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THE SPOTLIGHT

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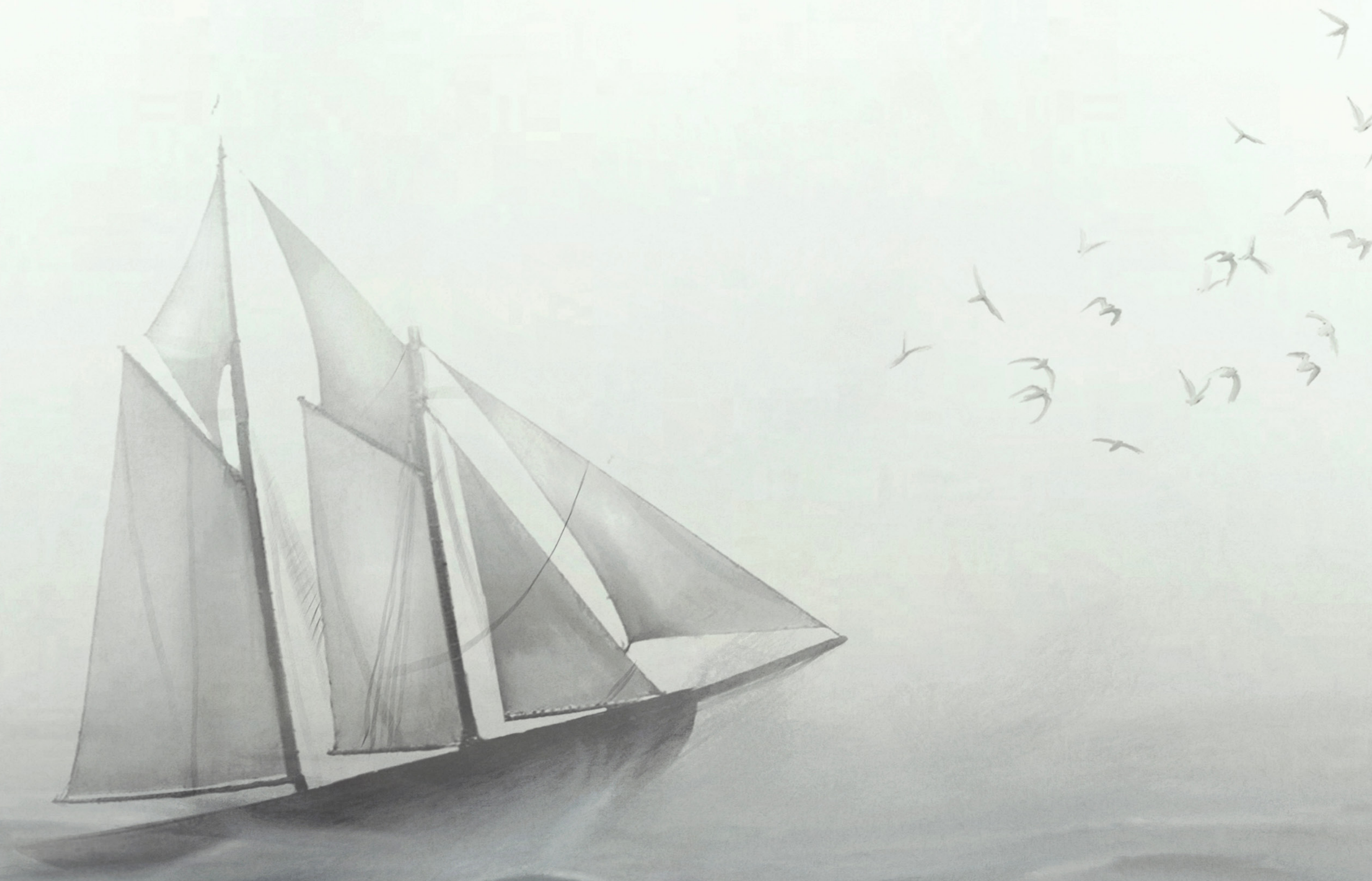

EXPECTING THE UNEXPECTED

Navigating Fiduciary Relationships

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ROBINS KAPLAN LLP

WELCOME TO THE SPOTLIGHT

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The Spotlight is the result of ongoing collaboration between our national trial practice and estate planning groups, with the goal of providing a forum to discuss the latest news and other issues impacting the trusts and estates community. Whether you are a trustee, beneficiary, trust officer, attorney, financial advisor, or other professional in this area, we hope that you will find this newsletter interesting, informative, and perhaps at times even a bit entertaining.

As leaders and teachers in the field of wealth planning and administration, our attorneys have built a reputation for excellence in meeting the needs of individuals and organizations from basic to complex testamentary planning. We counsel individuals and business owners in all aspects of estate planning and business succession, providing them with peace of mind and reassurance that their legacy is in the best of hands.

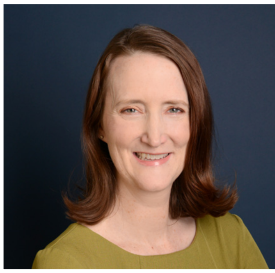
Furthermore, should a conflict arise, our fiduciary disputes attorneys are well positioned to resolve the matter with thoughtfulness, creativity, and compassion. Our national reputation for litigation excellence includes wins in the fiduciary arena for trustees and fiduciaries, personal representatives, beneficiaries, guardians, and conservators. Whether litigating fiduciary matters, inheritance issues, or contested charitable donations, we help clients cut through confusion to find a path to resolution.

Is there a topic affecting your practice that you would like us to discuss in an upcoming issue of The Spotlight? Let us know at all_marketing@robinskaplan.com.

– Denise S. Rahne and Steven K. Orloff

SHOULD YOU TAKE FINANCIAL ADVICE FROM MAGNUM P.I.?

BY ANNE LOCKNER



Unless you rely solely on streaming services, at some point in recent years, you have likely seen Tom Selleck pitching reverse mortgages as a retirement strategy. Is that a product for you? Or your parents? This article won't answer that question. The best person to answer that question for you is a financial advisor who is also a fiduciary—someone who puts their client's interests ahead of their own.

Many people assume that all financial advisors are fiduciaries. But that is not always the case, and knowing the difference matters. Fiduciaries have a legal obligation to act in the best interests of their client—even if it means placing the client's interests ahead of theirs. Therefore, a fiduciary must disclose any conflicts of interest and must resolve them in the client's favor.

To better understand this distinction, some definitions are in order. The term "financial advisor" is a broad one and does not have a set definition—meaning anyone can call themselves a financial advisor and offer financial advice. Some "financial advisors" offer financial advice in a specific field—insurance, annuities or tax, for instance. "Financial planners," however, are financial advisors who offer a comprehensive financial plan that generally addresses a client's short-term and long-term savings strategies, investments, life insurance, tax planning, estate planning, retirement planning, strategies for paying for college and other goals.

"Certified financial planners" are financial planners certified by the CFP Board, which requires applicants to earn a bachelor's degree and complete coursework through a CFP Board Registered Program. When providing financial advice to a client, a CFP® professional must also act as a fiduciary under the CFP Board's *Code of Ethics and Standards of Conduct*.

Under the Investment Advisers Act of 1940, "being in the business of giving investment advice for compensation," triggers the need for a financial planner to register. Therefore, before any financial advisor, CFP or not, can earn compensation for investment advice, that person must become an Investment Advisor Representative (IAR) of a Registered Investment Advisor (RIA).

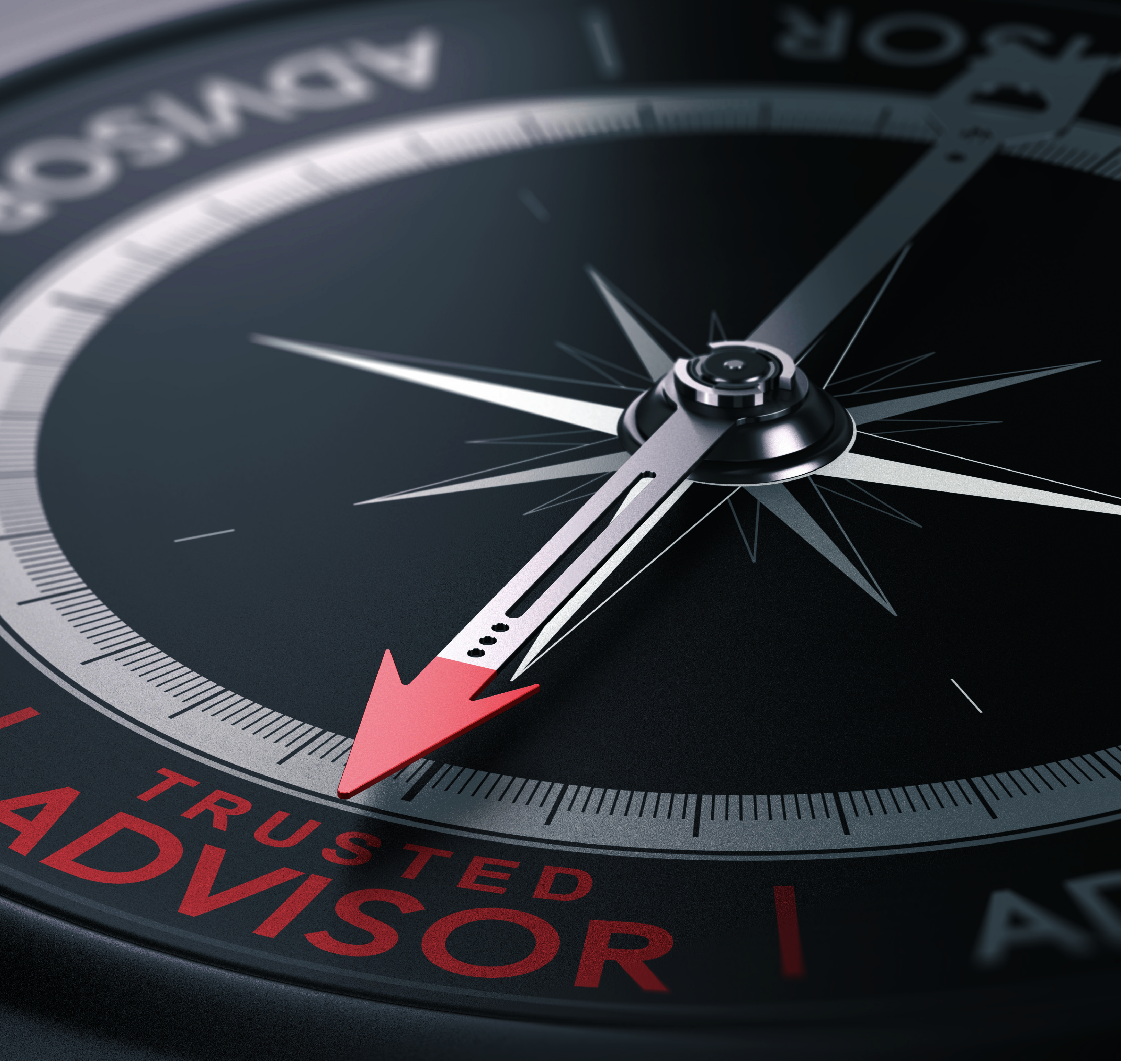
An RIA is the business entity that must be registered either with the primary state in which it does business or with the SEC, while the IAR is an individual who works for the RIA. (Note that the 1940 Act spells it "adviser" rather than the more-common and also-correct "advisor." While some use "adviser" to signify they are registered under the Act, whether someone calls themselves an "advisor" or an "adviser" tells you nothing about whether a person is a fiduciary.)

IARs in most states must pass the Series 63 and/or Series 65 exams or, alternatively, if coming from a broker-dealer background, the Series 66 and Series 7 exams administered by the Financial Industry Regulatory Authority (FINRA). Some states will waive these requirements if the professional has an advanced certification such as the CFP. IARs are fiduciaries. Many financial advisors are both IARs and CFPs.

The best way to determine whether a financial advisor is a fiduciary is to ask. It is also wise to check the background of the investment professional on **FINRA's BrokerCheck**. There, you can find out what exams the person has passed, their years of experience, their state licenses, and whether they were the subject of a final regulatory action or certain complaints.

In the past, broker-dealers did not have a fiduciary duty to retail clients. Instead, they could make investment recommendations solely if the investments were "suitable" for the client. But in 2016, the White House Council of Economic Advisers found that conflicts of interest resulted in a 1% point lower annual return on retirement savings and $17 billion of losses every year for America's families. As a result, under the Obama administration, the Department of Labor attempted to require all retirement advisors to act as fiduciaries, but that rule was hotly contested by many in the industry and ultimately defeated in court.

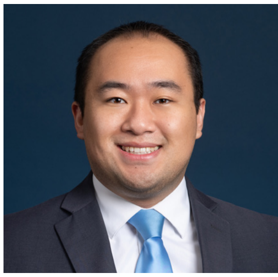
In June 2019, however, the SEC adopted rules and interpretations designed to enhance the protections afforded retail customers in their relationships with broker-dealers and investment advisors. Regulation Best Interest, or Reg BI, which the SEC implemented under the Securities and Exchange Act of 1934, requires broker-dealers to act in a retail client's "best interest" when making a recommendation on any securities investment or investment strategy involving securities. In other words, Reg BI prohibits broker-dealers from putting their own interest ahead of their retail customer's interest. Reg BI went into effect in June 2020, but the SEC did not bring any enforcement action until two years later. FINRA followed suit last October with its own disciplinary proceeding to enforce the rule.



Even with the SEC's rule, a dual-hatted financial advisor (one who acts as both a financial planner and a broker-dealer) can still make commissions off investments but must disclose this potential conflict to the client. And the investment still must be in the client's best interest—not the advisor's.

To be clear, there are plenty of financial advisors who are not fiduciaries who do a fantastic job at managing their clients' wealth. And simply being a fiduciary does not necessarily mean that one is getting the best financial advice. What is most important is that those seeking financial-planning services understand the different standards those offering such services are subject to, ask questions to ensure that the advice they are given is right for their needs, and—ultimately—that they trust the person giving them that advice, regardless of whether he or she is a celebrity.

WHEN LENDING A HAND RESULTS IN **LIABILITY**



BY TOMMY DU

In a typical lender-borrower relationship, the lender owes the borrower no fiduciary duty.[1] However, this general rule is set aside when the lender knowingly undertakes to act on behalf of and for the benefit of another. Such is the case when a lender excessively controls or dominates the borrower.[2] This basic principle is recognized by states across the nation.[3] When this occurs, the lender owes the customer a fiduciary duty, and the type of obligations imposed will depend on the facts of each case.

For example, in *Brown v. Wells Fargo Bank, N.A.*, 168 Cal. App. 4th 938, 960 (2008), the California Court of Appeal affirmed the trial court's finding that there was sufficient evidence supporting a fiduciary relationship between the bank and its customer requiring the bank to orally disclose an arbitration provision. In coming to such a conclusion, the court found the following facts persuasive: (1) the customers worked with the bank's relationship manager for at least 6 months; (2) the bank knew that one of the customers had limited vision and declining health that made him a "little slow"; (3) the relationship manager worked biweekly at the customers' home office; (4) the relationship manager had access to all of the customers' financial information and managed their financial paperwork; (5) the relationship manager introduced the customers to an estate attorney and accountant; (6) the relationship manager provided investment advice; and (7) the relationship manager urged the customers to retain another bank employee to handle the stock portfolio. These facts were sufficient to create "a fiduciary relationship between Wells Fargo and [its customers]." *Id.* at 961. As a result, the bank owed its customers additional obligations to explain the material terms of the agreement and to not treat the agreement as an arm's-length transaction, thus requiring oral disclosure of an arbitration provision.

The risks of unknowingly becoming a fiduciary are great. Recently, in *In re Bailey Tool & Mfg. Co.*, No. 16-30503, 2021 WL 6101847 (Bankr. N.D. Tex. Dec. 23, 2021), the bankruptcy court found that a lender was responsible for the borrower's bankruptcy and thus liable for damages in excess of $16 million. In this lender liability suit, the bankruptcy trustee, standing in the shoes of the failed business enterprise, among other various claims, alleged that the lender engaged in improper conduct that destroyed the business enterprise. While the court failed to reach a conclusion on fiduciary duty, the court found that the lender was liable for tortious interference by playing an "active role in the business decisions of the borrower and, in an attempt to secure the course of the borrower's business, the lender intentionally interfere[d] with such things as management selection and borrower's business contracts." *Id.* at *41. The court found that the lender's actions were "overreaching and drove away the customers . . . and made it impossible for the [borrowers] to fill orders from customers." *Id.* at *48. Specifically, the lender declared that the borrowers were in default and took over the management of the borrowers' businesses. *Id.* at *13–17. The lender instructed the borrowers' customers not to pay the borrower and threatened the borrowers' customers with litigation; withheld funds from the borrowers, causing the borrowers to be unable to fulfill customer orders; and prohibited the borrowers from paying their vendors, causing the borrowers to miss delivery windows. In taking on the role that it did, the court found the lender liable for $16,966,928, consisting of (a) $12,962,084 for breach of contract damages and breach of duty of good faith and fair dealing damages, (b) $12,274,000 for the tort of fraudulent misrepresentations damages (duplicative of the breach of contract and breach of good faith and fair dealing damages and, therefore, not separately awarded, (b) $2,044,844 for contractual and business interference; and (c) $1,960,000 for willful violation of automatic stay.

Brown and *Bailey* serve as useful case studies for the risks involved when a lender exercises improper control over a borrower's business and affairs. While some lenders act with the good intention of helping their customers or to protect their investment, such actions may lead to the unintentional creation of a fiduciary duty. The further lenders insert themselves into the decision-making process of the borrowers' business, the higher the risks of becoming a fiduciary to the borrowers.

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[1] *Kim v. Sumitomo Bank*, 17 Cal. App. 4th 974, 979 (1993) (noting that it is "axiomatic" that the relationship of a bank and its loan customers is not a fiduciary relationship).

[2] *Pension Tr. Fund for Operating Engineers v. Fed. Ins. Co.*, 307 F.3d 944, 955 (9th Cir. 2002) (noting that the "lender-borrow relationship . . . is normally an arms-length transaction involving no special duty to disclose").

[3] *Salek v. Suntrust Mortgage Co.*, 2018 WL 3756887, at *4 (S.D. Tex. Aug. 8, 2018) (applying Texas law); *Roswell Capital Partners LLC v. Alternative Const. Techs.*, 638 F.Supp.2d 360, 368–69 (S.D.N.Y 2009) (applying New York law); *see also LaSalle Bank Nal'l Ass'n. v. Paramont Properties*, 588 F.Supp.2d 840, 852 (N.D. Ill. 2008) (summarizing various state's laws); *Miller v. U.S. Bank of Wash.*, N.A., 72 Wash. App. 416, 426–27 (1994) (applying Washington law).

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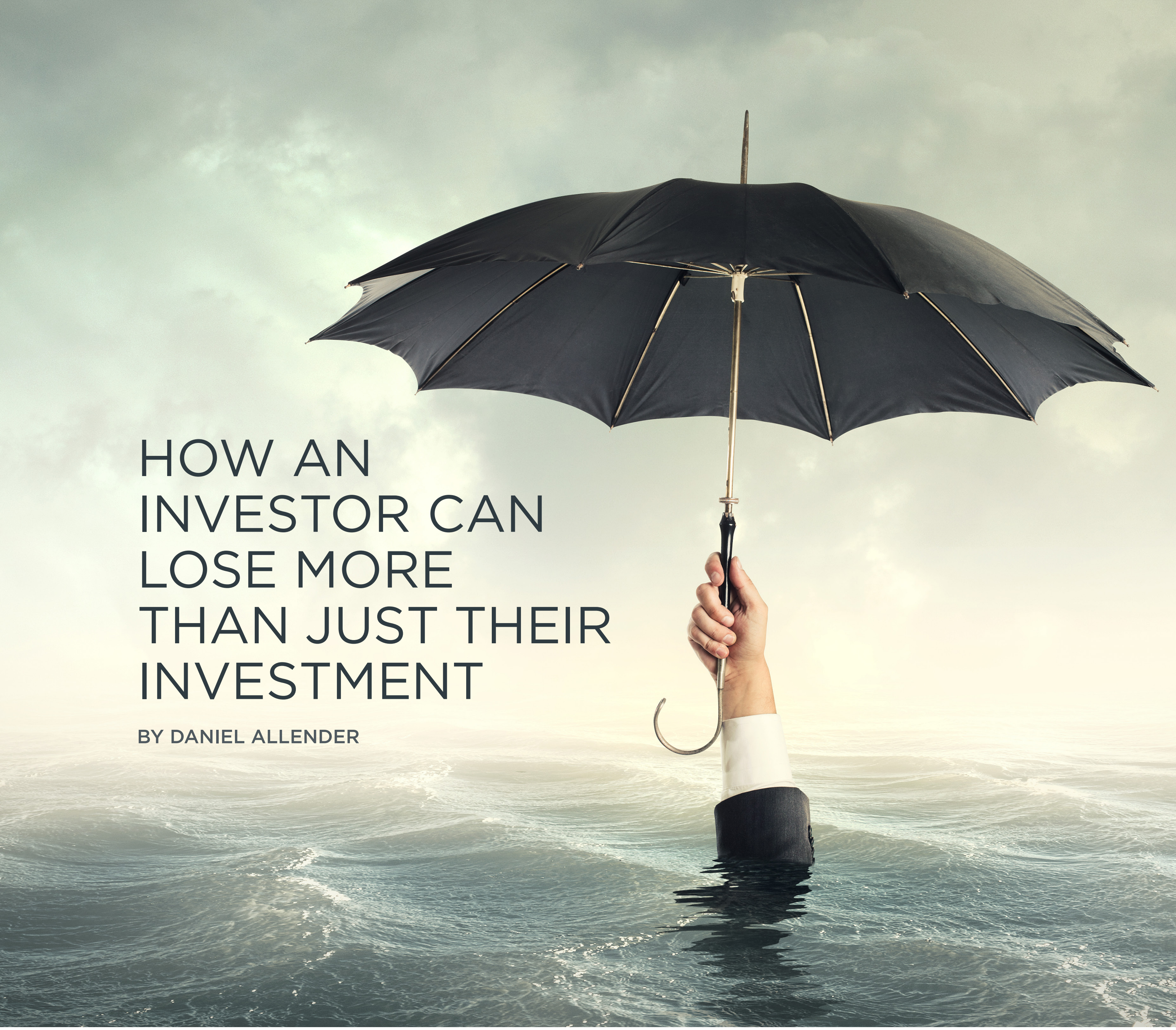

HOW AN INVESTOR CAN LOSE MORE THAN JUST THEIR INVESTMENT

BY DANIEL ALLENDER

When evaluating an investment opportunity, a would-be investor's risk analysis is usually limited to the potential loss of principal and related opportunity costs of the investment. But substantial investments in startups or small, closely held businesses carry the additional risk of unintended fiduciary obligations. When the investor develops a fiduciary duty, the theoretical risk of loss becomes unlimited. An otherwise passive investor may unexpectedly gain duties of care and loyalty to other investors in the company and expose themselves to liability far in excess of their investment should the fortunes of the enterprise erode.

Unexpected fiduciary obligations may be imposed on investors in a number of ways. The most common fiduciary relationship arises through appointment to a board of directors, where seats are often offered in exchange for large investments. While having a board seat can give the investor comfort, and even some control, directors by virtue of their position automatically gain a fiduciary duty to the company. This fiduciary duty includes the duties of care and loyalty.

These duties are also often interpreted broadly. For example, the duty of care includes not only a duty to act reasonably and prudently. It has also been interrupted to include a duty to exercise reasonable oversight. Similarly, the duty of loyalty has also been interpreted to include the duty of good faith and disclosure. While all these duties are owed to the corporation, the investor-director may find themselves in the crosshairs of litigation personally if the fortunes of the company turn and other shareholders look to hold the directors individually liable to recover losses.

But board membership is not the only way an investor can gain a fiduciary obligation. Controlling shareholders can have a fiduciary duty to other shareholders regardless of whether that investor owns the majority of the shares. Whereas the lines for the fiduciary obligations of a director are typically bright and clear, the point at which a controlling shareholder gains a fiduciary obligation is much more likely to catch one by surprise. Similarly, in many jurisdictions, investors in a closely held corporation are deemed to have fiduciary obligations toward the other investors, regardless of how much control they personally exercise. In those situations, the duties of an investor appear much more akin to a partnership than a typical corporation.

Most states impose fiduciary obligations on controlling shareholders. Whether an investor is a "controlling shareholder" requires consideration of the necessary level of "control." Some states evaluate the question both generally or with respect to a single issue or transaction. For example, in Delaware, the general rule is that an investor gains a fiduciary obligation once they own either a majority interest or otherwise exercise control over business affairs. *See Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987). But that control can come in many forms, and the test for control can be transaction-specific. For example, a minority investor can be held to owe fiduciary duties with respect to a single transaction, if that investor is able to control the outcome of the company's decision-making through the exercise of veto rights, threats or other strong-arm tactics. *See, e.g., Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994). Regardless of the investor's actual voting power, the court may consider whether the investor exercised a level of actual control such that other voting members could not exercise independent judgment. *See In re Tesla Motors, Inc. S'holder Litig.*, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018).

But the threshold for a "controlling" shareholder is not the only way a fiduciary obligation may come as a surprise. In some jurisdictions, like Illinois, minority investors in a closely held corporation may be deemed to have fiduciary duties to one another more akin to the duties of partners in a partnership. *See Hagshenas v. Gaylord, 199 Ill. App. 3d 60 (2d Dist. 1990); see also Donahue v. Rodd Electrotype Co. of New England*, 367 Mass. 578, 592–93 (1975) ("Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.").

Conflicts between the goals of a particular investor and the goals of others within the company are commonplace. Disputes over decisions that affect the timing of an exit or distribution, decisions that trigger tax consequences, and other similar situations may all tempt an investor to pull on any levers available to force a favorable outcome. While the test for whether the investor owes a fiduciary duty will always be fact-intensive and addressed case by case, wary investors must always give a thought to how the transaction or deal will be viewed with the benefit of hindsight, when the lawyers are involved. If a dispute arises later, the size of the investor's voting power—though relevant—will not be the only factor considered.

MEET OUR ISSUE EDITOR:

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Daniel Allender is a trial attorney who navigates high-stakes disputes across industries, with an emphasis on retail, real estate, and technology companies. Daniel regularly represents both plaintiffs and defendants in commercial and intellectual property matters and complex matters involving property insurance litigation and insurance coverage.

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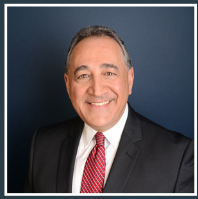

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