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'Knox,' the Prudent Investor and Fiduciary Duties

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Just over a year ago, an article in this column titled "Rulings of Trustee's Duty to Diversify: What Have We Learned?"[1] contained an examination of the lessons learned in the 25 years since the Court of Appeals decision in *Matter of Janes*[2] by looking to its progeny—*Matter of Rowe*, *Matter of Saxton*, *Matter of Dumont*, *Matter of Hyde*, *Matter of Creighton* and *Matter of Knox*.[3]

In all of these cases, a trust was created where a bank was named as either trustee or co-trustee. The vast majority of the trust assets consisted of one or two stock holdings (i.e., Kodak, IBM, Marine Midland, and Woolworth). The bank trustee initially decided to retain the concentrated holding. The retained stock eventually decreased in value and as a result, the beneficiaries alleged that the bank trustee negligently managed the trust's investments. At the trial level, each case, except *Hyde*, held that the bank trustee was liable for damages because it was negligent for retaining the concentrated positions and not diversifying the portfolio. The damages were measured by the value of the lost capital.

The lost capital was determined by 1) calculating the value of the concentrated holding on a date the court found it should have been sold; 2) then subtracting the potential capital gains tax that would have been paid if the stock had been sold (this was done in *Saxton*, *Dumont* and *Creighton* but not by the Surrogate in *Knox*); 3) then taking the hypothetical proceeds and compounding it annually by the statutory interest rate which was 9 percent in most instances during the course of administration; and 4) then subtracting the dividends received and the value of the retained stock at the end of the accounting period (or the proceeds received from the sale of the previously retained stock).

The lessons learned from these cases was summarized as follows: First, with the enactment of the Prudent Investor Act, as of Jan. 1, 1995, trustees have a presumed duty to diversify investments and may be liable if they neglect to do so. If diversification is appropriate, the concentrated holding can be sold immediately or sold over a period of time if, for instance, there is a considerable potential capital gains tax to consider. There may be an exception to the rule of diversification based on the circumstance or the language contained in the governing instrument.

In any event, it is critically important for a fiduciary to document every major facet of the investment process in case these decisions are questioned in the future. If a trustee negligently fails to diversify, the courts will calculate damages by determining when the concentrated holding should have been sold. If the concentrated holdings appreciate in value, the potential capital gains tax should be deducted from this calculation. The court should then have discretion in determining the amount of the surcharge, but a maximum award should be based on a variable statutory rate that reflects current market conditions and the use of compounding be considered on a case by case basis.

At the time "Rulings of Trustee's Duty to Diversify: What Have We Learned?" was published, only *Dumont* was reversed on appeal. Yet, many of the trial level decisions have been criticized as being overly harsh in their result and overly strict in the application of the legal principles that were born of *Janes*. An obvious example is *Knox* where, in a departure from most of the other cases, the court would not allow for a deduction for capital gains taxes. Another stark example is the seemingly automatic resort to applying a 9 percent compounding interest rate notwithstanding that such interest is not in line with current market realities and notwithstanding that the Court of Appeals in *Janes* cautioned against surcharges that are punitive and not merely compensatory. *Knox* too was one of those cases that applied a 9 percent compounding rate.

Appeal From 'Knox'

The Appellate Division, Fourth Department, has recently decided the appeal from the *Knox* decision in *Matter of HSBC Bank USA*.[4] The facts of *Knox* are summarized as follows: Seymour H. Knox II established a trust in 1957 for his grandchildren. His father, Seymour H. Knox, I, was the cofounder of the F.W. Woolworth Company. Knox, the son, served as chairman of the board for a time of HSBC Bank's predecessor, Marine Midland Bank, N.A. Knox funded the trust with 5,000 shares of Woolworth stock and 5,200 shares of Marine stock. In 1957, the trust had a value of approximately $325,525.

The trust instrument provided that Marine would be the sole trustee. The trustee had the power to invest and reinvest any and all of the funds "without regard to diversification or to limitations or restrictions of any kind." The trust instrument further provided that the trustee "may advise with counsel and shall be fully protected in respect of any action under this instrument taken, suffered or omitted in good faith by the trustee in accordance with the opinion of counsel." Additionally, the trust instrument authorized the retention and acquisition of Marine stock while Marine was acting as trustee.

The trust was diversified to the extent that the trustee had engaged in strategic asset allocation by investing in securities in different industries, holding cash and investing in bonds. Indeed, the trust had no precipitous decline in any particular stock, had a net increase in principal of more than $1.75 million, and generated more than $1.5 million in income. However, the trustee did not fully eliminate firm-specific risk (i.e., risk of the price of a particular stock declining due to an event that negatively impacts a particular company, but not necessarily the marketplace) as Woolworth and Marine were retained in overweight positions (or in other words, were retained in a larger proportion of the trust's portfolio than the market benchmark or average) during most of the period of account.

By March 1, 1995, Woolworth stopped paying dividends. Then, in 1997, Woolworth was removed from the trustee's "hold list," meaning that the trustee no longer deemed it advisable to hold Woolworth stock in its fiduciary accounts. At trial, the portfolio manager conceded that the balance of Woolworth should have been sold when it was removed from the trustee's hold list.

In 2006, HSBC sought judicial settlement of an intermediate account from 1957 through 2005 and acceptance of its resignation as trustee. The Knox beneficiaries objected to the account, primarily complaining of the retention of a concentration of 23,000 shares of Venator Group Inc. (formally known as Woolworth). Claims were also made by a guardian ad litem that the trustee abdicated its role to Knox's son (Knox III).

The Erie County Surrogate's Court determined that the trustee had breached its duties by purchasing and/or retaining six different securities. Within these six were Marine and Woolworth. The court held that the trustee should have sold: 1) all of the Marine shares and 90 percent of the Woolworth shares on Jan. 21, 1957 (the day the trust was funded) and 2) the remaining Woolworth shares on May 7, 1991. It held that the total combined damages totaled just over $21 million comprised of approximately $7.8 million for the Marine retention and $11.1 million for the Woolworth retention. Additionally, the court surcharged the trustee in the amount of $1.4 million for the objectants' attorney fees and expenses and the fees of the guardian ad litem. The trustee was also surcharged $1.6 million in interest for the period between the decision and the decree. As stated, the interest on all surcharges was at a rate of 9 percent compounding without allowing for credits for capital gains taxes.

The Fourth Department reversed the Surrogate in nearly all respects. As an overarching premise for its decision the court stated that "[i]n reviewing determinations on liability…courts must avoid reaching determinations that arrive at unreasonable or absurd results."[5] With that said, the court addressed the issue of concentration by reciting the following legal principles:

1) Under all three legal standards of care that have existed during the accounting period, to wit, the common-law rule (1957-1970), the prudent person rule (1970-1995) and the prudent investor rule (1995-present), "it is not sufficient that hindsight might suggest that another course would have been more beneficial; nor does a mere error of investment judgment mandate a surcharge."[6]

2) "…fiduciary is not judged strictly by the success or failure of the investment…the test is prudence, not performance… courts do not demand investment infallibility…and a fiduciary is neither insurer nor guarantor of the value of a trust's assets."[7]

3) "…it is well established that retention of securities received from the creator of the trust may be found to be prudent even when purchase of the same securities might not."[8]

4) "The diversification mandate of the Prudent Investor Rule is generally consistent with the diversification standards developed by the courts under the Prudent Person Rule."[9]

5) At times, holding an overweight concentration of a security may be in the best interests of the beneficiaries.[10]

6) The retention of securities which were in overweight positions when the trust was established, "may be found to be prudent even when purchase of the same securities might not."[11]

7) While it may have been prudent to reduce the concentration, "the mere availability of other prudent courses of action that a fiduciary could have pursued does not support a finding that the fiduciary acted imprudently in choosing one such course."[12]

Applying these legal principles, the court held that there was no breach of fiduciary duty in retaining the Woolworth and Marine concentrations. The court recognized that there was a "special relationship" between the Knox family and Woolworth and Marine, and that Knox III indicated a preference to retain the stock.[13] Moreover, the court determined that it would be unreasonable to find the trustee imprudent for retaining securities "that, by all accounts, had appreciated or were appreciating in value and were providing significant income" to the trust—a purpose of which was to generate income.[14]

While the trustee was not liable for failing to diversify the overweight Woolworth position in general, the court found that when Woolworth stopped paying dividends on March 1, 1995, and the price started to decline there was no longer any reason to continue to hold it. The trustee was thus imprudent in continuing to hold the remaining Woolworth stock as of March 1, 1995.[15]

As indicated above, we have learned that it is critically important for the trustee to document every major facet of the investment process. We have seen in cases such as *Knox* and *Creighton*, that the Surrogate faulted the trustees for not having documented diversification plans. Arguably, this does not mean that the trustee's investment strategy or plan need be embodied in one all-encompassing document though some litigants have interpreted it that way. Indeed, the court here agreed with the trustee that it kept adequate records and concluded "that, while it did not record investment objectives and strategies, a review of petitioner's voluminous records establishes that it was diligent in its management of the 1957 Trust."[16]

On the issue of abdicating responsibility to Knox III, the court found it relevant that the trust permitted the trustee to consult with "counsel" provided it acts in good faith and held that "counsel" was not limited to attorneys. Since the court found that Knox III was a knowledgeable and savvy investor, had served as co-trustee on other family trusts and had a vested interest in the success of this trust, the court found that there was a unique level of cooperation and communication between the trustee and Knox III and that the trustee acted prudently and in good faith in consulting with him.[17]

Damages and Interest Rate

On the issue of damages the court found that the Surrogate's error was twofold. First, the court held that the Surrogate's formula for calculating lost capital failed to apply an interest rate that was compounded annually on the dividend credits and failed to reduce the hypothetical sale proceeds with capital gains taxes.[18] Second, the rate of interest itself was a problem:

…we note that the decision to award interest and, if so, the rate at which to award it are matters that are generally left to the discretion of the Surrogate (see *Janes*, 90 NY2d at 55). Although we perceive no abuse of discretion in the determination to award interest, we conclude that the Surrogate erred in applying a 9 percent interest rate to damages occurring before June 1981. New York adopted a 6 percent statutory interest rate in 1972 (L 1972, ch 358). Effective June 15, 1981, the statute was amended to increase the rate of interest to 9 percent (see CPLR 5004; L 1981, ch 258). We conclude that the Surrogate should have used a 6 percent interest rate to any damages occurring before June 15, 1981. In any event, because we conclude that the only breaches that occurred were after 1981, the issue of the interest rate is rendered moot.[19]

The court did not explain its reasoning for its determination that tying interest to the statutory interest rate was reasonable in this case. However, it is significant that the court recited the law that the rate of interest is in the discretion of the court and that it did not adhere to a blind application of a 9 percent rate across the board. That notwithstanding, a 9 percent compounding interest rate awarded for lost capital in today's market climate is arguably punitive and not merely compensatory which is why, for example, in *Matter of Tydings*, the Bronx County Surrogate exercised his discretion to apply a lower interest rate at 5 percent.[20]

Finally, in *Matter of HSBC* the Fourth Department alleviated another harsh result imposed in *Knox* by reversing the Surrogate's award of the objectants' legal fees and expenses in addition to the fees of the guardian ad litem. The court reasoned that this proceeding was an accounting proceeding prescribed by statute and there was no evidence that the trustee generated "unnecessary, unfounded or purely self-serving litigation."[21] Moreover, the court found no evidence of "malevolence, dishonesty, or other malfeasance" by the trustee. Accordingly, it was an abuse of the Surrogate's discretion to award such fees and expenses in the absence of such conduct.[22]

The lesson that we take from the substantial reversal by the Fourth Department of the Surrogate's decision is that the legal standards articulated in *Janes* and its progeny should not be so rigidly interpreted without a reasonable application of the law to the facts of any given case as to do so may be a failure to "…avoid reaching determinations that arrive at unreasonable or absurd results."

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Endnotes:

1. See, C. Raymond Radigan and Raymond C. Radigan, "Rulings on Trustee's Duty to Diversify: What Have We Learned," NYLJ, Sept. 12, 2011, pg 3, col. 1.

2. *Matter of Janes*, 90 NY 22 41, 659 NYS 2d 165 (1987) reargue denied, 90 NY2d 885, 661 NYS2d 827 (1987).

3. *Matter of Rowe*, 274 AD2d 87, 712 NYS2d 662 (3d Dept., 2000), appeal denied 96 NY2d 707 (2001); *Matter of Saxton*, 274 AD2d 110, 712 NYS 2d 225 (3d Dept., 2000); *Matter of Dumont*, 26 AD3d 824,809 NYS2d 824 (4th Dept., 2006); *Matter of Hyde*, 44 AD3d 1195 (3d Dept., 2007), appeal denied 9 NY3d 1027 (2008); *Matter of Creighton*, 27 Misc.3d 1205 (A), (West. Co. Surr.Ct. 2010); *Matter of Knox*, No. DO-0659, and 30 Misc.3d 1203(A) (Erie Co. Surr, Ct., 2010).

4. *Matter of HSBC Bank USA*, 947 N.Y.S.2d 292 (4th Dept., 2012).

5. *Matter of HSBC Bank USA*, 947 N.Y.S.2d at 306.

6. Id. at 300.

7. Id.

8. Id.

9. Id. at 301.

10. Id. At 306.

11. Id.

12. Id.

13. Id.

14. Id.

15. Id, at 307.

16. Id.

17. Id, at 304, 305.

18. Id, at 308.

19. Id, at 309.

20. *Matter of Tydings*, (Surr. Ct., Bronx Co., 2011).

21. *Matter of HSBC USA*, supra, at 309.

22. Id, at 310.