Document ID#: 547200610047

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Damages for Breach of Fiduciary Duty

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PANEL: Measuring Damages in Fiduciary Litigation: A Review of Decisions and Trends

DATE: 10/21/06

COMMITTEE: Section Program: Litigation and Controversy Group

DAMAGES FOR BREACH OF FIDUCIARY DUTY

The measure of damages was one of the major innovations of the Third Restatement, looking at investments on a portfolio basis (rather than each investment in isolation) and allowing appreciation damages in certain circumstances based on what a broad market index would have returned. Restatement, Second, of Trusts §205 provided alternative damage measures: a) any loss of depreciation in value of the trust resulting from the breach, b) any profit made by the trustee through the breach of trust, or c) any profit which would have accrued to the trust if there had been no breach.

Restatement, Third, of Trusts (1992) modified the language of §205. It provides that a trustee is "(a) accountable for any profit accruing to the trust through the breach of trust; or (b) chargeable with the amount required to restore the values of the trust estate and trust distributions to what they would have been if the trust had been properly administered. In addition, the trustee is subject to such liability as necessary to prevent the trustee from benefiting personally from the breach of trust."

The Uniform Trust Code (2000) authorizes damages for the greater of: "(1) the amount required to restore the value of the trust property and trust distributions to what they would have been had the breach of trust not occurred; or (2) the profit the trustee made by reason of the breach."

As already noted, the UPIA looks at investments on a portfolio basis, rather than each investment in isolation. The combined effect of the UPIA and the changes to the Restatement (as reflected in the comments to Restatement (Third)) is to allow for appreciation damages in some circumstances based on what an appropriate market index would have returned for the portfolio, or segment of a portfolio, affected by the breach. However, a market measure such as the S&P 500 index may not be appropriate in most cases. The evolving basis for damages may curtail a line of cases that denied damages where an investment breach nonetheless caused no loss to the nominal value of the trust. On the opposite side of the coin, if a trustee's investment conduct was prudent under the appropriate standard, portfolio underperformance will not necessarily be a breach. The remedy of loss plus interest is still available, as is the remedy of disgorgement.

Under the Restatement, Second, courts found too little information on which to base a measure of damages bottomed on an index return (*see* Reporter's Notes to §§205 and 208-211, Restatement, Third, of Trusts at 167-168), and faced an absence of investment vehicles by which a trustee could invest in such index portfolios. The development of a robust index fund and ETF industry and the development of a statistical record of market segment performance by Ibbotson and others have remedied these difficulties. Of the $7 trillion invested in mutual funds, approximately 8.7% is invested in index funds, according to Vanguard. Proprietary index funds operated by banks comprise about 9.6% of all index funds.

In *Dennis v. R.I. Hospital Trust Nat. Bank* (1st Cir. 1984) 744 F.2d 893, 900, the Court of Appeals reversed a damage measure based on the rate of inflation. The trial court had held that the investment strategy represented a breach, and based damages on the .4% shortfall of the corpus measured against inflation during the 1950's. The Court held:

> ”We reach a different conclusion, however, in respect to the additional 0.4 percent, designed to reflect 'appreciation.' Neither the court nor the parties have provided us with any reason to believe that the trustee would have outperformed inflation. There is no evidence in the record suggesting that a hypothetical reinvestment of hypothetical proceeds from a hypothetical 1950 property sale would have yielded real appreciation over and above inflation's nominal increase. We have found no information about the performance of an average, or typical trust. And the general publicly available sources offer insufficient support for a claim of likely real increase. *See* R. Ibbotson & R. Sinquefield, [Stocks, Bonds, Bills and Inflation: The Past and the Future (1982)]. Moreover, one can imagine reasonable disagreement about whether any such hypothetical real appreciation would belong to the life tenant or to the remainderman. These factors lead us to conclude that, in addition 0.4 percent interest for real appreciation, the district court exceeded its broad remedial powers.

In the 1982 edition of Trusts and Trustees, Bogert discussed these problems in terms of the difficulty of proving what should have been acquired. G. Bogert, *Trusts and Trustees* §702 at 211-212 (1982 ed.). In a prescient comment, Bogert suggested that a court might be convinced to award damages based on the average prices of the types of securities which were appropriate for investment in the trust. §702 at 213. The Restatement Third, faced with detailed financial information and readily available investment vehicles for invested in broad indices, expressly authorized the use of such measures of damages.

The S&P 500, one of the measures frequently cited as an appropriate index, had a spectacular rise, climbing 251% from 1994 through the end of 1999. However, the same momentum factors that led to its rise based on the engine of large growth stocks, reversed after the peak of March of 2000 when the index value exceed $1527, then the growth leaders collapsed in the dotcom crash, accounting scandals, and the end of the telecommunications boom.

The S&P 500 index dropped 46.6% from its apex as of the end of the third quarter of 2002 (dropping 9.06% in 2000, 12.02% in 2001, and 22.10% in 2002). As of December 31, 2003, the index carried a value of $1,111.916, 27 percent below its peak. As of September 1, 2006, the index had recovered to $1,311, 14.1% below its peak. Despite such reversals, the use of the measure in earlier periods can still provide a major enhancement of damages over simple interest or other measures. For example, the index was valued at $459 at the end of 1994, a rise of 240 percent (assuming reinvestment of dividends and no correction for inflation). Moreover, the context of the case may justify the use of other benchmarks, as for example where the improper investment was in a fixed income portion of the portfolio. *See, infra, California Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036 (9th Cir. 2001).

The traditional use of interest rather than benchmarks can have enormous consequences given the rate of statutory interest and the effect of compounding. The New York Court of Appeals in *Matter of Janes*, 90 N.Y.2d 41 (N.Y. 1997) affirmed denial of the use of appreciation damages where there was no showing of self-dealing or intentional breach. In *Matter of Dumont*, 4 Misc. 3d 1003(A), 2004 WL 1468746 (Surr. Ct. 2004), *rev.*, 809 N.Y.S. 2d 360 (A.D. 2006), *leave to appeal den*. 813 N.Y.S. 2d 689 (A.D. 2006), use of statutory interest based on a failure to diversify in 1974 led to damages including such interest of over $25 million, before subtraction of the value of the concentrated position retained in the trust.

Restatement, Third, of Trusts § 211 provides that

> "If the duty was to acquire any property constituting a proper investment for the trust, charge the trustee with the amount of the funds the trustee failed properly to invest, adjusted for the amount of the total return, positive or negative, that would have accrued to the trust estate had the funds been invested in a timely fashion, this return to be based on a total return experience for suitable investments of generally comparable trusts."

The Reporter's notes to §211 notes the variety of measures of damages which could be applied when an improper investment scheme causes the trust to lose what it should have earned:

> "This approach can be carried out by referring the to performance of all or a relevant portion of the proper investments of the trust in question, to the performance of all or part of the portfolios of comparable trusts, or to the performance of **some suitable securities index or other benchmark portfolio**." (Emphasis added

Restatement, Third of Trusts, §211, Reporter's notes at 168.

The flexibility of the equity court to fashion a measure appropriate to the circumstances is emphasized in the new investment provisions of the Restatement. Comment f to §211 notes:

> "If the period during which the trustee has failed to make investments is not significantly prolonged, at least if the trustee is not guilty of bad faith or other serious misconduct, it would ordinarily be an appropriate exercise of equitable discretion to measure the performance of proper trust investments only by applying a suitable rate of interest, based on the income yields of investments of generally comparable trusts. In such a case the court would not look to a total return figure; that is, damages

> would not take account of capital gain or appreciation, nor of losses in value, that might have resulted in a suitable trust portfolio from general changes in stock and bond values in the security market. This approach would be particularly justified in such cases if a recovery based on some representative measure of total return performance of trusts appears highly speculative." (Emphasis added).

The case law since the adoption of the Restatement has tended to avoid the extreme measure of index returns where no conflicts or serious act of bad faith are involved.

The Court of Appeals in *Janes* affirmed the holding of liability, pointing to the duty of the trustee to "take into consideration the circumstances of the particular trust that he is administering, both as to the size of the trust estate and the requirements of the beneficiaries. He should consider each investment not as an isolated transaction but in relation to the whole of the trust estate (3 Scott, Trusts §227.12, at 477 [4th ed])." *In the Matter of Lincoln First Bank*, 90 N.Y. 2 41 (1997)

The trial court in *Janes* used the S&P 500 index as a measure of damages, the appellate division rejected it, and the New York Court of Appeals firmly rejected such a remedy in cases where there is no "deliberate self-dealing and faithless transfers of trust property." 659 N.Y.S.2d at 172. Hence the Court of Appeals decision was based on similar concerns to those stated in comment f to §211 above. While the use of interest reduced damages by $2,000,000, the fiduciary was still hammered for $4,065,029 plus prejudgment interest and $326,302. for commissions and attorneys' fees, plus post-judgment interest, costs and disbursements.

The Uniform Prudent Investor Act and the Third Restatement attempt to use such theories to establish a standard of conduct and a standard for measuring damages. When you actually prosecute or defend such a case, the facile theories and glib generalizations of econometric theorists provide little assurance and much opportunity for courtroom humor as econometricians meet reality.

A. Damages Even When There Was No Loss Of Nominal Value

Under the Restatement, Second, of Trusts, and the Prudent Person standard, one could be held liable for an individual investment, even if the overall trust corpus had grown in value. The Court in *Matter of Account of Bankers Trust Co.*, 219 A.D. 2d 266, 636 N.Y.S. 2d 741 (1995) the court held, in denying surcharge for investments in a common trust fund, that "the fact that the portfolio showed overall increase in total value during the accounting period does not insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged (*Matter of Bank of New York [Spitzer-Koenig]*, 35 N.Y. 2d [512, 323 N.E. 2d 700 (1974)] at 517…" 636 N.Y.S. 2d at 744-745. Under the Third Restatement, the overall return of the portfolio may provide a defense so long as the individual investment was prudent in terms of the risk and return characteristics of the trust.

1. *McCullough Trust:* Surcharge Barred Where Nominal Value Of Trust Increased (Modestly) Over 63 Years

In *McCullough Trust*, 21 Fiduciary Reporter 2d .135 (O. C. Allegheny 2001) the nominal value of the trust increased modestly over 63 years. The value was $25,189.60 in July of 1935. In 1998 the distribution to the remainder beneficiaries was $70,977.32. During the 63 year life of the trust there had been $97,003.82 in income distributions and fees. The Court held that since the nominal value of the trust had increased, there was no basis for surcharge. Prior decisions limited surcharge to circumstances where there was a "depreciation in the value of principal resulting from the breach of duty," citing *In re Mendenhall*, 398 A.2d 951, 954 (Pa. 1979) and *Killey Trust,* 29 Fiduciary Rep. 437 (O.C. Phila. 1979). Additional factors were laches (remainder beneficiaries had obtained information on the trust assets in 1968 but failed to object, witnesses had died, etc.) and acquiescence by the income beneficiaries in the investment program.

2. *Estate of Scharlach:* Appreciation Damages Allowed On 50% of Portfolio Due To Express Obligation To Invest In Equities

In *Estate of Scharlach,* 809 A.2d 376 (PA Super. 2002), the Orphans 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. However, the court allowed damages based on what the trust should have earned on a 50% allocation to stocks during the 8 years.

3. *Pitt v. First Union Nat'l Bank:* Surcharge Barred Where Trust Value Increased From $122,000 to $518,073 During 93 Years

Pitt v. First Union Nat'l Bank, 262 F.Supp.2d 593 (D. Md. 2003) represents a federal court sitting in diversity ruling on the teachings of *McCullough* and *Scharlach*. One trust had been funded in 1907 after the grandfather's death and second in 1924 following the grandmother's death. The trusts terminated in 2000. The remaindermen had not received accountings prior to 2000. Two court accountings had been filed in 1940 and 1943.

The 1907 trust had been funded with $122,000, and was worth $518,073 at closing. The 1924 trust had grown from $149,000 to $2,588,645. The beneficiaries filed suit in Maryland federal court seeking to surcharge the successor trustee for investment breaches. The rate of inflation from 1907, without deductions for trustee fees, other principal expenses, and invasions for the income beneficiaries, should have resulted in $2,259,000 in 2000. Conversely, the value in 2000 represented only $27,975 in 1907 dollars. Correcting the 1924 trust for inflation would have resulted in $1,515,789. Hence one trust grossly underperformed versus inflation and the other produced a result that beat inflation. There are no details about the investments and uses of principal, so that it is not possible to determine whether factors other than investment policy led to the disparate results. Given the almost 100 years of administration, even small principal disbursements, deduction of trustee fees, or one or two good for bad investments during the

Great Depression or any subsequent boom or bust period could have led to substantial differences at the time of termination. Moreover, it is unlikely that investment records would exist which would permit any analysis of the contemporary exercise of investment discretion by the trustee during the nine decades involved.

Neither of the instruments had a choice of law provision. The court held : "In the absence of a written choice of law provision in the applicable document, Maryland will apply the law of the 'state whose law governs the administration of the trust.'" citing Restatement (Second) of Conflicts of Law §268 (2)(a) (1971). 262 F.Supp.2d at 596. Since the wills were probated in Pennsylvania, the law of that State was followed by the federal court.

The Court followed *McCullough, supra*, denying surcharge on summary judgment based on the fact that the nominal amount of the 1907 trust had increased in value. Given the vigor with which the federal judiciary has sought to have their compensation raised to meet inflation, it is surprising that such a judge would consider this a sensible result. The Court then distinguished *Scharlach*, pointing out that in that case the trustee "failed to follow the investment plan that was developed for the trust and the Court concluded that the trustee had 'abrogated its fiduciary duties.' *Id.* at [809 A.2d.]384. In the instant case, neither party has identified a specific investment plan for the Trust that was ignored by either Defendant or its predecessors." 262 F.Supp.2d at 597 n. 3.

Other courts have dismissed such long term investment cases because of laches, or because of the failure of beneficiaries to act on accountings. *Lazzarone v. Superior Court*, 181 Cal.App.3d 581 (1986). However, such approaches would have led to factual questions which might have dictated against summary judgment -- hence the easy approach of ignoring inflation and following the nominal value approach of *McCullough*.

4. ***Williams v. J.P. Morgan & Co.:*** **Surcharge Allowed Where Portfolio Was Invested Exclusively In Bonds for 30 Years**

In *Williams v. J.P. Morgan & Co.*, 296 F. Supp. 2d 453 (SDNY 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.

B. Courts Can Approximate Damages Where Fact of Injury is Established

Courts have now allowed approximation of damages where the fact of injury has been proved. In *Vento v. Colorado Nat'l Bank*, 907 P.2d 642 (Colo. App. 1995), the trustee was surcharged for failure to obtain expert advice in negotiating a mining lease which allegedly lead to inappropriate mining procedures and decreased income to the trust. The threat of a suit by the lessee in the course of the negotiations led to a potential conflict of interest, which led the appellate court to hold that the trustee "should have hired outside legal counsel to assist in evaluating the modified terms of the lease upon its assignment." 907 P.2d at 646. The Court on appeal followed a common rule that "If a trust has been damaged, but there is uncertainty as to the extent of the damages, they are to be closely approximated by drawing reasonable and probable inference from the facts proven." 907 P.2d at 647. Based on the testimony of an expert, the Court affirmed both damages for lost income and prejudgment interest from the time of the alleged breach. 907 P.2d at 648.

The Court in *Meyer v. Berkshire Life Insurance Company*, 250 F.Supp.2d 544 (D. Md. 2003) dealt with pension plans that had been subjected to churning and to inappropriate investment selections. It found that "while awards may not be speculative, see, e.g., *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975), the court may approximate the extent of damages. See, e.g., *Martin v. Feilen*, 965 F.2d [660, 8th Cir. 1992] at 672 (citing *Story Parchment co. v Paterson Parchment Paper Co*., 282 U.S. 555, 563, 51 S.Ct. 248, 75 L. Ed. 544(1931))." 250 F.Supp.2d at 572. In that case the Court awarded damages based on what an appropriate portfolio based on moderate risk tolerance would have returned during the period of time, based on expert opinion.

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. 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 on appeal advised:

> "However, 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.

See Guthy-Renkar Corp. v. Bernstein, 39 Fed.Appx. 584, 587, 2002 WL 826231 (9th Cir. 2002) (damages based on reasonable approximation in breach of contract case, citing *Ironworkers*, *supra*.).

The trial court based its measure of damages on what the trust would have earned if it had been properly invested. On appeal, the court held:

> "While 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 Savings Bank v. Salomon Smith Barney, Inc.* 530 U.S. 238, 250...(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 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 seventy percent 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 thirty-five percent 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:

> "However, 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.

The Court affirmed the trial court's rejection of the attempt of the advisor to require the losses to be offset by gains elsewhere in the portfolio. The Court held:

> "Section 213 of the Restatement (Third) of Trusts addresses situations in which losses may be balanced against profits. This section, which the district court referred to as the 'anti-netting rule, states as follows:
>
> > "A trustee who is liable for a loss caused by a breach of trust may not reduce the amount of the liability by deducting the amount of profit that accrued through another and distinct breach of trust; but if the breaches of trust are not separate and distinct, the trustee is accountable only for the net gain or chargeable only with the net loss resulting therefrom.
>
> Restatement (Third) of Trusts, '213. In other words, a fiduciary is liable for the total aggregate loss of all breaches of trust and may reduce liability for the net loss of multiple breaches only when such multiple breaches are so related that they do not constitute separate and distinct breaches. Notwithstanding the possibility that a fiduciary may be permitted to balance losses and gains attributable to multiples breaches of trust, the comments to '213 make clear that a fiduciary may *not* balance losses attributable to a breach of trust against gains attributable to actions which do not involve a breach of trust. *Id.*, cmt. c."

259 F.3d at 1047-48.

In *Noggle v. Bank of America*, 70 CA4th 853 (Cal. App. 1999) the court of appeals affirmed a decision surcharging the trustee for investing primarily in bonds, in violation of its duty of impartiality. The decision also settled issues regarding the running of the statute of limitations, holding that the provision of an annual accounting pursuant to California law started the running of a three year statute of limitations, even though such accounts did not comply with all of the requirements for formal annual accounts. It was enough that such accounts provided "sufficient information so that the beneficiary...reasonably should have inquired into the existence of the claim." Hence the beneficiaries were on notice from the accountings of the investment scheme and hence were limited to damages during the three year period prior to suit.

Since 1984 California has followed a portfolio investment model. The beneficiaries argued that they were "entitled to appreciation damages based upon objective market criteria" i.e. an S&P 500 type of measure. The trial court disagreed, holding that the "most accurate rate of appreciation for the determination of...damages..would be the rate of appreciation experienced[d] by the common equity funds utilized by the [B]ank." The Court on appeal found that it was

> "undisputed that whatever portion of the trust estates that should have been invested in assets that would have benefited the remaindermen over their parents would have been invested in the Bank's common equity trust fund. It follows that it was appropriate for the probate court to approve the referee's calculation of damages based on the amount the trusts actually would have earned."

The trial court in *Conservatorship of Strader*, California Superior Court for the County of Los Angeles Case No. SOP 39241 (Feb. 2000) surcharged a Farmers and Merchants Trust Company as conservator for a variety of alleged breaches in liquidation and management of the conservatee's property. Damages of $706,790 were assessed. The judgment also recommended assessment of the attorneys fees against the conservator under a statutory provision allowing fee awards were there is a bad faith opposition to objections to an account. The Court reopened several intermediate accounts because of alleged extrinsic fraud based on purported statements to the relatives that they had no basis for objections as well as a failure to raise and include in the accounts various actions and omissions which resulted in losses.

The conservatee was confined in a care facility with little prospect of, and no demand for, return to her home. The home remained vacant for three and a half years over the objection of some heirs. When it was sold at auction, the court found that the contents had not been inventoried, the heirs had not been contacted about their desires regarding distribution of various antiques and mementos, and the fair market value of the furnishings was lost to the estate.

The heirs also objected to the retention of $300,000 in sweep accounts and the use of short-term government securities which garnered the fiduciary fees on the periodic rollovers.

The Court assessed damages for lost appreciation by measuring the average returns of domestically based mutual funds using industry statistics. It declined to adopt a S&P 500 measure or to measure the loss by intermediate term government bonds.

The findings of bad faith and the issues of self-dealing investment transactions place this case within the *Janes* exception for faithless fiduciaries.

In *Champagne v. Champagne*, 734 A.2d 1048(Conn. App 1999), the Court affirmed denial of a damage award because of the failure to invest funds in a trust for minor children pursuant to a divorce settlement. The trustee was an accountant, who was not tendered as an expert. The trial court noted that the trustee "did not operate in a climate free of acrimony" and that the plaintiff had refused to provide releases so that the funds could be invested, and had attempted to remove the trustee. 734 A.2d at 1050. The Court on appeal held "Such behavior on the part of the plaintiff was a factor to be considered by the court in determining whether the trustee acted prudently." 734 A.2d at 1050. The Court affirmed the finding that the trustee had acted prudently and concluded that "the trial court correctly considered the 'conflicted circumstances' of the case as one of the facts to be considered in evaluating the prudence of the trustee's action." 734 A.2d at 1051.

The acrimonious plaintiff's two highly qualified experts testified respectively that, prudently invested, the initial $62,852.95 would have grown to $142,852.95 or $124,543.42. The trustee, who was not submitted as an expert, opined that he would have simply put the money in a savings account in light of the disputes between the former spouses, resulting in $80,508 for the present value of the trust fund. The trial court disregarded the experts, and taking the plaintiff's conduct into consideration, required the trustee to fund the trust as if it had been timely placed in a savings account.

The dissent argued that while the trial court was free to disregard the experts, it needed expert testimony to establish what a proper investment strategy would be. Absent expert testimony, the dissent would remand for a proper factual hearing. Note that in Williams, supra, the court held that expert testimony was required to establish the standard of care and the breach of that standard. 591 N.W.2d at 748.

Champagne seems bound by its unusual facts; however it is useful for pointing out the possibility of utilizing the obstructive tactics of a plaintiff in evaluating damages. Here the plaintiff blocked investment until ordered by the court. As to the requirement for proving damages, the majority appears to conclude that a trustee can testify as to what is prudent despite not being tendered as an expert. Such a finding might be useful if one's trial expert is excluded for one reason or another and one is left with only a trust officer with minimal investment background. In this case the trustee was an accountant; it is not clear that a layperson would have been given the same solicitude. Note however, that in other contexts, laypersons are allowed to testify as to issues which are ordinarily reserved for experts, i.e. the value of property. Without express language qualifying the trustee as an appropriate witness, the utility of the holding may be minimal.

In *Trieweiler v. Sears*, 268 Neb. 952, 2004 WL 2913253 (Neb. Dec. 17, 2004) the Supreme Court of Nebraska held that a director was liable for failing to monitor the conduct of other employees and agents of the company. In a derivative action, the court affirmed a damage claim against the director and imposed a constructive trust on a corporate opportunity taken in violation of the parties' duties to the corporation. Because of the failure of the defendants to account or to keep records, the Court held that the defendants had the burden of proof to establish the value of the property they had improperly taken. "It was the appellants' burden to account for corporate revenues, and Anderson's testimony was not required to establish to the penny how much money was earned and where it ended up—rather, once Anderson established with reasonable certainty that the corporation's records were incomplete, it was the appellants' burden to make a proper accounting to the shareholders." 2004 WL 2913253 at 22. Because of the absence or destruction of records, the court upheld the damage calculation reached in the trial court based on the plaintiff's forensic expert, despite gaps in the record. The Court held that 'although the record does not allow calculation of Varsity Investments' losses to the penny, the law does not require such specificity. See *C &B Sales & Service, Inc. v. McDonald*, 177 F. 3d 384 (5th Cir. 1999). Anderson's testimony provided an approximation of Varsity Investments' damages that was reasonable given the circumstances." 2004 WL 2913253 at 23.

In *Bluebird Partners, L.P. v. First Fidelity Bank, N.A., New Jersey,* 784 N.Y.S. 2d 479 (N.Y. A.D., 2004), the court upheld breach of fiduciary duty claims against an indenture trustee which had allegedly failed to act to lift a bankruptcy stay in a timely manner, leading to losses to the collateral it held. The court upheld estimates of damages based on expert testimony of the decline in the value of the assets. The trustee argued that after it was removed as indenture trustee, its liability should have been cut off with respect to further losses. The Court rejected this: "Nor does the termination of First Fidelity as trustee immunize it from liability for damages that continued to accrue afterward as a result of its conduct or inaction while it still held that position. (*see LNC Investments, Inc. v. First Fidelity Bank*, 1997 WL 528283 [SDNY 1997]." 784 N.Y.S. 2d at 482.

In *Swenson v. Oxford Bank & Trust*, 2004 WL 1918778 (N.D. Ill. Aug. 26, 2004) the court dealt with a motion in limine to strike a damage expert in a case seeking damages for breach of fiduciary duty in recklessly managing an IRA account. Ninety-one percent of the portfolio had been invested in high tech and telecommunications stocks. The Court rejected the motion in limine, stating that the expert's testimony in measuring the portfolio against various benchmarks such as the Dow Jones Industrial Average, the S&P 500, and actively managed portfolios such as Vanguard or Fidelity mutual funds. "If the jury determines that Oxford did, in fact, mismanage Swenson's IRA account, this comparison will certainly help them determine what damages, if any, are appropriate." 2004 WL 1918778 at 2. The jury subsequently entered a judgment for $300,000. 2004 WL 24687-69.

In *Scalp & Blade Inc. and Scalp & Blade Scholarship Association v. Advest, Inc.* 765 N.Y.S. 2d 92 (App. Div. Oct. 2, 2003) the court reversed a jury instruction which denied a trust the right to collect appreciation damages based on a market index. The defendants included an advisor to the board of a charitable trust who also served as a trustee. The claims included churning and other inappropriate investments. The trial court had relied on Matter of Janes, 90 N.Y. 2d 41, 681 N.E. 2d 332 for such denial. The Court held that Janes dealt with mere investment negligence and did not reject the application of appreciation damages where the fiduciary's misconduct consisted of deliberate self-dealing and faithless transfers of trust property. 765 N.Y.S. 2d at 99. The Court held that in a case "involving claims of churning, investment unsuitability, or other acts of unauthorized trading by defendants, an appropriate measure of damages in plaintiffs' 'gross economic loss, adjusted for the overall market's performance.'" 765 N.Y.S.2d at 100.

In *Account of Beiny*, 2003 WL 21729779 (N.Y. Surr. 2003), a trustee was surcharged for the present value of assets which had been diverted into Lichtenstein accounts in any effort to shift money to one sibling in violation of the terms of the trust.

In *Toussaint v. James*, 2003 WL 21738974, (S.D. N.Y. 2003), the trustees of a pension plan sued their attorneys and predecessor trustees for investing primarily in fixed income securities. The court held that the proper measure of damages was what the trust would have earned but for the breach of trust. The court noted that "a pure heart and an empty head" are not enough to avoid liability for a duty to diversify. Summary judgment was denied where there was a question about whether the lay trustees should have obtained expert assistance in investing at least a portion of the trust.

In *Brown v. Schwegmann*, 861 So.2d 862 (La. App. 2004), the Court on appeal found that the trustee had breached his duties as trustee in investing the trust primarily in the family business, by diverting trust income to a partnership from which he personally obtained loans and financial benefit, and by investing in the partnership when it began to fail and ultimately went into bankruptcy. The court noted with respect to the investment in the family grocery business:

> "Although investing solely in the family business may have been wise during the senior Schwegmann's prosperous administration of the business, as the business declined in financial strength such a plan ceased being prudent management of trust funds. Clearly, after the partnership began declining in value in 1996, investing the trust property solely in the family business was not prudent—particularly by a trustee with appellee's specialized knowledge of financial health of the Schwegmann companies—or designed to protect and preserve the trust property in the interest of the beneficiary."

861 So.2d at 869.

The matter was remanded for calculation of damages based on the alternative measures contained in La. Rev. Stat. 9:2201, which is patterned on Restatement Second of Trusts §205.

Sims v. Heath, 577 S.E. 2d 789 (Ct. App. Ga, Nov. 22, 2002), affirmed a jury award against executors of $1,000,781 in compensatory damages and remitted $404,633 in punitive damages to $250,000. Liability was based on delays in selling estate property which subsequently dropped substantially in value. Damages were assessed per OCGA § 53-12-193(a)(3): "[a]ny amount that would reasonably have accrued to the trust or beneficiary if there had been no breach of trust with interest." Georgia did not adopt the Uniform Prudent Investor Act, but did adopt a portfolio investment model similar to that of California's prudent man rule. The damage statute quoted is based on Restatement Third of Trusts §205.

C. Limited Use of S&P 500 as a Measure

The S&P 500, one of the measures frequently cited as an appropriate index for estimating damages, had a spectacular rise, climbing 251% from 1994 through the end of 1999. However, the same momentum factors that led to its rise based on the engine of large growth stocks reversed after the peak of March of 2000, when the index value exceeded $1527 and then the growth leaders collapsed in the dotcom crash, accounting scandals, and the end of the telecommunications boom.

Since then the S&P 500 index dropped 46.6% from its apex as of the end of the third quarter of 2002 (dropping 9.06% in 2000, 12.02% in 2001, and 22.10% in 2002). As of December 31, 2003, the index carried a value of $1,111.916, 27 percent below its peak. Despite such recent reversals, the use of the measure in earlier periods can still provide a major enhancement of damages over simple interest or other measures. For example, the index was valued at $459 at the end of 1994, a rise of 240 percent (assuming reinvestment of dividends and no correction for inflation). Moreover, the context of the case may justify the use of other benchmarks, as for example where the improper investment was in a fixed income portion of the portfolio. *See, infra, California Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036 (9th Cir. 2001).

Restatement, Third, of Trusts § 211 provides that

> “If the duty was to acquire any property constituting a proper investment for the trust, charge the trustee with the amount of the funds the trustee failed properly to invest, adjusted for the amount of the total return, positive or negative, that would have accrued to the trust estate had the funds been invested in a timely fashion, this return to be based on a total return experience for suitable investments of generally comparable trusts.”

The Reporter’s notes to §211 point out the variety of measures of damages which could be applied when an improper investment scheme causes the trust to lose what it should have earned:

> “This approach can be carried out by referring to the performance of all or a relevant portion of the proper investments of the trust in question, to the performance of all or part of the portfolios of comparable trusts, or to the performance of **some suitable securities index or other benchmark portfolio**.” (Emphasis added).

Restatement, Third of Trusts, §211, Reporter’s notes at 168.

The flexibility of the equity court to fashion a measure appropriate to the circumstances is emphasized in the new investment provisions of the Restatement. Comment f to §211 notes:

> “If the period during which the trustee has failed to make investments is not significantly prolonged, at least if the trustee is not guilty of bad faith or other serious misconduct, it would ordinarily be an appropriate exercise of equitable discretion to measure the performance of proper trust investments only by applying a suitable rate of interest, based on the income yields of investments of generally comparable trusts. In such a case the court would not look to a total return figure; that is, damages would not take account of capital gain or appreciation, nor of losses in value, that might have resulted in a suitable trust portfolio from general changes in stock and bond values in the security market. This approach would be particularly justified in such cases if a recovery based on some representative measure of total return performance of trusts appears highly speculative.” (Emphasis added).

The case law since the adoption of the Restatement has tended to avoid the extreme measure of index returns where no conflicts or serious act of bad faith are involved.

The New York Court of Appeals in *Janes* affirmed a holding of liability for failure to diversify a portfolio, pointing to the duty of the trustee to "take into consideration the circumstances of the particular trust that he is administering, both as to the size of the trust estate and the requirements of the beneficiaries. He should consider each investment not as an isolated transaction but in relation to the whole of the trust estate (3 Scott, Trusts §227.12, at 477 [4th ed])." *In the Matter of Lincoln First Bank*, 90 N.Y.2d 41, 51 (1997).

The trial court in *Janes* had used the S&P 500 index as a measure of damages, the appellate division rejected it, and the New York Court of Appeals firmly rejected such a remedy in cases where there is no "deliberate self-dealing and faithless transfers of trust property." 659 N.Y.S.2d at 172. Hence the Court of Appeals decision was based on similar concerns to those stated in comment f to §211 above. While the use of interest reduced damages by $2,000,000, the fiduciary was still hammered for $4,065,029 plus prejudgment interest and $326,302 for commissions and attorneys' fees, plus post-judgment interest, costs and disbursements.

The trial court in *Nickel v. Bank of America NTSA*, 991 F.Supp. 1175, *rev. on other grounds*, *Nickel v. Bank of America*, 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 & Poors 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.

In *Williams v. J.P. Morgan & Co. Inc.*, 199 F.Supp.2d 189 (S.D. N.Y. 2002), the court denied summary judgment, rejecting appreciation damages where trustee negligently kept trust in cash and tax exempt bonds rather than diversify into other asset classes.

The assets had been invested in cash/bonds so that no income tax return needed to be filed, based on concern that prospective US/Brazilian treaty would have disclosed US income on which Brazilian taxes were not being paid. When treaty failed passage, trustee filed to diversify.

In granting summary judgment, the court rejected S&P500 or other market measures under §211 of Third Restatement of Trust, citing *In re Janes*, 90 N.Y.2d 41, 681 N.E.2d 332, 339-340 (1997).

Lost capital with interest was proper measure where only negligence alleged, according to the Court’s decision. It concluded that lost profits were allowed only where “deliberate self-dealing and faithless transfers of trust property." 199 F.Supp.2d at 194, citing *Janes* at 681 N.E.2d at 339.

The Court held that the "measure of appreciation damages for a wrongfully retained asset is too speculative. To grant them, a court would be forced to generate and assign real-world value to the hypothetically reinvested proceeds from the asset. *See generally Janes*, 643 N.Y.S.2d at 982." 194 F.Supp.2d at 195. In a subsequent opinion, however, the Court allowed damages based on what the trust should have earned. *Williams v. J.P. Morgan & Co.*, 296 F.Supp.2d 453, (SDNY 2003).

The S&P 500 has an allure for econometricians since it provides a record of historical prices which goes back to the 1920's. Hence it provides a source of data to evaluate various investment theories. Because the S&P 500 index includes the largest companies traded on exchanges, representing 80% of all listed equity securities, it has been considered a proper measure for the market as a whole. William Sharpe has concluded that this index serves as a statistically appropriate measure of the market. This concept has been attacked, in light of the impact of the market weighted positions of the 500 stocks, problems with limited float (subject to recent attempts by Standard and Poors to correct allocations to reflect actual float of each stock in assigning values), the volatility of the index itself, and its failure to include other asset classes such as bonds and real estate. R.D. Arnott, "Fundamental Indexation," 61 Financial Analysts Journal 2 (March 1, 2005); J.J. Siegel, "The 'Noisy Market' Hypothesis, Wall Street Journal A14 (June 14, 2006). Siegel and J. Schartz recently criticized the rotation into hot areas of the market in modifying the S&P 500 index, pointing out that simply holding the S&P 500 as of March of 1957 would have produced superior returns than the forays of S&P into the oil service sector and tech stocks in recent decades, *see* "Long-Term Returns on the Original S&P 500 Companies." 36 CFA Digest 95-96 (May 2006). The index is not created by The Invisible Hand, but rather by analysts who follow rotational theories of investing.

Nonetheless, this index is used in a variety of basic econometric models, serving as the base portfolio against which the volatility of stocks is measured. Sharpe recognized that this index was not a proper measure for other classes of securities, small capitalization stocks, foreign stocks, and so forth. Hence he developed a Sharpe Selection ratio which measures the performance of various categories of stocks against other benchmarks. However if one looks for the Beta of any given stock, it is likely measured against the S&P 500.

The Uniform Prudent Investor Act and the Third Restatement attempt to use modern portfolio theory and the capital asset pricing theories to establish a standard of conduct and a standard for measuring damages. When you actually prosecute or defend such a case, the facile theories and glib generalizations of econometric theorists provide little assurance and much opportunity for courtroom humor as econometricians meet reality.

D. Underperformance Is Not Necessarily A Breach

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 benchmark.

As held in *Bankers Trust, supra,* "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)." *** "The test is one of conduct rather than performance…." 636 N.Y.S. 2d at 745.

In *Matter of Jakobson Trust,* (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. Meendelson*, 769 A.2d 1025 (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, 323 N.E.2d 70."

E. Loss Plus Interest

In some cases, the damages allowed on an investment breach may be loss plus interest. The flexibility of the equity court to fashion a measure appropriate to the circumstances is emphasized in the new investment provisions of the Restatement. Comment f to Restatement Third of Trusts §211 notes:

> "If the period during which the trustee has failed to make investments is not significantly prolonged, at least if the trustee is not guilty of bad faith or other serious misconduct, it would ordinarily be an appropriate exercise of equitable

> discretion to measure the performance of proper trust investments only by applying a suitable rate of interest, based on the income yields of investments of generally comparable trusts. In such a case the court would not look to a total return figure; that is, damages would not take account of capital gain or appreciation, nor of losses in value, that might have resulted in a suitable trust portfolio from general changes in stock and bond values in the security market. This approach would be particularly justified in such cases if a recovery based on some representative measure of total return performance of trusts appears highly speculative." (Emphasis added).

As discussed above, the New York Court of Appeals in Janes assessed damages based on the value of the concentrated position at the time when it should have been diversified plus interest (less the dividends which had been received on the Kodak stock).

The New York Surrogate's court for the County of Broome surcharged a corporate fiduciary for failure to diversify in *In re Estate of Saxton* (NY Sur. 1998) 696 N.Y.S.2d 573, *aff'd* 274 A.D. 2d 110, 712 N.Y.S.2d 225(2000). This dealt with a testamentary trust funded in 1962 with 1,575 shares of IBM stock worth $569,853. At the time the trust terminated in 1993, there were 53,692 shares of IBM resulting from various splits, worth $2,986,617. Objections were filed to the final account of trustee Manufacturers and Traders Trust Company by the remainderpersons, based on the failure to diversify out of IBM, alleging that this had been motivated in part by a desire "to sustain its own trustee's commissions."

The court assessed damages based on the difference in the price at such date in 1987 and the value at the time of termination: $5,242,937 (less dividends on retained assets), plus 9 percent simple interest. Total damages and interest amounted to $6,681,038.49. The Court denied reimbursement of the bank's attorney's fees. Absent proof of self dealing, the court also denied payment of the beneficiaries' attorneys' fees. On appeal, the denial of commissions was reversed, the denial of attorney fees assessed against the fiduciary was affirmed, and the matter remanded for a recalculation of damages. It held that the trial court should have "computed interest on the full value of the stock at the time when it should have been sold and then deducted the value of the stock when actually distributed, as well as the dividends and other income attributable to the retained stock." 712 N.Y.S.2d at 233.

In *Matter of Estate of Rowe* (2000) 274 A.D. 2d 87, 712 N.Y.S.2d 662, the court dealt with a charitable lead trust which was required to distribute 8% of its tax value annually for 15 years, and then distribute the balance to the remaindermen. The trust was funded entirely with IBM stock, valued at the time of funding at $117 per share.

The trial court surcharged the trustee, awarding compound interest to the value of the stock, then deducting the value at the close of the account or at the time of sales, as well as dividends received.

In *Testamentary Trust of Hamm*, 707 N.E. 2d 524 (Ohio App. 1997) the Court remanded a surcharge award to a successor trustee based on the court failure to find the actual measure of damages. The Court had subtracted the ending value from the starting value plus interest, assuming that the predecessor trustee had the burden of establishing its accounts. The Court concluded that the successor trustee had the burden on going forward and had to prove the extent of damages. The Court noted that the trial court had discretion over the rate of interest, and could select "the legal rate, at the usual rate of return on trust investments or at some other rate considered to be equitable and fair..." 707 N.W. 2d at 530. It held that "generally, however, the trustee is charged only with interest at the usual rate of return for trust investments and not the legal rate, absent a showing of willful misconduct of breach of the duty of loyalty." Ibid. It further held that "interest in these cases is simple, rather than compound, unless there is a showing of intentional misconduct or bad faith." Ibid.

The Court on appeal concluded:

> "a negligent trustee may be surcharged for unreasonable investments, including lost principle (sic) and lost interest. Again, this award must be predicated upon a finding of negligence in a particular investment and supported by some evidence to show what a reasonable investment would have returned, during the time in which the funds were negligently managed."

Ibid.

F. Disgorgement of Profit by the Trustee

The object of damages awards is twofold: first, to compensate for losses sustained as a result of the breach and second, to induce trustees to comply with their obligations by making them disgorge any profit they have made or by imposing a penalty on them. Restatement (Third) of Trusts '205. Frachter, *Scott on Trusts* '205; *Redke v. Silvertrust*, 6 Cal.3d 94, 107(1971); *Coster v. Crookham*, 468 NW2d 802, 806 (Ia, 1991):

> "The law recognizes three alternative remedies available to beneficiaries when the trustee has breached the duty of loyalty to the trust. First, the trustee is obviously charged with any loss to the trust estate. Second, the trustee is liable for any profit made through the breach. Third, the beneficiary may recover from the trustee a profit that would have accrued to the trust if there had been no breach." Restatement (Second) of Trusts ' 205 (1959); Bogert, *Trusts and Trustees* '862, at 42-43 (2d rev. ed. 1982); Fratcher, *Scott on Trusts* '205, at 237 (4th ed. 1988).

Hence in *Crookham*, the trustee was surcharged for all of the profit obtained by the use of trust funds to purchase stock for the trustee personally. Where the investment is not tainted by impermissible self-dealing, the trust is entitled to recover its proportionate share of the profits of the investment. In *Bartelt v. Bartelt*, 522 So.2d 907, 908 (Fla. App. 1988), where the fiduciary estate contributed 40% of the investment, it was entitled to recover 40% of the net profits after return of the invested capital. Where the trustee has borrowed trust funds, the profits improperly garnered by the trustee may be disgorged, less the interest paid to the trust on the loan. *Estate of Stowell*, 595 A2d 1022, 1026 (Me. 1991). In *Stowell*, the court held that the trustee held the burden of proving that "no profits were earned as a result of his breach of fiduciary duties." *Ibid.* It denied recovery where commingled funds could not be traced into subsequent profitable investments.

In *Nickel v. Bank of America*, 290 F.3d 1134 (9th Cir. 2002), the Court reversed a trial court decision (991 F. Supp. 1175 (N.D. Cal. 1997)) holding that the proper remedy for overcharges in trusts containing fixed fee provisions was simple interest. On appeal that Court held that "The Court held that determination of the profits 'that would have accrued' to the 2,500 trusts was a matter of speculation, too difficult to prove because of the small size of many of the trusts, the variety of their terms and investment policies, and their different dates of termination...The court held that any profit made by the B of A was also speculative, incapable of proof because the overcharged could not be traced into any particular loans or investments made by the bank." 290 F.3d at 1137.

The Court held that California had eliminated provision for compound interest in Prob. C. §16441. The Court on appeal held that disgorgement was the proper remedy, in light of the fact that a breach of the duty of loyalty was involved. The Court held that Cal. Prob. C. §16004 did not alter the fiduciary's responsibility for restitution. 290 F.3d at 1138. The Court held that "Traceability and causation are not the same. If the banks had taken the overcharges and thrown the money out the window, there would be no causation, and, if the banks could prove they had done this, the plaintiffs would lose. But in the regular course of business, the banks put the overcharges to work. The overcharges caused an addition to profit." 290 F.3d at 1138. This is an oversimplification, particularly in light of the fact that the predecessor bank, Security Pacific, was in serious financial trouble during the applicable period of time and was forced to be acquired by a solvent bank by banking authorities. It is not entirely clear whether trust operations were profitable at all, even if the larger bank was profitable.

However, the Court on appeal held that "The exact course of the contribution made by the overcharges has not been shown. But the problem of showing where the money went is the tortfeasor's problem." *Ibid.* The court went on to state:

> "Money is fungible. Once in the bank's accounts as belonging to the bank, the specific sums taken from the trusts could never be identified again. A requirement of traceability nullifies the bank tortfeasor's obligation to cough up the profits it has made by the use of what it has wrongfully taken."

Ibid.

Again, this is a overly simplistic view of bank holding companies and their trust subsidiaries.

The exact nature of the calculation involved is quite unclear. The Court stated: "There is no speculation as to either the bank's annual profit or as to the *share of the bank's capital* represented by the overcharges. Once traceability is seen to be a chimera, the calculation of what is owed the trusts is straightforward." (Emphasis added) 290 F.3d at 1139. The court reconsidered its decision and modified its opinion as follows, on June 19, 2002, 02 C.D.O.S. 5409:

> "The money misappropriated from the trusts added directly to what the banks had to loan or to invest or, if not directly loaned or invested, was used to meet expenses, freeing an equal amount for loan or investment. In all, it is admitted that $24 million of overcharged were used in one of these ways. The first option under §16440(a), restitution with simple interest, is not appropriate under the circumstances because apparently (subject to final determination on remand) it does not give the trusts an amount close to equaling a share in the profits made with their money. The third option is inappropriate for the reasons given by the district court. The appropriate remedy is to allot to these unwitting and unwilling contributors a proportionate share of the banks' profits during the years of misappropriation."

This final comment seems to deal with the overcharges as part of revenues, rather than capital. Hence it is not clear whether the overcharges are part of the gross revenues or somehow have been transmuted, despite generally accepted accounting principles, directly into "capital." The net, as opposed to gross, income return on assets of Bank of America ranged from .9% to 1.4%, with one exceptional year since 1992. (This, of course, does not reflect the state of Bank of America prior to its acquisition by NationsBank or of the old Bank of America before or after its acquisition of Security Pacific). The remedy espoused by the Court on appeal does not make much sense.

Bank of America has now settled the Nickel case after the trial court, on remand, ruled on the methodology for determining how damages are to be calculated with respect to the "disgorgement of profit" alternative contained in Restatement, Second, of Trusts §205. The case settled for a reported $33 million dollars. The trial Court held that return on equity was the appropriate methodology, thus increasing damages where the bank was leveraged, rejecting a return on money available to lend (return on assets); partially allowed deduction of taxes, as discussed below; rejected the deduction of dividends in calculating profits, and limited the period of damages.

As courts have explained, disgorgement in the trust context is intended merely to "make sure that the fiduciary is not allowed to keep any ill-gotten profits." Courts therefore reject disgorgement awards that exceed the amounts actually retained by the defendant. *See, e.g.*, *Hateley v. S.E.C.*, 8 F.3d 653, 655 (9th Cir. 1993) (reversing an order of disgorgement that required defendant to pay the "total amount of [unlawful] commissions that were generated" rather than the "amount of commissions … actually retained"); *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb. Inc.*, 734 F. Supp. 1071, 1077 (S.D.N.Y. 1990) (holding that requiring "disgorgement of all fees and commissions without permitting a reduction for associated expenses and costs constitutes a penalty assessment and goes beyond the restitutionary purpose of the disgorgement doctrine"). The Ninth Circuit in *Nickel* itself made this point forcefully when it stated: "If the banks had taken the overcharges and thrown the money out the window, there would be no causation, and, if the banks could prove they had done this, the plaintiff would lose." *Nickel v. Bank of America* 290 F.3d 1134, at 1138.

"It follows, then, that sums not retained as profits or used to make profits must be deducted from revenues in order to determine the proper amount of disgorgement. California courts have long-recognized this in formulating remedies for breach of trust. *See, e.g., Savage v. Mayer,* 33 Cal. 2d 548 (1949) (affirming judgment requiring trustee who charged beneficiary a higher price for stock than the trustee paid to refund an amount equal to the actual value of the stock less the actual purchase price); *Edgar*, 50 Cal. App. 2d at 836 (rejecting testimony concerning rental value of land sold in violation of trust because '[t]hey were basing their value mainly upon the peculiar situation of this particular land and the gross value of crops produced thereon …, without considering the cost of production, planting, harvesting and sacks, and without considering the personal element of skill, industry and management'). This necessarily entails, among other things, that expenses such as state and federal income taxes that reduced the banks profits must be taken into account when determining the bank's profits. *See, e.g., Weiss v. Weiss*, 984 F. Supp. 675, 677-78 (S.D.N.Y. 1997) (holding that disgorgement of trustee's profits earned from stock dividends should include a credit in defendant's favor for any taxes paid on those dividends); *Tegtmeyer v. Tegtmeyer*, 40 N.E. 2d 767, 769 (Ill. App. 1942) (profits disgorged reduced by taxes and costs).

As a result, the conceptually correct way to calculate disgorgement takes taxes into account in three separate places.

First, there is the fee overcharge itself. If the overcharge was $100, but $40 went to the government as taxes, then only $60 remains in the bank's hands as "ill-gotten" profit from the breach of trust.

Second (assuming no continuing overcharge for simplicity's sake), the profit generated in the next year from the overcharge should be measured as $60 times the profit rate, not $100 by the profit rate, since only $60 remained in the bank's hands to generate profit.

Third, the profit rate should be measured by the total *after-tax* net income generated by loans and investments, divided by the total assets available to loan or invest. This is because the revenue generated by the $60 is subject to tax, and the bank retains only the amount left after taxes.

Thus, in many cases, disgorgement under section California Probate Code Section 16440(a)(2) should be less than reimbursement with interest under section 16440(a)(1). That is not to say, of course, that if plaintiffs establish liability they might not be made whole. Rather, under section 16440(a)(1), the trusts would, *at a minimum*, be entitled to repayment of the overcharge plus interest. Disgorgement comes into play if repayment of the loss with interest would leave the bank with ill-gotten profits still in its coffers. But plaintiffs cannot get more than the bank actually retains under the guise of seeking disgorgement. If loss with interest is greater than disgorgement, then loss with interest is the appropriate remedy.

On remand the trial court ignored the first two calculations and used only the third, thus magnifying the measure of profits calculated. It held that the money received as overcharges was repaid, and thus represented damages. Since damages would be calculated without reference to the taxes paid by the trustee on their receipt, it rejected consideration of the taxes paid by the trustee in calculating its profit. The case settled before the court, on remand, resolved the issue.

G. No "Peak of the Market" Damages

Hindsight is always flawless, however courts have been reluctant to award damages for failure to diversify based on the highest price obtained by a concentrated position of stock. The Court of Appeals in Ohio, in an unreported decision, *Pickerel v. Huntington National Bank*, 2002 WL 416970 (Ohio App. , 2002), relied on a 1955 Ohio Supreme Court decision to reject "peak of the market" damages where the trustee allowed an 11% concentration in The Limited stock to rise to 55% of the portfolio before plummeting.

The trust company's internal policy manual held that a trust could hold no more than 10% of the portfolio in any one stock. The trust, in 1981, held 11% of its assets in The Limited. The stock split on five occasions in subsequent years. The trustee sold shares at various times, but by 1992, the shares in The Limited represented 66.6% of the portfolio, based on $28.88 per share. By September of 1996, the price had fallen to $19.12 per share. The trial court granted summary judgment for the trustee because the beneficiaries had failed to raise an issue of fact to the trust company's assertion that no damages had been sustained.. The appellate court rejected damages based on the 1992 high water mark.

> "Appellee asserts that under appellant's theory of damages, almost a decade of phenomenal growth in Limited stock, during which time the trust held well over ten percent of its assets in Limited stock, and then assert breach based on the failure to diversify once the stock began to decline in value." 2002 WL 416970 at 3.

The Court, affirming the trial court's denial of damages based on a failure to prove damages, relied on *In re Estate of Bentley,* 163 Ohio. St. 568, 127 N.E. 2d 749 (Oh. 1955), dealing with liability of an executor:

> "Ordinarily, where a fiduciary is entrusted with securities and has the power of sale, in the absence of fraud or bad faith he can not be charged with any loss if he failed to make a sale at the peak of the market. The absurdity of any contrary rule is at once apparent. If the market was lower at the time the securities were sold, and the fiduciary was to be charged with the loss for not selling them at an earlier date, it would logically follow that, if he had sold them at the earlier date and the market had advanced, he would be held liable for not having held the securities and thus realized the gain." 2002 WL 416970.

The court noted that The Limited outperformed the S&P 500 by 100%, and that if it had been maintained at 10%, "distribution to the beneficiaries would have been reduced to roughly $362,000 compared to the pretax proceeds actually earned by Hunting of roughly $1.24 million (for a difference of roughly $879,000.)." *Ibid.* Citing Restatement (Second) of Trusts §209(1) and com. b., the court concluded that "the unrefutted evidence is that the trust, as a whole, benefited from the holdings in Limited stock." This is an unusual decision based on law prior to the Uniform Prudent Investor Act and Third Restatement of Trust. By framing the issue in terms of the benefits received from the multiple sales of the growing position, the trustee convinced the court it would have been improper to pick the market peak and denied all damages.

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.

The trial court based its measure of damages on what the trust would have earned if it had been properly invested. On appeal, the court held:

> "While 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:
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> > "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.
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> 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 Savings Bank v. Salomon Smith Barney, Inc.* 530 U.S. 238, 250...(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 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 seventy percent 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 thirty-five percent 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:

> "However, 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.

The Court affirmed the trial court's rejection of the attempt of the advisor to require the losses to be offset by gains elsewhere in the portfolio. The Court held:

> "Section 213 of the Restatement (Third) of Trusts addresses situations in which losses may be balanced against profits. This section, which the district court referred to as the 'anti-netting rule, states as follows:
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>> "A trustee who is liable for a loss caused by a breach of trust may not reduce the amount of the liability by deducting the amount of profit that accrued through another and distinct breach of trust; but if the breaches of trust are not separate and distinct, the trustee is accountable only for the net gain or chargeable only with the net loss resulting therefrom.

> Restatement (Third) of Trusts, §213. In other words, a fiduciary is liable for the total aggregate loss of all breaches of trust and may reduce liability for the net loss of multiple breaches only when such multiple breaches are so related that they do not constitute separate and distinct breaches. Notwithstanding the possibility that a fiduciary may be permitted to balance losses and gains attributable to multiples breaches of trust, the comments to '213 make clear that a fiduciary may *not* balance losses attributable to a breach of trust against gains attributable to actions which do not involve a breach of trust. *Id.*, cmt. c."

259 F.3d at 1047-48.

The trial court in Conservatorship of Strader, California Superior Court for the County of Los Angeles Case No. SOP 39241 (Feb. 2000) surcharged a Farmers and Merchants Trust Company as conservator for a variety of alleged breaches in liquidation and management of the conservatee's property. Damages of $706,790 were assessed. The judgment also recommended assessment of the attorneys fees against the conservator under a statutory provision allowing fee awards were there is a bad faith opposition to objections to an account. The Court reopened several intermediate accounts because of alleged extrinsic fraud based on purported statements to the relatives that they had no basis for objections as well as a failure to raise and include in the accounts various actions and omissions which resulted in losses.

The conservatee was confined in a care facility with little prospect of, and no demand for, return to her home. The home remained vacant for three and a half years over the objection of some heirs. When it was sold at auction, the court found that the contents had not been inventoried, the heirs had not been contacted about their desires regarding distribution of various antiques and mementos, and the fair market value of the furnishings was lost to the estate.

The heirs also objected to the retention of $300,000 in sweep accounts and the use of short-term government securities which garnered the fiduciary fees on the periodic rollovers.

The Court assessed damages for lost appreciation by measuring the average returns of domestically based mutual funds using industry statistics. It declined to adopt a S&P 500 measure or to measure the loss by intermediate term government bonds.

The findings of bad faith and the issues of self-dealing investment transactions place this case within the *Janes* exception for faithless fiduciaries.

In *Champagne v. Champagne*, 734 A.2d 1048(Conn. App 1999), the Court affirmed denial of a damage award because of the failure to invest funds in a trust for minor children pursuant to a divorce settlement. The trustee was an accountant, who was not tendered as an expert. The trial court noted that the trustee "did not operate in a climate free of acrimony" and that the plaintiff had refused to provide releases so that the funds could be invested, and had attempted to remove the trustee. 734 A.2d at 1050. The Court on appeal held "such behavior on the part of the plaintiff was a factor to be considered by the court in determining whether the trustee acted prudently." 734 A.2d at 1050. The Court affirmed the finding that the trustee had acted prudently and concluded that "the trial court correctly considered the 'conflicted circumstances' of the case as one of the facts to be considered in evaluating the prudence of the trustee's action." 734 A.2d at 1051.

The acrimonious plaintiff's two highly qualified experts testified respectively that, prudently invested, the initial $62,852.95 would have grown to $142,852.95 or $124,543.42. The trustee, who was not submitted as an expert, opined that he would have simply put the money in a savings account in light of the disputes between the former spouses, resulting in $80,508 for the present value of the trust fund. The trial court disregarded the experts, and taking the plaintiff's conduct into consideration, required the trustee to fund the trust as if it had been timely placed in a savings account.

The dissent argued that while the trial court was free to disregard the experts, it needed expert testimony to establish what a proper investment strategy would be. Absent expert testimony, the dissent would remand for a proper factual hearing. Note that in Williams, supra, the court held that expert testimony was required to establish the standard of care and the breach of that standard. 591 N.W.2d at 748.

Champagne seems bound by its unusual facts; however it is useful for pointing out the possibility of utilizing the obstructive tactics of a plaintiff in evaluating damages. Here the plaintiff blocked investment until ordered by the court. As to the requirement for proving damages, the majority appears to conclude that a trustee can testify as to what is prudent despite not being tendered as an expert. Such a finding might be useful if one's trial expert is excluded for one reason or another and one is left with only a trust officer with minimal investment background. In this case the trustee was an accountant; it is not clear that a layperson would have been given the same solicitude. Note however, that in other contexts, laypersons are allowed to testify as to issues which are ordinarily reserved for experts, i.e. the value of property. Without express language qualifying the trustee as an appropriate witness, the utility of the holding may be minimal.

H. Interest as a Measure of Damages: Following, but not citing, the Restatement Third.

In *Testamentary Trust of Hamm*, 707 N.E. 2d 524 (Ohio App. 1997) the Court remanded a surcharge award to a successor trustee based on the court failure to find the actual measure of damages. The Court had subtracted the ending value from the starting value plus interest, assuming that the predecessor trustee had the burden of establishing its accounts. The Court concluded that the successor trustee had the burden on going forward and had to prove the extent of damages. The Court noted that the trial court had discretion over the rate of interest, and could select "the legal rate, at the usual rate of return on trust investments or at some other rate considered to be equitable and fair..." 707 N.W. 2d at 530. It held that "generally, however, the trustee is charged only with interest at the usual rate of return for trust investments and not the legal rate, absent a showing of willful misconduct of breach of the duty of loyalty." Ibid. It further held that "interest in these cases is simple, rather than compound, unless there is a showing of intentional misconduct or bad faith." Ibid.

The Court on appeal concluded:

> "a negligent trustee may be surcharged for unreasonable investments, including lost principle (sic) and lost interest. Again, this award must be predicated upon a finding of negligence in a particular investment and supported by some evidence to show what a reasonable investment would have returned, during the time in which the funds were negligently managed."

Ibid.

I. Waiting for Prices to Rise Before Diversifying: Wishful Hoping

The Court in Trusteeship of Williams, (Minn. App. 1999) 591 N.W.2d 743, also dealt with a failure to diversify question. The trust held a local dairy which was acquired by Borden. At the time in question, Borden stock represented 39.3% of the trust corpus. There were two individual and one corporate trustees. One individual trustee voted to diversify, but the others "apparently felt that it would be prudent to hold Borden stock until the price of the stock rose in value." Unfortunately, when the stock was traded by RJR Nabisco, the value had dropped from $36.375 a share to $14.25. The plaintiff's expert had opined that a prudent trustee would hold no more than 10% of the trust in Borden. The Court on appeal concluded that this raised the issue of possible negligence and remanded the case for trial.

The court held that an exculpatory clause limiting liability to "misfeasance or nonfeasance" did not absolve a diversification breach:

> "Norwest concedes that it is a professional trustee and has greater skills in the area of trusts than does a person of ordinary prudence. Therefore, Norwest was under a duty to use those skills.... Further, failure of a professional to meet a minimum standard of care is not a mere error in judgment." 591 NW2d at 748.

The case was remanding for trial on the issue of negligence. While the individual trustees had also prevailed below, the appellate court reversed the order to the extent that it released the co-trustees "from liability for a future contribution claim" by the corporate co-trustee.

The trial court found that the corporate trustee had a duty to “educate or convince” the other trustees of the need to diversify, and if the trustee were unsuccessful in this persuasive endeavor, to seek instructions from the court on how to proceed.

Failing those options, the trial court found that the corporate trustee had an obligation to petition to withdraw. 591 N.W. 2d at 403.

In the second appeal *Trusteeship of Williams*, 631 N.W.2d 398 (Minn. App. 2001), the Court held that the trial court had inappropriately found an absolute duty to diversify under former Minn. Stat. '501B.10 which required that a trustee "shall consider the role that the investment plays within the trust's overall portfolio of assets" and that one of the factors to be considered was a duty to consider "the composition of the portfolio of the trust with regard to diversification." Hence this was a statute authorizing portfolio analysis, but not dictating diversification. Minnesota repealed this statute and adopted the Uniform Prudent Investor Act which imposed a duty to "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 diversification." Minn. Stat. '501B.151, subd. 3.

The trial court concluded that the prior statute imposed an independent duty to diversify. However, an earlier decision, *In re Trusts Created by Hormel*, 504 N.W. 2d 505 (Minn App. 1993) that court had ruled that the standard under the old portfolio statute was whether "the trustee prudently managed trust assets in light of the settlor's intent and the beneficiary's interests." 504 N.W. 2d at 512.

In September of 2001, the appellate court concluded that the trial court had imposed an inappropriate test based on a misreading of *Hormel*. Several issues are involved. First, whether the intent of the settlor and the needs of the beneficiaries require diversification. Second, whether the professional trustee can be held liable where it fails to persuade the co-trustees to act and/or fails to get instructions to deal with an impasse. The Court noted that Restatement (Second) of Trusts '184(c) merely held that where a co-trustee refuses to exercise a power where the trustee has a duty to do so, the trustees cannot merely acquiesce, but must apply to the court for instructions.

In other contexts, Courts have surcharged trustees who allowed an impasse among co-trustees to injure the trust, holding that they were obligated to petition the court for instructions. *Lynch v. John H. Redfield Foundation*. 9 Cal. App. 3d 293 (Cal. App. 1970) (failure to invest idle funds because of lack of agreement among co-trustees). Pennsylvania struggled with a similar situation where one co-trustee demanded that the trust buy canned goods and other assets as a hedge against hyperinflation. The trustee with the unusual investment schemes was removed and the bank trustee blocked from resigning, *In re White*, 467 A.2d 1148 (Pa. App. 1983); however Pennsylvania's highest court reversed, saying that the suggestions had not yet injured the trust and that the corporate trustee, under Pennsylvania law, required court approval to resign. It refused such approval. The opinion appears to have been written by Samuel Beckett: No Exit.

Hence the duty to educate or convince co-trustees, while sensible, probably should not result in surcharge. The failure to ask the court for instructions may be viable. However, it should be noted that many equity courts refuse to provide instructions on matters of investment discretion, on the theory that this is the trustee's discretion to exercise. Presumably such courts prefer, for some reason, to resolve such matters in the resulting surcharge action after the trust has been harmed by the action or inaction.

The Court sidestepped the expert testimony which held that a professional corporate fiduciary would have sought to diversify, educate other co-trustees, and then seek instructions when its advice and educational efforts failed. The Court pointed out that such expert advice was appropriate to establish a standard of care for a trustee, but did not, by itself, establish the underlying duty. That was a question of whether, "in light of the settlor's intent and the beneficiaries' interests, Norwest's duty as a prudent manager required it to support diversification or convince the other trustees to diversify the trust and, if so, whether it breached the duty." 631 N.W. 2d at 406. Note that the test under the Uniform Prudent Investor Act probably would include such issues among the factors to be considered, but requiring diversification "unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." In other words, the old standard required the court to divine a duty to diversify as part of a prudent man standard by looking at the intent of the settlor and the needs of the beneficiary; the UPIA mandates diversification unless special circumstances dictate otherwise.

In short, Norwest gets another chance.

Additionally, the Court held that the trial court had properly limited damages to the period from 1990 -1994 when Norwest reversed its earlier position supporting diversification out of the Borden's stock. The Court also directed the trial court on remand to reconsider its denial of all trustee compensation. It held that such compensation could be denied "absent a finding of fraud, bad faith, or inexcusable neglect," but required a finding "that the fees to be reduced or denied relate to a failure by Norwest to render services or to render services properly." 631 N.W. 2d at 409.

Finally the court denied attorneys fees to be paid to the plaintiff co-trustee, citing the American Rule barring such payments in the absence of a contract or statute. It expressly declined to adopt an exception where fees were awarded where the defendant was guilty of "gross or inexcusable conduct," finding that there was no evidence of such conduct here.

In *Matter of Estate of Rowe* (2000) 274 A.D. 2d 87, 712 N.Y.S.2d 662, the court dealt with a charitable lead trust which was required to distribute 8% of its tax value annually for 15 years, and then distribute the balance to the remaindermen. The trust was funded entirely with IBM stock, valued at the time of funding at $117 per share. The Trust Committee of the corporate fiduciary made an initial review of the trust in 1989 but concluded "that it would be imprudent to diversify immediately, but gave its approval to a plan of diversifying at a later time <u>when the stock had reached a higher price</u>." (emphasis added).712 N.Y.S.2d at 664. While some sales were made (when the stock moved up), by 1994 two thirds of the initial shares were still held in trust, valued at $74 per share. The trial court surcharged the trustee, awarding compound interest to the value of the stock, then deducting the value at the close of the account or at the time of sales, as well as dividends received. Retention of the stock was held imprudent, in part because the dividends were less than the required annual distribution, necessitating the sale of stock to meet distributions. Since harvesting corpus to support annual distributions is the mantra of the unitrust acolytes, one must wonder whether such principles will save a trustee from surcharge when the investments are unsuitable and fall in value, leading to excessive sales.

The Court in affirming the surcharge cited the plaintiffs' expert who state "that petitioner's tactic of waiting for the IBM stock to rise was based on 'wishful hoping' and that any hesitancy on the part of petitioner to sell the IBM stock below acquisition costs was a 'cosmetic kind of consideration.' Finally, [expert] testified that the use of call options increased the risk of the portfolio." 712 N.Y.S.2d at 665.

The Court in *Donato v. BankBoston, N.A.* (D.R.I., 2000) 110 F. Supp.2d 42, 53, looked at a variety of factors, including the belief of the trustee that "there might be a chance that it might come up," in denying surcharge for a staged liquidation of a thinly traded stock, CML, the maker of Nordic Track exercise equipment. The decision looked at the sale of the concentrated position in 1993 and 1994. This was before Rhode Island adopted the Uniform Prudent Investor Act. The Court cited as precedent, however, the Third Restatement of Trusts, highlighting again the pervasive impact of the Third Restatement on fiduciary standards and liability. The Court did not examine in detail in its decision the risks associated with concentration, as in *Janes*. Rather the decision carefully analyzed the terms of the trust and conditions specific to the stock in question. It dismissed the decision of plaintiff's expert as "hindsight" and unsupported by evidence that the market for the stock was liquid enough to support the liquidation of the position in a short period of time. The stock was liquidated by the trustees and then by the plaintiff acting as successor trustee over several years.

The Court focused its decision on the market factors unique to the issue which rose from 38% to 69% of corpus, after increases in its price and sales of other assets to meet trust expenses. Of importance to the Court was the fact that there was "no evidence to suggest that the market could have absorbed a sale of all of the remaining CML." *Ibid*. It also found significant that the plaintiff, after becoming successor trustee, delayed in liquidating the remaining stock. "That he did not do so belies his assertion that the defendants acted imprudently in retaining some of the stock."

Frequently trustees act to avoid the tax consequences of a sale of concentrated stock, hoping to spread these over a number of years and enjoy the benefits of the principal which would otherwise be paid to taxing authorities. Since capital gains are no longer an item for calculation of the Alternative Minimum Tax, the trustee therefore is making a calculation that the risk of loss in a given stock will be less than the combined federal and state capital gains taxes. At 25% combined rates, this is a risky speculation. When MaBell can fall 70% or more along with dozens of other blue chips, the calculus for speculating on stock prices rather than incurring a tax is not valid. Moreover, given the minuscule dividend rates on most stocks, the loss of income in a sale is negligible; the gamble is almost entirely on whether the tax costs will provide a further capital gains if deferred. In a trust subject to an estate tax, prior to 2010 the effective capital gains tax will be reduced by as much as half. Hence, if one pays the tax now, the amount of the tax will not be subjected to estate tax on the death of the life beneficiary, saving a third to a half of the total taxes. Hence in a large estate subject to tax, the speculation involved in holding concentrated stock is the belief that it will fall less than 12.5 before ultimate sale. Given today's volatility, sell rather than speculate.