Mennen Development: Delaware Supreme Court Affirms Court of Chancery Decision on Direction Adviser Liability

Introduction

On June 21, 2017, the Delaware Supreme Court affirmed a landmark decision by the Delaware Court of Chancery (the "Court") that found an "adviser," within the meaning of 12 Del. C. § 3313, liable for breach of his fiduciary duties. This decision is especially noteworthy because it provides significant insight into the Court's views with respect to the willful misconduct and bad faith standards of liability as well as the application of virtual representation principles to the statute of limitations defense. While we previously summarized the Court's substantive analysis of these issues when the Master's Draft Report was issued in 2014, and again when the Master's Final Report was issued in 2015, the long and somewhat complicated history of this case and the weight of its importance warrant additional presentation of its analysis.

This most recent ruling comes slightly more than a month after the Delaware Supreme Court affirmed another decision in the Mennen litigation in which the Court confirmed the strong protections afforded to beneficiaries of Delaware third-party spendthrift trusts. Our analysis of that decision is available here.

Background

Pursuant to a trust agreement dated November 25, 1970 (the "Trust Agreement"), George S. Mennen (the "Settlor") created a trust (the "Trust") for the benefit of John Mennen ("John") and his descendants. John has four children, Kathryn Mennen, Sarah Mennen, Alexandra Mennen, and Shawn Mennen. Wilmington Trust Company was the corporate trustee of the Trust (the "Trustee") and John's brother, Jeffrey Mennen ("Jeff"), was the individual co-trustee (sometimes referred to herein as the "co-trustee" or "adviser"). The Trust Agreement provides that the Trustee acts solely at the direction of the individual co-trustee with respect to the exercise of certain investment powers. The beneficiaries alleged that Jeff directed the Trustee to invest substantially all of the assets of the Trust in start-up companies in which Jeff was personally interested as an investor, director, or officer resulting in a decline in value from more than $100 million to $25 million over a period of approximately 20 years. The Trustee became increasingly concerned that the beneficiaries would bring claims against it and filed a petition with the Court to remove Jeff, for the appointment of a successor co-trustee, and to access certain investment information that Jeff was allegedly withholding. Shortly thereafter, the beneficiaries brought claims for breach of trust against both the Trustee and Jeff and also brought a claim against a trust that was established by the Settlor for Jeff, seeking a transfer of its assets from that trust to the Trust on equitable grounds. The beneficiaries settled their claims against the Trustee for an undisclosed amount but their claims against Jeff proceeded to trial in February of 2014.

On December 8, 2014, the Honorable Abigail M. LeGrow (now a Delaware Superior Court Judge), then serving as a Master in Chancery (in that capacity referred to herein as "Master LeGrow"), issued a draft report (the "Draft Report") entering a judgment against Jeff in the amount of $72,448,299 plus interest, finding that Jeff had engaged in an extensive pattern of bad faith misconduct. On April 24, 2015, after considering the parties' exceptions to the Draft Report, Master LeGrow issued a final report (as revised April 27, 2015, the "Final Report") increasing the judgment against Jeff to $96,978,299.93 plus pre-judgment interest of 7.75% compounded quarterly. Master LeGrow also expounded upon her analysis of the definition of "good faith" and the application of Delaware's virtual representation statute, 12 Del. C. § 3547. Following briefing on Jeff's exceptions to the Final Report, on August 18, 2015, Vice Chancellor J. Travis Laster issued an order adopting Master LeGrow's Final Report wherein Vice Chancellor Laster expressly "agree[d] with the analysis conducted in the Final Report." Thereafter, on December 8, 2015, Vice Chancellor Laster entered an order and final judgment (the "Final Order") in the amount of $86,599,200.26 plus $18,387.50 per day in post-judgment interest after accounting for lost principal, pre-judgment interest and all applicable set-offs. An appeal followed and, on June 21, 2017, Justice Collins J. Seitz, Jr. of the Delaware Supreme Court entered an order affirming the Final Order based on the reasons stated in Master LeGrow's Final Report. Having now withstood *de novo* review by Vice Chancellor Laster and appellate review by the Delaware Supreme Court, we reprise our analysis of Master LeGrow's Final Report below.

Alteration of Standard of Liability Validated

Importantly, the Court in Mennen acknowledged: "That settlors are accorded wide latitude to structure their trusts in a manner that varies from the default statutory scheme or the common law is a hallmark of Delaware's Trust Act". The Court concluded that the standard of liability applicable to Jeff was constrained in two respects. First, the Trust Agreement exculpates the co-trustee from losses to the trust estate so long as the co-trustee acted in "good faith." Second, under 12 Del. C. § 3303, the Trust Agreement may not exculpate the co-trustee for willful misconduct. The Court noted that prior to 2003, Delaware courts were precluded from exculpating a trustee from gross negligent conduct, however, the enactment of 12 Del. C. § 3303 overrides that principle with respect to trusts whenever created, and "[t]his Court is bound by the General Assembly's instructions and the Trust Agreement's exculpatory clauses therefore must be read as excusing grossly negligent conduct." The Court respected these limited standards of liability, which deviate from the common law, as well as the provisions waiving the prudent investor rule or any duty to diversify. The Court held that a trustee is "twice tested" under Delaware law, with the Court first considering whether the trustee was empowered under the law of a governing instrument to act in a certain manner, and then considering whether those actions, if permitted, were a breach of the trustee's fiduciary obligations. However, the Court continued, when "a grant of powers is combined with an exculpatory provision, a trustee is effectively insulated from liability, even under the 'twice tested' analysis, provided the exculpatory provision in question is enforceable and the trustee's conduct fell within it."

Distinguishing Willful Misconduct from Bad Faith

The Court distinguished willful misconduct from bad faith (the Court used bad faith as synonymous with the absence of good faith). It held that willful misconduct applies only "a subjective standard that depends on the alleged wrongdoer's state of mind," requiring "malicious conduct or conduct designed to defraud or seek unconscionable advantage," as provided in 12 Del. C. § 3301(e). In contrast, good faith is defined as "honesty in fact and the observance of reasonable standards of fair dealing." The Court held that bad faith is a standard that includes both a subjective and objective element. The "honesty in fact" portion of the definition refers to what the fiduciary subjectively believed. In contrast, the Court held that "the 'observance of reasonable standards of fair dealing' portion of the definition is objective and requires the Court to consider whether the trustee acted beyond the bounds of a reasonable judgment." The Court held: "[t]o the extent that the record shows – as it does – that some of Jeff's investment decisions were motivated by Jeff's preference for his personal interests, those decisions are, by definition, bad faith, if not willful misconduct, and are not exculpated by the Trust Agreement."

While the Court found that some of the Trust's bad investments were motivated, in part, by Jeff's personal financial interests, the Court appeared deeply troubled by Jeff's apparent "interest in establishing or maintaining his self-created persona as a skilled financier" and his "fervent desire to prove his 'unique capabilities' and his personal interest in preventing the Mennen family from realizing the extent of Jeff's failures." The Court also found that Jeff had "deliberately obscured the true value of these investments in a bid to continue his unfettered access to the Trust to further his personal interests." The Court held that Jeff's "irrationality" and "unconsidered" and self-interested conduct was "so far beyond the bounds of reason that it cannot be explained by anything short of bad faith."

Jeff maintained that he performed "extensive and continuous" due diligence, demonstrating that he was not motivated solely by self-interest. However, there was no record of his due diligence and, consequently, the Court presumed that no such due diligence occurred in the absence of documented records. The Court noted that "[a] trustee has an independent duty to maintain records for the trust." On this point, it is valuable to note that it is advisable, and could become valuable, for a fiduciary to maintain adequate records of his, her or its due diligence.

Jeff also argued that the statutory definition of good faith applies only to the use of that term in the Delaware trust code, and not when the same term is used in trust agreements. The Court rejected Jeff's argument as inconsistent with the Delaware trust code and the Court's prior precedent. That Court noted that, if Jeff's position was accepted, the Court may potentially be required to apply two different standards of good faith to a trustee's actions.

Statute of Limitations and Virtual Representation

Jeff argued that the claims brought against him by the beneficiaries were barred by the equitable doctrine of laches. The Court noted that it frequently uses an analogous statute of limitations period for the presumptive limitation period when analyzing a laches claim. Jeff argued that, pursuant to 12 Del. C. § 3583, the claims were barred upon the earlier of (i) two years after the date John received a report that adequately disclosed the facts constituting a claim, and (ii) the date the claims were otherwise precluded by a limitations period. Jeff argued that the date such claims were precluded was three years, which is the limitations period for breach of fiduciary duty under 12 Del. C. § 3585(a) and 10 Del. C. § 8106.

Notably, all but one of the challenged investments had been disclosed in monthly or quarterly statements received by John since at least 1980. Moreover, all but one of the investments occurred before March 22, 2010 and, consequently, Jeff argued that each such transaction was barred by the applicable three-year limitations period.

The Court noted that any statute of limitations applicable to John's children was tolled until they reached an age of majority. John's oldest child, Shawn, was unable to represent his minor siblings because of a disability and John's next oldest child, Katie, did not turn 18 until September 3, 2010. Consequently, the Court noted that the claims against Jeff were not time-barred unless the beneficiaries that turned 18 less than three years before the action could be virtually represented by John under 12 Del. C. § 3547.

The Court noted that under 12 Del. C. § 3547(a), "Delaware's virtual representation statute unambiguously limits virtual representation to circumstances where the putative representative has 'no material conflict of interest.'" The Court found that the beneficiaries' claims were not tolled because John has a material conflict of interest that precluded him from virtually representing his minor children under Section 3547. The Court found that John could not represent his children with respect to the challenged investments because he was unable to overcome the statutory presumption under 12 Del. C. § 3547(e)(3) that he had a material conflict of interest with his children. The Court reached this conclusion based on two factual findings. First, the Court found that John placed nearly complete emphasis on receiving income from the Trust, without any apparent regard for capital growth or long-term stability of the Trust. Specifically, the preponderance of John's testimony was that he judged Jeff's performance with respect to the Trust by reference to whether he received monthly distributions from the Trust without giving any consideration as to the viability of the Trust in the long-term. The Court concluded that because John placed so much emphasis on his receipt of regular distributions, he had a "differing investment horizon or an interest in present income over capital growth," which alone would be sufficient evidence of a material conflict of interest for purposes of Section 3547. Second, the Court found that John was so beholden to Jeff emotionally and financially that he could not take action to remedy Jeff's bad faith conduct and was unable or unwilling to consider the interests of the minor beneficiaries.

Jeff presented the additional argument that the Court should apply an objective rather than a subjective test to determine whether a material conflict exists between a putative representative and the other beneficiaries. More specifically, Jeff espoused the theory that if a person of ordinary intelligence could have virtually represented his minor children under similar circumstances, the Court should not consider the specific relationship between the parties before it. The Court rejected this argument in the Final Report for a few reasons. First, the Court stated that if Jeff's argument was the result that the legislature intended when enacting and amending Section 3547, the legislature could have simply defined what constitutes a material conflict and what does not. Second, the Court stated that an objective standard would be ill-suited to address the various relationships between parties that appear before the Court in trust matters. According to the Court, the likely result of applying Jeff's argument to the Court's Section 3547 analysis would be to unduly eliminate virtual representation in some cases where no actual conflict exists, while permitting virtual representation when the factors in a particular case demonstrate that a conflict plainly existed. Finally, the Court construed certain statutory amendments to Section 3547 as showing that the legislature intended that the Court rely on subjective factors. The Court indicated that reliance on subjective factors would be the only way to overcome a presumption of a conflict under Section 3547.

Jeff also argued that the reference in Section 3547 to a "material conflict … with respect to the particular question or dispute" means that John did not have a conflict with his minor children because his interests are aligned with his children's in the litigation. The Court concluded that this reading ignores the substance of Section 3547 and, instead, construed that language to mean that the interests of John and his minor children must be aligned at the time the alleged representation occurred. The Court continued to state that the issue of virtual representation as it applies to a laches analysis is not whether the parties' interests are aligned in the action in which a laches defense is raised, but instead whether the interests were aligned at the time the representation allegedly occurred.

Finally, Jeff argued that certain claims brought against him were barred because John had acquiesced in some of the troublesome investment decisions made by Jeff. However, the Court held that Jeff could not prove that John acquiesced to such transactions because he did not have full knowledge of all of the material facts. Moreover, the Court noted that, even if Jeff could prove that John acquiesced to those investments, the defense would not extend to the other Trust beneficiaries because John had a material conflict of interest that precluded him from representing their interests under 12 Del. C. § 3547.

Conclusion

Mennen has proven to be one of the most significant Delaware trust cases to address fiduciary liability and virtual representation in recent years. Not only did the Court confirm in Mennen that it will honor, subject to statutory limitations, the standard of liability selected by a settlor in a trust's governing instrument, it also demonstrated how it will apply the frequently used standards of good faith, bad faith and willful misconduct. Furthermore, Mennen guides fiduciaries, beneficiaries and practitioners regarding the application of Delaware's virtual representation statute and illustrates a scenario under which a material conflict of interest might prevent a beneficiary from representing other beneficiaries. While the facts of the case are unique, Mennen teaches valuable lessons that will be applicable in a myriad of situations.

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