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## Rulings on Trustee's Duty to Diversify: What Have We Learned?

In his Trusts and Estates column, C. Raymond Radigan, of counsel to Ruskin Moscou Faltischek, writes that in 1987, the New York Court of Appeals held that a bank was negligent for failing to diversify trust holdings of Kodak stock.<sup>1</sup> Since then, several New York cases examined whether a bank trustee was negligent for failing to diversify investments.

C. Raymond Radigan

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In 1987, the New York Court of Appeals held in *Matter of Janes* that a bank was negligent for failing to diversify the trust holdings of Kodak stock.<sup>1</sup> Since then, several New York cases, including *Matter of Rowe*, *Matter of Saxton*, *Matter of Dumont*, *Matter of Hyde*, *Matter of Creighton* and *Matter of Knox*,<sup>2</sup> examined whether a bank trustee was negligent for failing to diversify investments.

Trusts were created in these cases where a bank was named as either trustee, or co-trustee. The vast majority of the trust assets consisted of one or two stock holdings (i.e., Kodak, IBM, Marine Midland, and Woolworth). The bank initially decided to retain the concentrated holding. The retained stock eventually decreased in value, and the beneficiaries alleged that the bank negligently managed the trust's investments.

At the trial level, each case, except *Hyde*, held that the bank trustee was liable for damages for retaining the concentrated positions and not diversifying the portfolio. The damages were measured by the value of the lost capital, which was determined by 1) calculating stock value on a date the court found it should have been sold; 2) subtracting the potential capital gains tax that would have been paid if the stock had been sold (this was done in *Saxton*, *Dumont* and *Creighton* but not *Knox*); 3) then taking the hypothetical proceeds and compounding it annually at 9 percent in most instances during the course of administration; and 4) then subtracting the dividends received and the value of the retained stock at the end of the accounting period (or the proceeds received from the sale of the previously retained stock).

To date, only *Dumont* was reversed on appeal. However, at issue in all these cases was whether the trustees took an undue risk by retaining the concentrated positions and not diversifying the portfolio.

Most of the instruments lacked definitive language allowing the absolute retention of the large holdings or other such directions. The trustees were further criticized because of alleged lack of documentation either justifying retaining the stock or explaining the overall investment process. In certain instances, the courts held the trustee did not adequately or regularly communicate with the beneficiaries to explain appropriate investment strategy for the trust or to determine the

need for income or discretionary distributions.

These cases raise a few questions that deserve closer scrutiny.

### Duty to Diversify

Does a trustee have an absolute duty to diversify investments? The answer is no; it depends on the circumstances and the retention language in the governing instrument.

In New York, effective Jan. 1, 1995, "a trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard," as specified in EPTL §11-2.3.

The prudent investor standard requires a trustee "to diversify assets unless the trustee reasonably determines that it is in the interest of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument."<sup>3</sup> The duty to diversify is presumed because it can help minimize firm-specific risk (also known as "inherent risk") without sacrificing return. Firm-specific risk is when the price of a particular stock declines due to an event that negatively impacts a particular company, but not necessarily the marketplace. Firm-specific risk can be minimized significantly by creating a diversified stock portfolio.<sup>4</sup>

Unfortunately, even a diversified stock portfolio cannot protect against market risk. One way a fiduciary may minimize the impact of market risk, however, is to use a comprehensive asset allocation model when constructing a trust portfolio.

**Special Circumstances.** Sometimes, it might not be appropriate to diversify investments, given the terms and purpose of the governing instrument or the circumstances involved. For example, suppose Dad dies and funds a trust exclusively with closely held stock of a family business and assume his minor children are named as beneficiaries. They are to receive an outright distribution of their share of the trust assets at age 35. Does the trustee have a duty to diversify the stock?

Arguably, the rule of diversification should not apply to this trust given the property's special relationship to the beneficiaries and that Dad is simply using the trust as a vehicle to retain the family business stock until the children reach age 35. The grantor's intent to retain the property should be upheld, even without specific retention language. The safer approach especially under present law, however, is to include specific retention language and provisions that explain the specific intent of the grantor.

A similar issue was raised in *Matter of Hyde* where the Appellate Division, Third Department, affirmed the Surrogate's decision that it was not in the trust's best interest to diversify the stock of a closely held corporation.

**Retention Language.** The standard applies "except as otherwise provided by the express terms and provisions of a governing instrument with the limitations set forth by section (EPTL) 11-1.7 of this chapter"<sup>5</sup> which provides that the attempted exoneration of a fiduciary from liability for failure to exercise reasonable care, diligence and prudence is contrary to public policy. Thus, the statute will generally apply unless there is specific language in the governing instrument to the contrary. Does this mean that an instrument can eliminate the duty to diversify?

Theoretically, a grantor can create a trust that includes an ironclad retention clause where a trustee is directed to retain an asset that cannot be sold under any circumstances. This ironclad retention clause ought to include 1) an explanation of why the grantor wants the asset to be retained; 2) a direction that the retention is mandatory, not permissible and that the trustee has no authority to dispose of the asset; 3) the asset should be specifically identified; 4) the trustee's duty to diversify should be eliminated; and 5) the trustee should be exonerated from liability if the value of the retained asset decreases.

An ironclad retention clause can be problematic because the trustee would then have no flexibility to sell the asset, especially if the circumstances change dramatically. Furthermore, a true ironclad retention clause is extremely rare. None of the previously discussed cases had an ironclad retention clause, although *Dumont* came the closest.

In *Dumont*, the trustee was directed not to sell the stock just for the sake of diversification, but the trustee could sell the stock if there were some other compelling reason to do so. The beneficiaries in *Dumont* tried to prove that the trustee should have sold the Kodak stock due to its poor performance, not merely for the sake of diversification. The Appellate Division, Fourth Department, found there was no proof from the beneficiaries that there was a better alternative of investment.

Full Diversification?

Should a concentrated holding always be fully diversified on a certain date? No, especially if there is a capital gains tax to consider.

All these cases, except *Hyde*, picked a certain date when the trust portfolio should have been diversified. Thereafter, the bank trustee had 30 days to sell between 90 and 95 percent of the concentrated holdings (the "90/30 rule"). The courts held that the bank trustee was negligent if the stock was retained beyond 30 days.

The *Saxton* court rejected the New York Bankers Association's contention that the Surrogate's Court determination "created an inflexible 90/30 rule." This is important because depending on the circumstance, it may be prudent to diversify a concentrated holding over a period of time.

To illustrate, suppose a trustee determines that it is appropriate to diversify a concentrated holding valued at \$5.1 million. Further assume that the holding has a \$100,000 cost basis and the combined federal and New York capital gains tax rate is 23.97 percent (federal is 15 percent, New York is 8.97 percent).

One option is for the trustee to sell the stock immediately and pay a total capital gains tax of \$1,198,500 (\$5 million x 23.97 percent). Another option is to sell half the stock immediately, and sell the other half in the following year so that the capital gains tax is paid over a two-year period. Alternatively, it might be appropriate to diversify the position over a three- or four-year period. Sales also might be accelerated or delayed, depending on expected changes in the capital gains tax rate.

The selected strategy then should be explained and documented as part of the trustee's investment process. Meanwhile, if the position is large enough, the trustee can consider using hedging strategies (e.g., buying a protective put option, or creating a cashless collar) while the concentrated position is being retained.

#### Capital Gains and Damages

Should the potential capital gains tax be considered when measuring damages? Yes, if the fair market value of the concentrated holding is higher than the cost basis.

The *Saxton*, *Dumont* and *Creighton* cases subtracted the potential capital gains tax when calculating damages. In *Knox*, the court chose not to do so because it would result in "double taxation"—meaning the trust would essentially be taxed when the capital gains tax was deducted, and taxed again when the damages were awarded to the beneficiaries.

Fiduciaries argue that if the concentrated position had appreciated in value, then the trust would have paid a capital gains tax if this position was sold. Therefore, the trust would have kept only the net proceeds. Second, to argue that "accounting for a potential capital gains tax would result in the double taxation of damages" is inapposite because a trustee is likely to make several purchases and sales of securities held in the trust account during the course of administration. Consequently, the same proceeds in a long-term trust could be subject to a capital gains tax on several occasions as long as the assets are consistently appreciating in value.

#### Statutory Interest Rate

The cases discussed determined damages by annually compounding the value of the lost capital by the statutory interest rate.<sup>6</sup> The problem, however, is that the statutory interest rate in New York is 9 percent.

As a matter of background, New York adopted a statutory interest rate of 6 percent effective Sept. 1, 1972, at a time when inflation was rising at an annual rate of 3.19 percent and the 10-year U.S. Treasury Bond was yielding 6.55 percent. The statutory interest rate was raised to 9 percent on June 25, 1981, when inflation was rising at an annual rate of 13.13 percent and the 10-year U.S. Treasury Bond was yielding 14.28 percent.

Yet, as of April 2011, when inflation was rising at an annual rate of 3.16 percent and the 10-year U.S. Treasury Bond was yielding 3.46 percent, the statutory interest rate remains at 9 percent. Clearly, damages based on the statutory interest rate are designed to make beneficiaries "whole," but this rate is too high and beyond compensatory given current market conditions. In fact, to a certain extent, a fixed rate of 9 percent may be considered punitive.

One proposal is to make the statutory interest rate a variable rate that would be the rate of return on the one-year U.S. Treasury Bill plus 3 percent.<sup>7</sup> In any event, using a variable rate that is changed regularly would more accurately gauge current market conditions.

Another criticism is that the courts invariably used the maximum statutory rate of 9 percent to determine damages, even though they have discretion to use a lower rate, if appropriate. Bronx Surrogate Lee L. Holzman in *Matter of Tydings* exercised his discretion and used a lower interest rate (5 percent).<sup>8</sup> Furthermore, Surrogates should have the discretion to determine that compounding might not be warranted under certain facts and circumstances.

#### Protection for Trustees

What is the best way for trustees to protect themselves when making investment decisions in a fiduciary capacity? Trustees should in some form document the investment process.

The 1995 prudent investor act requires that a fiduciary should be judged "by a standard of conduct, not outcome or performance," and that "compliance with the prudent investor rule is determined in light of facts and circumstances prevailing at the time of the decision or action of a trustee."<sup>9</sup>

This means a fiduciary should not automatically be held liable merely because the value of the portfolio declined or because the portfolio did not perform as well as the appropriate benchmarks. The fiduciary is not a guarantor of performance. Instead, the decisive factor is whether the strategy and the investment decisions made by the fiduciary were prudent at the time they were implemented.

This is why under present law it is important for a fiduciary to document the investment goals and objectives of the trust. Once the investment strategy is in place, the portfolio needs to be reviewed regularly to ensure these investment decisions remain prudent, given current economic and market conditions, and if not, changes should be made accordingly. Most importantly, however, the trustee should prepare detailed documentation that the portfolio is being reviewed on a regular basis and adjustments are being made, when appropriate. The safest approach is to then communicate this information to the beneficiaries on a timely basis.

#### Conclusion

So what have we learned from *Janes to Knox*? First, as of Jan. 1, 1995, trustees have a presumed duty to diversify investments and may be liable if they neglect to do so. If diversification is appropriate, the concentrated holding can be sold immediately or sold over a period of time in instances where there is a considerable potential capital gains tax to consider. There may be an exception to the rule of diversification based on the circumstance or the language contained in the governing instrument. In any event, it is critically important for a fiduciary to document every major facet of the investment process in case these decisions are questioned in the future.

If a trustee negligently fails to diversify, presently the courts will calculate damages by determining when the concentrated holding should have been sold. If the concentrated holdings appreciate in value, the potential capital gains tax should be deducted from this calculation. The court should then have discretion in determining the amount of the surcharge, but a maximum award should be based on a variable statutory rate that reflects current market conditions and the use of compounding should be considered on a case by case basis.

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#### Endnotes:

1. *Matter of Janes*, 90 NY 22 41, 659 NYS2d 165 (1987) re argument denied, 90 NY 2d 885, 661 NYS2d 827 (1987).
2. *Matter of Rowe*, 227 AD 2d 87, 712 NYS2d 662 (3d Dept. 2000), appeal denied 96 NY2d 707; (2001); *Matter of Saxton*, 274 AD 22 110, 712 NYS2d 225 (3d Dept. 2000); *Matter of Dumont*, 26 AD 3d 824, 809 NYS2d 824 (4th Dept. 2006); *Matter of Hyde*, 44 AD3d 1195 (3d Dept. 2007), appeal denied 9 NY3d 1027 (2008); *Matter of Creighton*, 27 Misc.3d 1205 (A), (West.Co. Surr. Ct. 2010); *Matter of Knox*, No. DO-0659, and 30 Misc.3d 1203(A) (Erie Co. Surr. Ct., 2010).
3. EPTL §11-2.3(b)(3)(C).
4. See, Radigan and Radigan, "[Fiduciary Investing in a Challenging Economy](#)," New York Law Journal, May 4, 2009.
5. EPTL §11-2.3(a).

6. *Matter of Janes*, 90 NY2d at 55, supra.

7. See, Report of the Advisory Committee on Civil Practice to the Chief Administrative Judge of the Courts of the State of New York, January 2011, page 94.

8. See *Matter of Tydings*, 32 Misc. 1204(A), Surr. Ct., Bronx, June 28, 2011.

9. EPTL §11-2.3(b)(1).



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