A Matter of Trust
by: Sharon L. Klein

The root of the word “trustee” is trust. In this article we will examine the critical importance of communication when serving in the trusted role of fiduciary. We will also look at the unfortunate set of circumstances that can arise when a supposedly trusted family member or friend is appointed as trustee, but turns out not to be so trustworthy…

Finally, we will take a look at the issue of attorney-client privilege. If the interests of the trustee and beneficiary diverge, can the trustee trust that communications with the trustee’s attorney will be protected by the privilege?

Communication is Key

Communication is an integral part of the relationship between trustee and beneficiary; its importance cannot be over-emphasized. In fact, oftentimes trustees have been criticized not for taking or failing to take an action, but for the failure to communicate with the beneficiary.

In *Rollins v. Branch Bank and Trust Co. of Virginia*, 56 Va. Cir. 147 (2001), the grantor created trusts for family members, which were funded predominately with the stock of one company. Investment responsibility was bestowed exclusively on family members, the trust agreement providing: “Investment decisions as to the retention, sale, or purchase of any asset of the Trust fund shall…be decided by…living children or beneficiaries…”

When the stock plummeted in value, the beneficiaries sued the bank for breach of duty for the failure to diversify assets and the failure to communicate with the beneficiaries. The bank claimed that the language of the trust agreement insulated it from liability, by conferring investment responsibility on family members alone.

Additionally, the Bank relied on Virginia statutory law, which provided: “Whenever the instrument under which…fiduciaries are acting…vests in…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 resulting from such authorized directions.”

The court agreed that the language of the trust agreement and the statute protected the trustees from liability for failure to diversify. However, the court held, the trustee has a duty to (1) keep beneficiaries informed as to the conditions of the trust and (2) fully inform them of all facts relevant to the subject matter of the trust and material for a beneficiary to know for the protection of his interests. A trustee, said the court, cannot rid itself of this “duty to warn”.

Lack of communication has been a key component in establishing trustee liability in a number of high profile stock concentration cases. Typically in these cases, a large single stock concentration has been held in a trust portfolio, the value of the concentrated position has plummeted, and the trustees have successfully been sued for failure to diversify.

These cases usually involve a complete failure to communicate, as well as a failure to perform other fiduciary responsibilities (no monitoring of the concentrated position, no documentation of the reasons for the concentration), coupled with reliance on a clause in a document purportedly allowing retention of the concentration.

Under these circumstances, the courts have held that the trustees could not rely on the retention clause.[1]

The theme from these cases is very clear: Trustees will not be permitted to abdicate their fiduciary responsibilities and blindly rely on a retention clause to insulate them from liability. If, however, a trustee actually fulfills its fiduciary responsibilities and communicates with the beneficiaries, there is some hope for the proposition that a trustee can rely on the provisions of an instrument.

In *Americans for the Arts v. Ruth Lilly Charitable Remainder Annuity Trust #1*, 855 N.E. 2d 592 (Ind. Ct. App. 2006), the court actually honored the trust language and found that it was sufficient to exempt the trustee from the duty to diversify when the trustee openly communicated with the beneficiaries and acted properly and responsibly.

Margesson v. Bank of New York, 738 N.Y.S. 2d 411 (3rd Dept. 2002), involved a trust, the assets of which were composed predominantly of large concentrations of four stocks. Because sale of the highly appreciated stocks would result in substantial tax liability, there was a long-standing understanding that the trust would be managed to avoid their unnecessary sale.

Without communicating with the trust's administrative officer or the income beneficiary, the trust's investment officer sold a portion of the stock holdings, which resulted in the income beneficiary being personally liable for over $22,000 in capital gains. When he sued the trustee for breach of fiduciary duty, the trustee claimed it was merely complying with the prudent investor rule and that the sale was made for the purpose of diversifying the trust's investments.

The Third Department, however, found that, although the Bank complied with the prudent investor rule, a triable issue of fact existed as to whether it breached its fiduciary duty by failing to communicate in light of the long-standing understanding to avoid unnecessary sales:

"She [the administrative officer] had no conversation with [the investment officer] regarding this sale or the plaintiff's needs as income beneficiary. [The investment officer] has a responsibility to communicate with [the administrative officer]…to ensure his understanding of the investment objectives."

In *McGinley v. Bank of America*, 279 Kan. 426 (2005), the settlor created a revocable trust, which provided she was to be consulted by the trustee as to any purchase or sale, and that the trustee had to abide by her decision. The trust was funded with Enron stock and other assets.

Seven months later, she signed a letter directing the trustee to retain the Enron stock. The letter exonerated and indemnified the bank for all losses as a result of the retention and relieved it from responsibility for analyzing and monitoring the stock. By the end of 2000, Enron stock comprised 77% of the trust assets.

After Enron stock plummeted in 2001, the settlor brought suit against the trustee, claiming that it failed to comply with the prudent investor rule. The court rejected the arguments of the settlor because

(1) the applicable state law specifically provided that a trustee who followed the written directions of a settlor of a revocable trust was deemed to have complied with the prudent investor rule and was authorized to follow such written instructions, and

(2) pursuant to the terms of the trust instrument itself, the settlor retained investment control.

The Court did note, however, that even in these circumstances, the better practice of the trustee would have been to communicate the effects of the letter and to have notified the settlor of the significant decreases in the value of the Enron stock.

Fiduciary Self-Dealing

When appointing a trusted family member or friend to the ultimate position of trust as a fiduciary, that individual is typically chosen precisely because she or he is expected to act in accordance with the highest code of honor, and in the best interests of the beneficiaries. Betrayal of trust in that setting is all the more crushing, as the following cases demonstrate.

In *Estate of Hester v. United States*, 2007 U.S. Dist. LEXIS 14834 (W.D. Va.), *aff'd*, 2008 U.S. App. LEXIS 21971 (4th Cir.), *cert. denied*, 129 S. Ct. 2168 (2009), the decedent established a trust, naming her surviving husband as income beneficiary and trustee, with their two children as remainder persons. At the time of the testator's death, the trust was valued at $3.2 million.

The husband transferred all of the trust's liquid assets into his own brokerage account and commingled the funds. Over the next several months, he lost $2 million from day-trading, withdrew over $450,000 in cash, and collected $280,000 on a promissory note held by the trust.

When the husband later died, the funds had become so commingled that it was impossible to distinguish trust funds from the individual brokerage funds. The estate tax return for the husband included the misappropriated funds in his gross estate, and over $2.7 million was paid in estate taxes.

The children did not assert a claim against the father's estate, probably because the same individuals were beneficiaries of both estates. The estate later claimed an estate tax refund on two alternative grounds:

(1) as the widower had possessed no interest in the misappropriated assets, he was merely holding them in a constructive trust for the benefit of the remainder persons and the misappropriated funds were not includable in the decedent's gross estate, and alternatively,

(2) if the misappropriated assets were includable in the estate, the estate should be awarded an offsetting deduction for claims against the estate.

However, in a double whammy, the court confirmed that the children were obligated to pay estate taxes on the assets their own father misappropriated (the decedent "exercised dominion and control over the assets as though they were his own without an express or implied recognition of an obligation to repay," such that the misappropriated funds were properly includable in the gross estate), and also rejected the argument that there should be an offsetting deduction (the remainder persons had never asserted a claim against the estate and the statute of limitations for asserting such a claim had expired).

In *Davis v. Davis*, 889 N.E. 2d 374 (Ct. App., IN 2008), the settlor named one of her three sons, a former bank president, as trustee of her revocable trust and her attorney-in-fact. During his mother's lifetime, the trustee/son made gifts to himself and his children, invested trust assets in the bank where he was employed, made zero-interest loans to himself, and commingled trust funds with assets subject to a different trust.

After his mother died, the trustee/son did not respond to requests for an accounting of the trust.

The Court found that the trustee committed repeated instances of self-dealing and breach of fiduciary duty including failure to account, making loans to himself and commingling of funds between separate trusts. Indeed, at his deposition, the son/trustee was asked:

> "Q: You don't understand that you have to keep…as a…former bank president, you have to keep the assets straight in one trust…and the assets straight in the other…account?

> A: I…I can see…in retrospect that, uh, from a record keeping standpoint, it…it should've been done differently." 889 N.E. 2d at 381.

In *Mary and Emanuel Rosenfeld Foundation Trust*, 2006 Phila. Ct. Com. Pl. LEXIS 394, *aff'd in part* and *rev'd in part*, *remanded*, without opinion, 953 A.2d 849 (2008), Emanuel Rosenfeld, the founder of Pep Boys, established a charitable trust funded entirely with Pep Boys stock in 1952. He named a corporate trustee and three individuals co-trustees: his son Lester, his daughter Rita, and Lester's son Robert. Lester had worked for Pep Boys all his life. After his retirement in 1980, he continued to serve as a consultant and board member.

Beginning in 1997, Rita and the corporate trustee both urged diversification of the trust assets. Lester and Robert both opposed diversification, and the trustees were deadlocked. The court found that Lester's obdurate refusal to diversify stemmed from his own position with the company, the interests of which he put above those of the charitable beneficiaries.

The court also found that Robert abdicated any responsibility as trustee by inattention, his supine submission to his father's presumed inside knowledge of the company and his fear of the personal financial repercussions of failing to follow his father's lead (i.e., being disinherited by his father). The following excerpts from Lester's deposition transcript graphically illustrate the point that Lester was oblivious to the obligation of a trusted fiduciary to refrain from acting in his own self-interest:

> "Q: Do you consider yourself a trustee of the foundation to have any duties to beneficiaries of the foundation…?
> A: No."

That response prompted the attorney deposing Lester to re-ask the question, probably incredulously, not believing his good fortune, as he could not have scripted better answers to his questions:

> "Q: You have no duty to the beneficiaries?
> A: No." Id. at 7.

Both Robert and Lester were surcharged for breaches of fiduciary duty.

The much-publicized story of Brooke Astor exemplifies the hostilities that can arise between family members.

Socialite Brooke Astor died in August 2007 at the age of 105, leaving an estate valued at approximately $130 million. In 2002, Ms. Astor executed a will under which her son, Anthony Marshall, received significantly more assets outright than under her prior will, which was executed in 1997. Mr. Marshall was appointed sole executor and trustee.

In July 2006, Ms. Astor's grandson Phillip Marshall filed a petition in New York State Supreme Court accusing his father Anthony Marshall of neglecting Ms. Astor's care while enriching himself with her fortune. In November 2007, Mr. Marshall was indicted on multiple criminal charges stemming from his handling of Ms. Astor's finances during her lifetime. In October 2009, he was convicted of fourteen of the sixteen counts against him, including first-degree grand larceny in connection with a retroactive salary increase of about $1 million dollars that Mr. Marshall gave himself for managing his mother's finances.

In December 2009, Mr. Marshall was sentenced to 1-3 years in prison, but is currently free while an appeal is pending.

Perhaps the best way to prevent these tragic abuses by friends or family members is to appoint a trusted professional advisor that is involved in the day-to-day trust management. The appointment of a trusted professional advisor brings neutrality and accountability to the relationship. It can alleviate the pressure on a family member trustee, circumvent intra-family suspicion and prevent perceived or actual impropriety.

Attorney-Client Privilege

Effective April 1, 2009, the Code of Professional Responsibility was replaced with the Rules of Professional Conduct ("RPC") in New York.

Pursuant to Rule 1.6 of the RPC, a lawyer is prohibited from revealing confidential information, absent informed consent of the client, or in other limited circumstances.

The rule defines confidential information as:

> …information gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested be kept confidential.

Under New York law, the attorney-client privilege extends to fiduciary relationships. Civil Practice Law and Rules § 4503(2) provides that a beneficiary is not entitled to access privileged communications made between a personal representative and the personal representative's attorney, solely by virtue of his or her position as a beneficiary. However, a "fiduciary exception" to the privilege may apply. In other words, in the context of a fiduciary relationship, the privilege is not absolute and a showing of "good cause" may trump it.

The controlling feature for the applicability of the fiduciary exception is whether the advice sought was for the benefit of the beneficiary, as a result of the fiduciary relationship. See *Stenovich v. Wachtell, Lipton, Rosen & Katz*, 756 N.Y.S. 2d 367 (Sup. Ct. N.Y. Cty. 2003). Factors to be considered in determining whether the fiduciary exception applies are:

(1) whether the beneficiaries may have been directly affected by a decision the fiduciary made on the attorney's advice,

(2) whether the communications are the only evidence available regarding whether the fiduciary's actions furthered the interests of the beneficiaries,

(3) whether the communications relate to prospective actions and not advice on past actions, and

(4) whether the communications sought are highly relevant and specific. *Hoopes v. Carota*, 531 N.Y.S. 2d 407 (3d Dept. 1988), *affirmed*, 544 N.Y.S. 2d 808 (1989)

Note, however, that inter vivos trusts are excluded from CPLR § 4503(2) and communications with counsel may be accessible by beneficiaries of such trusts. Perhaps one factor that might weigh on the side of upholding of the privilege is whether the advice has been paid for out of the fiduciary's own pocket, as opposed to having been funded with trust assets.

Trust(ee) Selection

At its core, the selection of a trustee involves a judgment decision regarding the trustworthiness of the individual selected.

Diligence on the part of the settlor/testator in the trustee selection process, coupled with the guidance of trusted professional advisors in the trust management arena, are key to insuring that the trust reposed is not misplaced.

Sharon L. Klein is currently a Managing Director and Head of Wealthy Advisory at Lazard Wealth Management LLC in New York. She can be reached at 212-332-4504 or sharon.klein@lazard.com.

[1] *In Re Charles G. Dumont*, 791 N.Y.S.2d 868 (Surrogate's Court, Monroe Cty. 2004), rev'd in part, 809 N.Y.S.2d 360 (App. Div. 4th Dep't 2006), appeal denied, 813 N.Y.S.2d 689 (App. Div. 4th Dep't 2006), appeal denied, appeal dismissed, 855 N.E.2d 1167 (2006), *Wood v U.S. Bank*, 828 N.E.2d 1072 (Ohio Ct. App. 2005), appeal denied, 835 N.E.2d 727 (Ohio 2005); *Fifth Third Bank v. Firstar Bank, N.A*,. 2006 Ohio 4506, appeal denied, 860 N.E.2d 768 (Ohio 2007)