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No. 33966-8-II

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

NANCIE HATHEWAY,

Appellant,

v.

U.S. TRUST COMPANY, N.A., a Connecticut corporation,

Respondent/Cross Appellant.

APPELLANT'S BRIEF

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A. INTRODUCTION

Do statements of a client about risk release a fiduciary from its duties to seek the client's best interest? Does reliance upon these statements satisfy a fiduciary's duty? Does Washington's Investment of Trust Funds Act apply to investment managers who are fiduciaries and have been given complete discretion over a client's account?

These are questions of first impression in Washington. No Washington case has addressed the parameters of the duty owed by investment managers who have been given complete discretion over an investment account. Courts that have faced this issue in other jurisdictions have held that the investment manager is a fiduciary under duty to serve the best interests of a beneficiary. These decisions from other jurisdictions provide persuasive authority for the definition of U.S. Trust's fiduciary duties to Ms. Hatheway.

The Investment of Trust Funds Act (RCW Chapter 11.100) codifies the historic prudent investor's rule applicable to fiduciaries and incorporates into it the modern corollary of total asset management (see, RCW 11.100.020.

Here the Trial Court correctly found that U.S. Trust was a fiduciary for Ms. Hatheway's account (Finding No. 3, Clerk's Papers ["CP"] at 689). Indeed, Ms. Hatheway relied upon U.S. Trust's expertise in managing investments. The trial court effectively eviscerated its holding that U.S. Trust was a fiduciary in holding that U.S. Trust had the right to rely on Ms. Hatheway's statements as to her purported "high tolerance for risk" (Findings 9, 10, CP 690), rather than acting as a fiduciary in her objective best interest. The Court's focus on Ms. Hatheway taking an active interest in her account (Findings 5-19, 26, 27, Conclusion No. 5, CP 689-92; Oral Decision, Report of Proceedings [RP] 783-87) avoided the question as to whether Ms. Hatheway's statements and attention to her account acquitted U.S. Trust of its fiduciary duty as her investment manager with complete authority over her account, particularly where it assured her that her account was well diversified (e.g., Ex. 497) so as to protect her in a market downturn (Ex. 39, 490). The Court's holding that - since it was her money, it was not U.S. Trust's place to caution Ms. Hatheway about the level of monthly withdrawals against a falling account balance in a severe bear market, also begs the question as to an investment manager's duty as a fiduciary to avoid speculation. (See, e.g., Finding No. 22, CP 691; Oral Decision, RP 784, line 22 to 785, line 4.) Ms. Hatheway retained U.S. Trust as her fiduciary to use its expert investment management skills, not simply to hold, watch, disburse, report on, and talk with her about her funds.

B.1 STANDARD OF REVIEW

On appeal after a bench trial, the appellate court determines whether the challenged findings of fact are supported by substantial evidence in the record, and if so, whether the findings support the conclusions of law. *Bank of America, N.A. v. Wells Fargo Bank, N.A.*, 126 Wn. App. 710, 714, 109 P.3d 863 (2005). Substantial evidence exists if the record contains "evidence of sufficient quality to persuade a fair minded rational person of the truth of the declared premise." *World Wide Video, Inc. v. City of Tukwila*, 117 Wn.2d 382, 387, 816 P.2d 18 (1991). Questions of law are reviewed de novo. *Bank of America, N.A,* 126 Wn. App. at 714.

B.2 ASSIGNMENTS OF ERROR

1. The Trial Court erred in entering the Conclusion of Law embedded in Finding of Fact No. 10, which reads: "Defendant was entitled to rely upon Ms. Hatheway's representations regarding her high tolerance for risk." (CP 690)

2. The Trial Court erred in entering Findings of Fact Nos. 4, 5, 6, 7, 8, 9, 10, 17, 20, 21, 22, 25, 27, 28 (CP 689-90), to the extent that each is based upon (a) the Court's finding that Plaintiff Hatheway told Defendant U.S. Trust that "she had a high tolerance of risk"; or (b) that therefore the assets of her account were properly allocated and diversified.

3. The Trial Court erred in entering Conclusion of Law No. 5 (CP 692) which reads: "Defendant cannot be held liable for a loss in an account that results from a downturn in the market, rather than a breach of the agreement or a duty arising from that agreement."

4. The Trial Court erred in holding the Investment of Trust Funds Act, RCW Chapter 11.100. did not apply to this case (CP 554).

5. The Trial Court erred in awarding U.S. Trust judgment against Ms. Hatheway for U.S. Trust's reasonable attorneys' fees of $87,673.37 and costs of $100.00 (RP 808, line 20 to 810, line 7; CP 701-02; Conclusions of Law on Motion for Attorneys' Fees, No. 13 at CP 700.)

C. ISSUES PERTAINING TO ASSIGNMENTS OF ERROR

1. Whether the trial court erred in failing to apply the proper standard of care owed by an investment manager to a client where the investment manager has complete discretion over the client's account, where courts in other jurisdictions have held that an investment manager has a fiduciary duty to serve the best interests of a client, where Washington has historically applied the prudent investor's rule to fiduciaries, and where the trial court held that U.S. Trust was a fiduciary but that U.S. Trust could discharge its duty by relying upon statements the

Court attributed to the investor that she had a "high tolerance for risk." (Assignment of Error Nos. 1, 2, 5.)

2. Whether the trial court erred in failing to apply the proper standard of care owed by an investment manager to a client where, in a bear market, the investment manager failed to warn the client that continuing the client's monthly withdrawals would deplete the client's reduced account prematurely, and where the investment manager failed to have in place a process to rebalance the client's asset allocation which would have allowed the account to meet the client's monthly needs and would have avoided much of the market loss in the client's account, even though the investment manager had complete discretion over the client's account and the trial court held that the investment manager was a fiduciary for the client's account. (Assignment of Error Nos. 3, 5.)

3. Whether the trial court erred in holding that the Investment of Trust Funds Act, RCW Chapter 11.100, did not apply to an investment manager who was a fiduciary with complete discretion over the client's account. (Assignment of Error Nos. 4, 5.)

4. Whether the Court's Findings on "high tolerance for risk" are supported by substantial evidence (Assignment of Error No. 2).

D. STATEMENT OF THE CASE

1. Procedure. Plaintiff Nancie Hatheway brought this action to recoup losses in her investment management account with Defendant U.S. Trust Company (CP 1-6). Her claims under the Washington Securities Act, RCW Chapter 21.20, were dismissed on Summary Judgment (CP 553-55), which she does not appeal. Her claims for breaches of contract and of fiduciary duty proceeded to trial. The Court also held that RCW Chapter 11.100, the Trust Funds Investment Act did not apply (CP 554). After trial, the Trial Court, the Honorable Lisa Worswick, denied Ms. Hatheway's claims (CP 688-93) and under the investment management contract between the parties (Ex. 190) awarded U.S. Trust its reasonable attorneys' fees and costs (CP 701-02). Ms. Hatheway appeals the Court's denial of her claims and the award of attorneys' fees to U.S. Trust, asking that the decision below on liability be reversed and the case be remanded for a hearing on the damages she is entitled to recover from U.S. Trust for breach of its fiduciary duties to act in her best interest, as well as a determination as to the reasonable attorneys' fees she is entitled to recover, at the trial, on this appeal, and on the proceedings on remand.

2. Statement of Facts.

(a) Ms. Hatheway's Funds Came From an Inherited Windfall. Nancie Hatheway inherited from her deceased husband his shares of stock in a start-up Company, Cybex, that he had received in lieu of salary (RP 153, 157, 395). Some years after his death, Cybex went public and she sold all of her shares in the IPO, netting after taxes about $1.5 million.

(b) Ms. Hatheway Entrusted U.S. Trust With Complete Discretion Over Her Account. In 1996 she placed $1.3 million of this account under an "Investment Account Management Agreement - Letter Agreement" with U.S. Trust Company (RP 161-62), giving U.S. Trust complete discretion[1] over her account (Ex. 190, Section 1).

(c) Her U.S. Trust Investment Objectives Were to Provide Her a Stable Income and to Preserve Principal Over the Long Term. Ms. Michelle Dicus, a Certified Financial Analyst ("CFA") and Ms. Hatheway's first assigned Investment Account Manager at U.S. Trust, prepared an Investment Policy Statement (Ex. 11) for Ms. Hatheway targeting the allocation of her account to equities at 65% to 85% and

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1 In criminal law and the law of torts, It [discretion] means the capacity to distinguish between what is right and wrong, lawful or unlawful, wise or foolish, sufficiently to render one amenable and responsible for his acts." Black's Law Dictionary (6th Ed. 1990).

setting out the purposes and objectives for her account: (1) She needed the account to provide a stable income from which she would withdraw funds to meet living expenses, and (2) although "comfortable with taking risk" she needed to "preserve principal for retirement" (RP 220) so the account would last "over the long term", as she had no way to replace it.

(d) Her Account Would Support Her Increased Withdrawals As Long as "Returns Remained Reasonable". When she later medically retired, she asked to increase her monthly draw to $7,000 per month and she was advised by Ms. Dicus that to do so the account "would have to work a bit harder", but it would work out "if returns remained reasonable." (Ex. 35; RP 165, 267, 317-18, 382.) Mathematically, if returns did not "remain reasonable," meeting that level of withdrawal without a change in asset allocation would require the investment manager, in effect, to bet on the market (RP 271-72) - in violation of its fiduciary duty to avoid speculation under the prudent investor rule.

(e) Mr. Yandle Repeatedly Wrote That Ms. Hatheway Was "Comfortable With a Prudent Amount of Risk". Ms. Dicus left U.S. Trust in late 1997 and Mr. Yandle was hired and assigned to manage her account. He first stated in U.S. Trust's 1997 year-end report on her account that Ms. Hatheway was "comfortable with a prudent amount of risk" (Ex. 45); and this risk assessment was repeated by Mr. Yandle in subsequent year-end reports (e.g., Ex. 525, 530). When he rewrote the Investment Policy Statement in February 1998 (RP 162), he again stated that Ms. Hatheway "felt comfortable with taking risk," (Ex. 51). Tellingly, when he next revised that assessment in September 1998, there was no reference to "a high tolerance of risk" rather, he set the investment objectives as: "principal appreciation **with decreased risk** and volatility"; to produce $84,000 per year in income **"and to grow/protect the principal for the balance of her retirement years"**, with equities targeted at 80%. On page two of Mr. Yandle's September 1998 Investment Policy Statement of her account he stated that diversification was to be coupled with **"reduced risk"**. (Id.) (Ex. 497)

(f) Ms. Hatheway Was an Investment Novice Who Paid Close Attention to Her Account. Ms. Hatheway's experience in the stock market had consisted of watching her husband invest about $1,000 in penny stocks (RP 157-58), years later selling the Cybex shares that he had earned before he died and that she had inherited, and then maintaining a modest portfolio outside the U.S. Trust Investment Account (RP 80-81). She was, however, a stickler for details (RP 401-02, 454, 671-72) and managed to annoy U.S. Trust over mistakes it made in administration of her account (RP 217), and she tried to follow her account balances carefully. She received detailed monthly account statements (RP 163) and generally met quarterly with her U.S. Trust Investment Account Manager and her companion, Frank Underwood (Id., who had introduced her to U.S. Trust, for discussion of her account.

(g) U.S. Trust Represented Her Account Was Diversified Such That She Would Not be Badly Hurt in a Downturn. In the fall of 1997, during the interim between Ms. Dicus leaving U.S. Trust and Mr. Yandle being hired by U.S. Trust, Mr. Lawrence W. ("Tige") Harris III, U.S. Trust Senior Vice President, Chief Investment Officer, wrote to Ms. Hatheway relative to her account and the current financial scene, stating: **"Your investments are diversified in a way to allow you to continue to benefit from rising markets while not investing so much in volatile securities that you will be badly hurt in a downturn."** (Ex. 39)

(h) Mr. Zander, a Financial Planner With U.S. Trust Stressed the Need for Mr. Yandle's Continuing Attention to the Asset Allocation of Ms. Hatheway's Account. As an additional service for its investment account clients, in November 1997, as part of Mr. Yandle's first meeting with Ms. Hatheway, U.S. Trust offered to provide her and Mr. Underwood long term financial planning and counseling through Mr. Christopher Zander of the U.S. Trust New York office (Ex. 461). As noted by Mr. Yandle in his September 1998 Investment Policy Statement (Ex. 497), they accepted the proffered consultation contract and over the next year and one-half Mr. Zander and his staff devoted their expertise, time and energy in working through the complex financial and estate planning issues that Ms. Hatheway and Mr. Underwood would face as their respective retirements approached (Ex. 466, 481, 123, 124, 506, 510, 512).

Mr. Yandle and Ms. April Sanderson were present at some of the meetings and were tasked by Mr. Zander to provide a "continuing platform" for reviewing the investment asset allocations (e.g., Ex. 124, p. 4). Mr. Zander noted that Mr. Underwood's asset allocation was "conservative" and Ms. Hatheway's was "more aggressive," which could mean their heirs might fare differently (Ex. 506). On concluding his work, in his April 9, 1999 letter, Mr. Zander reassured them that "there is no need for a higher risk portfolio" (Ex. 124, p. 2) and urged them to look to Mr. Yandle "over time to amend the allocations based on his views of the market, . . ." and changes in their situation (Id, p. 3). Ms. Sanderson was copied on all seven of the Zander missives, and Mr. Yandle on the last four, but Mr. Yandle did not remember ever receiving Mr. Zander's correspondence, nor did he act on Mr. Zander's direction for them to provide continuing advice and direction as to changes in asset allocation with Ms. Hatheway until September 2002 (e.g., RP 48 at 121; RP 645-46).

(i) Ms. Hatheway Asked for a Defensive Strategy in a Market Downturn. In 1998, as the equities in her account were moving up in value, she and her companion asked that U.S. Trust put in place a defensive strategy to protect against a stock market downturn (Ex. 490; RP 215-16, 759). U.S. Trust took no such action (RP 216). Instead, on occasion Mr. Yandle recommended that she be 100% invested in equities (RP 102, 185, 461). In the bull market from October 1998 to August 2000, her account rose in value, despite the monthly withdrawals, to over $2.1 million (Ex. 627, pages 3-5), and as the equities side went up, the asset allocation between equity and debt (or "fixed income") assets drifted from its strategic target levels of 80% equity and 20% fixed income to a higher risk allocation of 92% equity, 8% fixed income (Id). In his second 1998 revised Investment Policy Statement (Ex. 51) Mr. Yandle set out asset allocation "Strategic Targets" for the balance between equity and fixed income assets at 80% equity and 20% fixed income, but installed "tactical ranges" allowing for a 100% allocation of her account in equities, effectively negating the prudent balancing required of U.S. Trust as her fiduciary, and effectively nullifying the stated goal of fixed income assets providing liquidity for distributions and of **"mitigating the risk of equity exposure"** (Ex. 51).

(j) Ms. Hatheway Asked For An Increased Allocation to Fixed Income Assets. In their discussion of the September 30, 1999 quarterly report, Ms. Hatheway asked Mr. Yandle to increase the fixed income allocation to 15% (Ex. 521) and in December 1999 to reduce the allocation to volatile technical stocks (Ex. 525 at UST 0018919). He did neither (Ex. 511, 521, 525, 530, RP 194). From September 2000 into 2002, as a bear market overtook the earlier bull market, Ms. Hatheway asked Mr. Yandle to increase the fixed income allocation to 20% to 30% (RP 192, 462). As her stock balances dropped, in desperation she asked Mr. Yandle if she would have to go back to work (RP 169). He reassured her that it "would all work out" (RP 169, RP-YD 139-40).

(k) As the Market Dropped U.S. Trust Did Not Have a Process in Place to Pay Withdrawals Without Speculating on Market Returns. Ms. Dicus's review underscored that, in point of mathematical fact, as the account dropped in value and as the interest rates on fixed income assets dropped, the account could not produce $84,000 in income per year without "betting" on stocks increasing in value sufficiently so that the gain to be realized in selling the stock would cover the short fall in revenue from the fixed income assets (RP 271-72). This "betting" process being followed by U.S. Trust was, by definition, speculative - in violation of the prudent investor rule.

(l) In 2002, After Her Account Lost Some $1 Million, Ms. Hatheway Demanded That Mr. Yandle Propose an Investment Plan, Which He Was Able to Do Two Months Later. Finally, in July 2002, when Mr. Yandle proposed selling a host of equities, including one of the producing equities in her portfolio, and with her account down by almost one-half to a balance of $1.14 million, she demanded that he prepare a plan, and do so before any other securities were bought or sold (RP 177). Note, the July 2002 warning against panic selling by Fred Taylor, Vice-Chairman and Chief Investment Officer (Ex. 294) "even we were not immune to the irrational exuberance" of the 1990s [NH 002453], and "panic selling" or paralysis are not the answers [NH 002450]. Two months and a further loss of nearly $200,000 later (Ex. 627, p. 7), he proposed a prudent rebalancing of the account to 65% equities and 35% in fixed income and cash (Ex. 110, RP 630), explaining in his newly proposed Investment Policy Statement for her, that such an asset allocation was now appropriate, since she was now "acutely" aware of the risk in the equity markets (Ex. 110, 294), having lost over $1.1 million in value in the prior two years (Ex. 627 at 507, RP 193, 594).

(m) <u>If Mr. Yandle's September 19, 2002 Plan Had Been Timely Done in 2000, Her Account Would Have Avoided Losses of Between $51,500 to $400,000 or More</u>. Dr. Roger DeBard, the U.S. Trust expert (RP 537), acknowledged that if such a rebalancing had been done to 80% equity, 20% fixed income when Ms. Hatheway had first asked for it in late 2000, some $51,500 of losses would have been averted (RP 552-53, <u>compare</u>, RP 775). Michelle Dicus, Ms. Hatheway's expert, testified that if the asset allocation balance between equities and debt had been set at 65-35 (the strategic targets that Mr. Yandle came up with in September 2002 after the debacle (Ex. 107A)), when the interest rates on bonds began to drop in late 1997, or at any time through late 1998, Ms. Hatheway's account would have not only allowed her account to meet her withdrawals out of income, but would have avoided some $400,000 in losses in value (RP 309-312), despite the crushing bear market on the equities side. Contrary to the Trial Court's decision, these losses are thus due to U.S. Trust's inaction - not the bear market. In the summer of 2002, while waiting for Mr. Yandle's plan, as her account at U.S. Trust lost another nearly 20% in value (Ex. 627, p. 7), Ms. Hatheway had her account reviewed by Michelle Dicus, who had been her first Investment Manager at U.S. Trust, but had left U.S. Trust in 1997 to start her own company. Ms. Dicus's analysis pointed out where U.S. Trust's management of Ms.

Hatheway's investment account had failed (Ex. 306; RP 253-54, 266-272, 273-275). Ms. Hatheway moved the account to Ms. Dicus' investment management firm (Ex. 111).

E. ARGUMENT

1. Parsing the Oral Decision. While the Assignments of Error (Section B above) points to the Court's errors in its formal Findings and Conclusions, a parsing of the Court's Oral Decision elucidates the fatal, fundamental flaw in the Court's analysis of the case: namely that U.S. Trust could shift investment responsibility from itself as a fiduciary to Ms. Hatheway as the beneficiary. (In the text below, parts of the Court's oral decision are quoted in bold typeface.)

(a) By Its Focus on What Ms. Hatheway Said and Did, the Trial Court Wrongly Shifted the Responsibility for Management of Her Account From U.S. Trust, the Hired, Professional Fiduciary Manager, to Ms. Hatheway, the Client.

(i) What of the Plaintiff's Alleged "High Tolerance of Risk"? **"The Plaintiff told U.S. Trust that she had a high tolerance for risk." "[R]isk was discussed often. There were many face to face meetings and many discussions about her tolerance for risk"**, including discussions with Mr. Underwood about this (RP 783). (See, Argument, Section E.2(b)(ii) below.) References to "high tolerance of risk" permeated the oral decision and are at the core of the Court's error in its Findings and Conclusions (see, Assignments of Error 1, 2, 3), but these findings are not supported by substantial evidence . (See, Statement of Facts, Sections D.2(b), (c), (e), (g), (h), (i), (j), (l), above.) The Court's Finding No. 4 states that April Sanderson and Jeff Yandle had "first hand knowledge" of the relevant issues. To the extent that in reaching her decision, the Trial Court viewed "risk" as a relevant issue, Finding No. 4 and the related Findings and Conclusions that derive from that Finding (see, Assignment of Error Nos. 1, 2, 3, and 4) are not supported by substantial evidence.

(A) Ms. Sanderson Never Discussed Risk With Ms. Hatheway. At trial, Ms. Sanderson testified that she had "specific conversations" with Ms. Hatheway "regarding her risk tolerance" "at every quarterly meeting" (RP 503-04), yet Ms. Sanderson testified, both at deposition (CP 939 – April Sanderson Dewposition, hereafter referred to as "RP-SD", at 57, ll. 8-10) and at trial (RP 731, ll. 9-11) that she had never discussed risk with Ms. Hatheway. There was no evidence that Ms. Sanderson had "first hand knowledge" that Ms. Hatheway had a "high tolerance" for risk. What Ms. Sanderson did testify was that she heard Ms. Hatheway "banter" with Mr. Underwood in a meeting with Mr. Yandle in January 1999, where Ms. Hatheway was comfortable with a 20% fixed income allocation and Mr. Underwood was not pushing her to 30% (RP 714, ll. 15-20; see, Zander studies and correspondence, Section D.2(h) above); this Ms. Sanderson, although not a portfolio manager (RP 686, ll. 3-6), concluded was a "pretty high tolerance of risk." Compare this assessment to Mr. Yandle letting the fixed income allocation drift to (and stay at) 8% for six months in 2000, and never rebalancing it to the 20% level, despite Ms. Hatheway asking repeatedly that he increase the fixed income allocation (Section D.2(j)). If there was "a high tolerance for risk", it was Mr. Yandle's. Significantly, Ms. Sanderson did not attend any quarterly meetings from 2000 forward (RP 706, ll. 3-5), so her testimony of the banter between Ms. Hatheway and Mr. Underwood, the only testimony on "high tolerance of risk," is of no relevance to Mr. Hatheway's risk tolerance from 2000 forward, nor to the independent duty of U.S. Trust to have acted prudently in Ms. Hatheway's objective best interest as the bull market faded to a bear market. Ms. Sanderson also acknowledged that when U.S. Trust made the September 2002 (Ex. 110) proposal to shift the fixed income target from 20% to 35%, she was not involved and did know when that shift was first seen as appropriate at U.S. Trust (RP-SD 60, 63).

(B) Mr. Yandle Said She "Was Comfortable With a Prudent Amount of Risk". The Court's finding on "risk" was not supported by the evidence provided through Mr. Yandle (see, Section D.2(e) above). Mr. Yandle's testimony is a litany of the areas in which he had no interest, took no action, or had no recall of the matter in question. Mr. Yandle said that he never discussed Ms. Hatheway's understanding of risk or educated her on the concept of "risk," including how U.S. Trust defined it, factors that affect it, strategies to reduce it, and what it could mean for the solvency of Ms. Hatheway's portfolio, particularly in the context of a market downturn. (CP 938, Jeffrey Yandle Deposition, hereafter referred to as "RP-YD" at p. 30, ll. 24 to 31, line 4; RP-SD, at 57, ll. 8-10.) When asked directly what discretion he exercised over Ms. Hatheway's account, Mr. Yandle said: **"I don't believe I employ any discretion**. I think it is me giving my feedback as to the reasonableness of what they're trying to achieve ..." (RP-YD at 45, ll. 8-10. Mr. Yandle's failure to exercise the discretion undertaken by U.S. Trust did not acquit him or U.S. Trust of its duty to use its discretionary authority over Ms. Hatheway's account for her benefit.

Jeff Yandle did not know his client's needs and financial circumstances: for example, he could not recall ever calculating whether Ms. Hatheway's withdrawals were reasonable, given the diminished size of her account, her long-term investment objectives, or warning to Ms. Hatheway that as her account balances fell sharply she could not continue to make withdrawals at that previously agreed level and have her account sill meet her investment needs of long term account stability and growth. (RP-YD., p. 52, ll. 3-5, and p. 53, ll. 15-18.)

(ii) Who Was Relying on Whom? The Trial Court said Defendant **"relied on these representations and had a right to rely on these representations."** (RP 784) It was error to hold that U.S. Trust, the fiduciary with investment management expertise, was to rely on Ms. Hatheway, the client. (See, Statement of Facts, Sections D.2(b), (c), (d), (e), (g), (h), (i), (j), and (l).) Ms. Hatheway had a right to rely on U.S. Trust, not vice versa (Section E.2).

(iii) Did Ms. Hatheway's Attention to Her Account Excuse U.S. Trust? **"Plaintiff was an active participant in her account. She demanded and she received constant communication from U.S. Trust. She received and reviewed statements and reports. She received and reviewed special statements and reports that were provided to her by U.S. Trust. She called management errors to the attention of the management of U.S. Trust, small and large. She reviewed and confirmed the Policy Statement with her account managers. She was involved enough to the extent that she wanted to be informed when her account managers went on vacation. It appears**

from everything that she was detailed and involved in this account." (RP 784) (See, Statement of Facts, Sections D.2(b), (f), (h), (i), (j), and (l), above.) If Ms. Hatheway only wanted clerical reports, she would herself have done each of the tasks that the Court recites without having to pay a fiduciary to manage her account.

(b) U.S. Trust Had the Knowledge, Duty and the Complete Authority to Put in Place a Process to Avoid Speculation and to Manage Her Account Prudently and in Her Objective Best Interest. (See, Statement of Facts, Sections D.2(b), (c), (d), (g), (h), (i), (j), (k), (l), (m), above.) When Ms. Hatheway asked in 1997 to increase her monthly withdrawals to $7,000 per month, Ms. Dicus reviewed the matter and wrote to her that the account "would have to work a bit harder", but it could do so "as long as returns remained reasonable" (Ex. 35, 36), and Ms. Dicus began a more detailed mathematical analysis as to the long range sustainability of such a withdrawal requirement, which she did not complete before leaving U.S. Trust shortly thereafter; nor did U.S. Trust ever complete the study. In his March 7, 2001 letter to Ms. Hatheway (Ex. 546), Mr. Yandle raised the same concern about account income and liquidity being such that the equity portion could be "dedicated to a long-term horizon" (Ex. 546). But he did nothing about it until he made the September 18, 2002 proposal (Ex. 110, p. 4). As a matter of mathematics (see, e.g., Ex. 36 at 2, RP 266-275), as the levels of return (dividends or gains on sale from equities, plus the interest from fixed income) dropped, the account was increasingly shy of meeting the withdrawal requirement without reducing principal to make up any income shortfall, or, alternatively, speculating by purchasing equities that would hopefully increase in value sufficiently to produce the needed income shortfall with the Manager selling enough shares to help meet the withdrawal requirement. As the value of the assets allocated to equities dropped in the bear market, the need to meet the monthly withdrawal shortfalls required a combination of either making invasions each month of principal, or increasing the buying and selling of equities with sufficient rises in price so as to pay the withdrawals and leave the principal balances intact. In these circumstances, the account manager was hoping to meet a known liability (the withdrawal each month) with an unknown source - in other words, betting or speculating as to what the markets will do (Id.) - contrary to the prudent investor rule. "Speculation" means "Buying or selling with expectation of profiting by a rise or fall in price." (Black's Law Dictionary (6th Ed. 1990, 1399) Mr. Yandle's failure to put in place 'a defensive strategy" or "process," allowed her account to drift up and plunge down with the market. He dutifully reported its status to Ms. Hatheway each month, quarter and year, but did not follow a process that would prudently provide for adjustments as needed to allocate the account's assets to protect and preserve the principal, provide the income requirement, and assure the stability of the account over the long term.

(i) U.S. Trust Did Not Protect Ms. Hatheway In the Downturn **"The account appeared to be well diversified in equity and debt. The equity portion was diversified appropriately."** (RP 784) When? The levels of diversification varied broadly over the six year period (see, Ex. 627). Diversification is used to eliminate volatility or risk (e.g., RP 599). "Volatility" means downward and upward shifts in the value of securities - yet as Mr. Yandle's September 19, 2002 proposal noted, after the market losses he then wanted to change the strategic targets back to 65% to equities, 35% fixed income, "to achieve the lower volatility and income production goals while not sacrificing the potential for additional [sic] long term equity growth." (Ex. 110 at NH 002462). The diversification in place in Ms. Hatheway's account during either the bull or the bear markets did not reduce the volatility of her investment account. Her account underwent dramatic increases from 1998 to 2000 - none of which did U.S. Trust rebalance back to the account's strategic target asset allocations between equities and fixed income (Ex. 627, pp. 3-5). Her account later underwent dramatic drops. (Id., pp. 5-7) The history of the account documents its swings and volatility and the Court was simply wrong that it was **"well diversified"**. This not a question of hindsight. Each month, both Ms. Hatheway and U.S. Trust could see what had happened since the prior month. U.S. Trust had the duty to act in seeing the losses accumulate. U.S. Trust addressed this volatility issue by Mr. Yandle telling Ms. Hatheway that she needn't worry about having to return to work, as it would all work out (RP-YD 140, ll. 2-17).

(ii) <u>This Case is Not About What Ms. Hatheway Spent. It is About Whether Her Account Entrusted to U.S. Trust With Complete Discretion Could Continue in a Bear Market to Sustain the Level of Withdrawals That it Had Been Able to Sustain in the Bull Market and Still Accomplish the Other Agreed Investment Objectives in the "Historic Market Downturn" to Which the Court Makes Reference</u>. **"Plaintiff makes a number of claims that the defendant violated both the contract and its fiduciary duty in a number of ways."**

"First is that it allowed her to take withdrawals." (RP 784) (<u>See</u>, Statement of Facts, Sections D.2(c), (d), (g), (h), (l), (j), (k), (l), and (m).) When Ms. Dicus was at U.S. Trust she had agreed that Ms. Hatheway's withdrawals could be sustained by her account if it <u>"worked a bit harder hard"</u> and <u>"returns remained reasonable"</u> (Ex. 35; Section D.2(d) above). **"I think that this was her money."** (RP 784) Again, this statement missed the point - of course the account was her money - it was always her money. Since she had entrusted its care and feeding to U.S. Trust, did U.S. Trust fulfill its responsibility in the way it handled that money? **"I think there were several discussions with her regarding how much money she spent."** (RP 784-85) Here, the Court shifted the focus of its analysis to what Ms. Hatheway was spending - not to U.S. Trust's duty to manage the investment of her account so that it could continue through the rest of her life to provide the agreed level of withdrawals (e.g., Ex. 51, 497) - whether she spent them or not - or reinvested them while allowing her account go grow over time. **"I don't think anyone from U.S. Trust ever said, 'You shouldn't be spending this much money.' I'm not sure it was necessarily U.S. Trust's place to tell her not to spend her own money."** (RP 785) It was not U.S. Trust's place to "tell her not to spend her own money"; it was U.S. Trust's duty to tell her whether the falling account could afford the withdrawals. Although he changed his opinion at trial, U.S. Trust's expert, Dr. DeBard, agreed in his deposition that a failure to warn in such a circumstances would not meet the standard of care (RP 606-07). To do so, U.S. Trust had to have a process to monitor and analyze her account as to whether it could continue to sustain the previously agreed withdrawals as the principal balance of the account fell (e.g., RP 311, ll. 13-18). (See, Statement of Facts, Section D.2(c), (j), (k), (l) and (m), above.) The

Prudent Investor Rule requires the fiduciary to consider "the probable income as well as the probable safety" of the account (e.g., RCW 11.100.020(2)(F)(a).) Mr. Yandle never did such a study or analysis. Here is the error of the Court's decision: If Ms. Hatheway had placed her funds with U.S. Trust in either a checking or savings account, or in a custodial account, or in a non-discretionary brokerage account, U.S. Trust would have had no duty - fiduciary or otherwise - to speak to her about the impact on her account of her monthly withdrawals. U.S. Trust was not merely a bank teller or an ATM, it was an investment account manager with complete discretion over her account.

(iii) The Duties to Make Proper Investment Asset Allocations and to Protect the Account in a Downturn, Were Never Ms. Hatheway's. They Were Always U.S. Trust's.

(A) Does a Fiduciary Excuse Itself by Taking a Beneficiary at Her Word? **"The Plaintiff claims that the defendant violated, again, its duties by taking her at her word that she had a high tolerance for risk."** (RP 785) (See, Statement of Facts, Sections D.2(b), (e) above.) First, U.S. Trust's own internally produced documents do not speak of "high tolerance of risk"; they speak of her being "comfortable with a prudent amount of risk" (Ex. 45) and of having a "moderate" tolerance of risk - in the middle between U.S. Trust's category of "conservative" and "aggressive " risk tolerance (Ex. 334). Second, U.S. Trust had duties independently of whatever Ms. Hatheway said (see, Section E.2(b) below).

"There is really nothing to prove otherwise, other than the horror I'm sure she must have felt in realizing what was happening to her investment as the markets declined in their historical decline at that time in history." (RP 785) The most telling error in this core part of the Court's analysis and decision of the case, is the Court's failure to hold U.S. Trust responsible as a fiduciary to have known its beneficiary-client (see, discussion of a fiduciary's duty to know the client at Section E.2(b) below), her financial situation and needs, and to have acted in her best interest, regardless of what she may have said or done. A fiduciary does not rely on its beneficiary for skill and good judgment. A fiduciary must know its client and rely on and use its own objective skills, training, studies, analysis and expertise (see, Sections E.2. (b)(iii) and (c) below).

"She was informed by U.S. Trust and by Mr. Underwood that she would lose in a downturn. There were many discussions regarding that." (RP 785) The substantial evidence was to the contrary. (See, Statement of Facts D.2(g) and (i).)

(See, Section E.2.(b)(iii) below.) Tige Harris stated in effect: "your account will be protected in a downturn." (Ex. 39)

(B) This Was Never a "Churning" Case.

"The plaintiff claims there was a violation because of multiple transactions, but I found that there was no violation of the standard of care of fiduciary duty over the multiple transactions. U.S. Trust didn't get paid by the number of transactions it made on this account. This wasn't a churning case." (RP 785) (See, Statement of Facts, Section D.2(c), (d), (g), (h), (i), (l), above.) Indeed, Ms. Hatheway has never claimed this to be a churning case, where a broker generates a churning of the account to increase his income from an inflated number of sales commissions, nor has she claimed damages for churning the account. However, where Ms. Hatheway's account was invested for the long term, U.S. Trust informed her that there would be relatively few transactions in her account (RP 169, ll. 14-17). As the market soured, there became increasing numbers of transactions (RP 169-70), until she and Mr. Underwood demanded in July 2002, that there be no further activity in the account until U.S. Trust had put together a plan for Ms. Hatheway's consideration. The frequency of transactions indicated U.S. Trust's failure to meet the standard of care applicable under the objectives put in place for the account (Ex. 115, p. 3-4, RP 376-77).

(C) What Did the Overdrafts Show?

"There was an issue with regard to overdrafts. I couldn't find any evidence that this really caused the plaintiff any damage." (RP 785-86) Again, this evidence was not presented as a direct cause of damages due to the overdrafts themselves; as the Court continued: **"It was offered as evidence of inattention to the account."** (RP 786) (See, Ex. 115, p. 4; Statement of Facts, Sections D.2(d), (i), (j), (k), (l), and (m).) Where the agreed monthly withdrawal amount was a liability to be met every month, as was known well in advance, U.S. Trust should have put in place a method to meet that withdrawal amount, out of dividends and interest payments (rather than reinvesting them and then having to liquidate securities each month to provide the cash for the withdrawal) (Ex. 115, p. 2, compare Ex. 546).

"I think Mr. DeBard spoke that the Plaintiff's insistence that cash reserves not be kept in the account required U.S. Trust to pay a high level of attention to the account. I found that the explanation of the settlement date differences and the plaintiff's desire to not have cash in the account was sufficient to account for this." (RP 786) The Plaintiff's resistance to substantial investment cash sitting uninvested in her account (RP 425, 693) was taken by the Court as justifying U.S. Trust's failure to provide that each month the agreed sum of $7,000 would be generated from earnings in an orderly, timely manner so as to meet the monthly withdrawal payment. Mr. Yandle addressed this issue in his March 7, 2001 letter (Ex. 546) but he put no process in play to implement such a plan, only first proposing a shift in asset allocations in his September 19, 2002 proposal (Ex. 110). (See, manager's duty to provide funds to meet agreed withdrawals at Section E.1(b), above.) Settlements of sales and purchases would not have been involved had a process been in place so that the account was allocated to generate, month by month the required withdrawal amount (e.g., Ex. 115), without leaving excess cash idle, nor invading or jeopardizing the principal. When the equities market began to drop, such a process would have rebalanced the account safely to continue to generate the required level of withdrawals. Such a process would have required prudently increasing the assets allocated to fixed income, thereby reducing the risk to the account of further drop in the equities markets. Instead, U.S. Trust's "process" was to let the account follow the equities market up and then down. That was not investment management. Ms. Dicus's point on overdrafts and on increased trading was that the account was not being given the fundamental planning attention required to accomplish the agreed objectives, including long term stability and meeting the monthly withdrawals (RP 266-275).

(D) Did U.S. Trust Have a Duty to Have in Place a Process to Keep the Account Safely Balanced in Order to Meet the Agreed Objectives? **"The real issue in this case seemed to me to boil down to whether the defendant breached its duties or contract by the allocation of assets in the Plaintiff's account. I looked at this the hardest. I was finally compelled by the evidence to determine that the defendant did not breach its contract or fiduciary duty by the allocation of the assets in this account."**

"To some extent, this was a he said/she said case, the plaintiff testifying that she had asked her account manager to increase and with him testifying that he didn't hear that until right before she withdrew all of her funds [September 29 2002], to increase the bonds." (RP 786) Despite his testimony to the contrary (RP 643), the evidence from Mr. Yandle's own contemporaneous notes on U.S. Trust's copy of the September 30, 1999 quarterly report to Ms. Hatheway set the date of Ms. Hatheway's first such demand at late 1999: as to the 11% invested in "Fixed Income" **he wrote: "Increase to 15%.**" (Ex. 521, UST 001827). Whether "she" (Ms. Hatheway) said "he" (Mr. Yandle) should have increased the fixed income allocation as early as 1999, she states that she did, or as late as he admits that she did (RP 643-44), is on a fundamental basis of no consequence. No matter who said what to whom, "he" always had the duty to prudently manage the account in Ms. Hatheway's objective best interest - he had no right to wait for his client to bring the matter forward. From the September 19, 2002 proposals (Ex. 110, 497) that Mr. Yandle finally generated for Ms. Hatheway's account we see that U.S. Trust apparently had the skills that it held itself out as having. If the September 19, 2002 plan was sound, then it should have been in place much earlier, before the losses. U.S. Trust offered no evidence in justification of its neglect, except the formal piece mailed in July 2002 to Ms. Hatheway by the Chief Investment Officer of U.S. Trust, Mr. Frederick Taylor (Ex. 294, where he acknowledged that even U.S. Trust had been caught up in the equity "cult" of the 90s. U.S. Trust failed to do in the second or third month of the bear market what - when pushed - it proposed doing in the twenty-fourth month of the bear market. As a fiduciary, it must answer for the consequences of that failure.

A fiduciary must advance the best interest of the beneficiary, regardless of the nature or level of expertise, incompetence, attention, indifference, experience, naiveté or sophistication, hopes, or wishes of the beneficiary. (See, e.g., Sections E.2(a), (b), and (c), above.)

(E) Did the Fact that Ms. Hatheway Did Not Turn the Mortgage Payoff Proceeds Over to U.S. Trust in Early 1999 Excuse U.S. Trust From Managing the Funds That it Continued to Hold?

"I found that the Plaintiff didn't want cash in her accounts." (RP 786) The testimony was that Ms. Hatheway did not want cash sitting idle (RP 425); but it was always agreed that the account would pay her cash every month, so that enough cash had to be in the account each month to pay the withdrawals (Ex. 115, p.2). **"She had declined an offer to buy bonds with U.S. Trust with the proceeds from the mortgage. She testified that she didn't do that because she wanted to put the money somewhere where it would be safe. I'll leave it at that."** (RP 786) (See, Statement of Facts, Sections D.2(c), (e), (g), (h), (i), (j), (k), and (l).) Ms. Hatheway's requests of Mr. Yandle to increase her account's asset allocation to more fixed income began some nine or ten months after the mortgage was paid off (Ex. 525), and there was no nexus between the two issues. Ms. Hatheway's keeping and investing funds outside her investment account with U.S. Trust was not a justification for what U.S. Trust did or failed to do with her investment account. **"I think she was actively involved in reviewing all aspects of her account."** (RP 786) See Statement of Facts, D.2(f); see, also, Argument, Sections E.1(a)(iii), and (b). The level of Ms. Hatheway's involvement is beside the point of

U.S. Trust's fiduciary duties. U.S. Trust was a fiduciary; U.S. Trust remained a fiduciary until Ms. Hatheway ended the contract arrangement.

(F) Did the Coming of the Bear Market Excuse U.S. Trust From its Fiduciary Duties? **"One of the experts testified that this was a near historical negative experience in the equity markets. I think even that was an understatement. This Court finds that U.S. Trust cannot be held responsible for a loss in the account that was based on a downturn in the market rather than a breach of their duties."** (RP 786-87) (See, Statement of Facts, Sections D.2(b)(, (d), (g), (i), (j), (k), (l), and (m).) This is where the case begins, not where it ends. U.S. Trust was not responsible for the market downturn. However, U.S. Trust is responsible for failing to put in place a process to provide to Ms. Hatheway the measures that U.S. Trust represented to Ms. Hatheway were in place to protect her in event of a downturn.

2. Points and Authorities. The trial court committed reversible error in failing to apply the proper standard of care owed by a professional investment manager to a client where the investment manager has complete discretion over the client's account, where courts in other jurisdictions have held that an investment manager has a fiduciary duty to serve the best interests of the client, and where the trial court held that

U.S. Trust was a fiduciary but that it could discharge its duty merely by relying upon the alleged statements of the investor that she had a "high tolerance for risk".

(a) A "Fiduciary" Carries the Highest Duties and Must Prudently Use Its Skills in Seeking the Best Interest of the Client. (See, Statement of Facts, Sections D.2(b), (c), (d), (g), (h), (i), (j), (k), (l), and (m).)

(i) What a Fiduciary Is. A "fiduciary" is a person who occupies a position of confidence and trust towards another or her property (e.g., *Tucker v. Brown*, 199 Wash. 320, 331, 92 P.2d 221 (1939). "Fiduciary," while a general title, shares a common root and meaning with the narrowed title of "Trustee". (See, e.g., "Fiduciary" and "Fiduciary Duty," Black's Law Dictionary (6th Ed. 1990 at 625).) In its contract U.S. Trust required and Ms. Hatheway agreed that U.S. Trust would have complete discretion over her account, "with the broadest power of management and investment over the account . . ." (Ex. 190, Section 1.) Although Mr. Sanderson understood the extent of U.S. Trust's responsibility to its investment account client was that they could leave if they were not satisfied (RP-SD 29), the Trial Court found that U.S. Trust was a fiduciary for Ms. Hatheway (Finding No. 3, CP 689).

> In a fiduciary relationship one party "'occupies such a relation to the other party as to justify the latter in expecting that his interests will be cared for . . ..'" Breach of a fiduciary duty imposes liability in tort. The plaintiff must prove (1) existence of a duty owed, (2) breach of that duty, (3) resulting injury, and (4) that the claimed breach proximately caused the injury. A fiduciary relationship arises as a matter of law in certain contexts such as attorney and client, doctor and patient, trustee and beneficiary, principal and agent, and partner and partner.

Micro Enhancement Intern., Inc. v. Coopers & Lybrand, LLP, 110 Wn. App. 412, 433-34, 40 P.3d 1206 (2002).

> Courts have imposed on a fiduciary an ***affirmative duty*** of "utmost good faith, and full and fair disclosure of all material facts," as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients.

SEC v. Capital Gains Research Bureau, 375 U.S. 180, 194, 84 S.Ct. 275 (1963) (emphasis added); *see also Favors v. Matzke*, 53 Wn. App. 789, 796, 770 P.2d 686, *review denied*, 113 Wn.2d 1033, 784 P.2d 531 (1989).

In the January 2, 1996 Letter of Agreement, Ms. Hatheway agreed to pay U.S. Trust for the benefit of U.S. Trust's expertise and "continuing study of economic conditions, security markets, industries, and other investment opportunities." (Ex. 190, Section 1.) U.S. Trust promised to exercise "complete discretion in the management of the Account, make investment changes without prior consultation or approval, and invest and reinvest available funds at such time and in such manner as [U.S. Trust] deem[s] to be in [Ms. Hatheway's] best interest and for [Ms. Hatheway's] account and risk." (*Ibid.*)

The Trial Court correctly held that a fiduciary cannot contract away its duties, excusing itself in advance from liability for its future wrongs to the beneficiary. (Conclusion of Law on Attorneys' Fees, No. 1, CP 696.) Likewise, a fiduciary cannot contract in advance for exoneration of the consequences of its negligence or intentional misconduct. (Compare the Indemnity language in Section 14 of Letter Agreement (Ex. 190) to the Court's Conclusion No. 1, CP 696.)

(ii) <u>U.S. Trust Was a Fiduciary and Held Complete Discretion Over her Account, Agreeing on a Continuing Basis Prudently to Use Those Skills to Provide Her Account Growth, Stability and Income</u>. U.S. Trust also breached its fiduciary duty as Ms. Hatheway's investment manager by failing to <u>disclose all material facts</u> to Ms. Hatheway and to employ reasonable care to avoid misleading Ms. Hatheway, particularly when the market began to fall in 2000.

U.S. Trust did not deliver on its promise (Ex. 39) that she would be protected in a market downturn. (<u>See</u>, Sections D.2(b), (c), (d), (e), (f), (h), (i), (j), (k), (l), and (m). It put no defensive strategy in place when the market was rising and took no protective action when downturn came, resulting in Ms. Hatheway's account losing between March 31, 2000 and September 30, 2002, when Ms. Hatheway closed her account with U.S. Trust (Ex. 627, pp. 5-7).

If indeed U.S. Trust was under no duty to use its investment expertise, nor to exercise any discretion over Ms. Hatheway's account, what was she paying for?

(b) Courts From Other Jurisdictions Who Have Considered the Standard of Care Applicable to a Fiduciary in Investment Management Have Held That the Fiduciary Must Prudently Seek the Objective Best Interest of the Client Regardless of Her Statements on Risk.

(i) The New Jersey *Erlich* Case Held That **"to Give Prudent Advice is the Standard of Care . . .."** In a 1984 New Jersey investment management case, the Court held that "the obligation of the investment manager to give ***prudent advice is the standard of care*** . . . ." *Erlich v. First National Bank of Princeton*, 505 A.2d 220, 235 (N.J. Sup. Ct. Law Div. 1984) (emphasis added).

> Prudent advice includes: (1) knowing the customer, his assets and objectives; (2) diversifying investments; (3) engaging in objective analysis as the basis for purchase and sale recommendations and (4) making the account productive. (Id.)

(A) Knowing the Customer Includes Refusing Her Imprudent Investment Strategies. To satisfy the "know the customer" requirement, the investment manager must

> [C]arefully assess the customer's circumstances, both at the outset and during the term of the account. The customer's age, health, family obligations, assets and income stream (both current and prospective) should be evaluated to determine his ability to absorb losses in the event an investment is unsuccessful ... **The manager has a further obligation to periodically review the customer's affairs to insure that the investment strategy remains suited to the customer's current ability to protect himself against loss** ... The obligation to give prudent investment advice imports the duty to make such recommendations as a prudent investor would act on "for his own account, **having in view both safety and income**, in the light of the principal's means and purposes." ... ***An investment adviser is charged with furthering the customer's investment objectives, but he has an ongoing duty to refuse to approve investment strategies that are desired by the customer but appear to the adviser to be imprudent and too risky for the customer.*** The adviser must keep in mind at all times "the preservation of the estate."

Id. at 235-36 (emphasis added). Thus, an investment advisor breaches its fiduciary duty by failing to stay current with its client's needs at all times and simply "giving the advice they thought their customer wanted." *Id.* at 236; see below, *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690 (1968). The Trial Court erred in holding that U.S. Trust could rely on what Ms. Hatheway may have earlier said about her tolerance of risk (Assignment of Error Nos. 1 and 2).

(B) Using Prudence Includes Prudent Diversification to Minimize the Risk of Large Losses. "The investment manager has an obligation to the customer to exercise prudence in diversifying investments in order to minimize the risk of large losses." *Erlich*, 505 A.2d at 236. Whether a portfolio is prudently diversified depends on the "accepted standard of professional performance, ..." *Id.*

(C) Doing Objective Analysis to Seek the Client's Objective Best Interest. "A third aspect of the duty of care is to maintain objectivity in order to give investment advice that is in the customer's best interest." *Erlich*, 505 A.2d at 237. "The hallmark of a professional is the ability to exercise sound judgment in advising clients." *Id.*

(D) Making the Investment Account Productive. Finally, the "duty to make an investment portfolio productive is grounded in trust law, as a corollary of prudent investment, and agency law." *Erlich*, 505 A.2d at 237.

In *Erlich*, the plaintiff "had invested in stocks and bonds for approximately 15 years" prior to opening his investment account with defendant, investing "as much as $230,000 in a portfolio of 40 different securities purchased through several brokerage firms," and incurring "$110,000 in losses." *Erlich*, 505 A.2d at 227.

Unlike Ms. Hatheway, the plaintiff in *Erlich* read various investment magazines and newspapers; he also "maintained a detailed record of all of his investments in a brown ledger," and "was a member and had been president of the Princeton Prospectors, an investment club." *Id.* "No stock was ever purchased or sold without plaintiff's written authorization." *Id.* at 228. Yet, the court found the defendant "negligent in its supervision and periodic review of the account, its failure to provide for diversification and its failure to consider the risks to plaintiff, given his financial circumstances" because defendant failed to act as plaintiff's fiduciary by not discussing with plaintiff his investment objectives beyond the initial inquiry and by allowing plaintiff to invest an imprudent amount of his portfolio in a single stock. *Id.* at 238.

(ii) Under *Twomey*, a California Case, the Standard of Care Requires the Investment Manager to Make Suitable Investments Given the Client's Financial Situation and Needs.

(A) The Standard Where the Client's Funds Are Irreplaceable and She Needs An Income. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690 (1968) further illustrates the standard of care for investment advisors are to meet. In *Twomey*, the plaintiff-widow employed defendants as her investment advisors. She told the defendant directly in charge of plaintiff's account "that the money she was turning over to him was 'nonreplaceable' and that 'he was to take them and to see that I would have a good income from them.'" *Twomey*, 262 Cal. App. 2d at 713. Compare, Statement of Facts, Sections D.2(a), (b), (e), and (f), Mr. Yandle's write-ups for an investment policy to meet Ms. Hatheway's long term needs (Ex. 51, 497, 107A). The Twomey plaintiff relied on defendants' advice. Id. at 696.

Dr. DeBard, the U.S. Trust expert (RP 537), acknowledged that suitability of investment asset allocation is part of the standard of care applicable to an investment manager (RP 593-94). The *Twomey* court describes this standard of care which an investment manager must meet. The defendants were investment advisors and fiduciaries, although broker-dealers in title (*Twomey*, 262 Cal. App. 2d at 714 and 720) who owed plaintiff "a duty to ascertain her financial situation and needs" but "neglected to do so, **investing in securities that were "unsuitable in quality for one in the situation of plaintiff.**" Id. The defendants in *Twomey* breached their fiduciary duty even though the plaintiff widow "acknowledged that she understood that there was a risk (see, Statement of Facts, Section D.2(e)), that she knew securities could go down as well as up (see Statement of Facts, Sections D.2(g), (i)), and that she understood that defendants were not going to make good her losses, or guarantee her a profit." *Twomey* at 722.

(B) The Investment Manager is Not Excused From its Fiduciary Duties By Providing Reports and Advice. (See, Statement of Facts, Section D.2(f).)

> **This, however, is not to say that she was competent to evaluate the extent of the risk she was taking or the propriety of one in her financial condition so doing.** The fact that she had inherited money, that she had prior transactions with other brokers, and that she had improvidently invested in one speculative security on her own initiative might justify a finding of knowledgeableness and lack of reliance, but they do not compel that result when taken with her other testimony. **The receipt of confirmation slips and accounts, and her ability to chart the cost and prices of her securities are facts of the same tenor.** They may permit, but they do not compel, findings that plaintiff knew she was engaged in a course of trading and purchasing securities of a type that were unsuitable for one of her financial situation and needs. The daily calls from Nankin only have significance if she was exercising some judgment herself. The trial court concluded to the contrary that **she was relying on his judgment**.

Twomey at 722 (emphasis added); *See also*, *Karlen v. Ray E. Friedman & Co. Commodities*, 688 F.2d 1193, 1200 (8th Cir. 1982) ("When a customer lacks the skill or experience to interpret confirmation slips, monthly statements or other such documents, courts have generally refused to find that they relieve a broker of liability for its misconduct").

(iii) The Standard of Care for U.S. Trust Included Prudently Using Its Investment Management Skills to Seek Her Objective Best Interest.

(A) *Erlich*: An Investment Advisor Has Maximum Responsibility Where it Takes On a "Discretionary" Account.

Compared with the *Erlich* plaintiff, Ms. Hatheway was a novice investor (see, Statement of Facts, Sections D.2(a), (b), (c), (d), (e), (f), (g), h)). U.S. Trust had complete discretion over Ms. Hatheway's account; whereas the *Erlich* plaintiff had to approve all transactions. The *Erlich* court recognized a higher fiduciary duty with respect to discretionary accounts:

> There are three types of securities accounts typically employed by banks and brokerage firms: a custodian account, a discretionary account and a custodian management account. The duty to the customer and the degree of management responsibility assumed vary with the type of account. In a custodian account, the responsibility to the customer is minimal, because the custodian merely holds, buys or sells, transfers or receives securities as directed by the customer. **Maximum responsibility is assumed in a discretionary account.** The manager assumes full responsibility for the buying and selling of securities without prior approval from the customer.

Erlich, 505 A.2d at 232 (emphasis added).

(B) The Trial Court Committed Reversible Error in Failing to Apply the Standard of Care Owed by U.S. Trust to Ms. Hatheway, Where in a Bear Market it Did Not Have a Process in Place to Warn the Client That Continuing the Client's Monthly Withdrawals Would Deplete the Client's reduced Account Prematurely, and to Make Asset Allocations That Would Have allowed the Account to

Meet the Client's Monthly Withdrawals While Preserving the Account Over the Long Term. (See, Statement of Facts, Sections D.2(b), (d), (e), (g), (h), (i), (j), (k), (l), and (m).) When the U.S. equity markets declined sharply beginning in late 2000, Mr. Yandle failed in his fiduciary duties to Ms. Hatheway until it was too late.

(iv) Under *Twomey*, An Investment a Manager Over a Discretionary Account is Not Excused By Telling Its Client That Stocks Go Up and Down. Ms. Hatheway is like the plaintiff in *Twomey*. Both "understood" risk to mean that stocks could go up and down; both had regular contact with their investment advisors, either in the form of meetings, telephone conferences or written reports; and both needed and hired an investment expert to help them manage marital funds after the death of their husbands.

(c) The Trial Court Committed Reversible Error in Holding That the Investment of Trust Funds Act, RCW Chapter 11.100, Did Not Apply to U.S. Trust, a Fiduciary With Complete Discretion Over the Client's Account, Where Section 11.100.020 of the Act Codifies the Historic Prudent Investor's Rule Applicable to Fiduciaries. (See, Statement of Facts, Sections D.2(b), (c), (d), (e), (g), (h), (i), (j), (k), (l).) Mr. Yandle's year end investment account reports repeated the mantra, year by year, that **Ms. Hatheway was "comfortable with a prudent**

amount of risk." (See, Statement of Facts, Section D.2(e).) By contract and by process U.S. Trust was bound by the Prudent Investor Rule. Ms. Hatheway submits the statutory codification of that rule should apply. Even as she was being badly hurt month-by-month in the market downturn (Ex. 39, Ex. 627, pp. 5-7), the expert, U.S. Trust, did nothing. Until September 19, 2002, Mr. Yandle simply maintained the same aggressive equity investment strategy in the bear market that he had employed during the bull market. Any lay person could have done that. Many did. Their losses were attributable to the historic market downturn; Ms. Hatheway's were not.

U.S. Trust's breach of its fiduciary duty contributed to Ms. Hatheway's account losing $1,127,167.29 between August 31, 2000 and September 30, 2002, when Ms. Hatheway closed her account with U.S. Trust (Ex. 111).

(i) The Investment Trust Fund Act Provides an Instructive List of Duties That a Professional Fiduciary Undertakes Toward Its Clients in Washington. The title to Chapter 11.100 is "Investment of Trust Funds". However, that does not end the discussion where the scope of the act expressly "govern(s) fiduciaries acting under . . . agreements", RCW 11.100.050, and where the prudent investor rule and total asset management approach have been codified in RCW

11.100.020, as duties of a "fiduciary" who invests and manages funds for another:

> . . . **In applying such total asset management approach, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds**, and if the **fiduciary** has special skills or is named trustee on the basis of representations of special skills or expertise, **the fiduciary is under a duty to use those skills**.

Further, in RCW 11.100.040, the Legislature expressly recognized the power of the courts of Washington "to permit a **fiduciary** to deviate from the terms of any . . . agreement, or other instrument relating to . . . fiduciary property." Like Sections 11.100.050 and .020, this section is not limited to the narrower class of fiduciaries who have been formally designated as "Trustee". As noted in Section E.2(a) above, the very term "fiduciary" is derived from the concept of a Trustee. RCW Sections 11.100.020, .040, and .050, dealing with rights and duties of a "fiduciary," carry no limitation to formally designated Trustees and do not in any way except or exempt fiduciaries who are investment managers, rather than "trustees".

(d) <u>U.S. Trust's Breaches of its Fiduciary Duty Proximately Caused Substantial Damages to Ms. Hatheway</u>. If U.S. Trust had prudently allocated Ms. Hatheway's account (see, Dicus Analysis, RP 253-75, 318-19) and had timely employed a defensive strategy as requested by Ms. Hatheway (Ex. 490) it would not only have provided an income flow for the account's withdrawals, but it would have either avoided, or later stopped the near "free fall" of Ms. Hatheway's account from 2000-2002. Mr. DeBard opined that if U.S. Trust had rebalanced Ms. Hatheway's account to the ratios between equity and fixed income in its September 2002 recommended investment policy statement and asset allocation 18 months earlier, when Ms. Hatheway first requested, it would have saved her some $51,500; Ms. Dicus testified that timely asset allocation keyed to the stated investment goals would have cut Ms. Hatheway's losses by some $400,000. These losses were not due to the market's historic drop - they were due to U.S. Trust not using its skill and expertise (RP 274, 3-14) to keep the account allocations at a prudent investor standard - thereby providing the needed income and protecting the account from losses. "[T]he proper measure of damages would depend on the precise nature of the wrong or wrongs committed by defendants." *Scalp & Blade, Inc. v. Advest, Inc.*, 765 N.Y.S.2d 92, 99 (N.Y. App. Div. 2003).

(e) Attorneys' Fees: In Addition To Her Damages Caused By U.S. Trust Breaching Its Fiduciary Duty, Nancie Hatheway Is

Entitled to an Award of Her Reasonable Attorneys' Fees And Costs As Provided By The Investment Management Account Letter Of Agreement. The trial court erred in failing to recognize U.S. Trust's breaches of its fiduciary duties to Ms. Hatheway; this error was compounded by the award to U.S. Trust of its reasonable attorneys' fees and costs under the contract between the parties. Because the Court did not apply the proper standards of care to U.S. Trust's performance as Ms. Hatheway's fiduciary, this Court should reverse the judgment below including the award to U.S. Trust of its attorneys' fees through trial and remand for a hearing on the amount of Ms. Hatheway's damages. Consistently therewith, under Section 15 of the Letter Agreement (Ex. 190), this Court should also direct the trial court on remand to determine the amount to award Ms. Hatheway as reasonable attorneys' fees and costs through trial, on appeal and on remand.

"[I]f a tort action is based on a contract central to the dispute including an attorney fee provision, the prevailing party may receive attorney fees." *Hill v. Cox*, 110 Wn. App. 394, 411, 41 P.3d 495 (2002) (citing *Brown v. Johnson*, 109 Wn. App. 56, 34 P.3d 1233, 1234 (2001)). *Brown*, 109 Wn. App. at 58-59 (citing *Edmonds v. John L. Scott Real Estate, Inc.*, 87 Wn. App. 834, 842, 855-56, 942 P.2d 1072 (1997)).

F. CONCLUSION

The duty to make continuing prudent investment asset allocations on an objective basis and to protect her account in a market downturn, never shifted from U.S. Trust. The foreseeable coming of the bear market did not excuse U.S. Trust from its fiduciary duties. U.S. Trust had the knowledge, duty and the complete authority to make needed, timely changes in the account's diversification so as to staunch the volatility that the account was subject to. It did not.

By its focus on what Ms. Hatheway, the novice client, purportedly said and did, the Trial Court's analysis wrongly thrust the weight of responsibility for management of the account from U.S. Trust, the hired, professional fiduciary manager, to Ms. Hatheway, the client. Such was reversible error.

RESPECTFULLY SUBMITTED this 31st of March, 2006.

VANDEBERG JOHNSON & GANDARA

By______________________________
G. Perrin Walker, WSBA # 4013
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Attorneys for Appellant

APPENDIX

11.100.020 Management of trust assets by fiduciary.

(1) A **fiduciary** is authorized to acquire and retain every kind of property. In acquiring, investing, reinvesting, exchanging, selling and managing property for the benefit of another, a **fiduciary**, in determining the prudence of a particular investment, shall give due consideration to the role that the proposed investment or investment course of action plays within the overall portfolio of assets. **In applying such total asset management approach, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds**, and if the **fiduciary** has special skills or is named trustee on the basis of representations of special skills or expertise, **the fiduciary is under a duty to use those skills**.

(2) Except as may be provided to the contrary in the instrument, the following are among the factors that should be considered by a **fiduciary** in applying this total asset management approach:

(a) The probable income as well as the probable safety of their capital;

(b) Marketability of investments;

(c) General economic conditions;

(d) Length of the term of the investments;

(e) Duration of the trust;

(f) Liquidity needs;

(g) Requirements of the beneficiary or beneficiaries;

(h) Other assets of the beneficiary or beneficiaries, including earning capacity; and

(i) Effect of investments in increasing or diminishing liability for taxes.

(3) Within the limitations of the foregoing standard, and subject to any express provisions or limitations contained in any particular trust instrument, a **fiduciary** is authorized to acquire and retain every kind of property, real, personal, or mixed, and every kind of investment specifically including but not by way of limitation, debentures and other corporate obligations, and stocks, preferred or common, which persons of prudence, discretion, and intelligence acquire for their own account.

* * * * *

11.100.040 Court may permit deviation from terms of trust instrument. Nothing contained in this chapter shall be construed as restricting the power of a court of proper jurisdiction to permit a fiduciary to deviate from the terms of any will, agreement, or other instrument relating to the acquisition, investment, reinvestment, exchange, retention, sale, or management of fiduciary property.

* * * * *

11.100.050 Scope of chapter. The provisions of this chapter govern fiduciaries acting under wills, agreements, court orders, and other instruments effective before or after January 1, 1985.

COURT OF APPEALS
THE STATE OF WASHINGTON
DIVISION II

Nancie Hatheway,, Appellant, v. U. S. Trust Company, N.A., a Connecticut corporation, Respondent/Cross Appellant.	)	No. 33966-8-II AFFIDAVIT OF MAILING

STATE OF WASHINGTON)
) ss.
County of Pierce)

The undersigned, being first duly sworn on oath, deposes and says:

That on the 31st day of March, 2006, affiant deposited in the mails of the United States, a properly stamped and addressed envelope containing a copy of Appellant's Brief (with corrected Table of Authorities) to the following attorneys:

Ms. Grace M. Healy
Grace M. Healy, PLLC
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Mr. Peter T. Petrich
Attorney at Law
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Tacoma, WA 98401

That, in addition, on March 31, 2006, affiant caused to be sent via e-mail, a true copy of Appellant's Brief to the above attorneys.

Linda LaFlamme

Linda LaFlamme

Subscribed and sworn to before me this 31st day of March, 2006.

VIRGINIA S. TUCKER
COMMISSION EXPIRES
NOTARY
PUBLIC
AUG 19, 2006
STATE OF WASHINGTON

Virginia S. Tucker

Virginia S. Tucker
NOTARY PUBLIC in and for the
State of Washington, residing at
Tacoma.
My Commission Expires: 8-19-06