

# New Legislation Holds Trustees to a Higher Standard

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**A**s new legislation begins to take effect—specifically, the Uniform Prudent Investor Act (UPIA) and the Revised Uniform Principal and Income Act (UPAIA)—trustees are under increasing pressure to exercise best practices in trust management. And as the pressure on trustees increases, levels of service and performance from the past no longer meet today's higher standards.

UPIA compliance is indeed an important issue for wealth managers, and a number of articles—several of them appearing in this publication—have explored this topic from a variety of angles.<sup>1</sup> This article illustrates the definition of “prudent” with regard to UPIA and UPAIA and specific trust management lessons to be learned as a result of recent litigation and the subsequent judicial decisions—notably the Dumont Trust case.<sup>2</sup> UPIA does not just require a higher standard of due diligence on the part of trust managers; it also compels them to consider new investment products, such as derivatives and exchange-traded funds (ETFs), and this article will explore the proper application of these investments as a means of risk management, as well as the necessity to leverage best-of-breed financial advisers for such highly specialized instruments.

## THE PRUDENT INVESTOR RULE

In essence, trustees in the 40 states that have adopted UPIA are now required to

manage trust assets as a prudent investor—that is, in a manner consistent with modern portfolio theory. They must consider the risk and return of the portfolio as a whole and must show due diligence in carrying out the investment goals of the trust, including the charter as expressed by the trust's benefactor, the needs of the beneficiaries, and the current state of the financial world and the trust.

No longer can trustees satisfy their obligations by investing in the most conservative vehicles. They must also protect against inflation erosion of the trust by balancing risk to generate a reasonable return. To mitigate the increased risk associated with investing to generate a greater return, trustees are therefore obligated to implement risk management appropriate to the portfolio's investment goals.

Under UPAIA, trustees are tasked with administering the trust based on what is fair and reasonable to all trustees—favoring neither income nor principal growth, but rather the benefit of the trust—by allowing the trustees to make allocation adjustments between dividend/interest income and principal growth. Significantly, the UPAIA also updates the outdated 1962 UPAIA by recognizing investment vehicles, such as hedge funds, that were not in existence when the original legislation was adopted.

Many trustees are finding challenging the intricacies of portfolio management needed to ensure that the trust remains UPIA and UPAIA compliant. The increase in recent years

of fiduciary litigation cases against trustees for failing to properly protect holdings, or for seeking aggressive returns by investing in too-volatile stocks, should make trustees sit up and take notice.

## THE SIGNIFICANCE OF THE DUMONT TRUST DECISION

In today's litigious society, trustees are well advised to protect themselves against the possibility of failing to comply with current regulations by delegating responsibility for the investment decisions to qualified advisers.

Take, for example, the Dumont Trust, which was adjudicated under UPIA legislation in Rochester, New York.<sup>3</sup> The heirs of the late Charles Dumont successfully sued the trust's financial managers, the former Lincoln First Bank (now a part of Chase Manhattan Bank), for failing to protect them from the value erosion of the trust's primary investment holding, Eastman Kodak stock. The bank was ordered to return some \$21 million in commission fees accepted for financial management of the portfolio, representing their entire financial management engagement since January 1974, the date the court ruled they should have begun to take action to protect the trust.

At the core of the issue in the Dumont Trust is the language of the trust instrument: Dumont expressed his desire that the trust hold the Kodak stock and that the trustees would not be held "liable for any diminution in the value of such stock."<sup>4</sup> The trust instrument further expressed that the Kodak stock may be sold "in case there shall be some compelling reason other than diversification of the investment for doing so." Despite lacking documentation, the financial managers, as can be inferred from their actions in the management of the trust, believed that Dumont's intention was that the trust hold the Kodak stock even in the face of a drop in value of the stock.

However, UPIA holds financial managers to a higher standard. Although the Dumont Trust managers might demonstrate that they followed the directives expressed in the trust instrument, they failed to protect the needs of the beneficiaries, and they failed to exercise due diligence in considering the current state of the trust's principal holding: the Kodak stock.

In essence, the judge ruled that the financial managers of the Dumont Trust did not take adequate steps to protect the trust from the devaluation of the Kodak stock and, furthermore, could offer no documentation to substantiate a claim of considered trust management. Judge

Calvaruso, the New York Judge in the Dumont Trust case, went as far as to state that the bank, in assuming that the trust's directives called for the maintenance of the Kodak stock position, thereby avoided performing portfolio management "while still collecting its standard fiduciary commissions." In effect, he said that the financial managers collected \$21 million in commissions for doing nothing.

Of particular interest is the method used to measure the damages to the trust implemented by Judge Calvaruso. He calculated a value for the trust based on the value the trust would have attained had it been managed in accordance with the prudent investor rule. That is, he projected the value of the trust as if the Kodak stock had been sold in 1974, when the wealth management firm first took over management of the account. Although the financial managers began to sell the Kodak stock in 2001, the court ruled that the diversification should have taken place in 1974, when Kodak's struggles first caused significant erosion in the value of the stock. And he concluded that the trustees were to return all commission fees received for management of the trust.

At first glance, the Dumont Trust case may not appear applicable to today's complex investment world, but trust managers should take heed. The judge in the Dumont Trust case rendered his decision in June 2004, and his opinion on the case demonstrates a strict interpretation of UPIA, as well as alarming penalties for failing to comply. The implications of the outcome of the Dumont Trust case, and the precedent it sets, are being felt throughout the country. Trustees in the 40 UPIA states should pay very close attention.

## COMPLYING WITH UPIA AND UPAIA

One of the clear messages sent by the UPIA and UPAIA and the subsequent judicial interpretations is that trust fiduciaries must exercise—and document—appropriate due diligence in the management of the trust.

In a May 2000 article entitled "The Total Return Trust Revolution: The Opportunity and the Challenge," Alan J. Mittleman articulated 10 guidelines for compliance with the Prudent Investor Rule:<sup>5</sup>

1. Diversification is fundamental to management of risk.
2. Trustees have a duty to diversify.
3. Risk or speculative investments are not prohibited from a portfolio, per se.
4. Losses are not prohibited in a diversified portfolio.

5. Diversification minimizes overall risk and permits a portfolio to assume greater risk in individual investments.
6. A diversified portfolio with great risk in individual investments can have less overall risk than an undiversified portfolio with lower risk in individual investments.
7. The “old rule” of the Restatement (Second) of Trusts that forbade any form of speculation inhibits truly effective trust management.
8. Overall return of the portfolio is more important than never having a loss.
9. Income tax consequences can be a valid consideration in determining investment strategy.
10. There is no single investment strategy that should apply to all portfolios.

In essence the Prudent Investor Rule requires trust managers to maximize total returns of the portfolio, rather than trying to maximize the return of each and every investment. This investment approach is in line with modern portfolio theory, which seeks to balance risk and return in the portfolio as a whole.

## THE IMPORTANCE OF NEW INVESTMENT PRODUCTS

One of the most interesting developments of the UPIA is that it opens up investment products that were previously considered to be speculative, as long as the product provides benefit to the portfolio in diversification or risk management. However, this broadening of risk management opportunities exposes the trust manager to increased risk of entering into uncharted territory. Under UPIA, fiduciaries are encouraged to seek out investment professionals, delegating responsibility for investment tactics that fall beyond the scope of the fiduciary’s expertise. The trustee is still responsible for exercising due diligence in selecting the appropriate financial adviser, monitoring the performance of the investment professionals, and ensuring that the trust’s strategic objectives are being best served.

The interrelation of Sarbanes-Oxley with UPIA is still being untangled in the courts, but as Sarbox, as it is commonly called, requires that the advisory relationships be at arm’s length—the relationship must be independent to avoid conflict of interest—it is not unreasonable to project that this legislative trend toward increased transparency will be extended to the management of trusts. Given the 30-year reach of the decision in the Dumont

Trust case, the prudent trust manager will take pains to comply with the increased ethical responsibility dictated by UPIA.

## THE USE OF DERIVATIVES IN TRUSTS

Once considered non-traditional and high risk, derivatives are becoming increasingly recognized as a responsible and effective method of managing investment risk as a means of preserving trust principal. However, many intricacies exist in terms of their structure and pricing. Trustees concerned about UPIA and UPAIA compliance can benefit from the addition of a derivatives expert as an independent resource in determining the most effective solutions.

Jay D. Adkisson, a Texas lawyer and author of *Asset Protection*, in a February 2004 presentation to the Second International Forum on International Estate and Income Tax Planning sponsored by the Institute for International Research in Miami, Florida, said:

Derivatives are a valuable financial tool that can manage risk. While the law is currently unsettled as to a trustee’s duty to use derivatives to minimize portfolio risk, certainly good financial practice demands their consideration and the law will soon reflect this.<sup>6</sup>

The value of derivatives as investment vehicles is determined by the underlying financial instruments, which can include stock, bonds, precious metals, or interest rates. Derivatives may be exchange-traded instruments or may be created for the investor by a bank or broker, in which case the derivatives cannot be traded in the open market. Further, derivatives may be based upon stipulated financial conditions many years in the future, and therefore a comprehensive understanding of their valuation requires complex analysis of a number of interrelated conditions.

The use of derivatives is also of particular importance for trusts that hold heavily concentrated stock positions but are constrained by the rules of the trust from divesting these holdings. By exercising a put-hedge strategy, the trust can benefit from limiting the market risk of the concentrated holding while maintaining the original investment—a strategy that might have protected the Dumont Trust’s managers.

One method of obviating sale of the original stock holding in a trust while taking steps to hedge against a

downside move would be to create a customized derivative product using zero-cost collars. In exchange for establishing some fixed maximum level of loss the holder would suffer from should the stock take a precipitous dive (e.g., a drop of more than 10%), the trust forgoes appreciation above a specified amount (e.g., appreciation of more than 30%). This allows for the protection of a hedge while still allowing for some upside potential. And the original stock holding is untouched.

Another method for achieving risk management while holding the original concentrated stock position would be to use options on an ETF that trades in correlation with the holding. Take, for example, a trust with a concentrated stock position in a bank stock. By finding an ETF that trades in tandem with, but doesn't include, the original stock position, the trust can buy put options on the ETF to obtain downside insurance. The strategy is that if the ETF falls, then the original bank stock position would drop as well, and the put options on the ETF will effectively serve the function of hedging the original bank stock position. For fiduciaries who want to partially finance the put purchase while capping their upside exposure in a proxy hedge synthetic short such as this, one strategy would be to sell a call and buy a further out-of-the-money call. This will allow for risk to be predefined should the ETF rally but the original stock holding not rally in correlation. Of course, a complex transaction of this nature is best handled by a financial adviser highly experienced in the use of ETFs and options, and that is especially true for a trust.

## DEMONSTRATING DUE DILIGENCE THROUGH THE USE OF EXPERT ADVISERS

Care must be taken, however, to avoid UPIA-problematic conditions when considering derivatives as an investment choice for a trust. The very nature of derivatives—their complex valuation and over-the-counter (OTC) trading status—can create potential conflicts of interest by financial advisers recommending derivatives products that are underwritten by their own firms.<sup>7</sup>

In the above scenario, the trust manager achieves the UPIA requirement of exercising the Prudent Investor Rule by protecting the trust principal while maximizing investment return—balancing the risk and return of the portfolio—and at the same time exercises due diligence by engaging the services of an adviser experienced in the strategy and execution of these complex financial products. By leveraging the expertise of an experienced

derivatives consultant, the trustee satisfies the requirements of UPIA and UPAIA legislation, including preservation of the trust principal, risk diversification, maximizing return, and showing due diligence in the management of the trust.

Although some protection is afforded investors by the Sarbanes-Oxley Act, UPIA compliance requires that trust managers exercise due diligence in the selection of financial advisers, and the need for expert advice increases in direct correlation with the complexity of the proposed investment vehicle. Trust managers indeed have a duty to obtain outside verification of the investment product when an open trading market does not establish a public value.

The emerging judicial and legislative landscape is in such flux that even without the intent to deceive, the possibility for conflict of interest is strong for advisers selling OTC products that are issued by their own firms. The most prudent approach, and one that will likely leave the trust manager in the safest position from a UPIA compliance perspective, is to choose financial advisers who are independent and who don't stand to benefit from an obligation to a specific firm's book offerings.

Both conceptually and practically, this brave new financial world requires a new level of due diligence and transparency on the part of the prudent trust adviser. With the new legislative outlook and today's litigious-minded trust beneficiaries, trustees would be well advised to adopt a sound portfolio management strategy that includes the guidance of best-of-breed financial advisers.

## ENDNOTES

<sup>1</sup>See Darryl L. Meyers, "Investment Considerations under the Prudent Investor Act: Applicable Law," *Journal of Wealth Management*, Fall 2005, pp. 25-35; Darryl L. Meyers, "Investment Considerations under the Prudent Investor Act: Part Two: Translation Analysis," *Journal of Wealth Management*, Winter 2005, pp. 50-54.

<sup>2</sup>For an analysis of the legal pedigree of the Dumont decision and its basis in English common law, see Ian Marsh and Michael Ben Jacob, "Trustees Everywhere—Be Afraid," *Trusts and Estates*, April 2005, pp. 70-72

<sup>3</sup>See "Estate of Dumont," *New York Law Journal*, July 13, 2004; "Bank at Fault in Trust Suit," *Rochester Democrat and Chronicle*, June 28, 2004.

<sup>4</sup>"Bank at Fault in Trust Suit." p. 1-A.

<sup>5</sup>See Alan J. Mittleman, "The Total Return Trust Revolution: The Opportunity and the Challenge," *Journal of Financial Service Professionals*, 54, 66-77.

<sup>6</sup>See Jay D. Adkisson, "Fiduciary Duty of Trustee to Utilize Alternative Financial Risk Management Techniques Including Derivatives to Minimize Portfolio Risk"; available at [http://www.assetprotectiontheory.com/derivdty\\_Final\\_version.pdf](http://www.assetprotectiontheory.com/derivdty_Final_version.pdf).

<sup>7</sup>See John M. Clark, O. C. Ferrell, and Linda Ferrell, "Conflicts of Interest Arising from the Prudent Investor Rule: Ethical Implications for Over-the-Counter Derivative Securities," *Journal of Business Ethics*, 46 (2003), pp. 165-173.

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**NEW LEGISLATION HOLDS TRUSTEES  
TO A HIGHER STANDARD** 7

STEVEN BRAVERMAN

The author starts with the observation that as new legislation begins to take effect—specifically, the Uniform Prudent Investor Act (UPIA) and the Revised Uniform Principal and Income Act (UPAIA)—trustees are under increasing pressure to exercise best practices in trust management. Further, as the pressure on trustees increases, levels of service and performance from the past no longer meet today's higher standards. The author illustrates the definition of "prudent" with regard to UPIA and UPAIA and offers specific trust management lessons to be learned as a result of recent litigation and the subsequent judicial decisions. Then, he argues that UPIA not only requires a higher standard of due diligence on the part of trust managers but also in fact compels them to consider new investment products, such as derivatives and exchange-traded funds. Finally, he explores the proper application of these investments as a means of risk management, as well as the necessity of leveraging best of breed financial advisers for such highly specialized instruments.

**TAX-DEFERRED RETIREMENT SAVING:  
MEASURING THE PURE GAINS FROM  
INTERTEMPORAL SHIFTING  
OF TAXABLE INCOME** 12

W. CRIS LEWIS AND FRANK CALIENDO

The authors first observe that both the widespread popularity of saving in tax-deferred retirement vehicles such as IRAs, Keogh plans, and 401(k) programs and the magnitude of the dollar flows into such saving are almost prima facie evidence that at the margin they provide significant gains over saving in traditional taxable accounts, at least for those wanting to defer some part of lifetime consumption to their retirement years. They focus on the gains arising solely from shifting taxable income from the working (i.e., accumulation) years to the retirement (i.e., distribution) years. They turn to the advantages of tax-deferred investing and to the motivation for focusing on the intertemporal shifting of taxable income. Finally, they propose an informal model of the gains from such income shifting and illustrate the magnitude of the gains for levels of annual wage income ranging from \$50,000 to \$200,000. They show that the gain (as measured by the difference in after-tax retirement income from

tax-deferred and taxable accounts) increases with wage income and ranges from 1.7% to 11.4%. A formal theoretical model is provided in the appendix to the article.

**THE USE OF DOWNSIDE RISK MEASURES  
IN TAX-EFFICIENT PORTFOLIO  
CONSTRUCTION AND EVALUATION** 17

BRIAN J. JACOBSEN

It has become almost a platitude to say that downside risk measures are superior to traditional risk measures such as standard deviation. One of the challenges of using downside risk measures as an alternative constructor of portfolios and diagnostic device is in their computational complexity, intensity, and opaqueness. The question investors, especially high-net-worth investors who are concerned about tax efficiency, must ask is whether downside risk measures offer enough benefits to offset their implementation costs in use. This article shows how to use downside risk measures to construct tax-efficient portfolios. A final insight is an outline of how to forecast risk using distributional scaling.

**ASSET ALLOCATION WITH ANNUITIES  
FOR RETIREMENT INCOME  
MANAGEMENT** 27

PAUL D. KAPLAN

The author starts with a statement of the problem: at, in, or near retirement, investors need to make specific decisions about how they are going to use their savings to generate income during retirement and meet their estate goals when they die. If they withdraw too much each year for spending needs, they face the risk of running out of assets before they die. This is often called "longevity risk." If they withdraw too little, they may not be able to meet their immediate expenses and support a certain lifestyle. Investors also need to decide how to invest their savings among asset classes and annuities. The author explores retirement income solutions in a simple setting to illustrate the trade-offs that retired investors face regarding how much income they can generate, how much short-term risk they are exposed to, how large an estate they can expect to leave, and how likely they are not to run out of assets before dying (the "success" probability).