Defending and Surcharging Fiduciaries
For Losses from the Great Recession and Other Disasters

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Damages for Failure to Diversify

The Surrogate's Court of the County of Eire surcharged the trustee In re *Intermediate Account of HSBC Bank USA, N.A., as Trustee of the Trust Under Agreement dated January 21, 1957, Seymour H. Knox, Grantor*, File # DO-0659, 30 Misc. 3d 1203(A), 2010 WL 5252842 (N.Y. Sur.), *aff'd as mod.,* (App. Div. 2012) 947 N.Y.S. 2d 292, *rev. den.* (N.Y. 2012) 953 N.Y.S. 2d 180, regarding seven separate trusts or actions, in a total of $21,437,084, in a series of Memoranda and Orders filed November 24, 2010. The trustee subsequently settled the actions involving three small trusts, the remaining trusts were appealed. The appellate division has now reversed substantial portions of the four judgments, as discussed below.

A trial on the issue of liability had been held for two weeks in December of 2009, with Memoranda and Orders issued on February 24, 2010, 30 Misc. 3d 1201(A), (N.Y. Sur. Feb. 24, 2010) 2010 WL 5186667.

The largest of these trusts was created by Seymour Knox, II (Knox II), in 1957 for the benefit of the issue of his son, Seymour Knox, III (Knox III). The Knox family co-founded F.W. Woolworth Company, and Knox II served as a chairman of the board of HSBC's predecessor in interest, The Maine Trust Company of Western New York, which underwent multiple expansions and mergers, ultimately being subsumed in the current HSBC Bank USA, N.A. As is common in many of the recent surcharge cases, the current institution and its personnel and policies arrived on the scene long after the events involving its predecessor corporate ancestor.

The 1957 trust was funded with 5,000 shares of Woolworth stock and 5,200 shares of Marine Midland common stock, with a total value in 1957 of approximately $325,525 (a starting value which assumed significance when the Appellate Division looked at the ultimate values of the portfolio at the time of the 2010 trial.) The silver lining of a half century of inflation is that one can point to substantial increases in the value of the corpus and income streams in today's enervated dollars and, if not declaring victory, at least ameliorating the impact of interim losses.

Midlands was appointed the sole trustee of the 1957 trust. Knox III succeeded his father as chairman of the bank, and participated actively in investment discussions with the trustee's employees. As can been seen from the trial court's discussion of investment meeting procedures, the presence of Knox III in such discussions overwhelmed the fiduciary instincts of the trust officers, becoming rubber stamps for his investment desires, particularly in the Knox trusts where Knox III was a beneficiary.

In 1975 the seventh of the trusts involved in this litigation was created by Seymour Knox, IV (Knox IV), naming himself and Knox III as individual trustees, with Marine Midlands Bank as corporate trustee. Knox IV brought suit on an accounting by the successor of Marine Midlands, HSBC.

In 2006, HSBC resigned and filed an interim accounting in the 1957 and other trusts. In the case of the 1957 trust, the interim account ran from January 21, 1957 through November 18, 2004, followed by a final account through November 3, 2005. Objections were filed by the current income beneficiaries, including Knox IV, and a Guardian ad Litem for the minor beneficiaries.

The trust contained a provision allowing the retention of the trustee's own stock. The trial Court found that the trustee had abdicated discretion over investments to the Grantor and Knox III, continuing the retention of overweight positions (greater than 10% as per the Trust company's Investment Policy Guidelines) on a handful of stocks. Although Woolworth ceased paying dividends, the trustee retained the stock at the direction of Knox III, and invaded principal to make up the loss of income to the four children of the Grantor. The Court found a "complete abdication of the bank's fiduciary duty to non-trustees, even going so far as seeking the approval of the non-trustees to go forward with investments it had advised against." 2010 WL 5186667 at *10. The Court concluded that there was no analysis or plan in the bank's files regarding the retention of the over-weight position in Woolworth, "[t]herefore, it is reasonable to infer that there was *no* analysis or plan (*see Matter of Camarda [63 A.D.2d 837(1978)]; Matter of Shulsky* [34 A.D.2d 545 (1970)]*; and Matter of Sakow* [21 A.D.3d 849 (2005) rev. denied 7 N.Y.3d 706 (2006)])." 2010 WL 5186667 at *12.

At annual investment reviews, the retention of the Marine Midlands stock was documented solely by "a literal rubber-stamped entry at various places in the investment diary, which states: 'APPROVED CONTINUED RETENTION FOR TIME BEING OF MARINE MIDLAND CORPORATION STOCK.'" 2010 WL 5186667 at *4 The absence of documentation of decisions to override 10% limits for individual stocks was pointed to as a failure to make and document appropriate exceptions to the investment plans. As to the overweight positions, the Court concluded that "there is nothing to show that HSBC performed any analysis for its retention of those overweight stocks. This was a violation of HSBC's policies in general, but the lack of documentation also reflects a continuing indifference to the careful analysis, planning and review which trust investment management required." 2010 WL 5186667 at *14.

The Court rejected as a defense an exculpatory provision in the Trust absolving the trustee from being responsible "for any loss or damages which may result from the exercise of judgment or discretion in carrying out the provisions of this instrument…." It held that the trustee "cannot be absolved of its negligence by the language of the trust agreement where it ignored its fiduciary obligation as the sole trustee to act with 'reasonable care, diligence and prudence' (see EPTL 11-1.7)." 2010 WL 5186667 at *13.

In a series of Memoranda and Orders for the seven trust matters, the Court assessed varying amounts of damages, including $11 million for the retention of Woolworth (Venator)

from dates in 1957 and 1991 when the Court found the positions should have been reduced, $1.5 million for the retention of Digital Equipment Corp after 1987, and $7.8 million for the retention of Marine Midlands stock after 1957. The total of surcharges in the seven matters totaled approximately $21,437,084. 2010 WL 5252842 at *5. Attorney's fees were also granted. *Ibid.* Three of the trust decisions were settled, and the remaining four were appealed. The Appellate Division reversed substantial portions of these four judgments, while allowing substantial damages to remain in several instances.

In decisions filed June 19, 2012, the Appellate Division reversed a number of the surcharges in the four cases appealed, but affirmed modified damages in one of the trusts. *In re HSBC Bank USA, N.A.* (App. Div 2012) 947 N.Y.S. 2d 288, *rev. den.* (N.Y. 2012) 953 N.Y.S. 2d 180.

a. Cotrustee Cannot Sue for Damages for which he was Jointly Liable

With respect to the 1975 trust created by Knox, IV, who sued the his corporate co-trustee for damages, the Appellate Division in a separate opinion held that "equity cannot permit objectant, the cotrustee who served as the driving force behind all of the challenged investments with the exception of one, and who had special investment skills, to recover damages from the Bank arising from any purported breaches of their joint obligation to the trust." *In re HSBC Bank USA, N.A.* (App Div 2012) 947 N.Y.S. 2d 288, 292, *rev. den.* (N.Y. 2012) 953 N.Y.S. 2d 180. The Court held that "in accordance with the cofiduciary liability rule (*see generally Zimmerman v. Pokart*, 242 A.D. 2d 202, 203, 662 N.Y.S. 2d 5) all cotrustees are jointly liable for any damages occasioned by the breach of their joint obligation to the trust. Pursuant to that rule, '[c]ofiduciaries are…regarded in law as one entity … [and thus one cofiduciary] cannot prevail in a cause of action against [other] cofiduciaries for breach of the same obligation' (*id.; see Matter of Goldstick,* 177 A.D. 2d 225, 238-239, 581 N.Y.S.2d 165, *rearg. granted on other grounds* 183 A.D. 2d 684, 586 N.Y.S. 2d 490). We reject objectant's contention that the cofiduciary liability rule should not apply in this case due to the Bank's specialized investment skills." 947 N.Y.S.2d at 291. The Appellate Division held that Knox IV had admitted that all of the challenged investment decisions except one were joint decisions. Also of significance is that Knox IV admitted that "he met with the Bank to review the trust portfolio at least once a year, or as often as four times a year, and he was aware of market fluctuations and their impact on the value of the trust." *Ibid.* Hence, the Appellate Division appears to be joining the majority of states in finding that beneficiaries with knowledge of facts sufficient to put a reasonable beneficiary on notice of breaches cannot sleep on their rights. In *Testamentary Trust UW Dumont*, 809 N.Y.S. 2d 360, (N.Y.A.D., 2006), *rev. den.* The Appellate Division, in reversing the Surrogate's surcharge judgment, noted the fact that the adult beneficiary had met annually with the corporate trustee officers and was aware of the underperformance of the concentrated portfolio (but reversed on several technical grounds). Here the Court on appeals is much more direct in smacking down a beneficiary directly for having slept on his rights. The result is that the British rule of treating remaindermen as not having to act until the final accounting is disappearing in its last haven in the United States.

b. Damages for Allocations Above Internal Guidelines

In the 1957 Trust, the Appellate Division, *In re HSBC Bank USA, N.A.* (App Div 2012) 947 N.Y.S.292, 297, *rev. den.* (N.Y. 2012) 953 N.Y.S. 2d 180, noted that at the time of the accounting "the 1957 Trust had increased in principal by over $1.75 million, had generated approximately $1.5 million in income and had $1.28 million in principal 'on hand.'" The Trial Court had issued surcharges to the extent six securities had been held in amounts in excess of 10% of the portfolio (based on the bank's 10% ceiling for asset allocations to single securities).

With the exception of the retention of Woolworth stock after the date its dividends were suspended, the Appellate Division reversed surcharges. "This case is unique in that it involves a trust that had no precipitous decline in any particular stock, had a net increase in principal of over $1.75 million and generated over $1.5 million in income for the income beneficiaries. Although Dome and Leesona were sold for losses, the losses were negligible.…All of the other securities addressed by the Surrogate increased in value." 947 N.Y.S. 2d at 298.

This approach is similar to the peak of the market analysis found in *Dumont* (*In re Chase Manhattan Bank*, 809 N.Y.S. 2d 360 (A.D. 2006), *rev. den*. 813 N.Y.S. 2d 689 (A.D. 2006)), where the Court on appeal rejected a finding of liability where the stock had reached a peak, but fallen 22%. It held that a fall in the price of the stock from $148 on January 12, 1973 to $115 on January 11, 1974 was not a compelling reason for a sale. It rejected liability based on "hindsight." 809 N.Y.S. 2d at 364. The Court held:

> "Indeed, the evidence establishes that the trustee would have acted imprudently had it sold the stock on January 31, 1974. The stock had outperformed the Standard and Poor's 500 Index by nearly 3 to 1 up to January 1973. Although the value of the stock fell from $148 on January 12, 1973 to $115 on January 11, 1974, it was still above its January 14, 1972 price of $97. In fact, the Valueline reports on Kodak stock indicated a Beta of .71 to 1.02 between January 14, 1972 and January 11, 1974 with a safety rating of one and 12-month performance ratings of two and three. Thus, the fluctuation in stock price could not constitute a compelling reason for the trustee to sell the stock on January 31, 1974, particularly in light of the extensive retention clause." 809 N.Y.S. 2d at 364-365.

Standard of Review Where no Jury

In *Knox*, since the Trier of fact was a surrogate rather than a jury, the Court found that it had a broader range of review than simply whether the decision was supported by the evidence. 947 N.Y.S. 2d at 301: "We note that '" this Court [upon an appeal following] a nonjury trial is not limited to determining whether the findings of the trial court are supported by the weight of the credible evidence "' (Matter *of Saxton,* 274 A.D.2d 110, 118, 712 N.Y.S.2d 225; *see Matter of Hyde,* 44 A.D.3d 1195, 1198, 845 N.Y.S.2d 833, *leave to appeal den.* 9 N.Y.3d 1027, 852 N.Y.S.2d 11, 881 N.E.2d 1197)." Given this broad standard, the Court simply disagreed with many of the factual findings.

Internal Guideline does not Per Se Result in Liability

The Appellate Division upheld surcharge for the retention of 23,000 shares of Woolworth. "At that point it is undisputed that Woolworth stock was removed from the petitioner's internal 'hold list,' i.e. a list of securities that petitioner deemed acceptable to be retained in trust portfolios. **We recognize that blind adherence to internal rules would not insulate petitioner from liability just as a violation of internal rules would not automatically establish imprudence, liability or loss.** Here, however, petitioner's portfolio manager conceded that the balance of Woolworth stock should have been sold once the stock was removed from the hold list. We thus conclude that the adult objectants established that petitioner acted imprudently in retaining the 23,000 shares of Woolworth stock beyond February 20, 1997, and that the Surrogate properly sustained amended objection No. 1 of the adult objectants to that extent." (emphasis added). *Ibid*.

Significantly the Court on appeal rejects the proposition that a violation of internal investment guidelines is *per se* imprudence. Take note if you have situations where trust officers disregarded internal investment guidelines -- hope may still spring in the right counties of New York.

Liability Where Asset No Longer Provided Income

The Appellate Division concluded that with respect to the Woolworth stock, "[T]he purpose of the 1957 Trust was to generate income for the children of Knox, III and, until it stopped paying dividends, the Woolworth stock was the greatest source of income for the 1957 Trust. Thus, when the dividends ended and the price of the stock began to decline, there was no logical reason, aside from the Knox family's personal connection to the company, to retain any shares of that stock." 947 N.Y.S. 2d at 304. Hence, the appeals court concluded that losses in the principal value of the shares were a consideration, rather than simply the requirement of providing income. The beneficiaries, particularly after the adoption of the UPIA by New York, clearly had an interest in the value of the shares rather than being limited to the income generated (again eroding the old English rules).

Special Relationship Exception to Diversification

On appeal, the Appellate Division upheld the retention of Woolworth and Marine Midlands because such assets were in an overweight position at the funding of the trust and since there was a "special relationship" between the family and these stocks. "Because the stocks were in overweight positions when the 1957 Trust was established, the retention of those securities 'may be found to be prudent even when purchase of the same securities might not' (*Hahn,* 93 A.D.2d at 586, 462 N.Y.S.2d 924; *see generally Weston,* 91 N.Y. at 508). As indicated herein, there was a **special relationship** between the Knox family and both Woolworth and Marine, and Knox, III indicated a preference to retain stock in those family businesses. Petitioner divested the 1957 Trust of all Marine stock in 1987 after the value of the stock began to decline. During the period in which the 1957 Trust retained Marine stock, it produced over $180,000 in dividend income and over $270,000 in net increases on sales. With respect to Woolworth, the 1957 Trust

was established with 5,000 shares, and another 39 shares were purchased by petitioner. All additional shares came into the 1957 Trust as a result of stock distributions. While it may have been prudent to reduce the concentration, "the mere availability of other prudent courses of action that a fiduciary could have pursued does not support a finding that the fiduciary acted imprudently in choosing one such course" (*Janes,* 223 A.D.2d at 27, 643 N.Y.S.2d 972). As previously noted, the stock was the main source of income to the 1957 Trust for the entire time it was retained, generating over $515,000 in dividend income. Inasmuch as the stated purpose of the 1957 Trust was to provide for the children of Knox, III, i.e., the income beneficiaries, we conclude that petitioner acted prudently in retaining the stock in an overweight concentration." 947 N.Y.S. 2d at 306 (emphasis added)

The Uniform Prudent Investor Act §3 provides that "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."

The comment to Section 3 notes that "[c]ircumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an underdiversified block of low-basis securities, the tax costs of recognizing the gain may out-weigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify."

Restatement (Third) of Trusts §90(b) provides "[i]n making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."

Restatement (Third) of Trusts §92 provides in Comment a, "[i]n some circumstances, for example, tax considerations (looking to the tax positions of both the trust and the beneficiaries) may tend to suggest retention of inception assets, and in others these considerations may tend to suggest that conversion be made promptly…. In addition, the trustee's decision to retain or dispose of certain assets may properly be influenced, even without trust terms expressly bearing on the decision, by **the property's special relationship to some objective of the settlor** that may be inferred from the circumstances, or by some special interest or value the property may have as a part of the trust estate or that it may have, consistent with trust's purposes and the trustee's duty of impartiality, to some or all of the beneficiaries. Examples of such property might be land used in a family farming operation, the assets or shares of a family business, or stockholdings that represent or influence control of a closely or publicly held corporation." (emphasis added)

Hence, the Appellate Division's decision to adopt a "special relationship" exception to the duty to diversify follows the general language of the UPIA and Restatement Third of Trusts.

Reliance on "Counsel"

The Appellate Division rejected the GAL's objection to the overweight holdings in several securities, undertaken at the request of Knox III, a non-trustee. "[I]n our view, although the GAL contends that there was a failure to diversify, it is apparent that the GAL is in fact objecting to overweight concentrations of particular securities and not diversification in general.

A review of the account summary establishes that the 1957 Trust was indeed diversified in its investments. It held securities, cash, and bonds, and the securities were spread out over different industries. In any event, we conclude that there was no failure to diversify and that petitioner did not act imprudently in holding overweight concentrations in certain securities." 947 N.Y.S. 2d at 305 . A whiff of diversification apparently is enough in upstate New York.

The Court rejected the objections of the Guardian Ad Litem that the petitioner abdicated its role as corporate trustee to Knox, III. "The 1957 Trust specifically provided that petitioner 'may advise with counsel and shall be fully protected in respect of any action under this instrument taken, suffered or omitted in good faith by [petitioner] in accordance with the opinion of counsel.'" 947 N.Y.S. 2d at 302. The Court held that the term "counsel" did not refer solely to attorneys, but rather included persons from whom a fiduciary could seek investment advice, which included the deceased beneficiary Knox III, and exonerated the trustee. It held that the exculpation was not barred by EPTL 11-1.7, which bars operation of an exculpatory clause which would excuse "a failure to exercise reasonable care, diligence and prudence." 947 N.Y.S. 2d at 302. "Indeed, prudent people, including prudent investors, often consult with other investors. Knox, III was a cotrustee on numerous other trusts involving the same family and he had a vested interest in the success of this particular trust inasmuch as it was intended to benefit his children. Due to the special relationship that the Knox family had with petitioner, there was a level of cooperation and communication that was unique and, in our view, prudent….[b]ecause the evidence at trial established that Knox, III was a knowledgeable and savvy investor, we conclude that petitioner acted prudently and in good faith in consulting with him and considering his advice in making investment decisions." 947 N.Y.S. 2d at 303. A reading of the trial decision makes this conclusion very difficult to credit—the chairman of the board of the corporate trustee dictated to the investment officers what they should do and they followed his directives without any indication of due diligence. Whether this reflects sympathy for the plight of these employees confronted with a demanding boss or a broad reading of the trust's exculpatory clause, it is nonetheless a surprising decision.

The Court interpreted the waiver of the conflict of interest with respect to the holding of the Marine Midlands stock as a retention clause, rather than simply a conflict waiver. These should be two separate and distinct issues.

Other Precedents for Excessive Concentration Liability and Damages

The Surrogate's measure of damages for investment breach, holdings in excess of a prudent amount, are based on the principles of the *Janes* decision, but here the measure was applied to multiple investments in excess of 10%, the bank's internal benchmark. Other courts have looked at excessive investments in portfolio components.

In *California Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036 (9th Cir. 2001) the Court affirmed a finding that the investment advisor to a pension trust imprudently invested too large a portion of the assets in inverse floaters, a derivative security based on CMO's. Unlike a common floater, an inverse floater's rate of return moves inversely to market rates, rising when the rate index falls and falling when the rate index rises. 259 F.3d at 1041.

On appeal, the Ninth Circuit held: "[w]hile we have not previously addressed the issue of the appropriate measure of damages when the breach of fiduciary duty arises from the degree rather than the mere fact of investment in a particular security, the Restatement (Third) of Trusts is instructive in this regard: "If a breach of trust consists only in investing too large an amount in a single security or type of security, the trustee is liable only for such loss as results from the investment of the excess beyond the amount which it would have been proper so to invest. Restatement (Third) of Trusts, §205, cmt. f. The common law of trusts in incorporated into analysis of ERISA claims unless inconsistent with the statute's language, structure or purpose. *See Harris Trust and Sav. Bank v. Salomon Smith Barney, Inc.* 530 U.S. 238, 250, 120 S.Ct. 2180, 147 L.Ed.2d 187 (2000). Moreover, the measure of damages set forth in the Restatement is based upon sound reasoning. It would be both illogical and unjust to require a fiduciary to pay damages resulting from the entire amount of an investment when only a portion of the investment was imprudent. 259 F.3d at 1046-47.

The Court in *California Ironworkers Field Pension Trust* looked to the decision in *GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobson, Inc.*, 895 F.2d 729 (11th Cir. 1990), the Court concluded that investment of 70% of the portfolio's assets in long-term treasuries was imprudent, but that investment of thirty-five percent of assets in long-term treasuries would have been acceptable. The Court measured the damages by calculating the difference in yields between the actual portfolio containing 35% long-term treasuries. 259 F.3d at 1047. The matter was remanded to determine what amount of investment in inverse floaters would have been appropriate. The trial court had calculated damages based on what the trust would have earned if the excess investments in inverse floaters had in fact been invested in appropriate fixed income securities, calculating a benchmark yield for measuring damages. The Court advised: "[h]owever, to the extent that the district court may wish to rely upon the benchmark yield in its recalculation of damages, such reliance would be appropriate. It would be extremely difficult to arrive at even an approximate calculation of the yields which reasonably could have been expected from different portions of the portfolio assuming appropriate investment. When precise calculations are impractical, trial courts are permitted significant leeway in calculating a reasonable approximation of the damages suffered. *See Sutton v. Earles*, 26 F. 3d 903, 918 (9th Cir. 1994)." 259 F.3d at 1047.

Measure of Damages for Excess Concentration: Annual Compilations

Unlike the measure of damages used in *In re J.P. Morgan Chase Bank,* 2010 WL 1340823, 27 Misc.3d 1205(A), 910 N.Y.S.2d 405 (Table) (N.Y. Sur. March 31, 2010), the Surrogate in *In re HSBC Bank USA, N.A*. used the same methodology as earlier decisions which attempt to follow the *Janes* decision. Compound statutory interest is calculated from the date when the Court found a sale should have been made, and then the total of sale proceeds and compound interest are reduced by the proceeds of actual sales, plus compound interest, plus dividends. Hence, the compounding runs for the entire period until the ultimate sale before being reduced. The Woolworth surcharges were remanded to the trial court for calculation, based on the Appellate Division's holding that the "[O]bjectant's expert failed to apply an interest rate that was compounded annually on the dividends and failed to account for capital

gains taxes to the hypothetical sales of stock." 2012 WL 2332825 at *12. The Court on appeal held:

> "Petitioner correctly contends that '[p]er diem interest [at the appropriate rate] shall be calculated each year on the rolling balance as adjusted for each dividend received and the proceeds from each sale of stock. The total annual per diem interest shall be added to the rolling balance at the end of each calendar year which shall then constitute the based for calculating per diem interest for the ensuing year' (*Hunter*, 2010 N.Y. Slip Op 50548 [U], *14)….We thus conclude that the Surrogate erred in failing to apply compound interest to dividends." 2012 WL 2332825 at *13.

The Court on Appeal cited *Matter of Lasdon*, 32 Misc. 3d 1245[A], 2011 N.Y. Slip Op 51710[U], *2) to find that "the purpose of damages is to replace capital that has been lost by the trust, not by the beneficiaries." 2012 WL 2332825 at *14. The Court looked at the statutory interest rate selected by the Surrogate, 9%, and concluded that it should have used the 6% rate applied to damages prior to 1981. Because the surcharge sustained was after 1981, the issue of damages was held moot. *Ibid.*

The Court held that since the Surrogate found "'no evidence of malevolence, dishonesty, or other malfeasance on the part of [petitioner],' we conclude that it was an abuse of discretion to order petitioner to pay attorneys' fees and expenses to the attorney for the adult objectants." 2012 WL 2332825 at *15.

In re Lasdon, 32 Misc. 3d 1245 (A), 2011 WL 4375062 (N.Y. Sur. Aug. 23, 2011) discusses a number of significant issues regarding calculation of damages. The case will not be published in a printed volume and it is not clear whether it has been appealed. The trusts in question were not distributed in a timely fashion, resulting in a substantial delay in which the principal asset, Pfizer stock dropped in value from $27.44 a share to $22.24. Approximately 82,000 shares of stock were held in the two trusts. The stock had a basis of $3.86, so that if sold, substantial capital gains would have been incurred. The parties stipulated to the length of the delay and to the price of the shares on the respective dates, apparently compromising to fix minimum potential damages at the expense of upside (since the stock continued to fall). The primary issues dealt with whether capital gains should have been subtracted from damages, and whether damages could be awarded even in the absence of sales. The beneficiaries sought damages even though they still held the stock, since they might have used the stock at an earlier time as collateral for loans or the basis for hedging strategies, suffering the loss of the benefits which might have accrued to them if they had the control over the stock at an earlier time with a higher price. This is new ground for damage calculations.

The trustee cited *In re Saxton*, 274 A.D. 110, 712 N.Y.S.2d 225 (2000), for the proposition that damages for failure to diversify a concentrated position in a single stock should be reduced by a sum representing imputed capital gains tax in respect of the hypothetical sale at the time the stock should have been diversified. 2011 WL 4375062 at *2. The Court distinguished *Saxton* on the ground that it that case the damage measure was intended "to put the trust in no worse –but no better—position than the one it would have occupied if the trustee had

duly sold. In other words, there was at least some logic to factoring into the calculation of the surcharge a tax imputed to the trust on its forgone gain." *Ibid.*

The Court held that "since objectants' losses arise from the fiduciary's delays in making in-kind distributions, it is wholly speculative to propose that objectants would have at some point sold what they received –and at a taxable gain at that—if it had been timely distributed to them." *Ibid.*

Offsetting Losses With Portfolio Gains

The Court also rejected the trustee's claim that damages should have been offset by gains enjoyed in the value of other trust securities, which appreciated during the period Pfizer fell in value. The Court rejected this based on the principles found in Restatement (Third) of Trusts §101 (formerly Restatement Second of Trusts §213): "The amount of a trustee's liability for breach of trust may not be reduced by a profit resulting from other misconduct unless the acts of misconduct causing the loss and profit constitute a single breach."

The Court cited the "anti-netting rule" contained in several New York appellate decisions, quoting *Matter of Buck*, 55 N.Y.S.2d 841 (NY Sur. 1945): "'[A] gain realized by the retention of certain securities may not be employed to offset a loss occasioned by the retention of other securities to which objection has been made. A trustee who is liable for a loss resulting from a breach of trust with respect to one portion of the trust property cannot reduce his liability by reason of a gain with respect to another portion of the trust property occasioned by a separate and distinct breach of trust.'" 2011 WL 4375062 at *3.

The Court explained: "a trustee who has harmed the trust by a breach of duty cannot be allowed to use his own advantage investment 'fruits' that the terms of the trust have earmarked for the beneficiary (*see Matter of Bank of New York (Spitzer)* (35 N.Y.2d 512 [1974]; Scott and Ascher on Trusts §24.18 [5th ed. 2007])." *Ibid.*

The Court held that "when (as here) a fiduciary's breach has been established, there is nothing to prevent a court from fidelity to the anti-netting precedents by imposing the surcharge without regard to such investment gains as the trustee may have at the same time achieved (see Jeffrey Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 NYUL Rev. 52, 97 [1987] ('[T]he anti-netting rule is not inconsistent with portfolio theory. [T]he rule pertains to balancing losses arising from one or more breaches of trust against gains from any source….'" *Ibid.*

Looking at the statement of the principle in *Buck* as well as the Restatements, the issue is whether the increase in value was created by a single breach, or by different breaches. Here the issue is not investments, but the delay in distributing investments. In other words, the breach in each case was the same—a delay. If one followed the letter of the rule, there should have been an offset. Following the explanation of the Court, since the beneficiary was always entitled to the fruits of the other assets, no netting should be possible.

Damages for Loss of Use

The Court then dealt with the trustee's claim that compound statutory interest should not be imposed since the beneficiaries requested in-kind distributions, and hence no interest should be awarded. The Court ruled that "[t]o the extent that objectants were denied timely receipt of the property in question, they were thereby denied the opportunity to do with the property thereafter as and when they wished, whether to hold it as a continuing investment, or to hypothecate it, or to reinvest it. An award of interest is the mechanism for compensating parties for just such lost opportunity (*see Bamira v. Greenberg*, 295 A.D. 2d 206, 207 [1st Dept.2002].)…In other words, factoring interest into the surcharge here serves the purpose of making objectants whole." 2011 WL 4375062 at 4.

The explanation of the Court regarding the damages sustained by the beneficiaries is a significant one, since most cases simply deal with lost interest. Here the Court notes that the beneficiaries lost the opportunity to have the trust assets to be used for various other investment transactions, such as borrowing against the value. This may be of significance in circumstances, where a fiduciary uses the property for her own benefit, and tracing may provide a use which the trustee should have made for the trust, resulting in damages based on what the trust would have earned or disgorgement of a profit made by the trustee by a breach of the duty of loyalty. Hence this explanation of the types of injury caused by an improper transaction may open other measures of damages appropriate to the factual context.

The Court did reject compound interest at 9 percent, stating that "the delay that is the basis for surcharge was to some extent the product of mixed signals among the trustees, aggravated by the passive role that two of them had played in the trust's management pursuant to an agreement among all three that apparently had been reached in good faith. Under such circumstances, a more moderate, albeit compensatory interest award is warranted. Accordingly, the surcharge in this case is subject to interest at an annual rate of six per cent, compounded annually (net of such ordinary income as was realized on trust assets during the period when they were improperly retained)." 2011 WL 4375062 at *5.

Diversification, Alleged Conflicts and Failure to Disclose

In *Matter of Trust of Burford*, Case No. PT-2006-013 the trial court held that the trustee violated its duty of prudence in entering into various variable prepaid forward contracts with the Exxon stock held in the trust. The trust contained a generic retention clause citing that the Grantors had high regard for the inception assets, including Socony Mobil Oil Company, Inc. (later merged into Exxon). The clause stated "they specifically *recommend* that, except for unusual circumstances, the Trustee retain all such stocks throughout the terms of the trust and regardless of whether or not such retention may appear to offend against what might ordinarily be considered a sound trust investment practice and the usual principles of investment diversification." (emphasis added). This could be construed as merely precatory language—however the court in its decision treated it as a mandatory direction. Restatement (Third) of Trusts §13com. d at 209-210; *Stevens v. National City Bank*, 544 N.E. 2d 612 (Ohio 1989). *See* discussion of precatory language in *Dumont*, "[t]here is no disputing the fact that the language which authorizes the sale of stock is worded much more strongly than the language which urges

retention. In fact, the empowerment language is written using mandatory terms whereas the retention language which relies upon the phrase "it is my desire and hope" is clearly precatory. Precatory phrases are not binding on a fiduciary (see discussion in Warren's Heaton on Surrogate's Courts, § 187.02[8][a]), and Dumont's words "desire and hope", have even less proverbial teeth than precatory phrases at issue in prior cases. See, In re Flanagan, 184 Misc. 938, 55 N.Y.S.2d 200 (1945)." 2004 WL 1468746 at 6.

The Court found that investment of trust assets in variable prepaid forward contracts constituted an impermissible conflict of interest, and also were imprudent. "The investment of the VPF proceeds did not satisfy the Bank's duty of prudence. Prudent use of a VPF also requires a plan to invest the proceeds to compensate for the high cost of the VPF. No Bank employee evaluating the VPF strategy ever made an inquiry regarding how proceeds would be invested. The Bank's failure to determine how the proceeds would be effectively invested prior to entering into VPF contracts was a breach of its duty of prudence." Incurring substantial borrowing costs plus the prospect of forced sales and capital gains led the Court to hold the actions imprudent.

The merger of Socony Mobil into Exxon also raises the question whether this was an inception asset, or whether the nature of the security had been changed. The Court in *Donato v. Bankboston, N.A.* (D. R.I. 2000) 110 F. Supp.2d 42, dealt with a number of provisions on which the trustee relied to avoid liability for alleged imprudent concentrations in a single security. The trust in question authorized the retention of original assets. In this case, the securities were convertible debentures of CML Group. These, however, had been converted to common stock. The Court noted that in some situations, "a security substituted for an original security 'as a result of a reorganization, recapitalization, or other cause' is not subject to the provisions of a retention clause," but holding that this was true only if it is "substantially the equivalent of the old security." 110 F. Supp. 2d at 50. The Court noted that the convertible debentures offered liquidation preferences, while the common stock did not. It cited Bogert, Trusts & Trustees, §682 at 126-127 (2d ed. 1982) for the proposition that "if in any material respect there has been a change in the nature of the ... risk, security, or priority, the new property ought not to be held under the [retention] authorization clause." 110 F. Supp 2d at 51.

Evaluation of the Portfolio as a Whole

Matter of HSBC Bank and Ely, 952 N.Y.S. 2d 740 (NY Sur, September 25, 2012) granted summary judgment for the trustee in a surcharge matter in which the objecting beneficiary claimed that the retention of positions in four stocks, General Electric, Merck, Microsoft and Pfizer, following the 2000 crash was imprudent. The trust was funded in 1968, with a total value of $172,618.45, and grew to over $3.6 million in 2006. The trustees had distributed approximately $1.9 million in distributions to the life beneficiary.

The trust was funded principally with shares of the Soper Company, a closely held entity. The beneficiaries argued that the positions of the four stocks each constituted more than 5% of the trust portfolio and then argued that 5% is the maximum amount that prudently could have been held. In *Matter of Janes*, 681 N.E. 2d 332, the Court held that the amount of stock which constituted an impermissible concentration was a question of fact, approving a surcharge to the

extent that the concentration exceeded 5% of the total portfolio. The trial court, facing a summary judgment, skirted this issue.

The judge properly pointed out that 60% of the value of the portfolio was Soper stock, and that of the remaining 40%, 25 stocks were involved, albeit with General Electric, Merck, Microsoft and Pfizer representing $1.3 million, or 70% of this multi-stock portfolio. 952 N.Y.S. 2d at 742-43.

Since there was no objection to the retention of the closely held Soper position, the Court concluded that isolating the four stocks was inappropriate—the individual positions had to be evaluated in the context of the overall portfolio. The decision cited the testimony of an expert, Kenneth F. Joyce, who had served on the Legislative Advisory Committee which led to the adoption of the provision adapted from the UPIA:

> "Both the statute and the Legislative Memo emanated from the Third Report of the New York EPTL/SCPA Legislative Advisory Committee of which I was a member. That Report elaborates on why the focus must be on the *entire portfolio.*"
>
> "Of particular importance is the Committee discussion in the portion of the report devoted to 'Modern Portfolio Theory,' where the Committee states:
>
> According to so-called modern portfolio theory, systematic risk cannot be avoided. The marketplace compensates the buyer only for systematic risk but not for specific risk. This is because specific risk can be eliminated by diversification. For example, a properly diversified portfolio of common stocks will greatly reduce specific risk associated with these securities taken individually. Indeed, the foundation of modern portfolio theory rests on the mathematically derived conclusion that a security which is itself highly volatile, when combined with one or more other securities to create a portfolio, can actually reduce overall portfolio volatility to levels below those associated with individual securities." 952 N.Y.S. 2d at 743 (emphasis added).

The Court then analyzed the steps taken by the trustee to determine whether its asset allocation should have been changed when the market crashed in 2000:

> "I find that HSBC complied with the prudent investor standards when it determined to retain the General Electric, Merck, Microsoft, and Pfizer stocks. The evidence establishes that these stocks were on HSBC list of approved stocks which could be held in its investment portfolios. The four stocks were selected to comply with trust beneficiary James, Jr.'s direction that the focus of the trust's investments be on long-term growth rather than on current income-generating assets. This strategy was consented to by co-trustee Franklin Ely, and was reflected in the

> accounting settled by release from James, Jr. in the year 2000. The accounting and the evidence submitted in support of its motion also demonstrate that HSBC complied fully with its internal policies regarding acceptable equity holdings in relation to these four stocks within the entire portfolio." 952 N.Y.S. 2d at 745.

The Court concluded:

> "The General Electric, Merck, Microsoft, and Pfizer stocks all did exceptionally well until the year 2001, when the record reflects that the entire market experienced an overall decline. At that time, the four stocks were reviewed, and it was determined, in light of the goal of long-term growth, that it was appropriate to retain the majority of those stock holdings because, given the overall market decline, it would not have been prudent to sell all of the stocks in a declining market. Further, the trustee also determined that, if substantial stock shares were sold, the trust would have to pay significant capital gains taxes. Even if one were to disagree with the strategy—and I express no opinion in that regard—the record demonstrates a thoughtful, well-considered evaluation by the trustee of the portfolio and the stocks it held, and the trustee came to a balanced approach to managing the assets under all the circumstances.
>
> "I find that HSBC has established its entitlement to judgment as a matter of law, and I further find that objectants have failed *884 to raise any issues of material fact that HSBC violated its fiduciary duty in any way in carrying out its management of the trust assets. See e.g., *Matter of Schnare*, 191 A.D.2d 859, 860, 594 N.Y.S.2d 827 [1993], lv. to appeal denied, 82 N.Y.2d 653, 601 N.Y.S.2d 582, 619 N.E.2d 660 [1993]; see also *Matter of Gallagher*, 81 A.D.3d 825, 916 N.Y.S.2d 804 [2011] and *Matter of Campione*, 58 A.D.3d 1032, 872 N.Y.S.2d 210 [2009]." *Ibid*

***Hunter* Decision Affirmed**

The Appellate Division affirmed the $4,322,412.40 surcharge of the trustee in *Matter of Hunter*, 955 N.Y.S. 2d 163 (A.D. 2012) for retention of a major concentration in Eastman Kodak stock for 20 years after it should have been diversified. The trial court found that 95% of the stock should have been sold after July 31, 1987. The Court affirmed the findings of the surrogate that the trustee "never formulated any investment plan for the trust that included diversification of the concentration of Kodak stock, that it acted contrary to its own internal policies, which restrict the retention of any one stock unless certain circumstances existed, none of which were present here, and that it failed to establish that it took steps to determine whether it was in the interests of the beneficiaries to retain nondiversified holdings in the trust in light of the purposes and terms of the trust and provisions of the governing instrument." 955 N.Y.S. 2d at 998. The Court denied without discussion of the amount of the surcharge. Such a calculation of

damages, including calculating the impact of capital gains taxes on the damages, is a major open issue in New York.

***Strong* Decision Denies Summary Judgment on Use of Index Measure of Damages**

The trial court in *Matter of Strong*, 2013 WL 150260 at *1 (NY Sur., Jan 11, 2013) denied partial summary judgment for the trustee in a separate case involving a long-term concentration in Kodak stock. The trustee had sought partial summary judgment excluding an index measure of damages. This was denied. The Court held that in light of a ruling allowing the Objectants to amend their claims to include allegations of self-dealing and conflict of interest, an appreciation measure of damages was possible, citing *Matter of Rothko*¸43 N.Y. 2d 305 (1977) and *Scalp & Blade v. Advest, Inc.*, 309 A.D. 219 (4th Dept. 2003).

The Objectants in four separate trusts had alleged that the trustee failed to step up the basis of the stock on the death of the holder of a power of appointment, leaving the stock with a basis of 81 cents, rather than $93 per share, leading to excessive payment of capital gains on the sale of the Kodak shares. 2013 WL 150260 at *2. The Court noted that the power of appointment involved was a pre-1942 power and that there was a dispute of fact as to whether the power had been partially released prior to November 1, 1951 under 26 U.S.C. §20141 (a)(1)(B)(i) and hence denied the partial summary judgment. The Court also denied partial summary judgment on the question of whether the value of capital gains taxes paid on the hypothetical stock sales should have been added back in. The Court cited conflicting opinions on the issue, including the decision in *Matter of HSBC Bank USA, N.A,* 94 A.D. 3d 300 (4th Dept. 2012). The Court concluded that in light of such conflicting opinions, partial summary judgment should be denied.

The New York Court of Appeals really should resolve this question.

Daubert and Fiduciary Investment Experts

The trial court in *Salmon v. Old National Bank*, ___F.Supp.2d___, (W.D. Ky., Sept. 19. 2012), 2012 WL 4213643, ruled on a host of partial summary judgment motions with regard to an alleged failure to properly create an appropriate trust investment portfolio, holding 20% of assets in equities from 1985 to 1994, and then moving to 50/50 equities and bonds. The remainder beneficiaries sought surcharge and tendered expert opinions on the issue of imprudence and the measure of damages. Defendant challenged the liability and damage measure experts under *Daubert*, but the Court denied the motions to exclude such testimony. The Court held: "[i]n this case, the Court agrees with Plaintiffs that the *Daubert* factors are not a useful tool for evaluating the reliability of Hoffer's opinions. Moreover, the Court finds that Hoffer's testimony is similar to the expert testimony admitted in *First Tennessee* and *Century Indemnity* and should, therefore, be admitted. Hoffer has extensive experience in trust administration with over fifty years of work in seven banks and as the founder and CEO of North Indiana Trust Company before its acquisition. (Pls.' Consol. Resp. in Opposition to Mot. For Summ. J .-Count IV & Mot. to Exclude Pls.' Expert Witnesses [DN 276] 20.) Through these myriad experiences, it is undeniable that Hoffer has become sufficiently familiar with the prudent investor standard and whether an investment plan satisfies that standard. Indeed, Hoffer's

report sufficiently indicates that he bases his testimony on the “same level of intellectual rigor that characterizes the practice in the relevant field.” *Bush v. Dyno Nobel, Inc.,* 40 F. App'x 947, 960 (6th Cir.2002) (quoting *Kumho Tire,* 526 U.S. at 152). His analysis indicates reliance on industry customs, as he notes that “[i]n the trust industry, process is unusually important because trustees are managing someone else's property” and that there remain “national standards” of appropriate trust management, as evidenced by the banks that “tout and advertise” certain conduct, behavior, and accountability when marketing their trust services. (Pls.' Consol. Resp. [DN 276] 15.) Also, Hoffer's identification of nine pieces of information that, in his experience, a trustee needs to know to implement an investment decision indicates that Hoffer is relying on prevalent standards in the industry, as he has witnessed during his experiences. His report is based on more than unsubstantiated beliefs; therefore, Hoffer should not be precluded from giving his opinion that given the needs of the primary beneficiary Ruth Salmon, including those based on her age, the focus of the trust should have been on income production, not asset growth.” 2012 WL 4213643 at *3

As to the damage expert, the Court refused to exclude, holding: “Defendant contends that Wheeler's report is incomplete, failing to provide Defendant with sufficient notice on the calculation's methodology and reasonableness. The Court finds, however, that Wheeler's report sufficiently identifies the method used to calculate damages-namely, the yardstick method. It also adequately addresses the inputs used to create the yardstick portfolio-namely, Morningstar software using benchmark indices for the damage period, with an 80% bond index and 20% S & P 500 index. This information provides Defendant with sufficient notice to prepare a rebuttal to the damages calculation such that there is no fear of ambush at trial. Again, to the extent that Defendant contends the report contains inadmissible factual and legal conclusions, the Court notes that ‘[a]n opinion is not objectionable just because it embraces an ultimate issue.’ Fed.R.Evid. 704. Thus, the expert report itself should not be summarily excluded.

“Further, in regards to the opinion on estimated damages, Defendant contends the calculation should be struck because it only considers a small portion of the period during which Wheeler opines that the assets were improperly allocated. Defendant highlights that while Wheeler believes the assets were improperly allocated from 1995 until 2002, his damage calculation only includes the years 1999 until 2002. Defendant believes that Wheeler's inclusion of only the years that the market as a whole performed poorly makes the report unreliable. Other courts that have considered this issue, however, have found that it is the defendant who bears the burden of demonstrating that losses from a breach of duty were offset by gains that resulted from the same breach. *See, e.g., Alco Indus., Inc. v. Wachovia Corp.,* 527 F.Supp.2d 399, 409 (E.D.Penn.2007). The Court believes this approach is more acceptable. Thus, while Defendant remains free to rebut Plaintiffs' damages calculation, that burden does not fall on Plaintiffs. The fact that Wheeler's report does not include an offset sum does not render it unreliable; it is still based on sufficient methodology. Defendant's motion to exclude the testimony of Wheeler is DENIED**.”** 2012 WL 4213643 at *5

The Court discussed the defendant’s claim that since the volatility (beta) of the portfolio was similar to the broad market, damages should be denied, citing *In re Duffy*, 2009 WL 2929420 (N.Y. Sur. Sept. 8, 2009). “Defendant suggests that it cannot be liable since the losses performed closely with the fall of the market itself. Defendant cites *In re Duffy* for the

proposition that to hold Defendant "liable for the portfolio's losses when the portfolio's valuation fluctuation almost exactly followed the market would be akin to expecting him to have had the prescience to invest and outperform the market, an unreasonable requirement the law does not expect." 2009 WL 2929420, at *6 (N.Y.Sur. Sept. 8, 2009). The Court finds, however, that the *In re Duffy* decision does not mandate summary judgment as to causation in this case.

"In *In re Duffy,* the Court entered its decision as to causation **after** a three-day bench trial. [citation omitted] The Court did not enter summary judgment as to the issue and did not indicate that doing so would have been proper. In fact, the Court's opinion merely suggests that it was 'logical to conclude that the losses experienced by the estate's portfolio were due to drops in the market itself.' [citation omitted] It in no way indicates that such conclusion was the only logical one to make. In this case, construing the facts in the light most favorable to Plaintiffs, a reasonable jury could conclude that Defendant's performance was the cause-in-fact of Plaintiff's harm. There are genuine disputes of material fact as to whether the asset allocation chosen by Defendant was prudent and whether the losses, if any, were attributable to Defendant's allocation or the market. Defendant has failed to meet its burden to establish the absence of a genuine dispute of material fact. Accordingly, its motion is **DENIED."** 2012 WL 4213643 at *9-10.

The Appellate Division in *In re HSBC Bank USA, N.A.*, (App. Div. 2012), 98 A.D. 300, 947 N.Y.S. 2d 292, 307, held that the expert witness of the Objectant had been properly admitted as an expert. "'[T]he qualification of a witness to testify as an expert is a matter that rests in the discretion of the trial Court, 'subject to review only if the Judge has made a serious mistake, committed an error of law or abused the discretion'….) *Matter of Pringle v. Pringle*, 296 A.D. 2d 828, 829, 744 N.Y.S. 2d 784; *see Werner v. Sun Oil Co.*, 65 N.Y.2d 839, 840, 493 N.Y.S.2d 125, 482 N.E. 2d 921).'" The Objectant's expert "had work experience managing 'hundreds of trust accounts' as well as three common trust funds, and he completed annual performance evaluations of those common trust funds. As an arbitrator for 'FINRA' and 'NASD,' he completed damage calculations related to trusts. Those calculations involved consideration of returns on various portfolios. In comparison, petitioner's expert was a 'distinguished university professor' of finance and statistics with a Ph.D. in finance, economics and econometrics. He was the managing editor of the Journal of Financial Economics, and had published numerous articles on the valuation of securities and the stock market. He had testified as an expert witness approximately 10 times, but had consulted on many additional cases involving the computations of damages under the lost capital methodology." *Ibid.*

The Court in *Matter of Lasdon*, 32 Misc. 3d 1245(A), 2011 WL 4375062 (N.Y. Sur. Aug. 23, 2011) struck the expert opinion of the trustee in that matter, finding that "[t]he affidavit, which reads like a memorandum of law, is not designed to inform a factual question (the usual province of expert testimony), but instead provides only case law analysis on the pure question of law as to how damages are to be calculated in this instance. The expert's report accordingly is stricken from the record on these motions (*Meason v. Greenwich and Perry Street Housing Corp.*, 268 A.D. 2d 156 [1st Dept 2000]['Expert testimony as to a legal conclusion is impermissible.']; *Russo v. Feder, Kaszovitz, Isaacson, Weber Skala & Bass LLP,* 301 A.D. 2d 63, 68-69 [1st Dept 2002]; *Franco v. Jay Cee of N.Y. Corp.* 36 AD3d 445,448 [1st Dept 2007])." 2011 WL 4375062 at *1, fn3.

Discovery of Trustee's Defense Counsel Billings

In *Bell v. Bank of America*. ___S.W. 3d___, 2012 Ark App 445, 2012 WL 3744701, the Court affirmed a decision holding that the former corporate trustee had not breached its fiduciary duties and refused to allow discovery of the detailed billings of the bank's defense counsel. The trial Court had awarded attorney's fees, reviewing the detailed billings *in camera*. On appeal, the Court affirmed the refusal to provide the detailed billings: "The Bells' main contention appears to be that they are entitled, under both Arkansas law and the trust instrument, to the detailed invoices provided to the bank by the law firm. We disagree. In *Salem v. Lane Processing Trust,* 72 Ark.App. 340, 343, 37 S.W.3d 664, 666–67 (2001), we held that a trust beneficiary 'is always entitled to such information as is reasonably necessary to enable him to enforce his rights under the trust or to prevent or redress a breach of trust.' (citation omitted) (quoting the Restatement (Second) of Trusts, § 173 cmt. c (1959)). In that case, we affirmed the denial of unlimited access to all of the records of the trust by the beneficiary because the beneficiary failed to articulate a need for the documents other than a vague need to prevent or redress a breach of trust. We noted that 'Arkansas law presumes a trustee has acted in good faith and places the burden of proof upon those who question his actions and seek to establish a breach of trust.' 72 Ark.App. at 343–44, 37 S.W.3d at 667. The *Salem* Court also agreed with the trial court's statement that the beneficiary was 'not particularly interested in vindicating his own rights under the trust,' but was interested in continuing a pattern of 'vexatious lawsuits' derived from 'second-guessing everything that [the trustees] have done. 72 Ark.App. at 342–43, 37 S.W.2d at 666." 2012 WL 3744701 at *4-5

"The Bells' request for the WLJ billing records falls squarely within the circumstances of *Salem.* In their brief to this Court, the Bells assert that they need access to the invoices in order to ascertain whether they were overcharged and to determine whether there has been a breach of fiduciary duty. However, in its April 20, 2010 order denying the Bells' petition to terminate the trust, the Circuit Court found no indication that the trust had been mismanaged. The Bells do not assert that there is any new evidence of mismanagement by the bank. Moreover, at the hearing on the petition for accounting, the Bells did not specify any reason other than that the trust was paying attorney's fees to WLJ and two other law firms, Friday, Eldredge & Clark, LLP and the Rose Law Firm. Although Ann Bell acknowledged that she had a statement from the bank showing the amounts paid to WLJ, she still wanted the detailed billing invoices. Bell also said that she was trying to protect the trust." 2012 WL 3744701 at *5

"What is reasonable is generally a question of fact. *Salem,* 72 Ark.App. at 344, 37 S.W.3d at 667. Because the Bells were reasonably informed as to what the bank was paying WLJ, we cannot say that the Circuit Court clearly erred in denying the Bells access to the detailed billing invoices. The statement provided by the bank covers the period of January 1, 2010, through November 20, 2010, shortly after the bank transferred the trust assets to its successor trustee, BancorpSouth, and shows that the trust paid fees of $22,905.29 to the law firm during that period. This period included the litigation over the termination of the trust. The statement also shows the receipts, disbursements, and distributions made by the trust, thus complying with the requirements of Ark.Code Ann. § 28–73–813 (Supp.2011) and the trust instrument. Contrary to the Bells' argument, this statement also shows that they were receiving regular distributions from the trust, as well as having expenses such as medical bills, insurance

premiums, mortgage payments, and household repairs paid by the trust. The expenses for which the Bells sought reimbursement were expenses associated with the litigation they instituted and in which they did not prevail and for certain veterinary bills." 2012 WL 3744701 at *6.

Enhanced Index Funds and the Search for Portable Alpha

The Court in *Prudential Retirement Insurance and Annuity Co. v. State Street Bank*, ___F. Supp.2d ___, (S.D.N.Y. November 19, 2012) 2012 WL 5868301 the Court denied summary judgment to PRIAC dismissing State Street's contribution and defamation claims, based on law of the case, arising from an ERISA decision by another judge following trial, *In re State Street Bank and Trust Co. ERISA Litigation*, 842 F. Supp. 2d 616 (S.D.N.Y. 2012). In that decision, the trial court awarded PRIAC $28,143,656, finding that "State Street (1) violated its duty of care, skill, prudence and diligence; (2) did not violate its duty of loyalty; and (3) violated its duty to diversify its investment portfolio." 2012 WL 5868301 at *1. The Court denied the summary judgment motion.

The ERISA decision was based on investments made in an "enhanced" bond index fund, which relied in part on State Street Funds which sought to obtain "portable alpha" by investing in "off-index securities" including derivatives backed by subprime-based assets. 842 F.Supp.2d 614 at 624-625. Suffice it to say, the opinion in the ERISA case does not award laurels for the financial engineering skills involved. It is cautionary reading for those who seek to enhance returns in a low-interest environment by looking to quants and black boxes for alpha.

Alternative Investments

Moving to alternative asset classes has not proved very successful in recent years, as hedge funds have performed poorly. The Court in *Parris v. Regions Bank,* ___F.Supp. 2d___, 2011 WL 3629218 (W.D. Tenn. Aug. 17, 2011) rejected summary judgment by the corporate co-trustee of a trust. Claims were brought under Tennessee's Uniform Trust Code and Consumer Protection Act. The plaintiff alleged that the co-trustee had urged the sale of existing trust assets and invested them in a "proprietary junk bond fund," which ultimately included 72% of the trust assets by 12/31/2006. 2011 WL 3629218 at *1. "Parris alleges that Regions should have known that the Fund held high-risk, illiquid securities and sub-prime debt obligations that were not reasonable and prudent investments for the Trust. Despite 'storm warnings' about the volatility of those investments, Regions allegedly failed to diversify the Trust and failed to take reasonable steps to protect the Trust's assets." *Ibid.* The losses were allegedly $92,000. The plaintiff sought punitive damages of $500,000, exceeding the $75,000 minimum amount in controversy to support federal diversity jurisdiction, *Ibid at* *2. The Court rejected defenses of statute of limitations, consent, laches, and estoppel. The plaintiff alleged that the co-trustee failed to inform him that "the Fund invested in high-risk securities and collateralized debt obligations and that it had delegated investment authority to a Regions affiliate, Morgan Asset Management." 2011 WL 3629218 at *6. The Court denied a defense of ratification based on a failure to show that there had been full disclosure of material facts. "Regions has not conclusively shown that Parris had all of the facts necessary to form an opinion about the Trust's investments in the Fund, which is required to prove the defense of ratification under Tennessee law. *See Valley Fidelity Bank and Trust Co., [v. Cain Partnership, Ltd.*], 738 S.W. 2d [638,] at 640." The Court held that the

complaint was sufficient to allege an unfair and deceptive practice, by pleading that Regions "knew or should have known that the Fund was not a reasonable and prudent investment for the Trust." 2011 WL 3629218 at *8.

Since this round dealt with pleading sufficiency, which does not deal with the actual facts, the outcome is not foreordained. However, a jury is possibly going to hear the facts about a trustee recommending a proprietary mutual fund, managed by an affiliate, whose risk was allegedly not fully disclosed.

Conflicts in Portfolio Construction

In *Tussey v. ABB, Inc*, 52 Employee Benefits Cas. 2826, ___F. Supp.2d___, 2012 WL 1113291 (W.D. Mo., March 31, 2012), the Court held ABB liable as fiduciary for several defined contribution plans for utilizing revenue sharing by the plan record keeper, Fidelity Trust, to subsidize the company's own record keeping expenses. During the course of negotiating a recordkeeping compensation agreement, "Fidelity Trust conveyed to ABB the revenue and cost information as to all of its services to ABB, including recordkeeping for the defined benefit plan, non-qualified deferred compensation plan, health benefits, and payroll, i.e. ABB corporate services." 2012 WL 1113291 at *28. The Court, after trial, found that a consultant to ABB issued a contemporaneous report that "ABB overpaid for Plan recordkeeping services and that the Plan's recordkeeping payments via revenue sharing appeared to be subsidizing services for ABB corporate plans." *Ibid.* ABB was surcharged for $13.4 million for overcharges resulting from the use of excessive fees because of the conflict of interest and failure to act prudently in negotiating a reasonable fee in the interest of the beneficiaries of the retirement plans. 2012 WL 1113291 at 40.

The Court also found that ABB had chosen to change one of the principal plan options, in Vanguard's Wellington Fund, which involved revenue sharing with Fidelity in the amount of 15 basis points, in favor of a Fidelity target date/lifestyle fund, which paid 35 basis points in revenue sharing (2012 WL 1113291 at *20) without proper analysis of the performance and cost characteristics of the funds, and without "winnowing" the alternatives. (2012 WL 1113291*18). The Court concluded that "[b]ecause of the failure of [ABB] and the Group to employ a winnowing process in selecting the Freedom Funds and their failure to examine the performance history of the Wellington Fund prior to suggesting its removal to the Committee, the Court finds that [ABB] did not solely consider the merits of the Freedom Funds or the Wellington Fund when recommending that they be added or removed. Rather, the Court finds that [ABB] considered other factors, such as the effect of the fund selected on recording keeping fees, and what changes to the fee structure were in ABB, Inc's best interest. In sum, [ABB's] recommendation to add the Freedom Funds to the Plan's investment platform and remove the Wellington Fund despite its excellent performance record was motivated in part by his desire to decrease the fees that ABB was paying and to maintain the appearance that the employees were not paying for the administration of the Prism Plan." 2012 WL 1113291 at *20. The mapping of the Vanguard Wellington Fund to the Fidelity Freedom Fund resulted in $21.8 million in damages because of the cost and performance differences, according to the Court. 2012 WL 1113291 at *40.

The Court also held that Fidelity improperly transferred to the benefit of ABB the interest earned on the float it held on investment payments made for the plan, assessing damages in the amount of $1.7 million. 2012 WL 1113291 at *38.

Class Action for Alleged Exclusive Use of Proprietary Mutual Funds

The Court in *Stoody-Broser v. Bank of America, N.A.*, ___F. Supp 2d___ 2012 WL 1657187 denied a motion to dismiss against Bank of America based on a claim that it allegedly selected its own proprietary mutual funds as investments for beneficiaries. The plaintiffs had their initial complaint dismissed without prejudice under SLUSA. "SLUSA requires preemption and dismissal of certain class actions that allege false statements or omissions of material fact made in connection with the purchase or sale of certain securities." 2012 WL 1657187 at *2. To get around such restrictions, the plaintiffs sought to eliminate securities or misrepresentation claims, "the amended complaint alleges merely that Defendants fail to act with due care under their fiduciary obligations to do so." 2012 WL 1657187 at *4. On a motion to dismiss, the allegations of a complaint are assumed to be true, hence the actual facts of the case await discovery. How this class action can proceed without naming guardians ad litem, joining known and unascertained beneficiaries, and weighing the respective rights of income and remainder and contingent beneficiaries, and determining the risk and return objectives of such beneficiaries, will be interesting to observe. The normal class action rules which only require parties to opt out of any litigation class do some violence to the due process rules involving beneficiaries, particularly where there are multiple beneficiaries with different interests and objectives. Trying in rem actions involving trusts in the wake of *Marshall v. Marshall*, 547 US 293 (2006) may prove a major barrier to this type of class action.

The search for diversification in alternative investments will be fraught with risks such as those alleged in the *Regions* case. Make sure that your selections have been thoroughly examined, their risks assessed, and the manner in which the risk and return objections of the trust were satisfied by the inclusion of such an asset in the trust portfolio. If Warren Buffett doesn't understand derivatives, don't expect a judge or jury to understand them either. As seen below, a key issue in all of such cases is the records of the trustee in assessing and explaining the decision to invest. The first hurtle is to show that there was in fact detailed analysis and understanding of the decision. The second is to make sure that the beneficiary understands the risk involved, particularly if proprietary funds are involved.

While some authorities argue that the fiduciary duty of loyalty should be relaxed in light of the market efficiencies derived from self-dealing financial transactions, some courts charged with enforcing ethical and fiduciary responsibilities remain adamant that breaches of duty will be met with removal, damages, disgorgement, deterrence and punitive damages. There are some cautionary tales from probate, orphans, surrogate and equity courts which should cause persons acting in a fiduciary capacity to pause before lapsing from their duties. These arise in a variety of contexts, some involving express fiduciaries, some involving persons acting in fiduciary capacities with respect to the property or rights of others. While corporate trustees may not be directly involved with providing care to vulnerable adults or holding powers of attorneys, cases involving persons who fail in such duties offer insights into the boundaries of ethical minefields and circumstances where express fiduciaries may become ensnared.

The trustee has now filed for summary judgment.

Concentration in Bonds

In *Carter v. Carter*, 965 N.E. 2d 1146 (Ill. App. 1 Dist., Feb.7, 2012) the Court affirmed a summary judgment in favor of the trustee/income beneficiary who had invested 100% of her marital trust assets in municipal bonds, resulting in alleged actual loss of $300,000. The trust had a generic waiver of diversification: "to invest in bonds, common or preferred stocks…or other property of any kind, regardless of diversification and regardless of whether the property would be considered a proper trust investment." 965 N.E. 2d at 1154. The trust language precluded invasion of principal for the widow/trustee. The Court held that this was not an indication that the settlor intended that the remainderperson be treated impartially, but merely an indication of who was to receive the principal. 965 N.E. 2d at 1154-1155. Since both sides had filed motions for summary judgment, the Court on appeal concluded that "they concede the absence of a genuine issue of material fact and invite the Court to decide the questions presented as a matter of law. *Steadfast Insurance Co. v. Caremark Rx, Inc.* 359 Ill. App.3d 749, 755, 296 Ill. Dec. 537, 835 N.E. 2d 890 (2005)." 965 N.E. 2d at 1151.

The Court on appeal rejected the concept that a trustee has to treat all beneficiaries with impartiality. It noted:

> "[T]he trial court made no finding that Audrey's beneficiary interest was superior to Tiffany's beneficiary interest but instead, as discussed above, inferred from the language of the Living Trust that Luther intended for Audrey to generate income during her lifetime in any way she deemed appropriate, regardless of diversification." 965 N.E. 2d at 1155-1156.

The Court of appeal found that "[t]he court acknowledged that as a result of Audrey's current strategy of investing solely in municipal bonds, inflation may take a toll on principal, but it found that the investment strategy Audrey adopted was consistent with Luther's intent in creating the Marital Trust. Therefore, we reject Tiffany's argument that Audrey breached her duty of impartiality." *Ibid.*

The Court concluded that the broad investment power, irrespective of diversification, meant that the trial court could infer that the trustor's intent was to allow the trustee to invest without considering the impact on the remainderperson. "Here, we find that the trial court did not err in finding that Tiffany failed to establish a cause of action under the prudent investor rule where there is no evidence that Audrey's decision to invest in municipal bonds was arbitrary or unreasonable." 965 N.E. 2d at 1158.

The Court on Appeal distinguished *In re Estate of Cooper*, 81 Wash. App. 79, 913 P. 2d 393, 398-99 (Wash. Ct. App. 1996), which is one of the lead cases on concentrations which involve a conflict of interest on the part of the trustee, and breaches of the duty of impartiality. (*see also Noggle v. Bank of America*, 70 Cal.App.4th 853 (Cal. App. 1999) below). The Court distinguished *Cooper* because that trust did not waive the duty to diversify. *Ibid.*

If this analysis of the bare terms of similar trusts is honored by other courts, a major barrier can be raised for trustees who ordinarily would be held to have exercised discretion contrary to the intent of the settlor, where the settlor creates a marital trust which denies invasion of principal to the widow. The purpose of the trust, unless indicated otherwise, will require impartiality in most jurisdictions. While appointing a trustee with a conflict of interest with remaindermen will provide a structural waiver of a per se conflict of interest, one would ordinarily scrutinize the discretionary acts of the trustee to see whether they violated the general duty of prudence, loyalty and impartiality. There was no express waiver of a conflict and no express waiver of a duty of impartiality. A waiver of a duty of diversification is not a declaration of open season on the remainderpersons. Nonetheless, this decision may serve as a useful defense in other cases. Below are some other precedents dealing with concentrations in bonds, some involving conflicts of interest.

Other Courts have surcharged fiduciaries because of imprudence or breach of a duty of impartiality when over concentrating in bonds. In *Estate of Scharlach*, 809 A.2d 376 (PA Super. 2002), the Orphan Court, at trust inception, had discussed a 50% allocation to stocks. However, the trustee failed to diversify for 8 years, investing only in bonds. There was no loss in the nominal value of the trust. The mother of the disabled child complained that the expenses of full-time care had grown to exceed the bond income, making it difficult to fulfill the purposes of the trust. The Court allowed damages based on what the trust should have earned on a 50% allocation to stocks during the 8 years.

In *Williams v. J.P. Morgan & Co.*, 296 F. Supp. 2d 453 (S.D.N.Y. 2003) the portfolio was invested in tax exempt bonds as a means of avoiding potential reporting of income and possible taxation in Brazil. The trustee defended on the grounds that there had been no loss in nominal value. The Court rejected this argument: "[U]nder Morgan's reasoning, as long as the trust suffered no diminution of principal, merely breaking even would always immunize the trustee from claims for breach of fiduciary duty. Consequently, simply by insulating principal from any prospect of loss, the trustee would be under no obligation to exert any effort to improve the value of the trust and would risk no exposure to liability for absence of long term performance of the account. Such a constrained, categorical result cannot be correct." 296 F. Supp. 2d 453 at 457. This case was subsequently settled, with the parties agreeing to withdraw the Court's order in September of 2004, posing an interesting question whether the defendant has limited its use as precedent or as collateral estoppel.

In *Noggle v. Bank of America*, 70 Cal.App.4th 853 (Cal. App. 1999) the Court of Appeals affirmed a decision surcharging the trustee for investing primarily in municipal bonds, in violation of his duty of impartiality.

SunTrust Bank v. Merritt, 612 S.E. 2d 818 (Ga. App. 2005) denied surcharge of the corporate trustee who invested all of the assets of a trust in tax free bonds. There were three trusts in question, one for each of the children of the settlor, with each child sitting as a co-trustee with the corporate trustee. Two of the trusts were diversified, but the subject trust was invested solely for tax free income. The diversified trusts were worth 300% of the starting value at the time of the death of the sibling, while the subject trust had increased only 8% in value during the same period. The beneficiary had objected to investment in stock because he was "reluctant to

invest in such higher risk investments." 612 S.E.2d at 820. In discussions after the beneficiary had been accepted appointment as a co-trustee, the beneficiary "preferred low-risk investments that yielded high, tax-free, income." *Ibid.* fn. 5.

The trust terms provided for income to be distributed to the income beneficiary, but strictly limited invasions of principal for his benefit to circumstances where he was in "actual need of support and has no other adequate means of support, including the income from this trust and any other means of support," and "I do not intend that the Trustees encroach on the corpus in order to provide a standard of living equal to that to which he may have been accustomed, but I intend the power of encroachment to be exercised only in case of absolute necessity." 612 S.E. 2d at 820. Hence there was a clear desire to protect the remainderpersons at the expense of the income beneficiary's standard of living.

Absent language favoring distributions to the income beneficiaries at the expense of the remainderpersons, one would expect that the trustee had to balance the competing interests of the classes of beneficiaries, and invest accordingly. Hence, when a trustee invests primarily in tax free bonds for his personal benefit, a breach of the duty of impartiality and duty to invest is normally found. *Estate of Cooper*, 913 P.2d 393 (Wash. App. 1996). Investment of the entire portfolio in bonds is generally a breach of the duty of prudence, *Noggle vs. Bank of America,* 70 CA4th 853 (Cal. App. 1999); *Estate of Scharlach*, 809 A.2d 376 (PA Super. 2002).

One would expect a trustee in a trust with remaindermen to invest equities in addition to bonds, depending on the expected duration of the trust. *See Noggle* and *Scharlach, supra.* Thus, as in the *Scheidmantel* case, the simplified statement of the duty of the trustee is to fulfill "both the income beneficiary's interest in producing income and the remaindermen's interest in capital growth." *In re Scheidmantel,* 868 A.2d 464 at 488. Particularly in a trust which is expected to continue for a number of years, the trustee generally takes care to prevent inflation from eroding the value of the principal and leaving the beneficiary with a diminishing income stream in constant dollars. A beneficiary who desires to invest all in bonds is either shortsighted or doesn't care about the remaindermen. A trustee faced with a duty of impartiality should seek to educate the income beneficiary as to the realities of investment risk or seek instructions if the beneficiary seeks to impose an investment strategy which is imprudent. Indeed, the beneficiary who accepts the position as co-trustee faces his own fundamental duty to protect the interests of the remainderpersons and not to allow his desire for tax free income to adversely impact his beneficiaries.

70/30 Asset Allocation Rejected as basis for Liability and Damages

In *Figel v. Wells Fargo Bank*, ___F. Supp. 2d ___, 2011 WL 860470 (S.D. Fla. March 9, 2011), the income beneficiary sued the trustee for failing to invest the trust corpus in an aggressive fashion to compensate for distributions from income and principal made for his benefit. On summary judgment, the Court ruled in favor of the trustee. The Court held that once the trustee had met its burden of "informing the district court of the basis for its motion, and identifying those portions of [the record] which it believes demonstrate the absence of a genuine issue of material fact," the non-moving party "'must do more than simply show that there is some metaphysical doubt as to the material facts,' *Matsushita Elec. Indus. Co. v Zenith Radio*

Corp., 475 U.S. 574, 586, 106 S. Ct. 1348, 89 L. Ed. 2d 538 (1986.)" 2011 WL 860470 at *2. The Court granted summary judgment for the trustee, finding that "[t]he record is replete with evidence that shows Wells Fargo invested the corpus of the Figel Trust in equities and other securities (i.e., in a manner consistent with the terms set forth in the Figel Trust and pursuant to Wells Fargo's buy list). The record is also replete with evidence that Wells Fargo sent Terry Figel quarterly account statements that revealed the state of the Figel Trust. Indeed, the undisputed facts show that Wells Fargo made the investment decisions that it did in an attempt to provide both income for Terry and growth, both to replace principal distributions and to provide growth to benefit Spencer as the remainderman." 2011 WL 860470 at *3.

The plaintiffs argued that if Wells Fargo had used a portfolio allocated 70 percent to equities and 30 percent to bonds, it would have earned $3 - $4 million more than the actual portfolio. 2011 WL 860470 at *3. The Court concluded that "[p]laintiffs offer not one case where a trustee was found to have breached a trust or a fiduciary duty, or was otherwise found negligent, because it had invested the corpus of the trust in a manner that did not earn as much as it could have." 2011 WL 860470 at *4.

Failure to Maximize Not a Breach

While there are cases where trustees were surcharged for failure to select investments of equal safety, but more return, than others, there are few cases where failure to maximize return is held to be a breach, where the investment allocation decisions were properly conducted and produced reasonable returns given the risk and return objectives of the trust. Hence Figel appears to be consistent with decisions holding that an investment strategy which was the result of appropriate due diligence and investigation of the terms and circumstances of the trust will not lead to surcharge based on the possibility that a higher return could have been obtained, with the benefit of hindsight.

Since the test under the Third Restatement and the Uniform Prudent Investor Act is the overall investment plan and its suitability given the risk and return needs of the trust, liability should not be assessed merely because a properly constructed portfolio did not obtain the highest performance obtained by other trusts or indices. A number of cases have denied liability and rejected damages where a reasonable portfolio nonetheless underperformed some benchmarks. As held in *Matters of Bankers Trust Co.,* 636 N.Y.S. 2d. 741, "the fact that slightly more income would have been earned had the trust purchased Treasury bills or some other investment does not establish a breach of duty which would warrant a surcharge. (*see, Matter of Miller v. Lee,* 116 A.D. 2d 580, 581, 497 N.Y.S. 2d 438 [2d Dept. 1986]], *appeal dismissed,* 67 N.Y. 2d 609, 503 N.Y.S. 2d 1025, 494 N.E. 2d 458)…." "[t]he test is one of conduct rather than performance…." 636 N.Y.S. 2d at 745.

In *Matter of Fleet Trust Co.,* (Surr. 1997), 662 N.Y.S.2d 360, the Surrogate denied a requested surcharge of a trustee for keeping 24.5% of the corpus in a single security. "The test is prudence, not performance and mere inferior investment performance cannot be the basis for a finding of imprudence (*Matter of Janes*, *supra*)." 662 N.Y.S. 2d at 362.

In *Helman v. Mendelson*, 769 A.2d 1025 at 1038 (Md. App. 2001), the Court dealt with a surcharge action where the sale of a closely held business resulted in proceeds which grew from $420,000 to $20 million during the time in question. "Although the AGM Trust might have generated greater growth if the trustees had chosen different investments, we cannot say that they were acting imprudently or only for the benefit of the income beneficiary...."

In *Trusts of Kuo Ching,* 717 N.Y.S. 2d 512 (App. Div. 2000) the Court affirmed a denial of a surcharge. "Although it might appear with the benefit of hindsight, that the assets of the subject trusts might have been more profitably invested by the petitioner, 'a mere error of investment judgment [does not] mandate a surcharge. Our courts do not demand investment infallibility, nor hold a trustee to prescience in investment decisions' (*Matter of the Accounting of the Bank of New York, as Trustee of Discretionary Common Trust Fund 'E'* [35 N.Y. 2d 512] at 519, 364 N.Y.S. 2d. 164, 323 N.E.2d 700)."

This is a dangerous precedent given the fact that the beneficiaries apparently could not articulate the nature of the loss they sustained from the delayed receipt at a lower price.

The Court in *Lasdon* also struck the expert opinion of the trustee, finding that "[t]he affidavit, which reads like a memorandum of law, is not designed to inform a factual question (the usual province of expert testimony), but instead provides only case law analysis on the pure question of law as to how damages are to be calculated in this instance.. The expert's report accordingly is stricken from the record on these motions (*Meason v. Greenwich and Perry Street Housing Corp.*, 268 A.D. 2d 156 [1st Dept 2000]['Expert testimony as to a legal conclusion is impermissible.']; *Russo v. Feder, Kaszovitz, Isaacson, Weber Skala & Bass LLP,* 301 A.D. 2d 63, 68-69 [1st Dept 2002]; *Franco v. Jay Cee of N.Y. Corp.* 36 AD3d 445,448 [1st Dept 2007])." 2011 WL 4375062 at *1, fn3.

The citing with approval of the measure of damages in *Lasdon* by the *Knox* appellate court, 947 N.Y.S. 2d 292, 309 (App. Div. 2012) appears to constitute a crystallization of the conflict in damage measures used by prior decisions.

Ethical Breaches by Holder of Power of Attorneys

In *Siegel v. JP Morgan Chase Bank*, 71 So.3d 935 (Fla. App. 2011) the Court dealt with a trustee under a trust instrument which authorized the trustee to follow directions of a holder of a power of attorney, decedent's daughter, to make gifts to individuals or charitable organizations, "provided that such gift either (i) shall be reasonably consistent with any pattern of my giving or with my estate plan or (ii) shall not exceed the annual exclusion available from time to time for federal gift tax purpose." 71 So. 3d at 936. The trust authorized the trustee in its sole discretion to pay so much of the income or principal for the "support, maintenance, health, comfort or general welfare" of the settlor. Beneficiaries filed a counterclaim for breach of fiduciary duty, as well as a cross-claim of the holder of the POA who had directed multiple gifts and revocation of assets from the trust during the life of the settlor. The beneficiaries objected to multiple gifts directed by the POA holder and approved by the trustee, including gifts to employees of the POA holder and the JP Morgan employee administering the trust, as well as gifts which resulted in gift tax liability. They also objected to forgiveness of debts to the settlor. The beneficiaries raised the

issue that a subtrust which was to be established on the death of the settlor, was in fact funded during her lifetime, "causing a substantial gift tax liability." They also objected to allegedly excessive expenditures for the "welfare" of the settlor. Despite an earlier appellate decision holding that the remainderpersons had standing, the trial court denied their standing to raise such objections. This was reversed on appeal. The appellate court held that the power of attorney limited the holder's powers, and that any gifts were strictly limited. "Significantly, the power of attorney also prohibited the attorney-in-fact from invading the principal of the trust by stating that the attorney in fact was *not* granted the power '[t]o amend, modify or revoke, in whole or in part, or withdraw any of the principal of, any trust over which I have reserved or have been granted such power....". The trust agreement specifically provided that the power of amendment, modification, and revocation were personal to the settlor and could not be exercised by her attorney-in-fact." 71 So. 3d at 941.

The Court, on appeal, held "[d]espite the lack of power of the trustee to make gifts, the trustee made gifts and permitted Novak to withdraw principal to pay other gifts. The trustee had no authority to make gifts itself. We can find no legal support which holds that gifts to others can constitute payments for the 'comfort or general welfare' of the beneficiary of a trust. Nevertheless, such a finding must be based upon a factual record, which the trial court did not have in concluding otherwise." 71 So. 3d at 941.

The Court, on appeal, found:

> "[i]n creating a trust, the settlor was not merely designating trustees as conduits through whom a gift could be made to the daughter whenever it would be to her advantage. The trust represented a plan of the settlor that included not only the beneficiary Margaret, but also remaindermen. In adding a flexible provision for the invasion of principal for the "best interest" of the beneficiary, the settlor was not injecting a facile means for destroying the trust." 71 So. 3d at 942.

The Court held that the pre-death funding of the subtrust was inappropriate. The review of the forgiveness of debts was remanded for a hearing on the merits. The Court concluded that a clause which seeks to exonerate an attorney-in-fact from any and all liability runs afoul of the spirit of New York's public policy and the duty of an attorney-in-fact as established under *Ferrara* [*Matter of Ferrara,* 7 N.Y.3d 244, 819 N.Y.S.2d 215, 852 N.E.2d 138 (2006)]. *Ferrara,* in turn, held that an attorney-in-fact must act in the best interests of the principal, which is consistent with the fiduciary duties that the courts have imposed on the attorney-in-fact. "[A] power of attorney ... is clearly given with the intent that the attorney-in-fact will utilize that power for the benefit of the principal" (*Mantella v. Mantella,* 268 A.D.2d 852, 852, [701 N.Y.S.2d 715] [3d Dept.2000] [internal quotation marks and citation omitted]). Because "[t]he relationship of an attorney-in-fact to his principal is that of agent and principal ..., the attorney-in-fact must act in the utmost good faith and undivided loyalty toward the principal, and must act in accordance with the highest principles of morality, fidelity, loyalty and fair dealing" (*Semmler v. Naples,* 166 A.D.2d 751, 752, [563 N.Y.S.2d 116] [3d Dept.1990] [internal quotation marks and citations omitted]). *Ferrara,* 7 N.Y.3d at 254, 819 N.Y.S.2d 215, 852 N.E.2d at 144. Although the power of attorney in this case was a Florida durable power of attorney, Florida law states that an attorney-in-fact must exercise the powers conferred as a fiduciary. *See, e.g., In re*

Estate of Schriver, 441 So.2d 1105 (Fla. 5th DCA 1983); § 709.08(8), Fla. Stat. (2011). Therefore, the principles of the foregoing case are applicable as they also consider an attorney-in-fact a fiduciary." 71 So. 3d at 943-944

The case was remanded to the trial court for a full trial of the beneficiaries' claims and the defenses and affirmative defenses of the appellees. 71 So. 3d at 945.

Forged Checks

In *Beedie v. Associated Bank of Illinois, N.A.*, 2011 WL 2460959 (C.D. Ill. June 21, 2011) the Court dismissed without prejudice a claim against a bank which allegedly cashed checks from a trust account on 186 occasions, depositing the proceeds into the co-trustee's personal account. The Court looked to the Illinois Fiduciary Obligations Act (IFOA) which provides that a depository bank is not liable for honoring checks signed by a fiduciary named on the account "unless the bank receives the deposit or pays the check with actual knowledge that the fiduciary is committing beach of his obligation as fiduciary in making such deposit or in drawing such check, or with knowledge of such facts that its action in receiving the deposit or paying the check amounts to bad faith. 760 ILCS 65/9." 2011 WL 2460959 at *3.

The Court held that "[i]t is not enough to establish bad faith that the bank could have discovered fraudulent activity merely because it had access to the fiduciary's financial information and handled other accounts for the fiduciary. *Mikrut v. First Bank of Oak Park*...832 N.E. 2d 376, 385-86 (Ill. App. Ct. 2005). Plaintiff has not pled enough facts to show that Defendant suspected the Haeffles were acting improperly, nor has Plaintiff pled enough facts to show that Defendant deliberately refrained from investigating the Haeffles behavior." 2011 WL 2460959 at *5. The Court held that under *Crawford Supply Group v. LaSalle Bank, N.A.*, 2010 WL 320299 (N.D. Ill January 21, 2010) at *8, "A 'formulaic recitation' of the law is not enough to withstand a motion to dismiss. *Id.* Plaintiff must allege some factual content to support an inference that Associated Bank is liable for misconduct. *Id.*" 2011 WL 2460959 at *5.

In *Borchers v. Vanguard Group Inc.*, 2011 WL 2690424 (D.AZ. July 11, 2011), the Court granted summary judgment against a claim that Vanguard had improperly cashed forged checks from a money market fund account it held for a trustee. Under Arizona law, such a claim against a depository bank must be reported by the account holder within one year of receiving an accounting and that any reported claim must be brought within three years. A.R.S.§47-4111. 2011 WL 2690424 at *2.

Vanguard raised the defense that it was not a bank and hence not covered by the Arizona statute. The Court held that "[c]ourts in several states that have adopted the UCC have held that non-bank financial and investment firms are engaged in the business of banking when they provide their customers with check-writing services. *See, e.g. Pinasco v. Ara*, 219 A.D. 2d 540, 541 (N.Y. App. Div. 1995)...; *Asian Int'l Ltd. v. Merrill Lynch*, 435 So. 2d 1058, 1062 (La. Ct. App 1983)...; *Woods v. MONY Legacy Life Ins. Co.*, 641 N.E. 2d 1010, 1071-1072 (N.Y. 1994)...." 2011 WL 2690424 at *2. While the claim was reported timely, the suit was not brought within the three-year statute of limitations and hence summary judgment was granted in favor of the defendant.

Miscellaneous

The Court in *Beckwith v. Dahl*, 205 Cal. App. 4th 1039, 141 Cal.Rptr.3d 142 (Cal. App. 2012) ruled that California recognizes the tort of Intentional Interference with an Expected Inheritance (IIEI). The intestate decedent's same-sex cohabitant brought the action against decedent's sister. The Court held that the complaint did not allege that the defendant had directed any independently tortious conduct against the decedent, the underlying tort supporting a claim of IIEI. The complaint did allege that the defendant had made a false promise to the plaintiff. Based on the rule that "liberality" should be allowed in allowing a plaintiff to correct defects in his pleading, leave to amend the IIEI claim was allowed. *Id* at 1059. As to a second cause of action for promissory fraud, the Court found that the complaint properly alleged the elements of that cause of action. *Id* at 1068.

In *Board of Trustees of the City of Birmingham Employees' Retirement System v. Comerica Bank*, 767 F. Supp. 2d 793 (E.D. Mich. 2011), the Court held that allegations of breach of investment duties regarding structured investment vehicles properly stated claims. The trustee defended on the grounds that a beneficiary could only raise a claim as part of the broader investment portfolio, rather than focusing on one specific investment in isolation. The Court followed Department of Labor commentary supporting the underlying ERISA regulations, concluding that "[t]herefore, while it is inappropriate to measure the ultimate prudence of a fiduciary's investment decisions by considering one individual investment in isolation, the modern portfolio theory does not permit a fiduciary to defeat liability simply by pointing out –at the initial pleadings stage of a lawsuit—that despite any decline in value of the individual investment, there was no net loss to the value of the entire portfolio as a whole. The determination of prudence requires a more refined approach than simply looking at a portfolio's net return." 767 F. Supp. 2d at 800.

The Court held that "[s]hould this case progress to trial, Plaintiffs will have the burden of demonstrating the imprudence of Comerica's investment in, and retention of, the Sigma notes. At that time, Comerica may seek safe harbor in the regulations by arguing that it gave 'appropriate consideration' to the relevant facts and circumstances, including the role that the Sigma notes played in the entire investment portfolio. The fact-finder will have to determine whether, in the context of the entire investment pool, and after considering a developed factual record, Comerica's investment in the Sigma notes was prudent." *Ibid.*

Procedural Prudence

Many of the recent fiduciary litigation and surcharge cases could have been prevented by careful attention to the duties imposed on trustees with regard to investments and the terms of the instruments involved. Establishment of procedures to mandate review of trust instruments and their requirements and protections, to deal with arbitration provisions, and to comply with the duty to determine the risk tolerance and needs of beneficiaries is essential to avoiding costly and protracted litigation. Seeking instructions from a court over doubtful trust provisions or deviations from investment duties can minimize surcharge risk. The expense of such reviews pales in the face of recent surcharge decisions imposing decades of statutory interest on investment lapses.

These cases provide a roadmap for establishing procedures and reviews of trust department activity for audit and risk avoidance personnel.

The conduct of fiduciaries is evaluated based on whether they have complied with the terms of the will or trust, and whether they have exercised the discretions given to them in a prudent fashion. However, the Restatement (Third) of Trusts §27(2) makes clear that "a private trust, its terms, and its administration must be for the benefit of its beneficiaries…." This provision places an emphasis on the needs of the beneficiaries, even if the trustor has placed restrictions on investments, which threaten the purposes of the trust and place the beneficiaries at risk.

The Uniform Trust Code §801 imposes a duty on a trustee "to administer the trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries, and in accordance with this Code." In States adopting the Uniform Prudent Investor Act, and in most of the remainder, the trustee must invest the trust assets with a view to the overall portfolio and with regard to the "risk and return" characteristics of the trust and its beneficiaries:

> "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Uniform Prudent Investor Act §2(b).

Hence the current state of the law requires review and monitoring of the status of current investments and their suitability in light of the changing needs and risk tolerance of beneficiaries.

Trustees are not guarantors of the value of the trust. This is an uncertain world, with little consensus among practitioners about an appropriate investment strategy in general, let alone for the unique circumstances of the beneficiaries of a particular trust. Hence a trustee will not be surcharged because a loss is suffered, so long as it took the steps required under the circumstances to make its discretionary decisions regarding the investment and retention of trust assets and made such decision in a prudent manner. *Matter of Estate of Janes*, 643 N.Y.S.2d 972, 977, *aff'd* (1997) 90 N.Y. 2d. 41, 659 N.Y.S.2d 165. The trustee is not liable for a loss which does not result from a breach of trust. Restatement (Second) of Trusts §204, Uniform Trust Code §1003(b).

Recent courts have focused their attention on the procedures undertaken by the trustees in exercising their discretion regarding investments. The trustee was surcharged $20,958,303.31 for failing to diversify a concentration in Eastman Kodak stock by the Surrogate Court in *Testamentary Trust UW Dumont*, 4 Misc. 3d 1003(A), 791 N.Y.S. 2d 868 (table), 2004 WL 1468746 (N.Y. Sur. Ct. June 25, 2004), *rev. on other grounds*, 809 N.Y.S. 2d 360, 2006 WL 259834 (N.Y.A.D.) (rev. den). The New York Attorney General appeared for the charitable remaindermen, seeking affirmance of the liability, but a recalculation of damages. The Pennsylvania Superior Court, *In re Scheidmantel, Appeal of Trustee Sky Trust, N.A.,* 868 A.2d 464 (Pa. Super. 2005), affirmed a holding of a breach of trust involving the purchase of proprietary mutual funds in diversifying out of a portion of an investment in the trustee's own

stock. In *Meyer v. Berkshire Life Ins. Co.*, 250 F.Supp.2d 544 (D. Md. 2003), *aff'd*, 372 F.3d 261 (4th Cir. 2004) the Court assessed damages based on what the trust should have earned, because of an overly conservative investment policy stemming from a failure to assess the risk tolerance of the beneficiaries.

The *Janes, Dumont* and *Scheidmantel* Courts all found breaches of trust based on the failure of the trustees to establish and implement procedures to comply with their investment duties, as well as to document their decisions. These decisions turned on the question whether the trustees fell below the standard of care of corporate fiduciaries in exercising their discretion. Because of the ubiquitous prudence standard for investment, most investment decisions are judged under a standard of care analysis. *In re Messer Trust*, 579 N.W. 2d 73, 76 (Mich. 1998). The Uniform Prudent Investor Act, in effect in 41 States, the District of Columbia and the US Virgin Islands (with bills being considered by two additional States), provides in §2(a) that "[A] trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution." Hence the UPIA looks to a standard of care based on following the procedures set forth in the Act, rather than an abuse of discretion standard.

As the Appellate Division held in *Janes*, "a fiduciary will be surcharged for losses resulting from negligent inattentiveness, inaction, or ill-consideration (see, *Matter of Donner, supra*, at 586, 606 N.Y.S.2d 137, 626 N.E.2d 922; *Matter of Wood*, 177 A.D.2d 161, 167-168, 581 N.Y.S.2d 405). Thus, while mere erroneous judgment or poor investment performance cannot be the basis of a finding of imprudence, where the facts known at the time of the decision establish its unreasonableness, a finding of imprudence is warranted (see, *Matter of Wood, supra*, at 167-168, 581 N.Y.S.2d 405). Generally, the determination whether a fiduciary's conduct measures up to the appropriate standards of prudence, vigilance, and care is an issue of fact for the trial court (see, *Matter of Donner, supra*, at 585, 606 N.Y.S.2d 137, 626 N.E.2d 922, citing *Matter of Hubbell, supra*, at 258, 97 N.E.2d 888; see also, *Matter of Yarm*, 119 A.D.2d 754, 501 N.Y.S.2d 163)." 643 N.Y.S.2d at 977. The Court in *Moench v. Robertson*, 62 F.3d 553, 565 (3rd Cir. 1995), in dealing with diversification under ERISA, held that the appropriate standard of review for investment decisions was not whether there was an abuse of discretion or arbitrary or capricious conduct, but rather was derived from the "'common law of trusts – most prominently, a standard of loyalty and a standard of care,'" citing *Central States, Southeast and Southwest Areas Pension Fund v. Central Transport, Inc.* 472 U.S. 559, 570 (1985).

Other breaches of duty, where discretion is involved, may be judged on an abuse of discretion standard. *Baker County Medical Services, Inc. v. Brown & Brown*, Inc. ___ F.Supp.2d ___, 2005 WL 2063021 (M.D. Fla. 2005, at 5, and *Korchek v. Nichols-Homeshield, Inc.*, 1997 WL 619869 (N.D. Ill. 1997). Where a conflict of interest is involved, the standard shifts from abuse of discretion to breach of a standard of care. Even where breach of discretion is the test, a failure to make realistic, good faith efforts to exercise discretion can be held to be an abuse of discretion, *Copley v. Copley*, 126 Cal. App. 3d 248, 284-285 (Cal. App. 1981); *Jacob v. Davis*, 738 A.2d 904 (Md. Ct. Spec. Appeals, 1999). "[G]iving trustees discretionary or broad powers does not mean that there are no limits to those powers. Trustees' actions will be reviewed for abuse of that discretion." *In re Green Charitable Trust*, 431 N.W. 2d 492, 498 (Mich. App.

1988). Restatement (Third) of Trusts §50(b) com. 1: "[F]urthermore, a court will intervene where the exercise of a power is left to the judgment of a trustee who improperly fails to exercise that judgment. Thus, even where a trustee has discretion whether or not to make any payments to a particular beneficiary, the Court will interpose if the trustee, arbitrarily or without knowledge of or inquiry into relevant circumstances, fails to exercise the discretion."

Dealing with the Debris and Survivors of the Great Recession

The Great Recession is still with us, posing major problems for fiduciaries who must try to invest trust funds in a world of changed financial basics. To understand the extent of the problem one must place this financial crisis in perspective and examine the trends which may increase or ameliorate the risks involved. The standard of care for a fiduciary is variable, depending on the skills which the fiduciary possesses or promises, and the terms of the governing instrument. The Uniform Prudent Investor Act and the Third Restatement of Trusts look not so much at results, but rather at the steps which the fiduciary took to investigate the terms of the trust, the needs of the respective beneficiaries, the amount and character of the assets available, and the prudence of the process in which the assets of the trust were selected and monitored. Since financial markets and the needs of beneficiaries change, the trustee must be vigilant to modify the investment plan when circumstances dictate. Hence the fiduciary must pay particular care to examine the financial realities confronting the trust's investments now and in the foreseeable future, rather than relying on hoary formulae and procedures whose validity have been savaged by two major recessions and a tsunami of trenchant econometric criticism.

The law governing fiduciary investments has been frozen in time, reflecting the strictures of Modern Portfolio Theory in its initial phases, before development of substantial computing power and econometric testing of its tenets. While the Third Restatement eschewed strict reliance on these strictures, the fiduciary defendant is likely to face an expert whose knowledge of modern economic theory is severely limited, but who is badged and armed with academic armor and certainty, and a judge or jury who have no hope of dealing with *modern* Modern Portfolio Theory. If the trust portfolio faces losses, the crucial defense will be the procedural prudence of the fiduciary's investment plan. *Board of Trustees of the City of Birmingham Employees' Retirement System v. Comerica Bank*, 767 F. Supp. 2d 793, 802 (E.D. Mich. 2011): "The ultimate outcome of an investment is not proof of imprudence. The fiduciary duty of care 'requires prudence, not prescience.' *DeBruyne v. Equitable Life Assur. Soc. of U.S.,* 920 F.2d 457, 465 (7th Cir.1990) (quoting lower court opinion, 720 F.Supp. 1342, 1349 (N.D.Ill.1989)). Accordingly, it is inappropriate to consider the prudence of an investment decision solely from the perspective of hindsight. *See Chao v. Merino,* 452 F.3d 174, 182 (2d Cir.2006); *Donovan, [v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983)] 716 F.2d at 1467 ('The test of prudence ... is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed.' (quotation marks and citation omitted)); *accord In re Messer Trust,* 457 Mich. 371, 382–83, 579 N.W.2d 73 (1998) (citing with approval *In re Janes Estate,* 90 N.Y.2d 41, 50, 659 N.Y.S.2d 165, 681 N.E.2d 332 (1997))."

The fiduciary or the advisor to a fiduciary who relies on assumptions which are demonstrably inaccurate or no longer applicable may face serious criticism and potential

liability. If you forecast returns for a unitrust based on *average* returns for asset classes since 1926, you will substantially exaggerate the returns which the trust and beneficiaries are likely to receive. If you establish trust investment plans which assume that market returns for securities are distributed in a Gaussian or uniform manner, you will substantially underestimate the risks of crippling losses to a portfolio given recent history. If you use as benchmarks for asset allocation historical returns which do not take account of semi-standard deviation or Morningstar risk, you may face beneficiaries who are no longer able to meet their basic needs with trust distributions. If you use benchmarks which do not include the effect of taxes, transaction costs, and distributions in allocating assets and constructing portfolios, you will build substantial underperformance into the trust returns. In establishing investment plans for specific trusts, care must be taken to assure that assumptions about performance match reality.

Modern Financial Crises and the Current Crash

a. **Housing Prices**. A study of financial crises such as that of 2008 shows that in modern times housing prices crashed an average of 35% stretched over 6 years. C. Reinhart and K. Rogoff, "This Time is Different" (Princeton, 2009) at 224. The recovery of prices in the US has been hampered by extensive class actions and government litigation over foreclosure practices, stretching out the overhang of foreclosed properties for years to come. In States where non-judicial foreclosures are common, rates of foreclosures average 2.8%, while in judicial foreclosure States the rate was 6.9%. N. Timiraos, "Foreclosures Show No Sign of Decline," Wall Street Journal May 16, 2012. With attorneys general having completed most of their class actions, and courts starting to weed out weaker cases, *Olson v. Bank of America*, ___F.Supp. 2d ___, 2012 WL 1660615 (D. Minn., April 19, 2012), the overhang of foreclosed housing may be diminishing. But one should expect that it will be difficult for housing prices to recover within the average 6 year period for modern collapses. Given the adverse wealth effect of crashing housing prices, a large swathe of the population will have constricted access to credit and restricted spending for years to come. The broad middle class, the middle 60% of households, relies on its housing investment for a major part of its wealth, and formerly relied on home equity as a major source of funding for its discretionary spending. The impact of the crash of housing prices and the loss of equity has been a major constraint on recovery from the Great Recession. M. Bordo, J. Haubrich, "Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record," Federal Reserve Bank of Cleveland, Working Paper, 12-4, June 2012. ("One factor we consider that may explain some of the slowness of this recovery is the moribund nature of residential investment, a variable that is usually a key predictor of recessions and recoveries.") The recent uptick in new housing starts and the rise of housing price in a number of major metropolitan areas may portend future increases in household wealth and an enhanced recovery.

b. **Equity Prices.** In modern financial crises, equity prices dropped 56% on average, with the impact felt for three and a half years. Reinhart and Rogoff at 224. Here the crash was not so severe, and prices recovered substantially following 2009. However, despite the rise of the broad market, future equity returns appear to be constrained by

the constricted middle class and the world recessions, limiting exports and hammering confidence in equity investments by Americans and the rest of the world. As discussed below, the old paradigms of high equity returns may be severely constrained in the future, reducing the predictable total return of fiduciary investment portfolios.

c. **Unemployment.** Historically, such financial crises caused unemployment to rise for almost five years, with the average rate climbing 7%. *Ibid.* at 227. The Great Recession of 2008 left 3 million construction workers unemployed, among many groups impacted by the economic collapse. The problem of construction workers is difficult because of the overhang of foreclosed housing which prevents such workers from being re-employed in their area of skills or moving to areas with job openings. The new normal for unemployment may be impossible for politicians and regulators to admit because of political repercussions, but there are many segments of the unemployed which may face protracted loss of employment or extended periods of underemployment. At a time of 7.9% unemployment, there are three million unfilled jobs which have training or academic requirements which cannot be met by unemployed workers. J. Rothwell, "Education, Job Openings, and Unemployment in Metropolitan America," Brooking, August 2012. Technical training for positions in the growth industries in America is sorely lacking and geographically constrained. The junior colleges, which once played a major role in equipping workers with the skills for Silicon Valley or the biotechnology field, have been shortchanged by local governments, and student loan programs have been diverted by commercial institutions more interested in maximizing the loans of students rather than equipping them for practical skills. A trillion dollars of student loans have not equipped the population for the openings highlighted in the Brookings studies. Current models of linking educational training with internships and specific job openings in local industries offer some prospects for hope, but will require a major retrenching of the educational options available to youthful applicants and the unemployed workers in rust bowl America. Such issues are structural burdens on a return to economic health and equity prices and dividends, and also reflect the return objectives of many beneficiaries who have children unable to support themselves. The fiduciary must evaluate asset allocations which can help meet the costs of parents with children moving back to empty nests but also such children's need for assistance in coping with unemployment and the need to retrain for the skill sets demanded for re-employment.

d. **Government Debt.** To prevent the collapse of their economies, governments in modern financial crises increased their debt an average of 86 percent in real terms following the Second World War. *Ibid.* The collapse in Europe is similarly continuing as one country after another attempts austerity, then faces political backlash, straining the bonds of the European Community and the ability to rescue one profligate spending country after another.

e. **Government Employment.** Moreover, as State governments and localities sought to balance their budgets, they have jettisoned huge numbers of workers, many of

them women, who have slim prospects for re-employment with wages and working conditions similar to those they formerly enjoyed. Many of these are college graduates, who will crowd out and outcompete unemployed private industry workers without such credentials. States and localities are not going to return to the glory days (if you could so term them) no matter who prevails in the 2012 elections. The Great Recession is different from earlier crashes, where government employment increased in recoveries: in the recoveries following the 1990 and 2001 recessions, local government employment grew 7.7 and 5.2 percent. In the aftermath of the current fiscal crisis, local government employment has fallen 3%, rather than growing, and State government employment has fallen 1.2%. B. Polak and P. Schott, "America's Hidden Austerity Program," New York Times (June 11, 2012). There is little prospect that local and State governments will be increasing employment in a time when most of these entities cannot even fund their vested retirement plans for workers, let alone meet rising expenses of local government and the needs of blighted residents.

f. **Consumer Spending and the Constricted Middle Class.** The broad middle class, largely families with two wage earners, have had their incomes constrained in real terms for more than a decade. Congressional Research Service, "The U.S. Income Distribution and Mobility: Trends and International Comparisons," March 7, 2012. The share of national income of the broad middle class has decreased: from 1968 through 2010, the share of national income of the middle 60% of households decreased from 53.2% to 46.5%. *Ibid.* at 4. Other commentators have emphasized the impact on middle class income of the benefits derived from the deduction of health care benefits provided by employers, causing some adjustments in such comparisons, R. Burkhauser, J. Larrimore, K. Simon, "A 'Second Opinion' on the Economic Health of the American Middle Class," 65 (1) National Tax Journal 7-32 (March 2012). However, adjusted for inflation, the broad middle class has not kept up with inflation for over more than a decade. A step up from this broad middle class is the bulk of the top quintile, known in retail circles as "Henrys" (High Earner Not Rich Yet). This 18% segment earns between $100,000 to $250,000, but represents 40% of consumer spending, Matt Townsend, "High Earners – Henrys - Cut Back on Spending Again" Bloomberg Businessweek, June 2012. The Henrys have started to cut back their spending after having reinvigorated the economy in the aftermath of the crash. Hence, disposable income, the main driver of prosperity in our consumer economy, will not recover soon. When Proctor & Gamble, Nestle, and now PepsiCo/Yum! re-formulated their product lines to de-emphasize their mid-range products, and focused on luxury products for the top 5% of the population and low-cost products to compete with house brands at the bottom, the effect of the loss of the broad middle class' disposable income became clear. It is difficult to predict what fiscal or economic policies will return this broad portion of the middle class to robust consumption again. For Boomers reaching the edge of retirement, former levels of disposable income will never return, hampering the economy far into the future.

Hence fiduciaries investing trust funds face a harrowing economic future, with little prospect of immediate recovery. The best laid plans of fiduciaries will be severely tested by these adverse financial trends and consequently the risks of surcharge become imminent.

Highest Level of Skill Will Be Required

Hence fiduciaries should be planning for years of financial turmoil, with the prospect of inflation looming on the horizon. Corporate fiduciaries are presumed to have the highest level of skill, Restatement (Third) of Trusts §77(3) "If the trustee possesses, or procured appointment by purporting to possess, special facilities or greater skill than that of person of ordinary prudence, the trustee has a duty to use such facilities or skill." *See also* Uniform Trust Code §806. Hence beneficiaries can easily point to the knowledge of any bank's chief economist to show that the bank's conduct was below the standard of care. As will be seen below, judges are surcharging fiduciaries for investment losses in a variety of circumstances. Knowledge of current economic principles is thus essential to develop programs to invest funds, to present beneficiaries with a record that shows that the fiduciary understood the potential upside and downside risks of investment models, and that the asset selection and implementation were prudent in such tumultuous times. An investment plan and investment committee minutes demonstrating such exercise of skill and the elements taken into consideration in exercising discretion are essential to defending conduct after the crash.

The UPIA Standard of Care and Reality

Fiduciaries must be cautious in structuring portfolios and explaining risk to beneficiaries, when we have had two major recessions in a decade. Despite the symmetry of the bell shaped (Gaussian) curve supposedly showing the distribution of security returns, with small tails at either end (that is, little risk of getting an Apple portfolio as well as low risk of getting an AIG or GM portfolio). The problem is that the standard models are based on the assumption that the distribution of returns is Gaussian, with most returns included in the central part of the chart. Unfortunately, this is not true. Modern Portfolio Theory taught that "a normal distribution model assumes that an asset return that is three standard deviations below its mean (commonly called a three-sigma event) has only a 0.13% probability of happening, or once every 1,000 return periods. From January 1926 to April 2009, however, the S&P 500 had a monthly mean return of 0.91% and a monthly standard deviation of 5.55%. A negative three-sigma event, therefore, means that the index would suffer a 15.74% monthly loss. In 83 years, the S&P 500 has suffered 10 monthly returns worse than that amount." James Xiong, "Nailing Downside Risk," (Morningstar Advisor, Feb/March 2010).

"One limitation of standard deviation as a measure of risk is the tacit assumption that returns can be described by measure that assumes a normal distribution of returns, while it is empirically acknowledged that many financial market returns exhibits excess kurtosis relative to the normal (Gaussian) distribution. This characteristic is referred to as a leptokurtic or 'fat-tailed' return distribution. Fat-tailed outcomes reflect market movements far larger than one would reasonably expect from a normal distribution returns. One of the most extreme examples of a fat-tailed return profile occurred on Oct. 19, 1987, when the Dow Jones Industrial Average declined by 22.68%, or more than 20 standard deviations. The magnitude of the deviation from normal returns can be understood when considering that a normal distribution would predict such a move once in more than 4.5 billion years. More recently, 2008 had 11 days with declines greater than 4 standard deviations, and on May 6, 2010, the Dow Jones Industrial Average

declined by 9 percent in a matter of minutes on an intraday basis, a move that on a daily basis would have been among the top 10 declines in recorded history." 2102 Ibbotson SBBI Classic Yearbook at 77.

Such frequent declines can make a major difference in the actual return of a portfolio, a difference which is obvious when the beneficiary examines her distribution check or looks at the quarterly value of the trust portfolio. If one is in a unitrust, with a distribution which is not smoothed, taking a 5% total return distribution can eat up the diminished corpus, never to be recovered.

If the stock market or trust portfolio fell 34% in 2008, the million dollar portfolio would be worth only $660,000. To get back to a million dollars, the portfolio would have to earn over 51% in the following years to get back to the original portfolio value. The beneficiary with a $50,000 annual distribution would have to eat into principal to maintain such a level of distributions in the future.

The effect can be demonstrated by comparing the average returns of asset classes to the geometric return. "A simple example illustrates the difference between geometric and arithmetic means. Suppose $1.00 was invested in a large company stock portfolio that experienced successive annual returns of +50 percent and -50 percent. At the end of the first year, the portfolio is worth $1.50 and at the end of the second year, it is worth $0.75. The annual arithmetic return is 0.0 percent, whereas the annual geometric mean is -13.4%." 2012 Ibbottson SBBI Classic Yearbook at 75.

The market crashes of 2000-2003 and 2007-2009 wrought enormous damage to fiduciary portfolios, leaving principal depleted and an uncertain future for income or total return distributions. For example, from 1926 through 2011, large cap stocks had an arithmetic annual total return of 11.8, but a geometric return of 9.8. Small company stocks had an annual total return of 16.5, but a geometric return of 11.9. *Op. Cit.* at 32. The compound annual returns for periods including the dot-com crash and the Great Recessions are quite sobering. For the period 1999 through 2007, large cap stocks had an compound annual return (assuming no distributions to pesky beneficiaries) of -1.38%, 2000-2009, had an annual return of -0.95, while the most recent ten-year period of 2002-2011, had compounded annual returns of 2.92%. *Op. Cit.* at 38. That is not much total return for the average unitrust, which pass out 4% or more each year.

As will be discussed below, when one combines an erratic equity allocation with a bond allocation at current reduced real interest rates, it become enormously difficult to construct a portfolio which can meet the return needs of beneficiaries. The temptation is for the fiduciary or her advisors to add risky assets to the mix, to try to protect asset values and to enhance income available for distribution. As the returns of recent decades makes clear, the addition of risk to fiduciary portfolios has failed miserably and is likely to continue to fail.

One other approach to calculating risk is to utilize semi-standard deviation or Sortino Ratio, which seeks to measure the standard deviation of the loss or downward movement of a security. See "Mean, Variance and Distributions" http://www.stanford.edu/~wfsharpe/mia/rr/mia_rr1.htm. William F. Sharpe. Downside risk has been calculated as "Morningstar Risk," offering the

possibility of assessing individual investments and entire portfolios for their performance on the downside.

The seminal work underlying the "random walk" hypothesis was first elucidated in 1900 in a Ph.D. thesis by the French Economist Louis Bachelier and amplified in later articles and publications. See Didier Sornette, "Why Stock Markets Crash" at 38 (Princeton University Press, 2003). Looking at apparently erratic stock market prices, Bachelier theorized that they followed a "random walk." While God may not play dice, Bachelier based his assumptions on market prices on the concept of a coin toss—each play comes up either heads or tails. This presupposes that all movements in stock prices are wholly independent, just as one toss of the coin does not influence the outcome of the next. This is clearly false, since price movements are dependent on one another, as the market reacts to up or down-ticks and money pours in or investors bail out.

As Sornette pointed out, such a random walk hypothesis does not square with the data. When running long run studies of stock transactions, Sornette concluded that "[T]he random walk model thus explains quite well the way typical returns in the stock market change with time and with time scale. However, it does not explain the large fluctuations that are not 'typical.'" *Ibid.* at 40.

Many investors and most beneficiaries would like to get rich, but they are more concerned whether their income will continue and their wealth level be preserved, particularly if they have large mortgages, tuition to pay for decades, or young spouses who may switch partners if the good times turn illusory. Not every participant in the investment world has the goals of hedge fund managers—the stated preference of many people is to achieve specific levels of income, short term benchmarks, or long term income streams, while others follow the tape continuously looking for opportunities on the upside and evaluating each new byte of information about investments for investment decisions. Any beneficiary may have several distinct goals, so it is important to determine the components of their risk and return objectives so that such distinct state preferences can be reconciled by the investment strategy. See William Sharpe's "Investors and Markets: Portfolio Choices, Asset Prices, and Investment Advice" (Princeton Lectures in Finance, 2006), where he discusses state preference analysis.

The invisible hand would never acquire a 50-year railway bond because of the inflation risks and company risks associated with such a security. However a pension fund manager or insurance company which faces obligations for decades to come based on nominal values, e.g., a $100,000 insurance policy or defined benefit payments, may reasonably put a portion of the portfolio designed to mature in 50 years into a bond with a fixed value. Placing a portion of the portfolio in such nominal value instruments may be an appropriate investment. Individual investors have similar mixes of objectives, not all of which are met by the market portfolio with its limited distributions, volatility keyed to market weighted investments, and high risk. Whether such individual goals of real beneficiaries can be reasonably reconciled is the job for the fiduciary. If you fail, you may end up explaining your decision to a court.

Active Management

Defending such claims is often difficult because of the persistence of negative views in some circles about the value of active management and the significance of asset allocation. One problem is the misconception that 93.6% of returns are the result of asset allocation decisions, based on a 1986 study by Gary Brinson, "Determinants of Portfolio Performance," which examined changes in asset allocation programs as respective mutual funds. This has been widely interpreted by commentators and well paid expert witnesses to mean that asset allocation in the primary job of a fiduciary, and larded with comments on the evils of active management. A thorough threshing of the shortcomings of the Brinson study can be found at John Nuttall, "The Importance of Asset Allocation," which can be found at http://publish.uwo.ca/~jnuttall/.

The 2012 Ibbotson SBII Yearbook examines this controversy and computes the actual benefit conveyed by asset allocation and active management. First, the statistics of asset performance are adjusted for the effect of overall market returns. "After removing this common market factor, on average for typical funds about half of the return variation comes from detailed asset-allocation decisions in excess of the market movement and about half of the return variations come from active management, although this 50/50 result dramatically changes from one period to the next." 2012 SBBI Yearbook at 89.

In dealing with unhappy beneficiaries, their counsel and hired experts, make sure you demonstrate that active management is not a sin, as long as you can provide a detailed record of the rationale for the various decisions made. One must also be prepared to deal with expert witnesses, who will attack with the cant of modern portfolio theory (without having a clue as to whether any of it is grounded in reality or what generations of economists have discovered when examining the actual performance of investments in the real world).

Most fiduciaries are governed by the Uniform Prudent Investor Act (except Massachusetts and Pennsylvania) or related statutory schemes which require the trustee to meet the "risk and return objectives reasonably suited to the trust." The term "'risk' is used (as it is commonly is in economic literature) to refer to volatility of returns." Restatement (Third) of Trusts §90, com. *e(1)* at 302. The Restatement does not expressly adopt Modern Portfolio Theory, "What has come to be called 'modern portfolio theory' offers an instructive conceptual framework for understanding and attempting to cope with nonmarket risk. **The trustee's normal duty to diversify in a reasonable manner, however, is not derived from or legally defined by the principles of any particular theory**." *Ibid.* (emphasis added) That being said, the Uniform Prudent Investor Act in most States dictates that the trustee examine "risk," that is, the volatility of stock in allocating assets to create a portfolio which meets the risk and return objectives of the trust and its beneficiaries.

However, the average attorney or judge is under the misapprehension that the fate of man is ruled by the efficient market, a random walk, and a bell shaped curve of investment outcomes from which can be utilized with a proper asset allocation into long term wealth. The University of Chicago preachers have triumphed in imposing a comprehensive myth on a host of players, using the complex argot of heteroskedasticity and covariance to cow ordinary folk into acceptance of such beliefs. The last 15 years, however, have forced the reality of the financial

markets into harsh conflict with the acolytes of modern portfolio theory, as stocks underperformed bonds for five ten-year rolling periods starting in 1998 (2012 Ibbotson SBBI Yearbook at 38), as bonds soared and their yields crashed under the panicked purchases of US paper by the lemmings of the world seeking safe haven in a global collapse, and as econometricians have used fractal geometry, truncated Levy flights, and conditional value at risk modeling to demolish the old theories.

Most people, who read or listened to the holy writ of the old order, numbly accepted their canons, because who could possibly contest the multiple-lined mathematical formulae and fabulous graphs.

In the real world, investment advisors and fiduciaries struggled to structure investment portfolios which provided income and stable principal while the world financial markets were emphatically not cooperating. Judges and regulators struggle to assess and advise investment conduct which used to make sense, but no longer works in the aftermath of two major crashes in a ten year period. The new models for investment offer both a haven for fiduciaries by pointing to conduct which can meet the requirements of feeding successive generations of beneficiaries. This also demonstrates procedurally prudent investment conduct, as well as providing defenses to those whose past conduct is now being attacked in courtrooms across the country. When plaintiff experts tell the court or jury that active management is culpable conduct for a fiduciary, or that damages should be assessed based on the returns of major indices, there are defenses.

However, the concepts of market risk and idiosyncratic risk and beta and alpha are embedded in the commentary on the duty to consider covariance of assets in structuring a portfolio, as if beta and alpha were facts, rather than concepts in highly contested economic theories.

Bonds and the Virtueless Cycle

Most trustees rely on the methodology and sometimes the econometrics of the Capital Asset Pricing Model to find an efficient frontier for mixing asset classes, without considering the fundamental changes in the economy itself and the problems posed by simplistic models. The 50/50 or 60/40 split between equities and bonds is fundamentally broken. Bonds are supposed to be used because of their low correlation to the S&P 500 ("market"), but also because they supposedly provide substantial guaranteed income and low downside risk, when compared to equities.

However, US government bonds have had their prices inflated by everybody in the world, and particularly Mr. Bernanke, reducing their yields to negative real returns. If inflation ever returns, one is likely to lose one percent of principal value for each percent increase in inflation multiplied by the average portfolio duration. Providing reasonable income is now a major problem for fiduciaries.

In 1982, 55% of Treasuries were owned by individual and institutional investors. At present, only 23% of Treasuries are held by such investors. Foreign holders, largely central banks desperate to stabilize their currencies and banking systems hold 34% of Treasury debt.

The Federal Reserve's share of ownership has doubled since 2008, with 11% of Treasuries currently owned. J. Zweig, "Are Bond Rates on a Road to Nowhere?" Wall Street Journal, June 8, 2012. The demands of Basel II and the need to find safe havens from fragile European debt instruments have increased investments in Treasuries and driven down their prices. At the same time, rates have fallen correspondingly.

Mr. Bernanke has adopted a course of holding down interest rates and promises to continue that practice for the next several years. The result of such downward pressure is nominal rates of return of 1.5% on intermediate term Treasuries. The real return, adjusted for inflation, is in fact negative. Even TIPS face negative real returns almost twenty years out.

The result of such a policy faces the investor with the prospect that the most she can earn on ten-year treasuries is their 1.5% coupon, which falls short of CPI. At such low rates, there is little prospect of increases in the principal value of such notes. If the beneficiary in question has a personal inflation rate tracking nursing home care, tuition expenses, or other expenses which inflate more than core CPI, the portfolio fails its goals for the foreseeable future.

Since 1982, interest rates have been falling, increasing the total return on bond allocations in a portfolio. Hence bonds provided solace in the crashes of the last decade, but no more.

The experience of investors in the post-World War II era was that bonds suffered substantial losses in nominal and after inflation returns, when interest rates were constrained by federal policy. From 1941 until 1951, the Federal Reserve "enforced rate ceilings at two and sometimes three points on the Treasury yield curve." B. Bernanke and V. Reinhart, "Conducting Monetary Policy at Very Low Short-Term Interest Rates" The Federal Reserve Board, January 14, 2004 at 4. Between 1941 and 1951, intermediate terms bonds lost principal value adjusted for inflation in every year except 1949. 2012 Ibbotson SBBI Classic Yearbook at 65. During the same period, long term treasuries lost their inflation adjusted value in 7 of the 11 years until the policy of holding down rates was terminated in 1951. Hence the trustee faced with current low interest rates faces the risk of loss of some principal as well as insufficient income for the income beneficiary.

If the returns on equities and bonds have changed, the prudent trustee must be alert to alter the trust investment model, seek instructions, or buy trustee insurance. Using average historical figures for equities will substantially overstate the returns of current asset allocations. While large cap equities might have an average return of 11 percent, the actual returns in the past decade have been butchered by two major recessions. If the geometric return of large caps from 1926 to the present may have been 9.8%, the last decade has fallen far short, and the prospect is that the market portfolio may yield 5%. When adjusted for inflation, this leads to real return of perhaps 2.5%. With ten year bonds having a nominal yield of 1.8%, likely inflation in the future will result in negative real returns for investors.

The combination of historically low bond rates and volatile equity performance make structuring portfolios a serious problem. A recent Morningstar study by D. Blanchett, M. Finke, and W.D. Pfau, "Low Bond Yields and Safe Portfolio Withdrawal Rates," (January 21, 2013)

predicts that the combination of low bond returns and high volatility make it very difficult to structure asset allocations which can provide long-term income for retirees. The authors construct Monte Carlo analyses of returns of investment portfolio using 20% equities, 40% equities, 60% equities and 80% equities with the balance in an intermediate term government bond index. The historic average return for equities was reduced by 2% to 9.77%, to reflect current analysis about the variation of returns and a reduce equity risk premium from prior decades. Taxes and required minimum distributions were ignored in favor of 3%, 4%, 5% and 6% returns. One percent was subtracted to reflect the costs of management, mutual fund fees, account fees and so forth. This structure assumes that the investor is willing to treat the portfolio as an annuity, that is, nothing left for the children or charities at the end. This is a major factor, since most people look for some residue when they shuffle off their mortal coil. Planning for a residue places a large drag on the ability of a portfolio to make continual distributions in a fixed percentage. In other words, don't tell the children that their parents are planning to spend it all.

The results are sobering, largely because of the low interest environment. Table 2 in the study, at page 10, shows that if a retiree with a 20% equity allocation wanted to plan for a 30 year time horizon and wanted a 90% probability of success, the initial withdrawal rate would be 2.7%. Forget about 4% forever!

Coached in the risk/return theory of the Capital Asset Pricing model, doubtless you will suggest that one should increase the equity component to a higher level—more risk, more return. Right?

The volatility of recent returns and the past decade make clear that picking the high volatility of the S&P 500 does not produce marginally better returns in the real world, as discussed below. The study concludes: "While the difference between a 3.0% initial withdrawal rate and a 5.0% initial withdrawal rate may not seem material, the 3.0% initial withdrawal rate requires 66.7% more savings than the 5.0% initial withdrawal rate to produce the same annual income. One way to reduce the required savings amount would be to potentially take on more risk during retirement by increasing allocation to equities. Unfortunately, **increasing portfolio risk does not have a material impact.** For example, the initial withdrawal rate for a 20% equity portfolio with a 90% probability of success for a 30-year retirement period is 2.7%. If the retiree increased the equity portion of the portfolio to 60% and lowered the probability of success to 80%, he or she could only raise the initial withdrawal rate to 3.2%. This would require 18.5% less savings, **but would subject the retiree to considerably more market risk, which is something that is not captured in the probability of success metric."** *Ibid.* at 10-11 (emphasis added.)

The report concluded that "a retiree who wants a 90% probability of achieving a retirement income goal with a 30-year time horizon and a 40% equity portfolio would only have an initial withdrawal rate of 2.8%. Such a low withdrawal rate would require 42.9% more savings if the retiree wanted to pull the same dollar value out of the portfolio annually as he or she would get with a 4$ withdrawal rate from a smaller portfolio." *Ibid.*

John Bogle has come to similar conclusions, although his assumptions are based more on economic fundamentals than the Monte Carlo analysis above. In an interview in October of

2012, his outlook for stocks in this damaged world economy is 7% in nominal terms. When adjusted for inflation, an intermediate bond portfolio would return 2.5 percent in nominal terms, and **zero in inflation adjusted returns.** With a nominal return of 7% for equities, after adjusted for inflation the balanced portfolio would produce 2% in real returns. C. Benz, "Bogle: Most Difficult Investment Conditions I've ever Seen," October 18, 2012 at Morningstar.com (emphasis added.).

The basic problem about most asset allocation models is that they rely on the premise that high beta or volatility is linked to high returns, hence in mixing assets one assumes that the beta of stocks or mutual funds can be combined to create a portfolio designed for superior returns. The Uniform Prudent Investor Act in most states directs the trustee to evaluate the "risk" of the investment portfolio. Moreover, all of this theory is based on the premise that the securities market is a random walk and that every asset price change is independent of the last. This is simply not true. "The random walk model thus explains quite well the way typical returns in the stock market change with time and with time scale. However, it does not explain the large fluctuations that are not 'typical,'" Didier Sornette, "Why Stock Markets Crash" at 40 (Princeton University Press, 2003).

"Evidence suggests that distributions of security returns might not be normal, with markets exhibiting more extreme events than would be consistent with a bell curve distribution….If extreme price changes occur substantially more frequently than predicted by a normal distribution, some extremely important events fail to influence conclusions generated from quantitative analysis. In fact, investors may care more about extraordinary situations, such as the 1987 stock market crash, than about outcomes represented by the heart of the distribution." David F. Swensen, "Pioneering Portfolio Management" at 106; see also Benoit Mandelbrot, "The (Mis)Behavior of Markets: A Fractal View of Risk, Ruin, and Reward" (New York, Basic Books, 2004) at 11 and 84-87.

The assumption that one needs to take more risk (volatility) to obtain more return has long been challenged. Fama and French in 1992 determined that the relationship between high beta and return was flat. Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns," (Journal of Finance 47(2) 427-465, 1992). If you buy high beta stocks, you don't necessarily get higher returns. As Burton G. Malkiel explained with respect to the Fama/French results, "there was essentially no relationship between the return of these decile portfolios and their beta measures. I found a similar result for the relationship between return and beta for mutual funds. It appears that there is no relationship between returns for stocks or portfolios and their beta measure of risk, confirming the Fama/French results." A Random Walk Down Wall Street, Norton, 2007 at 207.

In 2006 a study was made of the relationship between aggregate volatility and its impact on the price movement of stocks, A.Ang, R. Hodrick, Y. Xing, and X. Zhang, "The Cross-section of Volatility and Expected Returns," LXI The Journal of Finance, No. 1 (February, 2006). The Capital Asset Pricing Model predicts that a portfolio with higher volatility will produce higher returns than one with lower volatility. However this detailed econometric study, which provides detailed analysis of market returns as well as tests of alternative explanations for the results, concluded that higher volatility leads to lower portfolio returns. "We find that stocks

with high idiosyncratic volatility have low average returns. There is a strongly significant difference of -1.06% per month between the average returns of the quintile portfolio with the highest idiosyncratic volatility stocks and the quintile portfolio with the lowest idiosyncratic volatility stocks." *Op. cit.* at 261. This article is rocket science, and loaded with detailed formulae for testing the propositions. However, struggling through the article and particularly the scope of the analyses and the testing of alternative explanations for the results provides a compelling case for the conclusions. The risk/return metric found in the Uniform Prudent Investment Act is seriously flawed. Allocating assets based on the assumption that higher volatility equity portfolios will produce higher total returns is wrong. The experience of market returns based on the S&P 500 or S&P 100 since 1998 provides some validation for the proposition that high volatility will result in lower returns; conversely, lower volatility equity portfolios can produce better returns.

More recently, a study of the higher returns resulting from low volatility financial assets was published in 2011 in the Financial Analysts Journal by Malcolm Baker, Brendan Bradley and Jeffrey Wurgler, "Benchmarks as Limited to Arbitrage: Understanding the Low-Volatility Anomaly," 67 Financial Analyst Journal at 40 (2011). The study looked at the top 1000 US stocks by market capitalization from January 1968 through December 2008: "Regardless of whether we define risk as volatility or beta or whether we consider all stocks or only large caps, low risk consistently outperformed high risk over the period." *Ibid.* at 41. The authors conclude that investors do not take advantage of this anomaly because most fund managers must measure their performance against capitalization weighted indices, which tend to do better in rising markets. Hence, managers are unwilling to invest in lower risk assets because investors clamoring for performance abandon such funds as they lag behind in good markets. The quest for the maximum returns prevents managers and customers from utilization of strategies that profit in the long run by minimizing losses through low volatility stocks (or value stocks, or low PE stocks, or small cap stocks). The efficient market, in fact, is filled with people who want to pick the latest winner rather than plodding to consistent gains, and hence do not take the more cautious approach to limiting risk as a route to long-term returns.

As Ibbotson concluded, "[s]everal academic studies have shown that the market overreacts to bad news and underreacts to good news. This would lead us to conclude that there is more room for value stocks (which are more likely to have reported bad news) to improve and outperform growth stocks, which already have high expectations built into them." Ibid. at 158.

A study released by Robert Haugen in April of 2012 confirmed these results across 21 developed markets, for the period 1990 through 2011, and 12 emerging markets for the 11 year period from 2001 -2011. "The most interesting result is that the low risk quintile outperforms the high risk quintile in every country. On average, the lowest risk quintile wins by more than 14% per year over the high risk quintile. Although the consistency varies across countries, the low risk quintile wins in 80% of the years on average. This is called the 'hit ratio" and is calculated by counting the number of years in the test period. On a risk-adjusted basis, the consistency is greater. The Sharpe Ratio of the low risk quintile is greater than the Sharpe Ratio of the high risk quintile 85% of the time. Similar results were obtained for the emerging markets. The evidence is extremely compelling: high-risk stocks consistently underperform low-risk stocks, both across

time and across countries." *See also,* "Less Risk Offers More Reward" Jeff Benjamin, Investment News, April 22, 2012 at 1.

Roger Ibbotson in February of 2013 discussed an unpublished article he authored with Daniel Kim which evaluated low-volatility stocks for the period 1972 through 2012 and found that the mean performance of low-beta stocks was 14.03%. The result for high beta stocks was 8.25%, and that the same was true when looking at low daily and monthly volatility, concluding that "The lower-turnover stocks give you the greater returns at lower risk than value stocks do, and coming in a close second are the low-beta, low-volatility shares." J. Levaux, "Startling Stock-beta Study 'Turns Theory on Its Head' Ibbotson Says" (2/21/2013) http://www/advisorone.com/2013/02/21. Ibbotson discussed his findings on Morningstar, finding that from 1972 through 2012, low-violatility and low-beta stocks outperformed high beta and high volatility stocks. C. Benz, "Does Higher Risk Really Mean Higher Returns?" (2/12/2013) http://www.morningstar.com/cover/videocenter.aspx?id=586583.

Using the market-weighted S&P 500 or other indices as a benchmark for performance ignores the substantial volatility of such market-weighted indices. If you add Apple to an index, the volatility and concentration of such an index changes substantially. In recent years, with high volatility in the S&P 500, equal-weighted or fundamental indexes such as RAFI have had superior performance. There has been substantial academic criticism of market weighted index funds, because of the over-reactions described by Ibbotson. The market weighted fund buys more of a soaring large cap, thus creating more risk of a substantial loss when such stocks subsequently fall, and holds too little of smaller capitalization stocks which are more likely to rise in value. See Jeremy Siegel, "The 'Noisy Market' Hypothesis," Wall Street Journal June 14, 2006; Robert D. Arnott, Jason Hsu and Philip Moore, "Fundamental Indexation," March 1, 2005 Financial Analysts Journal, Vol. 61(2) at 83; but see D. Jamieson, "Critics Question New 'Improved' Equity Indexes," Investment News, December 19, 2005 at 3. Index funds based on other measures of size, such as sales, number of employees, gross revenues, gross dividends, cash flow, or equity book value arguably produce higher returns for less risk. See Arnott supra.

Other commentators question the assumption that everyone in the market seeks to maximize return. The assumption that all investors seek mean-variance efficiency, is false—investors have different utilities, goals, time horizons, and access to credit to hedge. Harry M. Markowitz, "Market Efficiency: A Theoretical Distinction and So What?" Financial Analysts Journal at 17 et seq. (2005). The Assumptions that all price changes are continuous, that price changes are independent of one another, and the factors used to compute prices have statistical stationarity are false based on detailed analyses of actual prices. Mandelbrot, at 84-87.

Other investigators, Fama and French, Campbell, and Shiller point to positive returns from a number of anomalies in the movement of stock prices which indicated that low price to earnings, dividend yield, or small capitalization in fact can assist in producing better returns. "Value" stocks also appear to have a premium which is inconsistent with the random walk or MPT assumptions. "Several academic studies have shown that the market overreacts to bad news and underreacts to good news. This would lead us to conclude that there is more room for value stocks (which are more likely to have reported bad news) to improve and outperform growth stocks, which already have high expectations built into them." 2012 Ibbotson SBBI Classic

Yearbook at 108.

John Y. Campbell and Robert J. Shiller found that computing ten years of earnings, adjusted for inflation for specific stocks or the broad market, provided correlations with subsequent performance, with low price earnings ratios for a prior ten year period correlated with subsequent superior performance in the subsequent ten years, while high price earnings were followed by years of poor performance. John Y. Campbell and Robert Shiller, "Valuation Ratios and the Long-Run Stock Market Outlook," Journal of Portfolio Management, Winter 1996 at 11 *et seq*; Robert Shiller, Irrational Exuberance at 12 (First Broadway Books, 2001).

For example, small cap stocks tend to outperform large capitalization stocks, a result which does not square with MPT or the Capital Asset Pricing Model. "[B]ased on historical return data on the NYSE/AMEX/NASDAQ decile portfolios, the smaller deciles have had returns that are not fully explainable by the CAPM. The return in excess of CAPM grows larger as one moves from the largest companies in decile 1 to the smallest in decile 10. The excess return is especially pronounced for micro-cap stocks (deciles 9-10). This size related phenomenon has prompted a revision to the CAPM that includes the addition of a size premium." 2012 Ibbotson SBBI Classic Yearbook at 100.

The Basic Assumptions of Modern Portfolio Theory Are Empirically Incorrect

Consider the problem of developing an accurate calendar. The Egyptians utilized the movements of the star Sirius or Sothis to develop a twelve month calendar of 30 months each, with an additional five added to one month to make 365. However they did not realize that every four years Sirius arrived on the 366th day, rather than the 365th. A minor statistical lapse. The calendar appeared to work fine and was in force for thousands of years, with peasants, kings and priests following its dictates. Doubtless the equivalent of NCCUSL endorsed it. However, this statistical error meant that their calendar shifted across the seasons on a 1,460 year cycle. The date of planting festivals moved from Spring to Fall to Summer to Winter and finally back in time for planting. The priests conducting the ceremonies, like attorneys, doubtless nimbly taught their orthodoxy and explained the primacy of their religious teachings, no matter how unusual it appeared to them to have renewal festivals at the height of harvest season and planting invocations in the dead of winter.

The Romans faced similar problems with their scientifically established calendar. Plutarch explains that "[F]or it was not only in ancient time that the Romans had wanted a certain rule to make the revolutions of their months fall in with the course of the year, so that their festivals and solemn days for sacrifice were removed by little and little, till at last they came to be kept at seasons quite the contrary to what was at first intended." Caesar recognized that the Roman calendar was three months out of step with the reality of the seasons, making a mockery of his role of Pontifex Maximus, and utilized the services of the Alexandrian astronomer Sosigenes in 46 B.C. to create the Julian calendar.

A similar problem is posed by the adherents to Modern Portfolio Theory ("MPT"), whose theories about how the market should function cause them to move out of step with current realities. Unfortunately for trustees, the "risk and return" principles of the MPT have been woven

into the fabric of the Uniform Prudent Investor Act, in force in 44 States, the District of Columbia, and the US Virgin Islands. So long as the standard of care utilized by a court reflects actual practice, there is no problem. However, faced with expert testimony about beta's and covariance and heteroskedasticity, the average judge or jury may adopt such theories and analytic tools as gospel, surcharging trustees who actually understand what day of the year it is.

Adherents to MPT have complete faith in the concept of the efficient market, reciting that the price of a stock on any given day reflects all of the information available and hence properly values broadly traded securities. This is a form of the pathetic fallacy, in which inanimate objects are imbued with intelligence or life. The price of any given stock is influenced by a host of factors which have nothing to do with some fundamental rule match past performance with present or future value. The market is overwhelmed by noise, with thousands of salesmen and gurus predicting bloom or doom at any given moment, most with no evidence whatsoever. Herding is a major factor, with the mob following supposed leaders or jumps in price, and overreacting as discussed by Ibbotson, *supra.* With over 30 percent of the value of stocks held in index funds which adjust their constituents only infrequently, and with large portions of the issues held by employees whose trading is restricted, the impact of fundamental financial changes on the prospects of a given stock are substantially muted. At the other end of the spectrum, hedge funds and computer generated trades generate huge volumes of trades which are designed to capture tiny movements in the price of specific shares with holding periods of several seconds. The availability of information, in an age of dark pools and direct computer trades, undercuts the ability of the invisible hand to react to major transactions. The valuation of a security based on its last trade is a convention, which may have nothing to do with the price which will clear the market.

These considerations can provide a reasonable basis for a corporate fiduciary to actively manage a portfolio, particularly in selecting assets which might have better performance in adverse markets. This is a significant issue as fiduciaries are forced by low bond yields, inflationary risks, and changing asset correlations into actively seeking changes in simplistic allocation models.

Asset Allocation and the New Math

Another risk facing fiduciaries arises from the asset allocation process itself. Most corporate fiduciaries can produce charts of efficient frontiers to help explain the basis for allocating different proportions of various assets into a portfolio to match the risk and return objectives of a beneficiary or customer. One of the key studies was done in 1975 by Edwin S. Elton and Martin J. Gruber and included in their textbook, "Modern Portfolio Theory and Investment Analysis." (1995 Wiley, 5th Edition). This study was based on monthly price statistics on all stocks on the New York Stock Exchange from 1970 to 1975. This gave the familiar risk return chart showing that having more than 80% in stocks would not increase returns. The same chart can be found in the 2007 edition of the textbook, at page 59. However times have changed since 1975. Unfortunately, many fiduciaries have not kept up with such changes. The interest return of bonds has changed radically with the inflow of flight money and the Federal Reserve's efforts to boost the economy by bond purchases.

Hence fiduciaries are now tempted to accept more risk by moving into bonds which are decidedly not "riskless" or to emphasize equities or alternatives strategies. Under a classic Mean Variance Optimization model, one creates portfolios based on the covariance of individual stocks, industries, or asset classes, or alternative strategies such hedge funds, commodities and the like.

The initial problem is that covariance between asset classes change continually, and that in market crashes such covariances move together. This happens in every major downturn, and the rise of correlations can last for multiple years. The correlation coefficients jumped with the financial crisis in 2008. Main Street Advisors' Correlation Coefficients of Asset Classes in 2008, measured against the S&P 500, showed mid-caps at .98, small caps at .98, large foreign at .91, real estate at .83, Hedge funds at .79, and commodities at .39. The Main Street Advisors' chart for the period 1997-2011, showed mid-caps had dropped to .91, small caps to .82, large foreign at .85, real estate at .59, hedge funds at .76, and commodities at .32. Other providers of such charts show a range of outcomes, but a similar pattern of high correlations in these troubled times, even when using one or two-year data sets. Relying on correlated assets can prove dangerous when the beneficiary's attorney realizes that the fiduciary's investment department continued to diversify as if there were substantial diversification benefits to be expected from the various asset classes, when the crash caused them to correlate. When such correlations are historically subject to long periods of high correlations, following past correlations can be risky.

The issue, of course, is whether the "market portfolio," the S&P 500, is in fact the proper measure for many investors in light of its income and volatility. The trial court in *Nickel v. Bank of America Nat. Trust and Sav. Ass'n.*, 991 F. Supp. 1175, *rev. on other grounds*, *Nickel v. Bank of America Nat. Trust and Sav. Ass'n*, 290 F.3d 1134 (9th Cir. 2002), rejected the use of the S&P 500 as a damage measure for a class of 2,500 trusts where trustee fees had been charged in excess of fixed fee provisions in the trusts over a period of more than 20 years. The Court pointed to problems in the use of such a measure in individual trusts as well as its inapplicability to a class of trusts:

> "The trouble with this methodology is that it does not reflect reality. The trusts had differing investment objectives, and those objectives sometimes changed during the lives of the trusts. The income beneficiaries and principal beneficiaries also had, at times, differing interests within individual trusts. There were different types of trusts. The liquidity needs of each differed. Taxes were an issue in some trusts, but not in others…. Most of the trusts have been terminated. And some trusts held quantities of cash that were not invested. The application of averages, ratios, combined rates of return, and the like simply do not fit the facts of these widely disparate trusts. Nor do those applications address the facts that all of the trusts, under plaintiff's methodology, would receive the benefit of a high rate of return, such as the Standard & Poor's Five Hundred Index, when in fact many trusts did not bear the investment risks of that type of growth investment." (991 F. Supp. at 1183-1184).

When correlations between individual securities and the market portfolio are at high levels, it is difficult to deal with the volatility of the components. Supposedly the free lunch of diversification is that one is paid nothing for idiosyncratic risk. When correlations are in the .90 plus range, one can argue that you are compensated for such single company risk by the risk level of the market portfolio. However, the risks of individual companies from bad products to embezzlements to new entrants in competitive markets to feckless management making stupid acquisitions or incurring crippling debt remain. Hence, such high correlations raise questions about whether "risk" in terms of beta or volatility is completely divorced from reality.

If in fact correlations are driven by index fund trading or market risk in this "risk on, risk off" environment or by authorized investors capturing the disparities between individual stock values and their price within indices, how does one evaluate how to assess the risk in such individual securities or the construction of appropriate portfolios?

One can attempt to attack the use of correlation statistics, since the imperatives of the market movements tend to overwhelm the specific assets movements. Jean-Philippe Bouchard and Marc Potters in Theory of Financial Risk and Derivative Pricing (2d Ed. Cambridge, 2009) at 186 *et. seq.* pointed out that "conditional correlations, exceedance correlations, tail dependence, and tail covariance…can lead to an apparent increase of correlations in extreme market conditions whereas the underlying stochastic process has fixed time independent correlations." In other words, the massive falls in asset values skew the actual dynamics between asset classes, which supposedly will retain some effect despite the figures showing high correlations. Just as one should isolate the effect of the market when computing the impact of asset allocation and active management, ignoring the impact of the market on covariance matrices can leave you with misleading correlations. Have your expert read Chapter 11 of Bouchard before giving up hope on your asset allocation model.

However, the simple fact is that while these changes may be too extreme when the statistical problems are parsed out, things are different and your asset plans and investment models must deal with the changes or face consequences when they fail.

Asset Allocation Liability

The duty of the trustee is to create an asset allocation and acquire financial assets to complete it, looking at the risk and return objectives of the beneficiaries and the terms of the trust. In determining the risk objectives of the beneficiary, the trustee must be alert to inform the beneficiaries of the consequences of assuming risk, and attempt to tailor the portfolio to meet such risk tolerance as well as their distribution objectives. In the current economic environment, the correct answer may be to inform the beneficiaries that their return requirements cannot be met, or can only be met by assuming unacceptable risk of losses of income and principal. When the plan designed to cater to the subjective demands of the beneficiary fails, the beneficiary is likely to find an attorney who will allege that the skilled fiduciary failed its duty of disclosure of the risks and/or constructed a portfolio whose risks were likely to be realized.

In *Merrill Lynch Trust Co. FSB v. Campbell*, 2009 WL 2913893 (Del.Ch., Sept. 2, 2009), the trustee prevailed because of statute of limitations and the reliance on a broker for asset advice who prevailed in an arbitration. The trust had been established in those halcyon days of 1996

when the market was moving smartly upward, allegedly at the suggestion of a broker who suggested a 10% charitable remainder unitrust for the plaintiff (with an ailing husband), as well as use of the plaintiff trust company as the trustee. The initial investment allocation of 60-70 percent equities was adjusted the following year when the illness of the plaintiff's husband required home improvements to allow him to be cared for at home and expenses increased. The trust was moved as high as 99% in equities in the coming years, just in time for the dot com boom to crash. However, in 1999 this aggressive strategy had nonetheless produced a principal value of $943,000; by 2002 the trust was $356,000, a 58% loss in 6 years. *Id.* at *4. Suit was brought against the broker in 2005 which was tried in a NASD arbitration which plaintiff lost. The trust had tried to intervene to prevent a hearing which might impair its defense. The plaintiff lost the arbitration and the Trustee then filed an accounting to resolve its potential liability.

The Court held that "[t]he record is clear that a 10 percent charitable remainder unitrust with an expected life of fifty years is rarely formed; however, that does not here indict MLCT in an actionable manner, as claims surrounding the decisions embodied in the Trust Agreement are time-barred." The Court conceded that "[t]here is something unsettling about allowing MLTC to evade liability by relying on the questionable acts of its sister entity Pierce (some of which may have been reviewed in the NASD arbitration) and the passage of time." *Id.* at *11.

Although the trustee prevailed on the facts in *Campbell*, a trustee in most States who creates an asset allocation with unreasonable return and risk goals may find herself paying the price for failing to inform the beneficiary that their objectives are unreasonable and imprudent. It is difficult to tell a beneficiary that they have to adjust their life style because of the financial realities, but that is the prudent task when the alternative is placing the beneficiaries at risk of failing to meet their return objects and catastrophic losses of principal and far more restricted income in the future. Moreover, when remaindermen appear after the crash, reliance on the goals of the income beneficiaries may be a source of liability for violating the duty of impartiality as well as financial imprudence.

Faced with poor prospects for equities and dismal prospect for bond investments, the trustee faces the temptation to try magic, or as commonly known, alternatives investments.

Alternative Investments

Moving to alternative asset classes has not proved very successful in recent years, as hedge funds have performed poorly. The Court in *Parris v. Regions Bank,* ___F.Supp. 2d___, 2011 WL 3629218 (W.D. Tenn. Aug. 17, 2011) rejected summary judgment by the corporate co-trustee of a trust. Claims were brought under Tennessee's Uniform Trust Code and Consumer Protection Act. The plaintiff alleged that the co-trustee had urged the sale of existing trust assets and invested them in a "proprietary junk bond fund," which ultimately included 72% of the trust assets by December 31, 2006. 2011 WL 3629218 at *1. "Parris alleges that Regions should have known that the Fund held high-risk, illiquid securities and sub-prime debt obligations that were not reasonable and prudent investments for the Trust [internal citation omitted]… [d]espite 'storm warnings' about the volatility of those investments, Regions allegedly failed to diversify the Trust and failed to take reasonable steps to protect the Trust's assets." *Ibid.* The losses were allegedly $92,000. The plaintiff sought punitive damages of $500,000, exceeding the $75,000

minimum amount in controversy to support federal diversity jurisdiction. The Court rejected defenses of statute of limitations, consent, laches, and estoppel. The plaintiff alleged that the co-trustee failed to inform him that "the Fund invested in high-risk securities and collateralized debt obligations and that it had delegated investment authority to a Regions affiliate, Morgan Asset Management." 2011 WL 3629218 at *6. The Court denied a defense of ratification based on a failure to show that there had been full disclosure of material facts. "Regions has not conclusively shown that Parris had all of the facts necessary to form an opinion about the Trust's investments in the Fund, which is required to prove the defense of ratification under Tennessee law. *See Valley Fidelity Bank and Trust Co, [v. Cain Partnership, Ltd.]*, 738 S.W. 2d [638,] at 640." 2011 WL 3629218 at *7. The Court held that the complaint was sufficient to allege an unfair and deceptive practice, by pleading that Regions "knew or should have known that the Fund was not a reasonable and prudent investment for the Trust." 2011 WL 3629218 at *8.

Since this round dealt with pleading sufficiency, which does not deal with the actual facts, the outcome is not foreordained. However, a jury is possibly going to hear the facts about a trustee recommending a proprietary mutual fund, managed by an affiliate, whose risk was allegedly not fully disclosed.