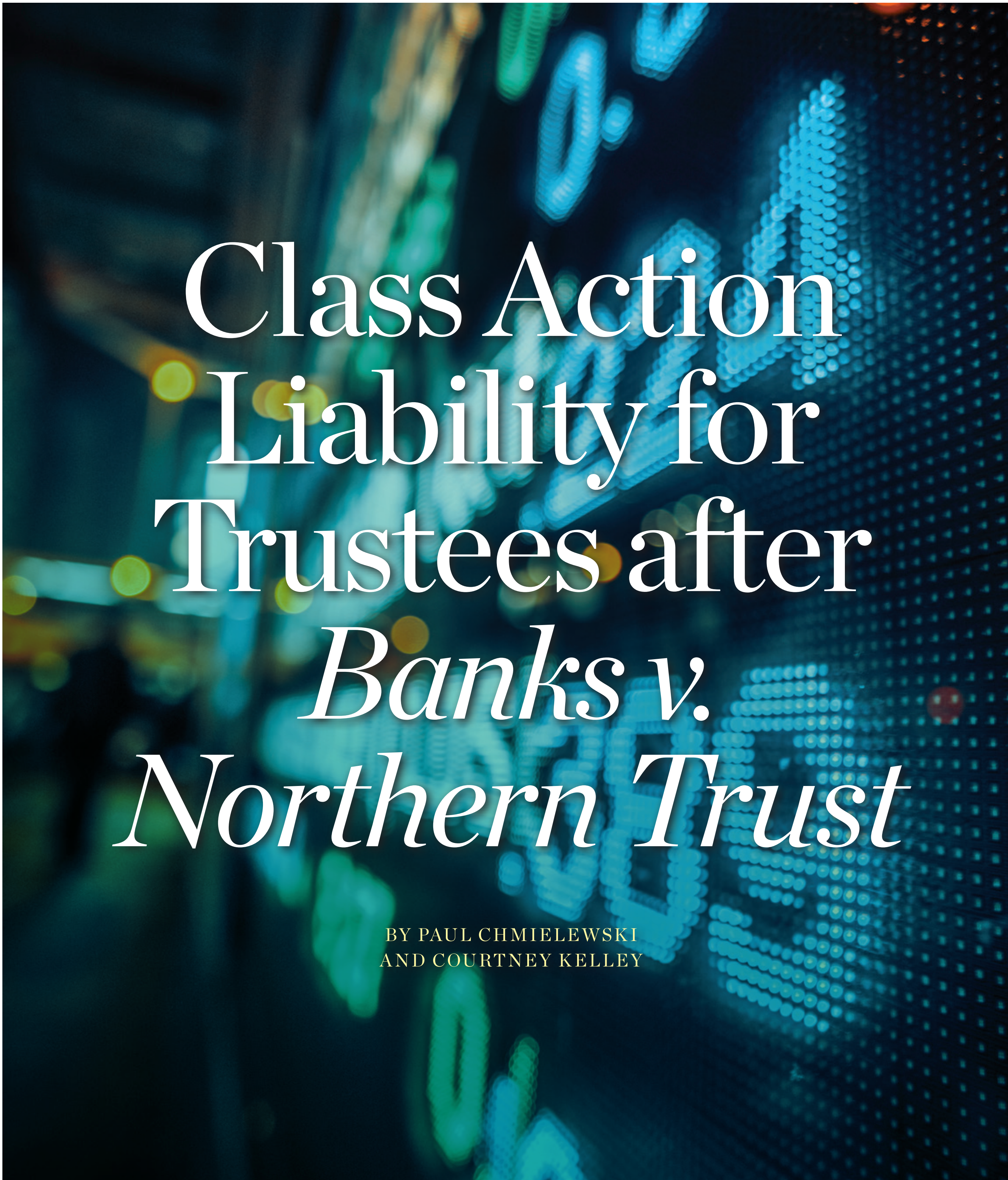

Class Action Liability for Trustees after *Banks v. Northern Trust*

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This article discusses potential trustee liability for investment decisions under evolving court interpretations of the Securities Litigation Uniform Standards Act.

Since 1998, federal law has barred class action lawsuits for claims shown to have a connection with an investment activity.[1] Most trustee activities could be construed to have a connection with an investment activity. Accordingly, trustees have felt relatively safe from class action claims brought by aggrieved beneficiaries. However, courts are increasingly recognizing a theory that abrogates federal law preemption of class action certification for cases involving investment-related actions against trustees. This trend in court decisions exposes trustees to increased risk of class action liability for a wide range of activities.

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Securities Litigation Uniform Standards Act

Section 10(b) of the Securities Exchange Act (Securities Act) makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe. . . ." The Securities Exchange Commission (SEC) promulgated Rule 10b-5, which broadly prohibits any deceptive device or fraud "in connection with the purchase or sale of any security."[2] The US Supreme Court has stated that Section 10(b) should be construed "not technically and restrictively, but flexibly, to effectuate its remedial purposes."[3] Section 10(b) does not directly address class action lawsuits, but decisions interpreting it were initially used by courts when analyzing class action certification requests under subsequently enacted federal preemption legislation.[4]

In 1995, Congress passed the Private Securities Litigation Reform Act (Reform Act) to make securities fraud pleading standards more stringent.[5] To circumvent these stringent pleading standards, plaintiffs' attorneys began filing class actions in state court based on state law or common law. Congress addressed this unintended federal flight in 1998 by enacting the Securities Litigation Uniform Standards Act (SLUSA)[6] to provide that no covered class action (i.e., one in which damages are sought on behalf of more than 50 people) based on state law may be maintained in any court by any private party alleging misrepresentation or manipulation "in connection with the purchase or sale of" a security covered by the Securities Act.[7] Under 15 USC 77r(b), a covered security is a security that is listed or eligible to be listed on a national securities exchange. After SLUSA's enactment, the key focus in determining eligibility for class action certification for many investment-related claims has been interpreting which activities are "in connection with the purchase or sale of" a covered security.

Evolving SLUSA Case Law

In *Securities and Exchange Commission v. Zandford*, the US Supreme Court interpreted the Section 10(b) coverage requirement that actions must be in connection with the purchase or sale of a security.[8] In *Zandford*, an elderly client opened a joint account for the client and the client's disabled daughter. The broker promised to invest the account in a conservative manner. The client gave the broker discretion to manage the account and provided the broker a power of attorney to engage in securities transactions without receiving prior consent. When the client died four years later, the account was depleted. A routine government audit revealed that the broker had transferred money from the client's account to individual accounts in the broker's name. The broker argued that his actions involved the misappropriation of funds and therefore were not in connection with the purchase or sale of a security. The Court disagreed, finding that the sale of securities and breach of fiduciary duty coincided and thus were "in connection" with the sale of securities and covered by Section 10(b).[9]

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, a former stockbroker at Merrill

Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) brought a class action against Merrill Lynch alleging that it had defrauded brokers by deceptively inflating stock prices, causing the brokers to hold onto stocks they otherwise would have sold.[10] Dabit filed the class action in US district court based on federal diversity jurisdiction and Oklahoma state law.

Merrill Lynch argued that SLUSA preempted Dabit's suit, and therefore it could not be brought under state law as a class action. Dabit argued that the suit alleged misrepresentation concerning only the holding of stocks, rather than buying or selling stocks, which was beyond SLUSA's scope. The District Court for the Southern District of New York ruled for Merrill Lynch, finding SLUSA's language broad enough to include suits such as Dabit's.[11] The Second Circuit Court of Appeals reversed, holding that suits by stockholders are distinct from suits by stock sellers and purchasers and that SLUSA was meant to preempt only the latter.[12]

The US Supreme Court took up the case. The key issue was whether SLUSA preempted class action securities fraud suits brought under state law alleging that misleading statements or omissions induced brokers to hold securities rather than to sell or purchase them.[13] In an 8-to-0 decision (Justice Alito did not participate), the Court adopted a broad reading of SLUSA that "holder" class actions such as Dabit's are "in connection with the purchase or sale" of a security and therefore are preempted by SLUSA.[14] The Court reasoned that Congress must have been aware of SLUSA's broad application and such interpretation is consistent with the law's stated purpose.[15] The Court found that for purposes of SLUSA preemption, the distinction between sellers, purchasers, and holders "is irrelevant."[16] The Court further found that SLUSA precludes class action certification for an action that merely "coincides" with the purchase or sale of a security.[17]

After *Dabit*, two cases denied class action certification against trustees based on SLUSA preclusion, *Siepel v. Bank of America, NA*, and *Segal v. Fifth Third Bank, N.A.* Both involved bank trustees that had invested trust accounts in mutual funds owned or affiliated with the banks ("proprietary funds") rather than in third party mutual funds that allegedly performed better. The cases were based on state law fraud claims. Relying on *Dabit*'s finding that class actions based on fraud that merely "coincide" with the purchase or sale of a security are precluded by SLUSA, both courts denied class action certification.[18]

Two noteworthy cases allowed class actions to proceed. First, in *Chadbourne & Parke LLP v. Troice*, Allen Stanford (Stanford) and Stanford International Bank offered fixed return certificates of deposit (CDs), which are typically non-covered securities, claiming that the investor money would be invested in covered securities that would back the CDs.[19] But Stanford was operating a Ponzi scheme and using the money for personal expenses. Plaintiffs filed a class action against law firms that represented Stanford and third-party investment firms that sold CDs on his behalf. Defendants moved to dismiss the complaints, arguing that the securities supposedly backing the CDs were covered securities, so SLUSA barred a class action.[20]

The Court stated that fraud must be material to a purchase or sale transaction involving a covered security, not an uncovered security (e.g., CDs).[21] Additionally, the Court noted that in all cases of which it was aware, SLUSA preemption was applied to situations where victims had or had tried to obtain an ownership in covered securities.[22] The victims in *Troice*, however, owned uncovered securities. The Court also stated that SLUSA preemption only applies to fraudulent transactions involving covered securities when the fraud is material to someone other than the fraudster.[23] The ultimate holding in *Troice* was that any fraud regarding the nonexistent covered securities that were supposed to back the CDs was merely incidental to the victims' purchase of non-covered securities (i.e., Stanford's CDs) and SLUSA preemption did not apply.[24]

Henderson v. Bank of New York Mellon Corp. involved an attempt to pursue a class action against a bank acting in its capacity as trustee.[25] Plaintiffs alleged that defendant, as trustee, invested clients in poorly performing and low-rated funds owned by Bank of New York Mellon Corp. and its affiliates rather than investing in better performing non-proprietary funds. The district court held that after *Troice*, a mere coincidental connection between alleged fraud and a covered security no longer supported SLUSA preemption. The court denied defendant's motion to dismiss the lawsuit based on SLUSA preemption. The parties settled in 2019.

Banks v. Northern Trust

Against this backdrop, the Ninth Circuit Court of Appeals decided *Banks v. Northern Trust Corp.*, in which Banks, the trust beneficiary, alleged that Northern Trust, in its capacity as trustee, invested in poorly performing mutual funds that were affiliated with Northern Trust rather than seeking to invest in better performing non-affiliated funds.[26] Banks also alleged that Northern Trust charged excessive fees for internal trust tax return preparation. Northern Trust argued that SLUSA barred these claims.

Banks argued that the materiality prerequisite for the "in connection" requirement did not exist because (1) as a mere beneficiary of an irrevocable trust, she had no ability to decide whether to purchase or sell securities for the trust; and (2) Northern Trust, rather than the trust beneficiaries, had control over the decision to purchase or sell securities for the trust. Given this fact, Banks argued that the fraudulent actions would only be material to the fraudster itself (i.e., Northern Trust) and class action certification was appropriate.

Citing *Zandford*, Northern Trust countered that its actions as trustee were no different than the actions of an agent and should be considered "in connection" with the purchase or sale of a security.[27] Northern Trust also cited *Dabit*, *Siepel*, and *Segal* to support its argument that fraud that merely "coincides" with the purchase or sale of securities results in SLUSA preclusion.

The Ninth Circuit framed the case as an issue of first impression: "whether allegations concerning a trustee's imprudent investments constitute activity 'in connection with' the purchase or sale of securities when those allegations are brought by the beneficiaries of an irrevocable trust."[28] In addressing Northern Trust's agency argument, the Ninth Circuit analyzed the differences between agents and trustees, explaining that agents are controlled by principals who direct and control the agent.[29] Conversely, beneficiaries of an irrevocable trust have no control over the trustee's actions and cannot unilaterally direct the trustee with respect to investments.[30] The Ninth Circuit held that there was no fraud with respect to the trust beneficiary "in connection" with the "purchase or sale of a covered security" because Banks had no ability to direct or otherwise compel investment decisions.[31]

The Ninth Circuit acknowledged that under *Dabit*, alleged fraud that coincides with a securities transaction meets the "in connection" requirement for SLUSA preemption but added that *Troice* clarified *Dabit* and required the fraud to be material to the decision to buy or sell a security to meet the "in connection" requirement.[32] Further, under *Troice*, fraud must be material to someone other than the fraudster to qualify as "in connection" with the purchase or sale of a covered security.[33] The Ninth Circuit held that Northern Trust was the only party with authority to trade based on the fraudulent activity, and because it was also the "fraudster," SLUSA preemption did not apply under *Troice*.[34] The dismissal of the putative class action was reversed and the case was remanded for further proceedings.

What About Discretionary Investment Authority?

The successful class action certifications cited above involve trustees with full investment authority rather than simply discretionary investment authority. But a recent opinion marks, to the authors' knowledge, the first class action certification for investments into proprietary funds by individual investors who provided their investment advisor with discretionary investment authority. On June 7, 2021, the US District Court for the Western District of Pennsylvania denied, in part, a motion to dismiss the class action complaint against Bank of New York Mellon Corp. and Bank New York Mellon, N.A.[35] Notably, the court rejected defendants' contention that SLUSA precluded the class claims from moving forward, and it sustained plaintiffs' breach of contract and consumer claims. Although the court granted the motion to dismiss the breach of fiduciary duty and negligence claims, it did so without prejudice.

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Trustee Liability in Colorado

Neither *Henderson* nor *Banks* are binding law in Colorado. Nonetheless, they support the proposition that SLUSA class action preemption does not apply when a trustee invests trust assets in its own proprietary funds.[36] *Henderson* was ultimately settled in 2019, preventing adjudication of whether a breach of loyalty or breach of fiduciary duty occurs when a trustee uses its own proprietary funds as trust investments. *Banks* remains pending, and the preliminary issue of whether SLUSA barred the claim as a class action was only recently decided. Nevertheless, it is clear that trustees may have reason to no longer feel confident in claiming their actions relate to their investment activities and are, therefore, not subject to class action liability under SLUSA. This leaves open what actions give rise to trustee liability when trustees invest and manage trust assets in Colorado. State statutes provide some guidance in answering this question.

Colorado's Uniform Trust Code (CUTC) states that pursuant to its duty of loyalty, the trustee must act in the best interests of trust beneficiaries.[37] The CUTC simultaneously provides a layer of protection for trustees when investing and managing trust assets by stating that a conflict of interest should not be presumed when a trustee invests in funds in which the trustee or its affiliate has an interest.[38] This may appear to operate as a safe harbor for trustees with a potential conflict of interest, but the CUTC also requires a trustee to comply with Colorado's Uniform Prudent Investor Act (CUPIA).[39]

CUPIA's prudent investor rule requires trustees to invest and manage trust assets using reasonable care, skill, and caution in conformance with the trustee's duty of loyalty.[40] The rule also discusses the dangers of self-dealing.[41] To comply with the duty of loyalty, a trustee "may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."[42] In addition to implementing a strategy focused on total return, the rule states that cost minimization is a key component when investing and managing trust assets.[43] To minimize costs, a trustee must compare costs among similar investment options being considered for a trust portfolio.[44] Therefore, trustees must select an investment portfolio that yields the best returns at the lowest cost.[45] Trustees who follow the CUTC and CUPIA have a liability shield.

Proprietary Investments

Colorado law does not prohibit trustee use of proprietary funds, but investments must be in the trust beneficiaries' best interests. In determining beneficiaries' best interests, the trustee must evaluate both the performance and cost of using proprietary funds relative to investing in non-affiliated funds. Based on the CUTC and prudent investor rule, it appears that a trustee violates its fiduciary duty if it uses proprietary funds and the returns underperform non-affiliated funds or if the cost of using proprietary funds exceeds the additional benefit, if any, realized from the use of such proprietary funds. Where the use of proprietary funds results in both underperformance and additional cost, a case for trustee liability appears viable.

Other Proprietary Services

Banks touched on proprietary trustee tax preparation services that were alleged to be violations of fiduciary duty, though the main focus of the case was whether class action certification was warranted due to the trustee's use of proprietary funds. Regardless, the trend away from SLUSA preemption for trustees raises whether other proprietary trustee services, including tax preparation, oil and gas management, real estate management services, and management of closely held business assets could result in trustee liability.

Tax Preparation Fees

One of the allegations in *Banks* was that Northern Trust had transformed its tax services to create a new profit center for the bank by charging an additional $900 annually to prepare the trust tax returns.[46] Previously, Northern Trust's trust tax return preparation fee had allegedly been part of the standard trustee fee assessed against trust assets.[47] While an annual trust tax return preparation fee of $900 is not excessive per se, if Northern Trust switched from including this fee as part of the standard trustee fee to charging it as an additional fee, it could have potential liability.

In *Henderson v. Bank of New York Mellon, N.A.*, plaintiffs alleged that Bank of New York Mellon, N.A. (BNY Mellon), as trustee, started using an outside tax firm to prepare its trust tax returns and passed to the trust the cost of the outside tax preparer and a mark-up fee.[48] The court certified the case as a class action.[49] BNY Mellon settled the case for $10 million.

It is common for trustees to offer trust tax preparation services for a relatively reasonable fee because they can access the tax information efficiently. By itself, charging a fee for tax return preparation is not a breach of fiduciary duty. But if the fees charged are excessive or undisclosed, or the service is substandard, trustee liability may result.

Oil and Gas Management

Oil and gas management can potentially generate substantial revenue for a trust. Some trustees manage oil and gas interests internally, while others hire external managers to manage the assets on the client's behalf. The standard corporate trustee fee schedule for managing oil and gas interests is based on a percentage of the assets managed. This practice raises two significant issues for trustees. First, trustees must pay attention to the percentage fees they charge relative to those charged by third-party professional oil and gas managers. Because a trustee is required to act in the best interests of the trust beneficiaries, a trustee may not charge a higher fee than a third party professional simply because it chooses to manage the oil and gas interests internally. Second, trustees that use outside managers must be careful to (1) pass on only the outside manager's costs rather than charging a percentage that greatly exceeds the outside manager's actual charges, and/or (2) assess a markup fee that is justified by the trustee's oversight responsibilities. Based on *Henderson*, an unjustified and undocumented markup may be considered a breach of fiduciary duty.

Real Estate

There are many potential layers of fees when a trust owns real estate. Many trustees charge a percentage fee based on the value of real estate a trust holds. The trustee may also hire property managers to oversee and manage the property. Property management fees may or may not be included in the standard trustee management fee for the property. When buying or selling trust owned real estate, many trustees charge an additional fee, usually 2 to 5% of the value of the property being bought or sold, which is intended to compensate the trustee for the additional services it provides in the sales process (e.g., reviewing the contract, overseeing due diligence, etc.). Realtor fees are added to the trustee's fees. The authors are unaware of litigation involving trustee real estate fees, but it is reasonable to foresee a potential claim based on excessive real estate fees.

Closely Held Business Assets

Closely held businesses (CHBs) are owned or controlled by a family rather than by a vast collection of individual shareholders. While CHBs are often incorrectly thought of as small businesses, they can have significant revenue and are increasingly being transferred into trusts for estate planning purposes. Typically, partial interests in CHBs are transferred to future generations while the company's founder is still alive and running the business. This practice may lead to conflict between the founder and the trustee. For example, because the founder continues to run the business, the founder often believes that the trustee does not have any real responsibilities with respect to the business and should therefore be entitled to minimal fees. However, trustees bear responsibility for regulatory compliance and ensuring that the business is properly functioning and continues to be a prudent investment for the trust, even if the trust owns a minority interest.

Trustees must justify fees for CHBs like they do for any other asset. But a standard percentage fee based on the value of the underlying CHB asset may be difficult, given the trustee's unique duties in holding a minority interest as opposed to a majority interest. Even a trustee holding a majority interest will likely not directly manage the business on a day-to-day basis. Instead, the founder will likely operate the business with a third party taking over management on the founder's death.

Charges for CHB fees, as for other fees discussed above, should be handled prudently, with trustees monitoring whether the fees charged are comparable to those that an outside business management firm would provide, whether there are excessive markups over outside consultant fees, and whether the overall services provided to the trust are reasonable.

Addressing Liability Up Front

Trustees can proactively address potential liability concerns through good management practices, which include properly using directed trusts and employing outside experts where necessary.

Using Directed Trusts

Directed trusts are split duty trusts where a trust director handles specific duties, such as investment management or managing oil and gas interests, real estate, or a CHB. An administrative trustee is responsible for all other duties that are not specifically granted to the trust director. Colorado law relieves the administrative trustee from all liability related to the duties granted to the trust director.[50] Accordingly, administrative trustees should not charge trustee management fees on assets assigned to the trust director.

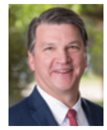
Employing External Experts

Instead of attempting to manage all assets in-house, trustees can use outside experts. There is a recent and growing trend among corporate trustees to employ external experts in oil and gas management, real estate, and business management rather than handling those functions in-house. Of course, even when external experts are used, trustees must still perform periodic due diligence regarding the experts' cost and competency to evidence the trustee's conformance to its fiduciary duty in selecting and overseeing the expert.

In addition, trustees can use an open architecture investment platform for products and services rather than limiting themselves to proprietary options. This helps avoid potential conflict of interest claims.

Conclusion

Trustees in Colorado face potential class action liability and should adapt their conduct accordingly. The one-stop, in-house model for all investment and management responsibilities invites increased scrutiny and potential liability. Practitioners should work with trustees to employ comprehensive and detailed due diligence on both internal and external management operations. A well-documented decision reflecting a comparison of all service offerings will help insulate a trustee from liability. CL

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NOTES

1. 15 USC § 78j(b).
2. 17 CFR § 240.10b-5.
3. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (quoting *SEC v. Capital Gain Research Bureau*, 375 U.S. 180, 186 (1963)).
4. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Supt. of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).
5. 15 USC §§ 77z-1, 78u-4.
6. 15 USC § 78bb(f)(1)–(3).
7. 15 USC § 78bb(f)(1).
8. *SEC v. Zandford*, 535 U.S. 813 (2002).
9. *Id.* at 825.
10. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006).
11. *In re Merrill Lynch & Co., Inc.*, 2003 WL 1872820 (S.D.N.Y. Apr. 10, 2003) (vacated in part by *Dabit v. Merrill Lynch*, 395 F.3d 25 (2d Cir. 2005)).
12. *Dabit v. Merrill Lynch*, 395 F.3d 25 (2d Cir. 2005).
13. *Merrill Lynch*, 547 U.S. at 72.
14. *Id.* at 86–89.
15. *Id.* at 85.
16. *Id.* at 72.
17. *Id.* at 85.
18. *Siepel v. Bank of Am., NA*, 526 F.3d 1122 (8th Cir. 2008); *Segal v. Fifth Third Bank, NA*, 581 F.3d 305 (6th Cir 2009).
19. *Chadbourne & Parke LLP v. Troice*, 571 U.S. 377 (2014).
20. *Id.*
21. *Id.* at 386–87.
22. *Id.* at 388.
23. *Id.* ("If the only party who decides to buy or sell a covered security as a result of a lie is the liar, that is not a 'connection' that matters.").
24. *Id.* at 397.
25. *Henderson v. Bank of New York Mellon Corp.*, 146 F.Supp.3d 438, 443–44 (D.Mass. 2015).
26. *Banks v. N. Trust Corp.*, 929 F.3d 1046 (9th Cir. 2019).
27. *Id.* at 1052.
28. *Id.* at 1051.
29. *Id.*
30. *Id.*
31. *Id.* at 1053.
32. *Id.*
33. *Id.*
34. *Id.*
35. *Walden v. Bank of New York Mellon Corp.*, No. 20-CV-01972-CRE, 2021 WL 2317856 (W.D.Pa. June 7, 2021).
36. This concept was once again confirmed by orders issued on June 4, 2020, and March 31, 2021, in *Bernard v. Bank of New York Mellon, N.A.*, No. 2:18-CV-00783-RJC-CRE (W.D.Pa. 2020). This case involved a claim that Bank of New York Mellon (BNY Mellon), as trustee, had improperly invested in proprietary funds. The court denied BNY Mellon's requests to dismiss the case based on SLUSA preemption.
37. CRS § 15-5-802(1).
38. CRS § 15-5-802(6).
39. *Id.*
40. CRS § 15-1.1-102(a).
41. CRS § 15-1.1-102 cmt.
42. CRS § 15-1.1-107. *See also* CRS §§ 11-24-102 and 11-109-205 (requires transactions with trust company affiliates to be on comparable terms as a third-party provider would charge).
43. CRS § 15-1.1-107 cmt.
44. *Id.* (quoting *Restatement of Trusts 3d*: Prudent Investor Rule § 227, cmt. m (Am. Law Inst. 1992)).
45. CRS §§ 15-1.1-102 cmt. and -107 cmt. *See also* FDIC Trust Examination Manual, § 3 F.4.b. Due Diligence Standards ("The performance of proprietary, affiliated, or bank advised mutual funds should be reasonable in comparison to other available funds. If the proprietary funds' performance is significantly below benchmark indicators (poorly performing funds), management's decision to retain the investments should be reviewed regularly and supported by appropriate documentation. The Board of Directors or a committee thereof, which reports to the Board of Directors, should review and approve the decision to retain poorly performing proprietary funds."), https://www.fdic.gov/regulations/examinations/trustmanual.
46. *Banks*, 929 F.3d at 1049, 1056.
47. *Id.* at 1046.
48. *Henderson v. Bank of New York Mellon, N.A.*, 332 F.Supp.3d. 419, 432 (D.Mass. 2018).
49. *Id.* at 435.
50. CRS § 15-16-809(1). *See also* www.eeoc.gov/coronavirus.