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Estate and Trust Fiduciary Litigation: Minimizing and Defending Breach of Duty Claims

Navigating Causes of Action; Leveraging Waivers, Investment Duty Exceptions, Standing and In Terrorem Clauses

THURSDAY, FEBRUARY 27, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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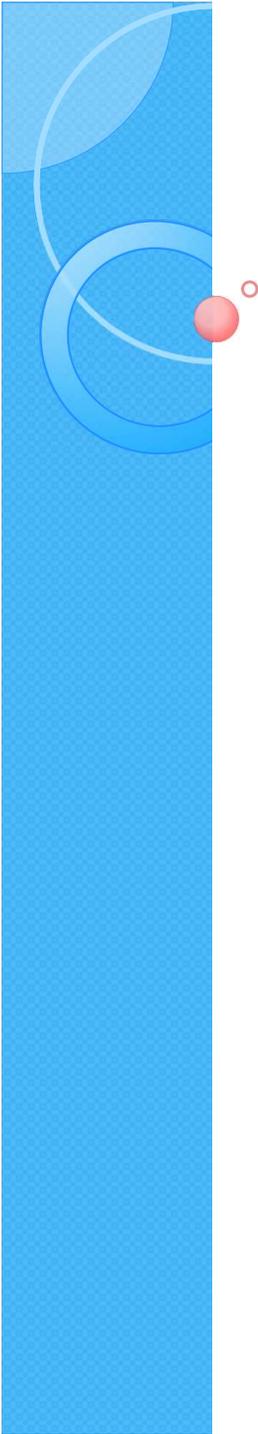
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Estate & Trust Fiduciary Litigation

Causes of Action for Breach of Fiduciary Duty

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Breach of Fiduciary Duty





Fiduciaries

- Executor
- Administrator
- Administrator c.t.a.
- Administrator d.b.n.
- Testamentary Trustee
- Guardian
 - *New York Surrogate's Court Procedure Act, §103(21)*



Fiduciaries

- Preliminary Executor
- Temporary Administrator
- Ancillary administrator
- Ancillary administrator c.t.a.
- Ancillary executor
- Ancillary guardian
 - *New York Surrogate's Court Procedure Act, §103(21)*



Fiduciaries

- Personal Representative
- De facto fiduciary
 - *Matter of Djeljaj*, N.Y.L.J., Dec. 13, 2012, p. 26, col. 1 (Sur. Ct. Bronx Co.)
- Fiduciary responsibility attaches on date of death
 - *Matter of Donner*, 82 N.Y.2d 574 (1993)



Standing

- Residuary legatees
 - Virtually anything
- General legatees
 - If paid in full, no standing
- Creditors
 - Only to the extent of claim
- Co-Fiduciaries
 - Cannot object to joint obligations (e.g., diversification of investments)



Fiduciary Duty

“Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”

- *Meinhard v. Salmon*, 249 N.Y. 458 (1928) (Cardozo, J.)



Duty of Loyalty

- Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose.
 - *Restatement Third, Trusts, §78(a)*
- Except in discrete circumstances, the trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests.
 - *Restatement Third, Trusts §78(b)*



Duty of Loyalty

“A fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect.”

- *Birnbaum v. Birnbaum*, 73 N.Y.2d 461 (1989)

“An executor must at all times discharge his fiduciary duties so that all legatees are treated in like manner and without prejudice or discrimination.”

- *Matter of Kinzler*, 195 A.D.2d 464 (1993)



Rule Against Self-Dealing

“The value of the rule of equity, to which we have adverted, lies to a great extent in its stubbornness and inflexibility. Its rigidity gives it one of its chief uses as a preventive or discourage influence, because it weakens the temptation to dishonesty or unfair dealing on the part of the trustees, by vitiating, without attempt at discrimination, all transactions in which they assume the dual character of principal and representative.”

- *Munson v. Syracuse G. & C. Ry. Co.*, 103 N.Y. 58 (1886)

Rule Against Self-Dealing



Matter of Rothko, 43 N.Y.2d 305 (1977)



“No Further Inquiry” Rule

“The law...does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent without undertaking to deal with the question of abstract justice in the particular case. Only by this uncompromising rigidity has the rule of undivided loyalty been maintained against disintegrating erosion.”

- *Wendt v. Fischer*, 243 N.Y. 439 (1926)



“No Further Inquiry” Rule

Birnbaum v. Birnbaum

- 73 N.Y.2d 461 (1989)

Matter of Farrell

- 91 N.Y.S.2d 89 (Sur. Ct. Westchester Co. 1943)

Matter of Fulton

- 253 A.D. 494 (3d Dep’t 1938)

Matter of Segal

- 11 N.Y.S.2d 306 (Sur. Ct. Kings Co. 1939)



Duty to Preserve Assets

Fiduciary duty to preserve all estate assets.

- *Matter of Skelly*, 284 A.D.2d 336 (2d Dep't 2001)

Authority of an executor is derived from the will, not from the letters issued by the Court.

- *Matter of Yarm*, 119 A.D.2d 754 (2d Dep't 1986)

Duty may attach before a person is appointed fiduciary by a Court.

- *Matter of Donner*, 82 N.Y.2d 574 (1993)



Mishandling of Assets

Common law rule: “test of conduct, not performance”

- *Matter of Bank of New York*, 35 N.Y.2d 512 (1974)

Prudent Person Rule

- *N.Y. E.P.T.L.*, §11-2.2(a)(1)

Prudent Investor Rule

- *N.Y. E.P.T.L.*, §11-2.3

Failure to diversify

- *Matter of Janes*, 90 N.Y.2d 41 (1997)



Distributions

- Statutes often dictate time period when beneficiaries can demand payment of legacy/distributive share
 - New York: 7 months after issuance of letters (*E.P.T.L. §11-1.5*)
- Demand and refusal
- Statute of limitations
- Accumulation of interest



Miscellaneous Claims

Failure to Marshall Assets

- Failure to collect bank/securities account
- Failure to bring proceeding to recover assets belonging to estate
 - Statute of Limitations considerations
- Failure to collect rent
- Failure to take possession of business
- Failure to collect trust proceeds/exercise a power of appointment



Miscellaneous Claims

Compensation to fiduciary

- *Birnbaum v. Birnbaum*, 73 N.Y.2d 461 (1989)

Failure to keep property separate

- *N.Y. E.P.T.L.*, §11-1.6; *Matter of Lanza*, 19 A.D.3d 494 (2d Dep't 2005)

Failure to obtain interest on estate funds

- *Cooper v. Jones*, 78 A.D.2d 423 (4th Dep't 1981)



Miscellaneous Claims

- Failure to Keep Records
 - All inferences will be against fiduciary
- Failure to pay taxes
- Improper calculation of commissions
 - Early payment of commissions
- Untimely distributions to beneficiaries
- Expenses
- Attorney's and Accountant's Fees



Potential Causes of Action

- Breach of Fiduciary Duty
- Conversion
- Constructive Trust
- Fraud
- Objections to an Accounting
 - *Pro Tanto* Rule



Attorney's Fees

- American Rule: victors and the vanquished pay their own costs of litigation
- Fiduciaries regularly can use estate/trust funds for legal expenses
 - Did you add value to the estate?
- *Matter of Hyde*, 15 N.Y.3d 179 (2010)
 - Trial court has “discretion to allocate responsibility for payment of a fiduciary’s attorney’s fees for which the estate is obligated to pay – either from the estate as a whole or from shares of individual estate beneficiaries.”



Hyde Factors

1. Whether the objecting beneficiary acted solely in his or her own interest or in the common interest of the estate
2. Possible benefits to individual beneficiaries from the outcome of the underlying proceeding
3. The extent of an individual beneficiary's participation in the proceeding
4. Good/bad faith of the objecting beneficiary
5. Whether there was justifiable doubt regarding the fiduciary's account
6. Portions of interest in the estate held by the non-objecting beneficiaries relative to the objecting beneficiaries
7. Future interests that could be affected by reallocation of fees to individual beneficiaries instead of to the corpus of the estate generally



Practical Considerations

1. Statute of Limitations
2. Burdens of Proof
3. Co-Fiduciaries
4. Personal Jurisdiction
5. Time
6. Remedy Sought



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Common Defenses to Breach of Fiduciary Duty Claims

- **Jurisdictional defenses**



Jurisdictional defenses

- Lack of jurisdiction

- *Stauffer v. Nicholson*, 438 S.W.3d 205, 213, 215 (Tex. Ct. App. 2014) (probate court could not exercise personal jurisdiction over successor trustee where there trustee had no contacts with the state, and remaining claims were general tort claims that would not affect the Trust, so they were not within the subject matter jurisdiction of the probate court)
- *In re Aboud Inter Vivos Trust*, 314 P.3d 941 (Nev. 2013) (court lacked *in rem* jurisdiction over matter where trust assets were properly transferred to a limited partnership with consent of all trust beneficiaries)

- Lack of standing

- *In re Walker*, 208 A.3d 472, 478 (2019), *appeal denied*, 218 A.3d 856 (Pa. 2019) (beneficiaries did not have standing to challenge trustee's actions that settlor consented to during settlor's life)

- Forum non conveniens

- Case can be **dismissed** in favor of litigation in another state. *In re Estate of Mullin*, 155 A.3d 555, 561–62 (N.H. 2017) (affirming dismissal of New Hampshire case on grounds of forum non conveniens on findings that witnesses and evidence were in California, and decedent, Trust, and parties had “extensive connections” to California)
- Case can be **transferred** to another venue in the same state. *Susman v. North Star Trust Co.*, 30 N.E.3d 622, 628-29 (Ill. App. Ct. 2015) (affirming transfer of case to different county pursuant to forum non conveniens motion)

- First-filed doctrine

- *Olsen v. Olsen*, 575 N.W.2d 874, 878 (Neb. 1998) (citing *Minn. Mutual Life Ins. v. Anderson*, 410 N.W.2d 80, 81-82 (Minn. Ct. App. 1987)) (when courts have concurrent jurisdiction over an issue, the first court to acquire jurisdiction generally has priority to consider the case)

Common Defenses to Breach of Fiduciary Duty Claims

- Jurisdictional defenses
- ***Res Judicata* / Collateral Estoppel**



Res judicata / Collateral estoppel

Court approval of a fiduciary's accounts has *res judicata* effect in subsequent litigation, but does not bar claims based on undisclosed transactions/conduct.

Examples:

- *In re Estate of Gillespie*, 78932-5-I, 2020 WL 525850, at *11-13, ___ P.3d ___ (Wash. Ct. App. Feb. 3, 2020) (*res judicata* barred beneficiaries' claims for accounting and breach of fiduciary duty when facts underlying claims could have been litigated, but were not, in prior law suit)
- *Lazzarone v. Bank of Am.*, 181 Cal. App. 3d 581 (Cal. Ct. App. 1986) (lawsuit against the trustee was barred by the *res judicata* effect given to the probate court's order approving trustee's periodic accountings)



Common Defenses to Breach of Fiduciary Duty Claims

- Jurisdictional defenses
- *Res judicata* / Collateral estoppel
- **Consent / Ratification**



Consent / Ratification

- Beneficiaries “who, with full knowledge of the facts and [their] legal rights, consents to or confirms and ratifies a breach of trust, may not thereafter complain.” *Scullin v. Clark*, 242 S.W.2d 542, 548 (Mo. 1951); *see also Rajamin v. Deutsche Bank Nat. Tr. Co.*, 757 F.3d 79, 90 (2d Cir. 2014) (applying New York law) (trustee’s unauthorized acts are not void but voidable because they may be ratified by beneficiaries).
- If settlor consents to trustee’s action, beneficiaries cannot challenge trustee’s action. *In re Walker*, 208 A.3d 472, 478 (Pa. 2019).
- Similarly, a co-fiduciary that participates in or approves of a decision cannot later challenge the decision. *See In re Kelly’s Will*, 266 N.W.2d 700, 703 (Minn. 1978).



Common Defenses to Breach of Fiduciary Duty Claims

- Jurisdictional defenses
- *Res judicata* / Collateral estoppel
- Consent / Ratification
- **Laches / Statutes of limitation**



Laches / Statutes of limitation

For the defense of laches to apply, the beneficiary must have delayed for so long in asserting his/her claim that it would be inequitable for the fiduciary to be held liable.

- **Example:** *Drake v. Pinkham*, 217 Cal. App. 4th 400 (Cal. Ct. App. 2013) (laches barred sister's claims to invalidate trust amendments that eliminated her as a beneficiary where she filed suit more than 3.5 years after becoming aware of the amendments during prior litigation, and all of her claims centered on mother's mental capacity, trustee's influence over mother, and mother's understanding of the trust amendments and her estate).

Exception: Laches defense may not apply where records providing "notice" to the beneficiaries were false or inaccurate. *In re Baker Trust*, No. A-13-0248, 2013 WL 3968782 (Minn. Ct. App. Aug. 5, 2013).

So, when does the laches/statute of limitations period start to run? The lawyerly answer is **it depends.**

•But statute of limitation period may commence when fiduciary provides notice of actions to beneficiaries. *See Konrardy v. Vincent Angerer Tr., Dated March 27, 1998*, 925 N.W.2d 620, 624 (Iowa 2019) ("breach-of-trust claim is barred by the statute of limitations if the trust provided [beneficiaries] with an accounting or report that disclosed the existence of a claim so that they knew of the claim or reasonably should have inquired into its existence").



Common Defenses to Breach of Fiduciary Duty Claims

- Jurisdictional defenses
- *Res judicata* / Collateral estoppel
- Consent / Ratification
- Laches / Statutes of limitation
- **No-contest / *In Terrorem* clauses**



No-contest / *In Terrorem* clauses

The purpose of such a clause is to discourage contests by imposing a penalty of forfeiture against beneficiaries who mount certain types of legal challenges.

- **These clauses are not always enforceable.** They are often disfavored and strictly construed in a way that permits colorable claims against the fiduciary. *E.g.*, *Matter of Sochurek*, 174 A.D.3d 908, 910 (N.Y. App. Div. 2019) (legatees did not violate *in terrorem* clause by bringing breach of fiduciary duty claims against executor because claims did not “contest the validity of the will”), *Betts v. City National Bank*, 156 Cal.App.4th 222 (Cal. Ct. App. 2007) (claim against trustee for breach of fiduciary duty does not violate no-contest clause); *Barr v. Dawson*, 158 P.3d 1073 (Okla. App. 2007) (claim for spousal election is not a “contest.”).
- That said, some jurisdictions (notably, California) **favor these clauses** “as a matter of public policy ... because they discourage litigation and give effect to the purposes expressed by the testator or trustor.” *Colburn v. N. Tr. Co.*, 151 Cal. App. 4th 439, 447 (Cal. Ct. App. 2007).
- Besides discouraging litigation, a valid and enforceable *in terrorem* clause may strip a beneficiary of his/her standing to challenge the fiduciary’s conduct. *See Estate of Goyette*, 14 Cal. App. 3d 224 (Cal. Ct. App. 1971) (explaining that the decedent’s nieces and nephews had violated the *in terrorem* clause and thus, had forfeited any legal standing to object to future administration issues).

Common Defenses to Breach of Fiduciary Duty Claims

- Jurisdictional defenses
- *Res judicata* / Collateral estoppel
- Consent / Ratification
- Laches / Statutes of limitation
- No-contest / *In Terrorem* clauses
- **Exculpatory / exoneration provisions**



Exculpatory / exoneration provisions

These types of provisions can narrow the scope of a fiduciary's potential liability or authorize certain types of conduct that might otherwise give rise to liability for breach of duty.

- **Exculpatory provisions are not always enforceable.** Courts may strictly or narrowly construe such provisions. They may also refuse to enforce provisions that waive liability for certain types of conduct. *See e.g. In re Shore*, 854 N.Y.S.2d 293 (N.Y. Sur. Ct. 2008) (trust provision eliminating trustee's duty to account is unenforceable).
- **Some states have specific statutes proscribing certain types of exculpatory provisions.** *E.g.*, Ohio Rev. Code § 5810-08 (trust provision "relieving a trustee of liability for breach of trust is unenforceable to the extent that it relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust"), Tex. Prop. Code § 114.007(b) (trust provision "relieving the trustee of liability for a breach of trust is ineffective to the extent that the term is inserted in the trust instrument as a result of an abuse by the trustee of a fiduciary duty to or confidential relationship with the settlor").



Common Defenses to Breach of Fiduciary Duty Claims

- Jurisdictional defenses
- *Res judicata* / Collateral estoppel
- Consent / Ratification
- Laches / Statutes of limitation
- No-contest / *In Terrorem* clauses
- Exculpatory / exoneration provisions
- **Prudent investor rule**



Prudent investor rule

- The prudent investor rule is, in essence, a guideline that requires a fiduciary to invest and manage assets as a prudent investor would. Of course, a prudent investment will not always turn out to be a good investment.
- The prudent investor rule may provide safe harbor for certain types of conduct. Most states will provide a fiduciary with certain guidance as to what he/she should consider with respect to investment decisions. If a breach of duty claim is based on a fiduciary's investment or asset management decisions, the prudent investor rule may provide a defense.
- **However:** not every fiduciary has access to the prudent investor rule as a defense, as “an entity that holds itself out as having special investment skills, ***such as a bank***, is held to a higher standard” *In re Hyde*, 44 A.D.3d 1195, 1198 (N.Y. Sup. Ct. 2007) (emphasis added).



Common Defenses to Breach of Fiduciary Duty Claims

- Jurisdictional defenses
- *Res judicata* / Collateral estoppel
- Consent / Ratification
- Laches / Statutes of limitation
- No-contest / *In Terrorem* clauses
- Exculpatory / exoneration provisions
- Prudent investor rule
- **Unclean hands**



Unclean hands

A beneficiary who has behaved inequitably cannot seek equitable relief.

- **Example:** Beneficiary was barred from certain claims where he had breached his own fiduciary duties by attempting to take the trust's benefits for himself, instead of distributing them as he had promised. *In re Trust for Grandchildren of Gore*, No. 1165-VCN, 2010 WL 3565489 (Del. Ch. Sept. 1, 2010).
- The doctrine is applicable to other parties to trusts and wills. *E.g. In re Vincent J. Fumo Irrevocable Children's Tr. ex rel. Fumo*, 104 A.3d 535, 548 (Pa. 2014) (court's "deep repugnance over [settlor]'s conduct" justified decree declaring [settlor]'s appointment of successor trustee a nullity).



How Can Planners and Fiduciaries Leverage These Defenses to Manage Risk and (Hopefully) Avoid Litigation?

- **Authorize Certain Types of Self Dealing** - Consider including an authorization for any fiduciary under the will/instrument to sell, transfer, exchange, or loan assets between trusts/estates of which the fiduciary is an acting personal representative or trustee. This type of provision will offer your trustee/PR flexibility that he/she might not otherwise have.
- **Limit Liability for Failure to Diversify** - Consider whether (or not) to include an provision waiving liability for failing to diversify (and any imprudence associated therewith) with respect to retaining certain assets that might have sentimental or other intangible value to the family. Also consider just how flexible/vague you want the provision to be. *See Chase Manhattan Bank v. Hunter*, 26 A.D.3d 824 (N.Y. App. 4th 2006) (turning on whether the trustee had a “compelling reason” to diversify).
- **Favor Beneficiaries (by Class or Otherwise)** – Oftentimes, grantors/testators will add children as beneficiaries of a trust even though their real objective is to provide for their grandchildren. Consider adding a provision allowing the trustee to favor beneficiaries by class (i.e. grandchildren vs. children) in the trustee’s discretion.

How Can Planners and Fiduciaries Leverage These Defenses to Manage Risk and (Hopefully) Avoid Litigation?

- **Address Fiduciary Fees** – Consider whether or not the grantor/testator wants certain individual trustees to collect fees. If not, you may want to consider a clause that provides for reasonable fees, compensation, etc., provided, however, that “my spouse and my descendants shall receive no compensation for serving as personal representatives or trustees under this instrument.”
- **Proactively Seek Court Oversight** - Consider providing regular, complete, and accurate accountings to all of the beneficiaries, and seek their approval by the Court, in order to gain the benefit of res judicata and laches-type defenses.
- **Obtain Beneficiary Consents** - Consider obtaining the consent of beneficiaries with respect to potentially controversial fiduciary actions, and carefully document any related communications, in order to gain the benefit of the consent/ratification defense.
- **Communicate** – A fiduciary should communicate regularly with the beneficiaries, and attempt to understand their family circumstances and financial situation.

Questions?

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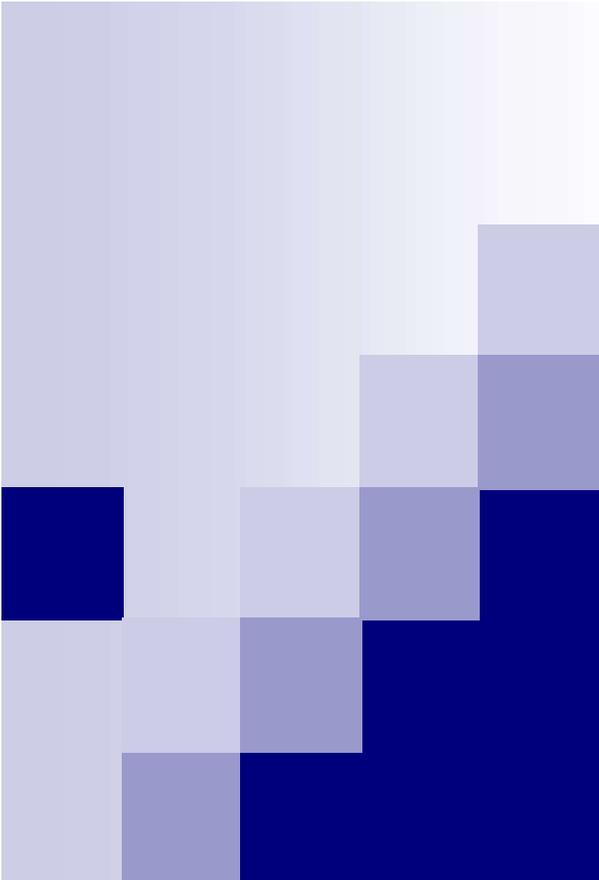
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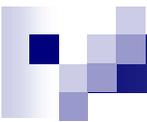
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Constructive Trust

- A constructive trust is not a trust at all. Rather, it is an equitable remedy.
- May be appropriate to disgorge property from a person to prevent unjust enrichment and to satisfy the transferor's intent

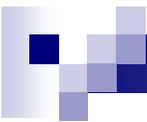


Restatement (Second) of Trusts

§ 199:

The beneficiary of a trust can maintain a suit:

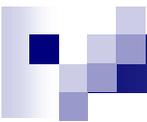
- to compel the trustee to perform his duties as trustee;
- to enjoin the trustee from committing a breach of trust;
- to compel the trustee to redress a breach of trust;
- to appoint a receiver to take possession of the trust property and administer the trust; and
- to remove the trustee.



Traditional Damages Rules – Rest. (2d) § 205:

If the trustee commits a breach of trust, she is chargeable with:

- any loss/depreciation in value resulting from breach of trust; or
- any profit made due to the breach; or
- any profit which would have accrued to the trust if there had been no breach.



Restatement (Third) § 100:

A trustee who commits a breach of trust is chargeable with

- (a) the amount required to restore the values of the trust estate and trust distributions to what they would have been if the portion of the trust affected by the breach had been properly administered; or
- (b) the amount of any benefit to the trustee personally as a result of the breach.



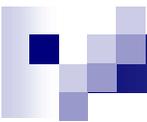
Restatement (Third) § 100:

In addition, a trustee who commits a breach of trust normally is not allowed to benefit individually from the breach, and the trustee is subject to liability to eliminate any such benefit.



Rest. (3d) allows recovery of appreciation damages

If the breach of trust causes a loss, including any failure to realize income, capital gain, or appreciation that would have resulted from proper administration, the beneficiaries may surcharge the trustee for the amount necessary to compensate fully for the consequences of the breach.



Improper investment by trustee

– Rest. (3d) § 100, cmt. b(1).

The difference between (1) the value of the investment and its income and other products at the time of surcharge and (2) the amount of the funds expended in making the investment, increased (or decreased) by the amount of the total return (or negative total return) that would have accrued if the funds had been properly invested.



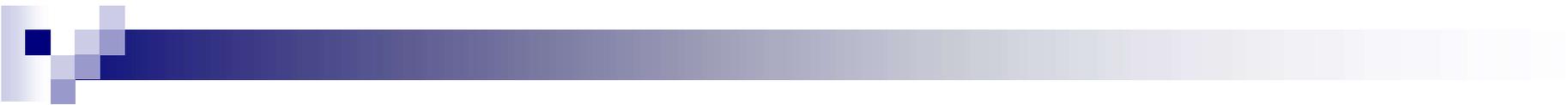
“Total Return” measure of damages:

- Rest. (3d) measures trustee’s liability for improper investment conduct by reference to total return, positive or negative.
- Damages can be recovered through surcharge actions that reflect gains/losses reasonably expected from appropriate investment program.



Prudent Investor Rule

Trustees who have ignored important aspects of their fiduciary obligations by employing inadequate investment strategies will not be insulated from liability merely because their investment programs escaped loss of dollar value during periods of significantly rising markets, from which their trust assets should have but did not benefit.



Relief under UTC § 1001:

- compel trustee to perform trustee's duties;
- enjoin trustee from committing breach;
- compel trustee to redress breach by paying money, restoring property, etc.;
- order trustee to account;
- appoint special fiduciary to take possession of, administer trust property;



Relief under UTC § 1001 (cont'd):

- suspend trustee;
- remove trustee;
- reduce/deny compensation to trustee;
- void an act of trustee, impose lien or constructive trust, or trace trust property wrongfully disposed of and recover; or
- order any other appropriate relief.



UTC § 1002(a):

Trustee who commits a breach is liable to the beneficiaries for the greater of “the amount required to restore the value of the trust property and trust distributions to what they would have been had the breach not occurred; or . . . the profit the trustee made by reason of the breach.”



UTC § 1002(b):

- Where there is more than one trustee, he is entitled to contribution from the rest, unless substantially more at fault.
- A trustee is not entitled to contribution from the other trustee if the trustee is substantially more at fault than the other trustee or if the trustee committed the breach of trust in bad faith or with reckless indifference to the purposes of the trust or the interest of the beneficiaries.