

Less Than Arms Length?

Duties Owed By Financial Institutions

David F. Johnson
dfjohnson@winstead.com
817.420.8223



DISCLAIMERS

- These materials should not be considered as, or as a substitute for, legal advice; and they are not intended to nor do they create an attorney-client relationship
- Since the materials included here are general, they may not apply to your individual legal or factual circumstances
- You should not take (or refrain from taking) any action based on the information you obtain from these materials without first obtaining professional counsel
- The views expressed in this presentation do not necessarily reflect those of the firm, its lawyers, or clients

Introduction

- Financial institutions and their affiliates interact with the public in many different forms and capacities:
 - Trustee or estate representative;
 - Investment advisor or broker/dealer;
 - Lender;
 - Escrow agents;
 - Holder of deposits; and
 - Many other capacities.
- This presentation is intended to explore the various duties that arise in these situations.

Duties As Fiduciaries

- Financial institutions often act in a formal fiduciary capacity as a trustee, estate representative, or investment advisor.
- These roles are voluntarily entered into and give the institution great authority or power over the assets of a trust, estate, or client.
- Correspondingly, with this great power comes great responsibility and duties.

Duties As Trustee/Estate Representative

- Texas courts hold that a trustee and an estate representative have similar duties.
- Indeed, an estate representative holds estate assets in trust for the devisees of the estate.
- These duties are broad, comprehensive, and required by Texas common law and statute.

Duties As Trustee/Estate Representative

- Duty of loyalty and utmost good faith.
- Duty of obedience to trust document or will.
- Duty of candor and full disclosure.
- Duty to refrain from self-dealing and conflicts of interest.
- Duty to make the assets of the trust productive while preserving the assets.
- Duty to properly manage, supervise, and safeguard assets.

Duties Of Investment Advisor

- A Registered Investment Adviser (RIA) is an investment adviser (IA) registered with the SEC or a state's securities agency.
- Generally, individuals or firms that receive compensation for (i) managing portfolios of securities; (ii) advising private funds; and/or (iii) giving advice on investing in securities such as stocks, bonds, mutual funds, or exchange traded funds are deemed to be investment advisers.

Duties of Investment Advisor

- All investment advisors (registered or unregistered) are subject to Section 206 of the Advisers Act, which makes it unlawful for an adviser to engage in fraudulent, deceptive, or manipulative conduct.
- Section 206 also imposes a fiduciary duty on investment advisors by operation of law. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).
- The purpose is to eliminate conflicts of interest and to prevent an advisor from overreaching or taking unfair advantage of a client's trust.

Duties of Investment Advisor

- As a fiduciary, RIAs have the following general duties:
- Duty of loyalty;
- Duty of disclosure;
- Duty to act with competence; and
- Duty to avoid self-dealing.

Duties of Investment Advisor

- The SEC has indicted that an RIA should meet the following obligations:
- Advice: a duty to have a reasonable, independent basis for its investment advice;
- Best Execution: a duty to obtain the best execution for clients' securities transactions where the advisor is in a position to direct brokerage transactions;

Duties of Investment Advisor

- Suitability: a duty to ensure that its investment advice is suitable to the client's objectives, needs, and circumstances;
- Personal activities: a duty to refrain from effecting personal securities transactions inconsistent with client interests;
- Disclosure: a duty to disclose all material facts to clients, including conflicts of interest; and
- Loyalty: a duty to be loyal to a client.

Broker Duties

- Section 202(a)(11)(C) of the Investment Advisers Act of 1940 exempts from the definition of an Investment Adviser (and therefore the associated fiduciary standard) "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."
- In Release 34-51523, the Financial Industry Regulatory Authority (FINRA) determined that BDs are "not to be deemed investment advisors" and therefore are not subject to the same fiduciary standards as IAs when recommending investments to clients.

Broker Duties

- The FINRA “Suitability” standard requires that a member shall make reasonable efforts to obtain information concerning a client’s:
 - 1. Financial status;
 - 2. Tax status;
 - 3. Investment objectives;
 - 4. Risk tolerance; and
 - 5. Other information used or considered to be reasonable.

Broker Duties

- The Department of Labor released a new rule this spring invoking a uniform fiduciary rule for RIAs and BDs that provide advice to retirement funds and IRAs that are controlled by ERISA.
- SEC is also looking into a new uniform rule that would apply to all brokers.

Non-Discretionary Account

- Texas courts have generally held that self-directed accounts are not special deposits that require fiduciary duties between the holder and depositor.
- A custodian has no right to approve a transaction, and the customer has the legal right to transfer assets that are supposed to be in the account.

Non-Discretionary Accounts

- A self-directed account agreement generally provides that the customer retains the right to invest the proceeds and that the financial institution has no discretion and shall invest as directed by the customer.
- Typical agreements severely limit custodial duties, and in most instances, the only remaining duty is the duty to transfer funds as directed by the investor.
- Self-directed IRAs normally limit the bank's duties to: (1) keeping the funds safe and (2) investing the funds pursuant to the customer's directive.

Non-Discretionary Accounts

- Notwithstanding, customers have sued financial institutions for doing as directed and not warning the customers of the impact of their directions.
- In *Sterling Trust Co. v. Adderley*, the Texas Supreme Court remanded an issue back to the trial court due to an improper jury instruction regarding breach of fiduciary duty. 168 S.W.3d 835 (Tex. 2004).
- The self-directed IRA custodian-defendant was originally found to be secondarily liable for aiding a fraudulent scheme that misappropriated money from investors.
- The Court made clear that contractual limitations would impact duties owed between the parties.

Escrow Services

- An escrow agent owes fiduciary duties as a matter of law, and an agent must be appointed through a specific legal document that imparts a specific legal obligation.
- An escrow agent's duties are strictly limited to those set forth in the escrow agreement.
- An escrow agent's fiduciary duty consists of: (1) the duty of loyalty, (2) the duty to make full disclosure, and (3) the duty to exercise a high degree of care to conserve the money and pay only those entitled to receive it.

Escrow Services

- One Texas Court has held that an escrow agent cannot limit its duty of full disclosure. *Home Loan Corp. v. Tex. Am. Title Co.*, 191 S.W.3d 728, 733 (Tex. App.—Houston [14th Dist.] 2006, pet. denied).
- “To the extent an escrow agent is employed only to close a transaction in accordance with a contract that has already been entered into by the parties, it is not apparent how the agent’s duty of disclosure could extend beyond matters affecting the parties’ rights in the closing process to those concerning the merits of the underlying transaction.”

Lending Transactions

- Generally, a lender has no fiduciary duty or duty of good faith to its borrowers.
- In *Johnson v. Bank of America, N.A.*, the court held: “The record supports that the relationship between Johnson and BOA can be described a number of different ways: borrower and lender, bank and customer, mortgagor and mortgagee, mortgagor and mortgage servicer, and escrow agent and escrow account holder. These types of relationships are not, as a matter of law, fiduciary or otherwise special.” No. 09-12-00477-CV, 2014 Tex. App. LEXIS 11900 (Tex. App.—Beaumont October 30, 2014, no pet.).

Lending Transactions

- A duty of good faith and fair dealing does not arise in ordinary commercial transactions, such as an ordinary, arms-length lender-borrower relationship.
Federal Deposit Ins. Corp. v. Coleman, 795 S.W.2d 706 (Tex. 1990).

Lending Transactions

- When a special relationship between a borrower and lender has been found, it has rested on extraneous facts and conduct, such as excessive lender control over, or influence in, the borrower's business activities.
- Older precedent holds that a lender may owe tort duties based on these types of facts. *State National Bank v. Farah Manufacturing Co., Inc.*, 678 S.W.2d 661 (Tex. App.—El Paso 1984, writ dismiss'd by agr.).
- *Farah* broadened the scope of lender liability beyond contract claims and recognized exposure under traditional tort theories of fraud, duress, and tortious interference.

Lending Transactions

- In *Farah v. Mafrige & Kormanik, P.C.*, the court dismissed a claim of a special relationship between a lender and borrower even though the plaintiff alleged that its lenders forced the election of a new chief executive officer, installed directors loyal to the banks, and interfered with the company's corporate governance:
 - Admittedly, the record indicates a long-standing relationship between Farah and the First City entities that extended beyond a normal debtor-creditor relationship. However, the fact a business relationship has been cordial and of long duration is not by itself evidence of a confidential relationship. The fact one businessman trusts another and relies upon another to perform a contract does not rise to a confidential relationship. Subjective trust is not enough to transform arms-length dealing into a fiduciary relationship.
- 927 S.W.2d 663, 675 (Tex. App.—Houston [1st Dist.] 1996, no writ).

Lending Transactions

- An informal fiduciary duty may arise from a moral, social, domestic or purely personal relationship of trust and confidence.
- However, such a relationship is not created lightly, and not every relationship involving a high degree of trust and confidence rises to the stature of a fiduciary relationship.
- The test for a special relationship is whether the plaintiff has objectively reasonable expectations that the defendant will act in the plaintiff's best interest and above the interests of the defendant.

Lending Transactions

- Subjective trust is not enough, and something apart from the transaction between the parties is required.
- A fiduciary relationship may arise if the dealings between the parties have continued for such a period of time and a party is objectively justified in relying on another to act in his best interest.
- A party is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party in legal, financial, and accounting matters, and there exists a long association in a business relationship as well as personal friendship.

Retail Customers

- Generally, the relationship between a bank and its customers does not create a special or fiduciary relationship.
- Texas Business and Commerce Code (UCC) § 1.203 provides that “Every contract or duty within this title imposes an obligation of good faith in its performance or enforcement.”
- Furthermore, the Code defines “Good Faith” as “honesty in fact in the conduct or transaction involved.” Tex. Bus. & Com. Code (UCC) § 1.201(19).

Retail Customers

- For example, Section 3.406(a) provides: “A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.”
- Thus, the UCC imposes good faith obligations in various different provisions, which may create broader breach-of-contract claims.

Civil Liability

- An institution may be held liable for breaches of fiduciary duty under state common law.
- Further, there are three separate bases for imposing liability on an employee who carries out the fiduciary functions of an entity: (1) the employee owes a fiduciary duty directly as a subagent carrying out the employer's fiduciary functions, (2) the employee is liable if he 'participates' in the employer's breach of fiduciary duty, and (3) the employee is personally liable for any tort he commits in the course of his employment.
- *Medve v. JPMorgan Chase Bank, N.A.*, No. H-15-2277, 2016 U.S. Dist. LEXIS 11961 (S.D. Tex. February 2, 2016).

Civil Liability

- Any party in Texas may be held responsible for another party's breach of fiduciary duty under an aiding and abetting breach of fiduciary duty theory.
- The elements are: 1) a breach of fiduciary duty by a third party, 2) the aider's knowledge of the fiduciary relationship between the fiduciary and the third party, and 3) the aider's awareness of his participation in the third party's breach of its duty.

Civil Liability

- UCC section 3.307 normally deals with holder in due course issues, but it provides when a bank has notice of a third party's breach.
- It generally provides that the bank has notice when it: (1) takes an instrument as payment or as security for a personal debt of the fiduciary; (2) takes an instrument known to be for the personal benefit of the fiduciary; or (3) deposits funds into an account other than an account of the fiduciary, as such, or an account of the represented party.

Civil Liability

- In *Max Duncan Family Invs. Ltd. v. NTFN, Inc.*, a company sued its former president for using corporate property as collateral on a personal real estate transaction. 267 S.W.3d 447 (Tex. App.—Dallas 2008, pet. denied).
- The issue was whether a holder of a note, who sold the property to the president, was a holder in due course.
- Citing Section 3.307(b)(4), the court found that the holder had notice of the president's breach of fiduciary duty because the holder knew the president was a fiduciary of the company, the company was the payor of the note, the holder did not see or request any documentation to establish the president had authority to pledge the corporate property as collateral, the holder was aware the note was for a personal debt of the president, and the holder sold the land to the president personally.

Criminal Liability

- SEC can seek civil fines and can potentially send matters to the Department of Justice for criminal prosecution.
- There are also federal and state criminal statutes that may apply.
- In Texas, there are also a number of more exotic criminal offenses.

Criminal Liability

- There is a criminal charge for misapplication of fiduciary property. Tex. Penal Code 32.45.
- A person commits the offense of misapplication of fiduciary property by intentionally, knowingly, or recklessly misapplying property he holds as a fiduciary in a manner that involves substantial risk of loss to the owner of the property. Tex. Penal Code Ann. § 32.45(b).

Criminal Liability

- Financial exploitation of the elderly is a criminal offense in Texas. Tex. Pen. Code § 32.53.
- “A person commits an offense if the person intentionally, knowingly, or recklessly causes the exploitation of a child, elderly individual, or disabled individual.” *Id.* at 32.53(b).
- “Exploitation” means the illegal or improper use of a child, elderly individual, or disabled individual or of the resources of a child, elderly individual, or disabled individual for monetary or personal benefit, profit, or gain. *Id.* at 32.53(a)(2).

Conclusion

- Because financial institutions impact so many different aspects of a person's life, the law provides very different duties that institutions owe.
- There is no one-size-fits-all duty.
- The author hopes that this presentation has been helpful to frame the right duty owed depending on the relationship.