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The Eleventh Circuit Court of Appeals Declines to Impose a Duty on a Custodian Bank to Protect a Customer From an Investment Adviser's Fraud, and Enforces a Customer's Duty to Timely Object to Statements

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In *Lamm v. State Street Bank and Trust*, No. 12-15061 (11th Cir. April 14, 2014), the United States Court of Appeals for the Eleventh Circuit affirmed the dismissal, with prejudice, of a complaint filed against a custodian bank, State Street Bank and Trust ("State Street"). The court held that State Street had no duty, contractual or otherwise, to supervise the conduct of the customer's investment adviser and, therefore, was not liable for the adviser's purchase of $1 million in fraudulent and worthless securities.

In reaching its decision, the Eleventh Circuit explained that (1) the custody agreement defining the custodian bank's rights and duties did not impose a duty of care on the bank greater than its typical function of simply executing the written orders it receives from the customer's agent and (2) custodian banks with no discretion to invest a customer's assets have no independent duty to supervise transactions in a customer's account or to ensure that assets held for the customer are marketable or in valid form. The court also found that the customer was bound by a provision requiring him to object to account statements within 60 days.

The Customer's Allegations of Wrongdoing

The dispute arose after the customer engaged an investment adviser and the adviser's firm to manage the customer's assets. The customer granted the advisory firm broad authority to invest assets in his two accounts, for which State Street later became the custodian. After moving his firm to the Virgin Islands, the adviser invested the customer's assets in risky and speculative securities, including promissory notes from micro-cap companies, as well as personal loans and mortgages. State Street, which simply settled the transactions, accepted documents purporting to be the promissory notes and listed them on the customer's monthly account statements. Years later, however, State Street could not obtain updated valuations for the securities and sent a letter to the customer advising that it was listing the securities as having no market value. The promissory notes turned out to be worthless, and the customer lost $1 million of principal.

The customer sued State Street, asserting claims for breach of express contract, breach of implied contract, breach of fiduciary duty, negligence, gross negligence, aiding and abetting the breach of a fiduciary duty, and aiding and abetting fraud. The customer alleged that State Street had a duty to notify him that the securities in his account were worthless and that it breached its duty to him by: (1) allowing his funds to be disbursed as payment for fake notes; (2) failing to notify him that the purported securities were not signed by the purported obligor; (3) failing to notify him that the purported securities were not payable to him, but to a different payee; (4) allowing cash to be diverted from his accounts without timely delivery of a security in exchange; (5) allowing cash to be diverted from his accounts without delivery of any security; (6) listing fake CUSIP numbers on the monthly statements; (7) issuing monthly statements to him that included incorrect market values; (8) charging excessive custodian fees based on false market values; (9) failing to perform the audits, reporting, and custodian duties required of IRA custodians; and (10) otherwise not reporting or disclosing the fraud to securities regulators and to him.

The Eleventh Circuit's Analysis

In analyzing the customer's contract claims, the Eleventh Circuit looked to the custody agreement to determine what obligations, if any, State Street owed. The Court found that, under the custody agreement, State Street held the customer's assets and carried out certain transactions as directed by the customer or his investment adviser. As such, State Street had no decision-making role regarding the customer's investments, but simply held his assets, carried out his and his agents' investment instructions, and rendered accounts, very much like a securities broker handling a nondiscretionary account, for which the broker ordinarily owes no duty other than simply to execute orders.

The Eleventh Circuit also reaffirmed the generally-accepted principle that a custodian bank's duties are very limited, holding that the language in the custody agreement expressly rebutted the existence of the additional duties advocated by the customer. For example, as to the claim that State Street improperly disbursed funds to pay for the fake notes, the custody agreement expressly authorized State Street "to purchase or receive securities and make payment therefor" in accordance with the customer's instructions, permitted State Street to honor funds transfers in accordance with the customer's instructions "without inquiry into the circumstances," and, further, absolved State Street of the responsibility to "supervise the investment of . . . any investment relating to the account." Consequently, the court expressly rejected the customer's efforts to expand the traditional duties of a custodian bank.

The Eleventh Circuit additionally addressed the language in the custody agreement requiring the customer to object to any error contained in an account statement within 60 days or be deemed to have approved the statement and waived and released all liability by State Street with respect to the items set forth in the statement. The customer claimed that the waiver provision should not be enforced because the monthly statements did not include "sufficient information" to discover the purported errors. In rejecting the customer's argument and upholding the provision, the Eleventh Circuit explained that, absent a controlling statute like U.C.C. § 4-406 or bad faith on the part of the non-disclosing party, a waiver provision requiring one party to make objections within a certain time is not tolled or rendered unenforceable because the other party fails to provide "sufficient information," where the contract included no such exception to the operation of the waiver provision.

As for the customer's tort claims, including breach of fiduciary duty and negligence, the Eleventh Circuit affirmed the dismissal of these claims because the custodian bank had no discretionary role in investing the customer's assets, was fully authorized to rely on the instructions it received from the customer's agent, had no duty to monitor the transactions made by or on behalf of the customer, and had no duty to scrutinize the form in which the transactions were submitted. The court rejected the customer's attempt to import duties from other sources, including S.E.C. Rule 206(4)-2 and U.C.C. § 4-103, explaining that the former applies only to investment advisers and not custodian banks, while the latter applies only to bank deposits and collections and pertains to specific actions relating to the processing of checks and similar instruments, which were not at issue. The Eleventh Circuit also explained that no duty could exist because the custody agreement and the relationship of the parties established an arm's length bargain imposing limited obligations on the parties, not a relationship of "trust and confidence" or "special circumstances." Lastly, with regard to the customer's aiding and abetting claim, the Eleventh Circuit held that the customer had not pled facts sufficient to establish State Street's knowledge of the investment adviser's fraud and breach of fiduciary duty, a legal requirement to state a claim.

Conclusion

In this important decision, the Eleventh Circuit reaffirms that a custodian does not have duties beyond those specified in the custody agreement, absent a statutory requirement or a legally-recognized special relationship between the custodian and the customer. The court also holds that a customer must comply with provisions in the agreement requiring the customer to timely object to any errors in the statement. ■

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