<u>Title</u>

The law of trusts and the fiduciary conundrum of ESG-investing politics

<u>Text</u>

The trustee who ESG invests fiduciary funds signals his personal support for environmental, social, and governance causes unrelated to the trust's purposes and its beneficiaries' pecuniary interests. Take the G part. Assume trustee of an irrevocable trust for a child's education elects to invest a portion of trust res in companies producing satellites, but only in those with a sizable percentage of hard-science PhDs on their boards. That's not ESG investing, the purpose of the caveat being to maximize trust estate's economic value, not to signal personal solidarity with the scientific community. But if trustee, to signal, say, personal solidarity with society's elderly, makes a public display of avoiding companies with boards lacking age diversity, that would be ESG investing. *Cf.* Gray & Berry, *Nasdaq's Boardroom Diversity Push Isn't Evidence-Based*, WSJ, April 29, 2021.

Common law as enhanced by equity provides that "[a] trustee ordinarily violates the duty of loyalty by using trust property to benefit anyone other than the beneficiaries, or to accomplish any objective other than a trust purpose." 3 Scott & Ascher §17.2.3. "We conclude that the duty of loyalty…forbid[s] social investing in its current form." Langbein & Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 76 (1980). *See also* Rest. (Second) of Trusts §170 cmt. q ("The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person").

Consider unlikely situation of two companies being identically suited in all respects for inclusion in the portfolio of the child's trust. One is non-ESG-compliant. Is the trustee free to signal the trustee's personal solidarity with ESG constituencies by investing fiduciary funds in the other? Is equity fine in theory with such a "tiebreaker"? Time will tell. In practice, however, if the ESG-compliant company underperforms relative to non-compliant one and it comes out at trial that the trustee knew at the outset that the non-ESG-complaint company had been better suited for the portfolio, then the trustee could be held personally liable not only for consequential investment losses but also for the fees of the special master tasked with running the "identicality" numbers. As to the constructive-fraud implications, see §8.15.60 of *Loring and Rounds: A Trustee's Handbook* (2023), which section is reproduced in appendix below. Handbook is available for purchase at https://law-store.wolterskluwer.com/s/product/loring-rounds-trustees-hanbook-2023e/01t4R00000Ojr97QAB.

ERISA requires that trusts associated with qualified plans be dedicated solely to securing/ protecting the equitable property rights of plan participants and their beneficiaries and administered solely for their benefit. The ESG-investing "tiebreaker" is inconsistent with those statutory purposes. See §404 of ERISA and its declaration of policy. Congress relied on the common law of trusts to define the general scope of an ERISA-fiduciary's authority and responsibility, not the Secretary of Labor.

Still, effective 1/30/23, the Secretary of Labor, via an ERISA-regulation revision, would carve out an exception to the pension trustee's duty of undivided loyalty, one that, as a practical matter, gives trustees *carte blanche* to ESG-invest. The gimmick is a neutering of the tiebreaker's "identicality" threshold: "If a fiduciary prudently concludes that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. A fiduciary may not, however, accept expected reduced returns or greater risks to secure such additional benefits." See 29 CFR § 2550.404a-1(c)(2). Pension trustees seeking to ESG-invest unconstrained by the fiduciary principle whose investments never underperform can take comfort in the revised regulation, but not in the likelihood that it violates ERISA's statutory letter and spirit.

Appendix

§8.15.60 *Constructive Fraud* [from *Loring and Rounds: A Trustee's Handbook* (2023), available for purchase at https://law-store.wolterskluwer.com/s/product/loring-rounds-trustees-hanbook-2023e/01t4R00000Ojr97QAB]

Constructive fraud has all the elements of fraud, except the element of intent to defraud or deceive: "The principle is well settled, that if a person makes a representation of a fact, as of his own knowledge, in relation to a subject matter susceptible of knowledge, and such representation is not true; if the party to whom it is made relies and acts upon it, as true, and sustains damage by it, it is fraud for which the party making it is responsible."[1043] The negligent misrepresentation must be incident to some legal or equitable relationship.[1044] Parties in a contractual relationship generally have a legal duty to deal fairly and in good faith.[1045] The fiduciary in an equitable relationship, *e.g.*, an agent or a trustee, has a panoply of duties incident to that relationship, duties that are enumerated and discussed in Chapter 6 of this handbook.

In the trust context, the doctrine of constructive fraud and the *Cambridge Trust Case*[1046] will be forever linked in the minds of trust professionals on this side of the Atlantic. The case involved a testamentary trust for the benefit of the settlor's widow. Upon her remarriage, the trust was to continue for the benefit of a charity. The trust was funded in 1932. In 1945 the widow remarried but through the employment of elaborate ruses she managed to hide the fact of her remarriage from the trustee until her death in 1967. Thus, the trustee in violation of the terms of the trust and to the detriment of the charity continued to pay the net trust accounting income to the widow until her

---

[1043] Page v. Bent, 43 Mass. 371, 374 (1841) (Chief Justice Lemuel Shaw rendering the opinion).

[1044] *Cf.* Est. of Draper v. Bank of Am., N.A., 288 Kan. 510, 205 P.3d 698 (2009) ("Constructive fraud is a 'breach of a legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others or violate a confidence, and neither actual dishonesty [n]or purpose or intent to deceive is necessary.'").

[1045] Wells v. Stone City Bank, 691 N.E.2d 1246 (Ind. Ct. App. 1998).

[1046] Nat'l Acad. of Sci. v. Cambridge Tr. Co., 370 Mass. 303, 346 N.E.2d 879 (1976).

death, when at last it discovered its mistake.

The charity sought to have the court reopen a number of the trustee's previously allowed accounts and order the trustee to make the trust whole out of its own pocket, if necessary, for the amounts that it had misdelivered. By statute, allowed trustee accounts generally cannot be reopened, except for fraud or manifest error.[1047] While it was clear that the trustee had not intended to misrepresent the widow's marital status on the accountings, it was also clear that the trustee's inattention, in the words of even the dissent, was "pathetic."[1048] In fact, the trial court found that the trustee had exerted no effort whatsoever to ascertain the widow's marital status, not even going so far as to solicit from her periodic affidavits. Accordingly, the court found that the trustee's negligent misrepresentation of the widow's marital status on the face of the accountings, a misrepresentation that was occasioned by the absence of even a halfhearted effort to ascertain the critical fact of the widow's marital status, constituted a constructive fraud perpetrated by the trustee against the charity warranting a reopening of the trustee's previously allowed accounts.

The Uniform Trust Code, specifically §1007, would deem certain innocent acts of maladministration not to be constructively fraudulent: "If the happening of an event, including marriage, divorce, performance of educational requirements, or death, affects the administration or distribution of a trust, a trustee who has exercised reasonable care to ascertain the happening of the event is not liable for a loss resulting from the trustee's lack of knowledge." The policy behind the exoneration is "to encourage trustees to administer trusts expeditiously and without undue concern about liability for failure to ascertain external facts, often of a personal nature, that might affect administration or distribution of the trust."[1049]

One court, this time in New York, has ruled that misrepresentations of law and fact made by a corporate cotrustee's counsel to a beneficiary, *i.e.,* by an agent of the corporate cotrustee, were grounds for opening and vacating a decree that had judicially settled the intermediate accounts of the cotrustees, notwithstanding the fact that the beneficiary had signed a general waiver and release running to the cotrustees.[1050] The time for appeal had long passed. As it happened, the testamentary trust during the period covered by the intermediate account had sustained substantial realized losses from the sale of stock in the corporate cotrustee.[1051] Granted the stock was an inception asset; but the will contained no language expressly authorizing its retention. All things being equal, the presence of such language would have been a defense to allegations that the corporate cotrustee had breached its duty of loyalty to the beneficiary in retaining its own stock in the trust.[1052] Trust counsel's statements to the beneficiary to induce the beneficiary to execute the waiver and release, namely, "that nothing could be done about…[the shrinkage in value of the trust estate]…and that

---

[1047]*See generally* §6.1.5.2 of this handbook (duty to keep and render accounts).

[1048]Nat'l Acad. of Sci. v. Cambridge Tr. Co., 370 Mass. 303, 313, 346 N.E.2d 879, 885 (1976).

[1049]UTC §1007 cmt.

[1050]*In re* Gillies' Will, 98 N.YS.2d 853 (Sur. Ct. 1950).

[1051]*See generally* §6.1.3.2 of this handbook (trustee invests in its own stock).

[1052]*See generally* §7.1.2 of this handbook (defenses to allegations that the trustee breached the duty of loyalty).

the signing of the release would save time and money," constituted at least constructive fraud such that a reopening of the accounts was warranted.[1053] The fraud having been perpetrated by an agent of the corporate cotrustee, the court imputed it to the cotrustee.

A trustee seeking a waiver or release who fails to disclose to the beneficiary all material facts, including those facts that are not in the interest of the trustee to disclose, perpetrates a fraud against the beneficiary.[1054] If the failure to disclose is *not* coupled with an intent to deceive, then the fraud is constructive.[1055] To the extent trust counsel is involved in a continuing deliberate effort to defeat the rights of the beneficiary through the withholding of material information, communications between the trustee and trust counsel made in the course of that effort may not be privileged.[1056] They are said to come within the crime-fraud exception to the attorney-client privilege.

[1053]*In re* Gillies' Will, 98 N.YS.2d 853, 856 (Sur. Ct. 1950).

[1054]First Union Nat'l Bank v. Turney, 824 So. 2d 172, 188–189 (Fla. 2002).

[1055]First Union Nat'l Bank v. Turney, 824 So. 2d 172, 191 (Fla. 2002).

[1056]First Union Nat'l Bank v. Turney, 824 So. 2d 172, 191 (Fla. 2002).