

Understanding Fiduciary Duties and Obligations in Investment and Divestment

By David Martinez and Nargress Hadjian – June 2023

Fiduciaries, such as trustees, financial advisors, corporate directors, and fund managers are legally bound to act in the best interests of their beneficiaries and/or clients. Duties owed by fiduciaries, including duties of prudence, diligent monitoring, loyalty, and disclosure often arise in the context of asset investment and divestment. Understanding the contours of these fiduciary duties as shaped by caselaw is important to evaluate potential exposure for breach.

One of the fundamental principles guiding fiduciary obligations is the duty to invest and manage trust assets, also known as the prudent investor rule. Governed by the Uniform Prudent Investment Act (“UPIA”), the rule requires trustees to exercise reasonable care, skill, and caution in managing trust investments. This includes the duty to diversify the investments so as to minimize the risk of loss, unless it is reasonably determined that it is better not to do so. For instance, a trustee managing a trust fund should avoid concentrating investments in limited vehicles, instead spreading them across asset classes to ensure prudent risk management. However, stock in closely held businesses need not be sold for diversification reasons if the stock has a special relationship to a trust purpose or to the beneficiaries.

However, the duty to diversify is not absolute. Fiduciaries must balance diversification with other factors, such as the specific needs and circumstances of the different beneficiaries, the purposes of the trust, and the nature of the trust assets. Thus, the level of diversification required may vary depending on factors such as the size of the trust, the investment goals, and the risk tolerance of the beneficiaries.

Duty to Monitor Investments

Fiduciaries also have a duty to actively review investments to ensure their continued suitability. For example, in *Tibble v. Edison International*, beneficiaries of a defined-contribution retirement savings plan brought an Employee Retirement Income Security Act (“ERISA”) action for breach of fiduciary duties, seeking to recover damages for losses suffered by the plan, among other relief. The Supreme Court held that “a trustee has a continuing duty to monitor trust investments and remove imprudent ones.” This continuing duty exists “separate and apart from the trustee’s duty to exercise prudence in selecting investments at the outset.”

Duty of Loyalty and Conflicts of Interest

The duty of loyalty is another essential aspect of fiduciary obligations. Fiduciaries must act in the best interests of beneficiaries, avoid conflicts of interest, and disclose any potential conflicts to ensure transparency and maintain the trust placed in them. The widely cited case *Meinhard v. Salmon, et al.* established this principle. The court held that the defendant breached his fiduciary duty of loyalty by exploiting a business opportunity for his personal gain that rightfully belonged to the partnership. The court further held that fiduciaries must disclose any conflicts of interest and have an ongoing duty to fully disclosure opportunities that may arise during their fiduciary relationship.

Duty to Disclose Material Facts

Transparency and full disclosure of material facts are essential components of fiduciary obligations. *Lingsch v. Savage*, a formative California case, established that fiduciaries, such as real estate brokers, have a duty to disclose all material facts to beneficiaries or clients, especially when making investment decisions on their behalf. In this example, the real estate broker was found to have breached its fiduciary duty to disclose material facts to the purchasers, including that the property was in a state of despair and the building had been placed for condemnation by city officials, among other things. The duty to disclose material facts ensures that beneficiaries can make informed decisions based on complete and accurate information. Failing to disclose relevant information may not only lead to a breach of fiduciary duty, but also a finding of fraud.

Divestment Strategies and Winding Up Assets

Divestment from certain investments has also become a significant consideration for fiduciaries. In a New York district court case involving an employment benefit fund against an insurer and insurance agent, *Buccino v. Continental Assurance Co., et al.*, the court found that the fiduciaries' failure to advise the investment fund to divest itself of unlawful and imprudent investments resulted in a continuing breach of its fiduciary obligations, giving rise to a new cause of action each time the fund was injured by its continued possession of the investments. Therefore, fiduciaries are obligated to properly divest of assets when reasonably necessary, and the continued failure to do so can result in a continuing breach of the fiduciary duty.

The obligation to properly divest of assets also may arise in "wind-up" scenarios of trust affairs. In a well-known California case, *Sterling v. Sterling*, the court held that the trustee's act of selling a professional basketball team held by a revoked trust was not only a valid exercise of the trustee's power to wind up trust assets, but also in the best interest of the beneficiaries. The sale of assets during the wind-up process was challenged for increasing the trust assets in violation of Section 15407(a)(5). However, the court rejected this notion, instead noting that even when acting within its "wind-up" powers, a trustee must still abide by the obligation of seeking the best possible result for the beneficiaries.

Conclusion

It is critical for fiduciaries to exercise due diligence in assessing investment opportunities, monitoring the performance of investments, and regularly reviewing the composition of portfolios. Understanding these and other obligations is important to avoid exposure, ensure the protection of beneficiary interests, and maintain the integrity of the fiduciary relationship.