By Ian Marsh,
principal, Withers LLP,
London, and
Michael Ben Jacob,
principal, Withers
Bergman LLP, New York

Trustees Everywhere—Be Afraid

The *Dumont* decision is a shocker, especially to those working under English law. But advisors across the globe must absorb its lessons—just in case a trust they manage comes to be governed by New York law

A New York judge's recent decision in *Estate of Dumont*[1] should give trustees reason to pause and re-evaluate the investment policies and procedures of any trust for which they act, that is governed by or may come to be governed by New York law. The judge held a trustee liable—to the tune of $21 million—for failing to diversify Eastman Kodak stock when its share prices fell in the 1970s, even though the trust's settlor specifically instructed that the Kodak stock not be sold solely for diversification reasons.

The July 13, 2004, decision by Monroe County, N.Y. Surrogate Judge Edmund A. Calvaruso in *Dumont* makes fascinating reading, particularly for anybody brought up in the English common law tradition. The decision highlights some significant distinctions between the law in New York (which many English practitioners view as typical of that of the United States) and that in England (which, of course, underpins the law in most "offshore jurisdictions").

Dumont involved the settlement of Lincoln First Bank's second intermediate account as trustee of a testamentary trust with a high concentration of Eastman Kodak stock. In his will, the decedent indicated his "desire and hope" that his executors and trustees would hold the Kodak stock for the ultimate benefit of the trust beneficiaries and not "dispose of such stock for the purpose of diversification of investment [nor shall the trustees be] held liable for any diminution in the value of such stock" but that they may sell the stock " in case there shall be some compelling reason other than diversification of investment for doing so."[2]

The trust beneficiaries sought a surcharge of $39 million against the trustee for failing to diversify the trust portfolio in light of a precipitous drop in the value of Kodak stock in the early 1970s.

In levying a surcharge of nearly $21 million against the trustee, Judge Calvaruso provides a thorough overview for trustees in the areas of trust portfolio diversification and adhering to the testator's intent. But the decision also serves to alert offshore attorneys and fiduciaries to important differences between fiduciary obligations in U.S. jurisdictions such as New York, and those grounded in the English common law.

SETTLOR'S AUTHORITY

New York's Estates Powers and Trusts Law (EPTL) often permits its default provisions to be overridden by a trust settlor. However, EPTL Section 11-1.7 provides that, for reasons of public policy, a settlor cannot exonerate a fiduciary for, among other things, failure to exercise prudence, reasonable care and diligence. Beyond this limitation, one would think that the settlor's intent as evidenced in the trust instrument should govern a fiduciary's duties. Yet *Dumont* teaches that, at least under New York law, there are three voices to which the fiduciary must listen: the settlor (his intent and strength of wording); the beneficiaries (regarding their economic situation and expressed desires); and the market (the realities of the financial world and composition of the trust corpus).

This stands in sharp contrast to the "Anglo"[3] view that, to form a trust, a governing instrument must not only create certain minimum duties and responsibilities that are enforceable in a court of equity[4] but also (unless the settlor provides otherwise) requires, at a minimum, that the trustee behave honestly and in good faith toward his beneficiaries.[5] It is therefore shocking to Anglo lawyers and fiduciaries to see a state impose higher duties of prudence, reasonable care and diligence.

Most Anglo trust practitioners already think the trust law of states such as New York confer many more rights on settlors than English law does.[6] English law, in the broadest sense, sees trust property as belonging to the beneficiaries: A settlor has only those rights that he has reserved in the trust instrument once the ink dries.

The one power a settlor clearly retains is the power to dictate the terms of his trust. Neither the state nor the trust beneficiaries should second guess what a settlor wants. Nor should a state or beneficiaries vary the trust terms based on market conditions or expressed desires of the beneficiaries. So most trustees whose duties are governed by English law would find suprising Judge Calvaruso's conclusion in *Dumont* that "a retention clause cannot trump the application of prudence in the management of an estate" even where the settlor has provided otherwise.

MEASURING DAMAGES

Also shocking is how Judge Calvaruso measured damages for the trustee's failure to prudently manage the trust investments. In *Dumont*, he calculated damages by projecting what would have been the sale proceeds had the trustee sold the Kodak stock in 1974 (the time it would have been prudent to do so), then subtracted capital gains that would have been paid and applied statutory interest to the net amount. The judge then subtracted from the total dividends received by the trust beneficiaries and the actual sale proceeds received. Finally, the judge ordered that all of the commission paid to the trustee over the period in question be returned to the trust.

By contrast, under English law the standards for measuring damages differ depending on whether the damages are for a breach of fiduciary duty or for a breach of executorial or managerial responsibilities. For breaches of fiduciary duty, damages arise from a failure to act in good faith (at a minimum) or a failure to adhere to a higher standard if one was imposed by the settlor. This was established in *Bristol and West Building Society v Mothew*,[7] where the court held that a breach of fiduciary duty required some degree of disloyalty or infidelity beyond mere incompetence, and that damages in such cases are calculated in equity, that is to say what would be the economic position of the damaged party had the trustee taken appropriate and timely action and in light of succeeding market conditions. This approach is not unlike that of Judge Calvaruso's, aside from the fact that the application of statutory interest appears to be more of a penalty than an attempt to make up for lost appreciation. Under English law, however, the failure of the trustee to diversify the trust portfolio would not be treated as a breach of fiduciary duty in the first place; rather it'd be considered a tortious breach of executorial or managerial responsibilities.[8] Therefore, an English court would employ an entirely different strategy for calculating damages than was used in *Dumont*.

Because English law would see the trustee's failure as tortious, damages would be based on tort principles of foreseeability and remoteness. The difference in legal theories applied could have resulted in very different damage awards.

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PRUDENT INVESTOR

The *Dumont* decision also discusses the need to diversify and the shift from the prudent person standard to the prudent investor standard.[9] While it's true that a settlor can override the prudent investor standard set forth in EPTL Section 11-2.3, at least some have taken the position that non-diversification is *per se* imprudent and violates EPTL Section 11-2.3. So, a clause inserted by a settlor authorizing non-diversification must always fail.[10] Under this view, the prudent investor standard seems to mandate the application to trusts of modern portfolio theory.

Neither England nor (so far as we know) the offshore jurisdictions use the prudent investor standard. The English Trustee Act 2000 empowers trustees to make any investments they would make if they themselves were entitled to the trust's assets.[11] Under Section 5 of Trustee Act 2000, trustees are required to take proper advice concerning their investments, and that advice must consider both the suitability of the investments in relation to the trust and the "need for diversification...in so far as is appropriate to the circumstances of the trust."[12] But that's a long way from requiring trustees to

adopt modern portfolio theory.

Indeed, it's clear from Section 5's wording that a settlor can eliminate any need for investment diversification. In fact, that's what settlors commonly do in their offshore trusts. There is simply no notion in the Anglo world of the settlor's wish in that regard being subject to some form of statutory override.

EXCULPATION

Dumont provides little discussion of how trustees might be exculpated, beyond noting that the trust instrument attempted to absolve the trustees from responsibility for losses arising from non-diversification, and the court's view that this was trumped by the statutory duty of prudence.

Many older English trusts leave a trustee liable even for innocent breaches of trust. But most modern trusts, particularly those with professional trustees, limit a trustee's liability to, for example, fraud (in the equitable sense), wilful default and either negligence or gross negligence. Further, it's clear from the English Court of Appeal decision in *Armitage v. Nurse*[13] that a trustee may be absolved from all wrongdoing provided he acted honestly and in good faith in the best interests of the beneficiaries.

Not all of the offshore jurisdictions go so far. Jersey and Guernsey, for example, do not allow a settlor to absolve trustees from liability for gross negligence,[14] and it may well be that England will go the same way when the legislative timetable permits.[15]

PAPERING THE FILE

There is another line in the *Dumont* decision that provides a sharp contrast to English law. Judge Calvaruso declared that "the complete lack of documentation alone is itself a breach of trust."[16] There can be no doubt that the absence of any paperwork presents trustees with a considerable evidentiary burden in any jurisdiction.[17] But while the fact that a trustee never wrote anything down may not be bright, it does not mean that there have not been meaningful discussions leading to the decisions made. Indeed, English tradition used to be that company directors should record their thinking in full, but trustees should do no more than record the bare fact of their decisions. That has changed (in no small part due to the volume of anti-trustee litigation). Even so, no one in the Anglo world would imagine liability hanging on lack of paperwork alone.

THE MESSAGE

One of the most surprising things about *Dumont* is that it happened at all.

Apparently the *Dumont* trust officers found the term "compelling reason" clear, but it's baffling why. In England, we'd expect the trustees, soon after Charles Dumont's death, to have consulted external counsel. And certainly the advice the *Dumont* trustees would have received would be: Go to the courts to have the will construed.

Surely there is sufficient doubt in the trust document's wording that the costs of such an application would have been ordered to be paid out of the trust fund, and a judicial construction would have absolved the trustees of future liability.

Dumont sends a clear warning to trustees throughout New York that they must be sure to institute policies and procedures to ensure that fiduciary responsibilities are met, particularly in the area of trust investment. But it sends an even louder message to offshore trustees subject to New York laws: Don't assume you understand the rules of the game even if you have extensive experience as a fiduciary in the Anglo world. Fiduciary responsibilities are quite different in New York. Don't be taken by surprise. ■

Endnotes

1. *Estate of Dumont*, *New York Law Journal*, July 13, 2004, p. 19, col. 3.
2. *Ibid.*
3. By "Anglo" we mean all non-U.S. jurisdictions, in England or elsewhere, that derive their law from the English tradition.
4. *See* David Hayton, "The Irreducible Core Content of Trusteeship," *Trends in Contemporary Trust Law*, A.J. Oakley, ed., 1996. At a minimum, there must be "a duty of confidence imposed upon a trustee in respect of particular property and positively enforceable in a Court of Equity by a person." *Ibid. See also Morice v Bishop of Durham* (1804) 9 Ves. 399; *Re Endacott* [1960] Ch. 232; and *Re Denley's Will Trust Deed* [1969] 1 Ch. 373.
5. That of course entails being made aware of the trust and being entitled to adequate information concerning its administration.
6. For example, EPTL Section 7-1.9 permits the trust creator to revoke or amend a trust with the consent of all of those beneficially interested in the trust. While this power cannot be exercised by the trust creator alone, to the Anglo practitioner, involving the trust creator at all, flies in the face of the basic trust law premise that once property is settled in trust, the creator has no further interest in the property.
7. [1998] Ch 1.
8. Essentially the duties to avoid fraud, dishonesty and conflicts of interest.
9. Although we note that the decision was based upon the then-applicable prudent person standard.
10. Charles F. Gibbs and Colleen F. Carew, "Diversification—What if the Instrument Provides Otherwise?" *New York Law Journal* (Aug. 19, 2004) at p. 3 (discussing the view of Professor Kenneth Joyce of the University of Buffalo Law School).
11. Trustee Act 2000, Section 3(1).
12. Trustee Act 2000, Section 4.
13. [1997] 2 All ER 705.
14. *See* Article 26(9) of the Trusts (Jersey) Law, 1984 and section 34(7) of the Trusts (Guernsey) Law, 1989.
15. *See* "The Law Commission Consultation Paper on Trustee Exemption clauses," *Consultation Paper No. 171* (Dec. 2, 2002).
16. Citing *Matter of John D. Rockefeller, Jr.*, *New York Law Journal*, March 1, 2004.
17. *See* the sham trust case of *Grupo Torras SA and another v. al Sabbah and others, re the Esteem Settlement* [2003] JLR 188 (Jersey, Channel Islands).