustee to make appropriate present and future distributions . . .

(B) *To consider . . . the size of the portfolio . . . duration of the fiduciary relationship, the liquidity and distribution requirements . . . general economic conditions, the possible effect of inflation or deflation, the expected tax consequences . . . the needs of the beneficiaries.*

(C) To diversify assets unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify."

See, e.g., N.Y.E.P.T.L. § 11-2.3 (McKinney 2011) (emphasis added).

No particular investment is inherently prudent or imprudent. Further, the trustee must also consider an asset's special relationship or value to one or more of the beneficiaries and whether to delegate investment decisions. *Id.* Banks and trust companies are particularly at risk under the Prudent Investor Act, which holds such entities to an even higher standard -- that of a prudent investor "of discretion and intelligence having special investment skills." See, e.g., *Id.* at § 11-2.3 [b](6).

Significantly, if a trustee breaches the Prudent Investor Standard, the trustee may be held liable for any loss or depreciation in the value of the trust estate resulting from the breach. Further, in some states, the trustee may be liable for lost profits as well.

RECENT DECISIONS FINDING THAT THE TRUSTEE FAILED TO MEET THE PRUDENT INVESTOR STANDARD

In one recent decision, the trustee, working with Morgan Stanley, invested one-third of the trust portfolio into covered calls, resulting in a large loss. Plaintiff's expert testified that investing in covered calls was too risky, especially since there was only a short time before the trustee needed to liquidate the trust assets to pay debts and taxes. Accordingly, the trustee was held liable for the entirety of the loss. *Amiad v. Cohen*, 2011 WL 2040817, *6 (Cal. App. 4 Dist. May 25, 2011).

Similarly, a court found that professional trustee J.P. Morgan Chase Bank failed to live up to the applicable heightened Prudent Investor Standard by retaining too large a concentration of Kodak stock. The court found that J.P. Morgan failed to proactively review the investment or formulate an investment plan. The court also found that J.P. Morgan violated its own policies by failing to obtain consent of the beneficiaries for holding such a large concentration in one stock. *In re J.P. Morgan Chase Bank*, 27 Misc. 3d 1205(A), 2010 WL 1340823, *7 - *13 (N.Y. Sur. March 31, 2010).

In another recent decision, the trustee invested the entire share of trust proceeds into a High Income Bond Fund. After suffering losses, the plaintiff argued that the trustee violated the Prudent Investor Standard by failing to diversify. The trustee argued that, although the investment was made into only one fund, the fund itself consisted of many different classes of bonds, making it diverse. The court rejected this argument, finding that a "fund consist[ing] of many different bonds fails to establish proper diversification. Bond[s] are an asset class [and types of] bonds are a subset of the asset class of bonds." Investing all trust property into one asset class violates the Prudent Investor Standard. *Guest v. Frazier*, 2011 WL 986200, *7 (Cal. App. 2 Dist. March 22, 2011).

Similarly, last month a court found that a trustee's investment of trust proceeds into an investment fund owned or controlled by the trustee, without disclosing same, violated the Prudent Investor Standard. *In re Garrasi*, 33 Misc. 3d

1224(A), 2011 WL 5843028, *7 (N.Y. Sur. Nov. 10, 2011).

5 KEY POINTS FOR LITIGATORS

1. Get Inside the Trustee's Head at the Time of the Investment

A trustee does not breach the Prudent Investor Standard by achieving a bad result or, in hindsight, making a poor decision. Rather, the issue is whether the investments were prudent and reasonable at the time they were made, considering all relevant facts.

Absent fraud or self dealing, it is rare that a professional trustee makes or maintains investments it did not believe in at the time. It is therefore important for counsel to take the trustee "back in time" so that the trustee may fully recall and explain why it made the investments it did. Obviously, a litigator should ask for any memoranda prepared by the trustee explaining its rationale. However, such memoranda may not exist or tell the whole story. Therefore, it is often necessary to use the litigator's version of a "time machine" by taking the trustee through, in chronological order, contemporaneous correspondence, e-mails, newspaper articles, investment reports and other documents. It is the litigator's job to use those tools to help the trustee fully remember its rationale and to present a coherent, logical and supportable story for its actions. For example, if Morgan Stanley in the *Amiad* matter discussed above was able to present a coherent story explaining why it was reasonable at the time, with support from contemporaneous articles and studies, to invest a portion of the trust estate in covered calls, it may have prevailed.

2. Flesh Out Communications With the Beneficiaries

It is helpful to establish that the trustee fully communicated its investments to the beneficiaries, and that the beneficiaries expressly or implicitly consented thereto. For example, in the *J.P. Morgan Chase* matter discussed above, the bank's policy allowed for a large concentration in one stock if "all concerned parties are satisfied with the portfolio." Had the bank established such satisfaction with regard to its large concentrated holding of Kodak stock, it may have prevailed.

Establishing knowledge or consent may of course be done through correspondence between the trustee and the beneficiary, but counsel should also carefully explore whether any verbal communications occurred, which could be suf-

ficient as well. Further, counsel may be able to draw admissions of implicit consent and knowledge through testimony of the beneficiary, to wit:

Q: You generally review documents you receive that you consider important?

A: Yes.

Q: You consider the trust to be important, right?

A: Yes

Q :And you received trust statements from time to time, correct?

A: Yes.

Q: And since you consider the trust important and you generally review important documents, you at least reviewed those statements, correct?

A: Yes.

Q :And up until filing this lawsuit you never complained about any of the trustee's investment decisions, isn't that right?

A: Yes.

3. Scour the Trust Document and Search for Other Evidence of the Donor's Intent

Counsel should carefully read the trust documents to find language demonstrating that the trustee's investment decisions, although perhaps poor in hindsight, are consistent with at least some aspect of the trust document. Litigators should also carefully search for other evidence of the overall intent of the donor or decedent by interviewing witnesses and analyzing relevant documents. For example, in one case, although the trustee maintained the entire trust corpus in one stock, the trustee's counsel was able to demonstrate that this purported failure to diversify was nevertheless prudent because the stock was of a particular company owned by decedent which the decedent wanted to someday be passed on to his beneficiaries -- despite the fact that this intention was not set forth in the trust document. *Matter of Hyde*, 44 A.D.3d 1195, 845 N.Y.S.2d 833 (3d Dep't 2001).

Experts

It is important for counsel to find an expert who is not only credible and whose testimony is supported by documentary evidence, but is also as independent as possible. It may be wise to retain an expert who does not regularly act as a bank or trust company trustee so that the expert's

testimony is not viewed by the trier of fact as self-serving or a matter of professional courtesy.

Policies

As the *J.P. Morgan Chase* case demonstrates, litigators should carefully review the subject bank or trust company's investment policies to see if the investments are in keeping therewith. If so, this certainly supports the argument that the trustee acted as a prudent investor. If not, the litigator should be aware of this fact and plan accordingly.

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