TRUSTEE CONFLICTS OF INTEREST IN TEXAS–REVISITING *RISSER*

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I. Background

As financial institutions have grown in size and complexity, the potential for conflict of interest claims arising from those institutions' activities as trustees have increased as well. The leading Texas case in the area, *InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882 (Tex. App.—Texarkana 1987, no writ), *disapproved on other grounds by Texas Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240 (Tex. 2002), was decided before the explosive growth of banking institutions and Congress's passage in 1999 of the Gramm-Leach-Bliley Act. *See* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.). In today's financial world, large banks have lending, deposit, investment banking, and cash management relationships with untold numbers of businesses around the country and the world. Likewise, most large companies have banking and investment banking relationships with numerous institutions. As banks have expanded their size and their services, the number of potential conflicts of interest also has expanded. In this complex landscape, the potential liability facing a bank trustee when, acting on behalf of a trust, it does business with a bank customer is an important issue that will increasingly arise. The vague liability standard adopted in *Risser* does not reflect today's economic or regulatory reality or the manner in which today's financial institutions operate and should be revisited in light of subsequent developments.

II. *Risser*

Reduced to their essence, the complicated facts of *Risser* can be summarized as follows: InterFirst Bank Dallas, N.A. (InterFirst) was the trustee of trusts that owned stock in Southwest Pump Company (Southwest). Southwest was also an InterFirst commercial banking customer. In December 1980, InterFirst sold the 968.5 shares of Southwest it held in trust back to Southwest for $500,000 ($512.26/share). Some of the beneficiaries of the trust filed suit against InterFirst, alleging it had breached its fiduciary duties by selling the Southwest stock at below market value to benefit its customer, Southwest, and thereby enhanced Southwest's ability to repay its loans to InterFirst. A jury awarded the beneficiaries $1,000,000 in actual damages and $10,000,000 in exemplary damages.

The fair market value of the Southwest stock at the time of the sale was hotly disputed at trial; however, on appeal, the court of appeals determined that there was sufficient evidence to support the jury's finding regarding market value. On liability, the court of appeals held that an "excessive variation" between fair market value at the time of the sale and price received in the sale could be considered evidence of bad faith and that a self-serving motive could be inferred because InterFirst was "in the position of obtaining an advantage to itself as a lender to Southwest." *Risser,* 739 S.W.2d at 905. There was no evidence that commercial bankers at InterFirst attempted to influence the transaction, so liability was primarily predicated on two factors—the allegedly inadequate price received by the trust and the existence of a lending relationship between InterFirst and Southwest.

Interestingly, *Risser* is not a model of consistency and the *Risser* court made several observations somewhat at odds with its holding. The *Risser* court observed that (1) the "mere fact that InterFirst lent money to Southwest . . . did not constitute self-dealing or bad faith," *id.* at 900; (2) a bank trustee is not prohibited from doing business on behalf of a trust with a loan customer of the bank or from engaging in

reasonable conduct relating to that loan relationship, such as meals and entertainment, *id.* at 901; (3) a sale by a trustee "at a price which is slightly less than the fair market value is not alone enough to create liability," *id.* at 905; and (4) a bank's loan customer is not a "business associate" with whom the bank as trustee is prohibited from doing business under Texas Property Code § 113.052(a)(4), *id*. at 896. A bank trustee confronted with a claim under these circumstances is faced with a vague standard based on a jury's *post hac* valuation of the asset sold, which in turn is inevitably affected by hindsight. (The vagueness of this standard is demonstrated by the evidence of fair market value in *Risser*, where the testimony on value ranged from $200 per share to $3,996 per share, with the jury adopting a mid-range value of $1,500 per share. *See id.* at 890.) Thus, under *Risser*, a trustee doing business on behalf of a trust with a commercial customer of the bank proceeds at its own risk, even if those making decisions for the bank as trustee are unaware of the commercial relationship. The poorly-defined liability standard adopted in *Risser* exposes bank trustees to second-guessing with millions of dollars at risk, and may ultimately adversely affect the beneficiaries of the trusts they administer by chilling the trustees' activities.

III. The Chinese Wall

In today's banking world, the Office of the Comptroller of the Currency (OCC) requires that national banks that exercise fiduciary authority adopt written policies and procedures to "ensure[] that fiduciary officers and employees do not use material inside information in connection with any decision . . . to purchase or sell any security . . . and prevent[] self-dealing and conflicts of interest." 12 C.F.R. § 9.5(b)-(c) (2015). The Federal Reserve and the Federal Deposit Insurance Corporation have made similar pronouncements about procedures at state member or nonmember banks. *See* Policy Statement Concerning Use of Inside Information, 43 Fed. Reg. 12755, 12756 (Mar. 27, 1978); *Trust Examination Manual* § 8(D.1), FDIC (last visited June 8, 2015). An information barrier or "Chinese Wall" is an important part of these procedures.

A Chinese Wall is intended to prevent the flow of information between a bank's trust department and other areas of the bank, such as commercial lending and investment banking. A common method to implement this barrier is to restrict communications between the trust department and the commercial and investment banking departments, to physically separate the trust department from other areas of the bank, to prevent the trust department's access to paper and electronic documents in the commercial and investment banking departments, and even to operate the trust department as a semi-autonomous business. In *Risser*, while the court briefly discussed the protection that could be afforded by a Chinese Wall, InterFirst had no Chinese Wall. *Risser*, 739 S.W.2d at 903-904. Further, it was not disputed that InterFirst's commercial banking department was aware that the trustee sold the Southwest stock to Southwest or that InterFirst's trust department was aware of Southwest's commercial lending relationship with InterFirst. Thus, the impact of a Chinese Wall on conflict of interest claims of this nature is an open question in Texas.

The primary basis of claims in this situation is the duty of loyalty. As recognized in *Risser*, one owing a fiduciary duty violates its duty of loyalty when it "use[s] the position of trust to obtain an advantage by action inconsistent with the trustee's duties and detrimental to the trust." *Id.* at 888. Since *Risser*, trustee defendants have begun to rely on the information barrier as a defense to conflict of interest claims, arguing that the absence of communication between the trust department and other areas of the bank prevent a conflict, because absent influence being brought to bear by commercial or investment bankers, the bank as trustee cannot be said to have used its position of trust to gain an advantage over the beneficiaries. A recent decision from Judge Shira Scheindlin of the Southern District

of New York in *Aftra Retirement Fund v. JPMorgan Chase Bank, N.A.*, 806 F. Supp. 2d 662 (S.D.N.Y. 2011), supports the position that information barriers or Chinese Walls are an effective defense to claims based on the duty of loyalty, as well as the duty to disclose.

In *Aftra*, JPMorgan invested certain of its clients' cash collateral in "medium-term notes"—a structured investment vehicle offered by a company called Sigma Finance, Inc. (Sigma). Some of those clients were plans covered by ERISA. *Id*. at 665. In the same timeframe, JPMorgan's investment bank began extending "repo financing" to Sigma. *Id*. at 671. Sigma later collapsed, rendering the notes virtually worthless. JPMorgan as a repo lender later sold many Sigma assets pursuant to its repo agreements, although there was a dispute whether JPMorgan made a profit or lost money in connection with the repo financing. JPMorgan's investor clients sued alleging, among other claims, breaches of the duty of loyalty and of the duty to disclose.

Initially, Judge Scheindlin recognized the rapidly changing landscape of the banking world, noting that earlier cases decided before these changes were inapplicable because courts in the past "could not have predicted the scale of modern-day multi-service financial institutions, the scope of services they would be permitted to offer simultaneously, and the information barriers they would be required by law to erect in order to avoid liability for insider trading and related conflicts-of-interest." *Id.* at 688. While information barriers began as a method to prevent the transmission of nonpublic information between areas of the bank, Judge Scheindlin determined they also prevent "(1) banks' commercial relationships from 'influencing the advice and decisions made by the fiduciary in its fiduciary capacity' and (2) the 'theoretical possibility' that a bank might 'extend[] credit in order to improve the performance of its trust accounts.'" *Id.* at 689 (alteration in original) (footnotes omitted). She also observed that if it was improper for a bank to act as a secured lender for an entity with whom it does business in a trust capacity, "that conclusion surely would be reflected in the extensive regulations that govern the banking industry." *Id.* at 690.

Judge Scheindlin also relied on the existence of JPMorgan's information barrier in rejecting the plaintiffs' claim that the bank had a duty to disclose (1) that it had a conflict of interest because of its dual roles as a repo lender and a discretionary investment manager and (2) that it knew that Sigma would fail as a result of knowledge gained in its capacity as Sigma's repo lender. *Id*. at 693. The court concluded that JPMorgan had no conflict of interest that had to be disclosed: "As [JPMorgan] rightly notes, '[c]rediting plaintiffs' new disclosure theory would turn banking law and regulation on its head, eviscerating information walls . . . making it practically impossible for banks to offer secured financing to issuers of securities held in fiduciary or custodial accounts.'" *Id*. at 694 (alteration in original).

Thus, *Aftra*, combined with some aspects of *Risser*, suggests the direction Texas law should proceed, both as to the duty of loyalty and the duty of disclosure. As recognized in *Risser*, a lending relationship between a bank and an entity with which it does business in a trust capacity is not prohibited. However, *Risser* holds such relationships, when coupled with the vague concept of an "excessive variation" between price received and fair market value determined by a jury, is enough to impose liability. In light of the changes in the banking world since *Risser* was decided and the implementation of information barriers the bank did not have in *Risser*, liability should only arise where there is evidence that the information barrier has been breached, and that communications from the nontrust areas of the bank have caused the bank, in its trust capacity, to breach its duty of loyalty.

As recognized in *Aftra*, any other rule would logically result in chilling the legitimate activities of banks. Although the particular activities at issue in *Aftra* did not involve a bank acting as trustee for a trust, the concepts are no different. If a bank acting as trustee cannot enter into any transaction with a

third party who is also the bank's commercial customer, without fear of later claims that the price it received rendered it liable for a breach of its duty of loyalty or that it should have identified and then disclosed the customer relationship to its beneficiaries, the natural result is to chill legitimate trust activities.

IV. Conclusion

Risser was decided twenty-eight years ago. In the interim, the banking world has changed. Absent evidence that a breach of the information barrier occurred and influenced the bank in its trust capacity to act to the detriment of its customer-beneficiaries, a bank trustee should be free to do business with anyone on behalf of its trust customers without fear that subsequent appreciation of an asset sold by the trustee will render it liable to hindsight evaluation and liability.