Thought Leadership Discussion

Overview of the "But-For" Investment Portfolio to Measure Trustee Breach of Fiduciary Duty Damages

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The "but-for" investment portfolio is a tool that damages analysts may use to estimate economic damages when there is an allegation of a trustee's breach of fiduciary duty with regard to the management of an investment. In its simplest form, the "but-for" investment portfolio estimates the value of a portfolio but for the alleged breach of fiduciary duty. Judicial precedent establishes the "but-for" investment portfolio analysis as one method to estimate economic damages on a market adjusted basis. While the concept of a "but-for" investment portfolio analysis is simple, the construction of a "but-for" investment portfolio is often complex. This discussion, from a damages analyst perspective, provides (1) a historical context for the "but-for" investment portfolio in case law, (2) an overview of common breaches of fiduciary duty, and (3) an examination of important areas involved in the construction of the "but-for" investment portfolio.

Introduction

The "but-for" investment portfolio is one version of the "but-for" test, which asks the question: "but for the existence of X, would Y have occurred?"[1]

The "but-for" investment portfolio analysis is one method that may be applied to measure damages related to an alleged trustee breach of fiduciary duty with regard to an investment or investment portfolio. The damages analyst constructs the "but-for" investment portfolio to estimate the value of the investment portfolio but for the alleged trustee breach of fiduciary duty. Economic damages are then calculated by subtracting:

1. the ending value of the actual trust investment portfolio (i.e., the actual portfolio suffering from the alleged breach of fiduciary duty) from
2. the ending value of the "but-for" trust investment portfolio.

The "but-for" investment portfolio analysis provides a market-adjusted estimate of economic damages designed to make the trust beneficiary whole. The "but-for" investment portfolio analysis is intended to capture opportunity cost, whereas other methods for estimating damages may overlook—or inappropriately estimate—the trust beneficiary's opportunity cost.

Fiduciaries in breach of fiduciary duty cases involving an investment portfolio may include, but are not limited to, trustees, investment managers, and financial advisers. The fiduciary is typically the defendant in the breach of fiduciary duty dispute. The plaintiffs in the breach of fiduciary dispute may include, but are not limited to, investors and trust beneficiaries. This discussion focuses on trustees as fiduciaries (or defendants) and trust beneficiaries as plaintiffs.

In a trustee breach of fiduciary duty dispute, the damages analyst role is to provide an estimate of economic damages related to the alleged breach of fiduciary duty. The damages analyst may create multiple "but-for" investment portfolios to estimate a range of hypothetical scenarios, which can be used to estimate a range of economic damages.

The damages analyst typically does not opine on causation or liability aspects of the legal claim. The damages analyst typically operates based on the assumption (or legal instruction) that there was a breach of fiduciary duty. The burden of proving the antecedent of a breach of a fiduciary duty is not part of the damages analyst role.

The concept of a "but-for" investment portfolio is relatively straightforward, but the construction of a "but-for" investment portfolio is often complex. The analyst generally constructs the "but-for" investment portfolio according to:

1. the investment objectives and constraints of the beneficiary or
2. the investment objectives and constraints provided in the trust's governing documents (i.e., trust agreements, investment policy statements, etc.).

There are many variables that can affect the "but-for" investment portfolio damages analysis, such as determining the initial economic damages amount, assessing alternate investment suitability, setting alternate investment asset allocations, establishing rebalancing criteria, and understanding portfolio income tax consequences.

This discussion (1) provides historical precedence for the "but-for" investment portfolio, (2) summarizes common allegations in breach of fiduciary duty disputes, and (3) examines the construction of the "but-for" investment portfolio and the accompanying complexities in its construction.

History

The "but-for" investment portfolio is a product of case law. In 1978, the judicial decision from the Second Circuit Court of Appeals in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*,[2] adjusted economic damages based on changes in the stock market.

In the *Rolf* decision, the Second Circuit concluded economic damages by adjusting the plaintiff's "gross economic loss" for the change in value of "any well-recognized index of value, or combination of indices, of the national securities market during the period commencing with defendant's [breach of fiduciary duty]."

It is noteworthy that, in the *Rolf* matter, markets generally declined, so the influence of the market adjustment was to decrease the amount of economic damages.

In 1981, the Fifth Circuit Court of Appeals decided a case that involved churning in a brokerage account. The court determined that the broker initiated unauthorized and/or excess trading or churning.[3] Judge Goldberg colorfully described the excessive commissions paid to the broker as "skimmed milk" and the decline in the plaintiff's portfolio value as "spilt milk."

Judge Goldberg explained the calculation of economic damages as follows: "In order to approximate the trading losses caused by the broker's misconduct, it is necessary to estimate how the investor's portfolio would have fared in the absence of the such misconduct. The trial judge must be afforded significant discretion to choose the indicia by which such estimation is to be made, based primarily on the types of securities comprising the portfolio."

The court upheld the jury's estimate of economic damages, which incorporated the decline in domestic equity indexes. However, the court's opinion referenced the use of a "specialized portfolio" that would more accurately estimate damages. The "specialized portfolio" referenced by the court opinion is analogous to a "but-for" investment portfolio.

The *Donovan v. Bierwirth*[4] matter involved market-adjusted damages and the use of a "but-for" investment portfolio. In *Donovan v. Bierwirth*, the Secretary of the Department of Labor filed suit against pension plan trustees for the Grumman Corporation Pension Plan. The complaint alleged a breach of fiduciary duty for improperly buying Grumman Corporation securities on behalf of the pension plan.

The trustees, who were also Grumman Corporation executives, acquired Grumman securities to block a tender offer for a controlling ownership interest made by the LTV Corporation.

The Grumman stock purchase was at an elevated price, as the share price increased from $26.75 per share to $35.88 per share as a result of the tender offer announcement. The Grumman stock traded between $36.00 and $39.34 during the tender offer period (prior to the enjoining of the tender offer for antitrust purposes).

When the tender offer failed, the Grumman stock price decreased to approximately $23 per share. Approximately 17 months later, the trustees sold the shares of Grumman stock at the then-current price per share of $47.55. Pension plan beneficiaries received a total benefit of $11.41 per share due to capital gains and dividends over their holding period.

The district court dismissed the case, concluding that the pension plan beneficiaries were not damaged due to the gain earned by holding the Grumman Corporation stock. However, in the Second Circuit Court of Appeals, Judge Pierce reversed the district court decision.

Judge Pierce determined that "ERISA section 409 requires a comparison of what the [Grumman Corporation Pension] Plan actually earned on the Grumman investment with what the Plan would have earned had the funds been available for other Plan purposes."

Judge Pierce elaborated on the calculation of economic damages as follows:

> In determining what the Plan would have earned had the funds been available for other Plan purposes, the district court should presume that the funds would have been treated like other funds being invested during the same period in proper transactions[5]

Plaintiffs provided a range of economic damages based on three alternative "but-for" investment portfolios that were available to Grumman Corporation pension plan participants during the damages period.

Breach of Trustee Fiduciary Duty

The prudent investor rule is the standard that trustees are held to in 43 states, the District of Columbia, and the U.S. Virgin Islands.[6]

The prudent investor rule is established in the Uniform Prudent Investor Act. The prudent investor rule is described as follows:

> A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
>
> A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.
>
> A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Two common federal laws that may be relevant to breach of fiduciary duty cases are the Securities Exchange Commission ("SEC") Rule 10b-5 and the Employee Retirement Income Security Act ("ERISA") section 409.

SEC Rule 10b-5 deals with fiduciaries trading securities based on misrepresentation and omissions of facts. SEC Rule 10b-5 is used to protect investors and trusts from fraud related to investments and/or transactions due to a breach of fiduciary duty.

ERISA section 409 holds fiduciaries personally liable for a breach of fiduciary duty. Imposing personal liability on fiduciaries allows the Department of Labor to enforce liens on the fiduciaries' property, future income, or accounts to pay debts associated with a breach of fiduciary duty in a retirement fund.

There are many ways in which a trustee breach of fiduciary duty can occur. The following nonexhaustive list presents the actions that may result in a breach of fiduciary duty:

1. The sale of property for less than fair market value
2. The purchase of property for more than fair market value
3. The sale of property in violation of duty to retain and the subsequent appreciation of value in the property
4. The sale of property in violation of duty to retain and the subsequent depreciation of value in the property
5. The fiduciary generating excessive profits
6. An improper investment that decreases in value
7. Failure to remain loyal to a specified or predetermined asset allocation
8. The misuse of funds for personal usage,
9. The sale of trust property to the trustee[7]

Generally, the most contested portfolio management breach of fiduciary duty issues relate to:

1. excess fees and/or expenses regarding an investment or portfolio and
2. the suitability of an investment or portfolio.

This discussion focuses on these two issues.

Fees and/or Expenses

Excess fees and/or expenses in breach of fiduciary duty disputes are often related to:

1. excess trading to generate fees (also known as churning) or

2. charging undisclosed fees and/or expenses.

We first examine the issue of excessive trading in an account which leads to generating excess fees and expenses.

In the case of *Hatrock v. Edward D. Jones & Co.*,[8] the Ninth Circuit defined churning as, "when a securities broker engages in excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business." It is important to note that a plaintiff may hold a fiduciary liable for churning without proving loss causation. In other words, churning can occur even when the plaintiff generates a positive return.

Fiduciaries often charge several types of fees and expenses in exchange for portfolio management services and expertise. Common types of fees include an assets under management ("AUM") fee, performance fees, account fees, redemption fees, exchange fees, purchase fees, and others.

Due to the significant amount of fees, it is important for a fiduciary to effectively communicate the fees and/or expenses charged on the investment portfolio. A fiduciary may breach its fiduciary duty by charging undisclosed or excessive fees.

The following example relates to an undisclosed fees case. In 2015, the Securities and Exchange Commission charged private equity fund advisers within the Blackstone Group L.P. with:

1. failure to disclose the practice of accelerating monitoring fees,
2. failure to disclose a legal fee agreement providing it with a greater discount on its legal fees than the discount the funds received, and
3. failure to adopt and implement written policies and procedures designed to prevent violations of the Investment Advisers Act of 1940, among other charges.

The case settled out of court with the Blackstone Group L.P. paying roughly $29 million to the affected fund investors.[9]

Investment Suitability

An additional manner in which a breach of fiduciary duty can occur is through improper investments based on suitability. In laymen's terms, suitability is whether or not an investment is appropriate for a trust. Fiduciaries often consider several factors when determining the suitability on an investment, two of which are the risk profile and investment goals of the trust.

Each trust has its own unique risk profile, which is based on the trust's objectives and constraints. The portfolio managers typically develop an Investment Policy Statement ("IPS") for the trust portfolio. The IPS characterizes a trust's objectives and constraints which, in turn, provides a framework for the fiduciary to determine investment suitability and asset allocation.

Risk tolerance is based on the propensity and the ability to assume risk. For example, in general, an older, retired client may have a lesser ability to assume portfolio risk than a younger client given:

1. less human capital,
2. a shorter investment time horizon, and
3. a greater need for current income.

Investment goals are another factor often considered when determining investment suitability. If the goal of the portfolio is capital appreciation or maximizing returns, then it may be improper for the fiduciary to recommend a significant allocation to U.S. Treasury securities. However, if the goal of the portfolio is to maintain value, then recommending U.S. Treasury bond investments could be perfectly acceptable.

The trust governing documentation is another factor that a fiduciary typically considers prior to determining the suitability of an investment.

Let's suppose that a stock broker suggests to a trust to invest in Google just after its initial public offering. However, trust bylaws forbid it from investing in equity securities other than utilities. While the stockbroker provided the trust with what we now know as a phenomenal investment, the fiduciary would not be allowed to execute the trade on behalf of the trust due to its bylaws. The governing documents may also place limits on asset allocations and portfolio rebalancing.

Hindsight Bias

Any decision can be subject to hindsight bias. Hindsight bias occurs when a past event appears obvious after the event has transpired. Making investment choices is extremely difficult and, especially, any "poor" or "missed" investments can be subject to hindsight bias.

In investment portfolio breach of fiduciary duty disputes, the plaintiff has the benefit of hindsight, whereas the fiduciary (or defendant) is always looking at the portfolio or a specific investment in the portfolio in the present. In these instances, the issue is not investment performance—but rather investment suitability.

An example of hindsight bias is the Great Recession in 2008. In the wake of the Great Recession, many institutions and individuals sued investment banks for failure to avoid investment losses on mortgage-backed securities and collateralized debt obligations. In reality, very few investors utilized investment strategies to take advantage of the economic downturn.

The Great Recession example could be viewed by beneficiaries as either a "poor" or a "missed" investment opportunity. Investors who took short positions in collateralized debt obligations made millions; therefore, not investing in the short position exemplifies a "missed" investment opportunity.

Alternatively, investors who took long positions in collateralized debt obligations lost big on housing market defaults; therefore, investing in the long position exemplifies a "poor" investment opportunity.

Hindsight bias may lead plaintiffs to question why their fiduciary did not recognize either "poor" or "missed" investment opportunities, which can lead to a legal complaint. Thus, fiduciaries should be weary of the hindsight bias associated with a plaintiff's complaint of breach of fiduciary duty.

Breach of fiduciary duty claims are often trial before a jury. Jury trials can favor the plaintiff in cases where improper investments are alleged because, similar to the plaintiff, jurors are often subject to hindsight bias.[10]

The fact that jurors are also subject to hindsight bias adds additional pressure on fiduciaries facing improper investment allegations.

Transparency and Documentation

One way for fiduciaries to protect themselves against allegations of breach of fiduciary duty is through transparency and documentation.

Transparency and documentation of all fees that will be charged on the account can mitigate breaches of fiduciary duty for excessive fees. Documenting any and all proposed investments and transactions and the outcomes can help defend against a churning allegation. Documenting the outcome of any proposed investment or transaction may also aid in a defense against improper investment allegations based on hindsight bias.

If the fiduciary documents why a particular investment was either made or not made, then it could remove the crux of the plaintiff's complaint. This is because the investment decision was documented at the time of the proposition.

Construction of the "But-For" Investment Portfolio

While the logic behind the "but-for" investment portfolio is relatively straightforward, the construction of a "but-for" investment portfolio can be complex—depending on the facts and circumstances of the litigation. The "but-for" investment portfolio is developed to demonstrate what the value of the actual investment portfolio would have been but for the alleged breach of fiduciary duty.

The "but-for" investment portfolio is created on the date of the initial breach of fiduciary duty. The "but-for" investment portfolio consists of securities that are appropriate for the trust. The "but-for" investment portfolio is then analyzed over the economic damages period according to the facts and circumstances of the portfolio. Economic damages are measured considering, in part, the difference between the "but-for" investment portfolio ending balance and the actual investment portfolio ending balance.

There are numerous factors for the damages analyst to consider in the construction of the "but-for" investment portfolio. These factors are generally considered with regard to the trust governing documents and the approved (or understood) investment policies for the actual investment portfolio. These factors include the following:

- Economic damages period(s)
- An assessment of the breach or breaches of fiduciary duty
- Investment suitability/asset allocation
- Tax considerations
- Treatment of investment portfolio cash flow

- Frequency of rebalancing
- Application of fees/expenses

The failure to consider and incorporate these factors into the "but-for" investment portfolio may result in a calculation of economic damages that is inconsistent with economic reality. Any of the above-listed factors may be disputed as part of the litigation process.

Often, the damages analyst will create multiple "but-for" investment portfolios—based on varying assumptions for the factors listed above. The multiple "but-for" investment portfolios may be used in conjunction with the actual investment portfolio to produce a range of economic damages. That range can assist the finder of fact in determining an appropriate economic damages measure once the finder of fact opines on the contested issues.

Economic Damages Period

Defining the appropriate economic damages period is important for constructing the "but-for" investment portfolio and, ultimately, providing an indication of economic damages. While this fact may seem straightforward, the economic damages period may be disputed.

It is a common practice for legal counsel to advise the damages analyst to construct "but-for" investment portfolios with different starting and ending dates to account for the unresolved economic damages period. The different dates add to the overall complexity of the damages analysis.

Assessment of the Breach or Breaches of Fiduciary Duty

There are certain instances when the timing and amount of the initial damage from the breach of fiduciary duty is disputed.

Take for instance a claim of a breach of fiduciary duty due to a concentrated stock position. A stock position may become concentrated because the investment outperforms the rest of the portfolio. If the portfolio does not have established rules for trading a concentrated stock position, it may be difficult for plaintiffs and defendants to agree upon a sale date, sale price, and percentage of the concentrated position sold.

This variable alone can greatly influence the estimate of economic damages. The variation and the assessment of the initial breach of fiduciary duty adds to the overall complexity of the damages analysis.

Investment Suitability/Asset Allocation

The asset allocation decision is typically an important factor in determining the returns on a portfolio. Therefore, it is no surprise that the asset allocation decision is often contested in breach of fiduciary duty claims.

Generally, investment portfolios with thorough, well-defined investment objectives and constraints provide acceptable asset allocation ranges. For instance, an illustrative asset allocation range could be as follows:

- Cash and money market funds: 0-10 percent
- Fixed income securities: 40-50 percent
- Equity securities: 40-60 percent

In this simplified example, the damages analyst would likely create several "but-for" investment portfolios with different asset allocations within the specified bands. The analyst may use these alternative allocations to asses a range of reasonable investment returns.

In situations where there is (1) a lack of clarity in portfolio governing documents and/or (2) a broad investment mandate, the range of asset allocation and investment suitability is much broader. In these instances, the range of economic damages for the "but-for" investment portfolios can be substantial.

An additional consideration in the construction of the "but-for" investment portfolio is the fact that investment suitability and asset allocation may change over the economic damages period—as investment goals and risks change. This consideration may further complicate the construction of the "but-for" investment portfolio.

Income Tax Considerations

The income tax status of the trust needs to be considered over the entire economic damages period. The damages analyst may need to understand if there are any specific income tax considerations in the disputed portfolio and incorporate certain tax strategies in the "but-for" investment portfolio.

The tax profiles and characteristics of portfolios are generally in line with the tax profiles and characteristics of their trust beneficiaries. Therefore, the damages analyst may consider not only the tax profile and characteristics of the "but-for" investment portfolio, but also the tax profile and characteristics of the beneficiaries.

Some of the factors that make up a tax profile are income level, adjustments to taxable income, exemptions and tax deductions, tax credits, and filing status.

One consideration for a damages analyst is that the tax profile of the "but-for" investment portfolio may change over the economic damages period, similar to the changing tax profiles of the beneficiary over their lives.

Depending on the length of the economic damages period, the tax treatment for investment asset classes and tax environment for trust beneficiaries may change. This consideration may further complicate the "but-for" investment portfolio analysis.

Treatment of Investment Portfolio Cash Flow

During the life of the trust's investment portfolio, it will produce a level of cash flow from dividends, coupon payments, and distributions from its investments. The investment portfolio may distribute this income to beneficiaries, reinvest the income, or a combination of the two.

The trust investment portfolio may receive regular, periodic, or random contributions. And, the investment portfolio may be asked to make distributions on regular, periodic, or random intervals to its beneficiaries.

As part of the "but-for" investment portfolio, the damages analyst may need to make assumptions regarding the treatment of the various forms of investment portfolio cash flow. These assumptions will invariably influence the estimate of any economic damages and the overall complexity of the damages analysis.

Frequency of Rebalancing

Rebalancing is the process used by portfolio managers to realign asset allocation weights in an investment portfolio. There are typically three methods for determining when to rebalance a portfolio:

1. Time only
2. Threshold only
3. A combination of time and threshold

Time only rebalancing is the procedure where a fiduciary rebalances a trust portfolio at predetermined intervals to maintain the ascribed asset allocation. Time only rebalances typically occur on a monthly, quarterly, semiannual, or annual basis.

Threshold only is a procedure that considers the actual asset weights as a percent of the entire port-

folio as they drift from the ascribed allocation based on market values. The threshold only rebalance occurs when the asset allocation crosses a predetermined threshold for the allocation.

For example, if the ascribed asset allocation for the portfolio is to be 60 percent equity and 40 percent fixed income with a threshold of 10 percent, then a rebalance would be triggered at any time the equities account for more than 70 percent or less than 50 percent of the portfolio.

The third rebalancing procedure is a combination of the threshold rebalancing procure and the timing rebalancing procedure. This procedure takes into account the predetermined times to rebalance and any allocation-triggered rebalances. The combination rebalance is triggered by either the time since the last rebalance or by exceeding the threshold.

If the IPS describes a clear procedure for rebalancing the portfolio, then that procedure, generally, is most applicable for the "but-for" investment portfolio. However, in the case that the IPS does not describe a well-defined procedure for rebalancing, then the damages analyst may consider the factors above and how they relate to the profile of the trust and the "but-for" investment portfolio.

Application of Fees/Expenses

The "but-for" investment portfolio will typically be adjusted for fees and expenses. The damages analyst may look at the fees and expenses stated in the IPS, or the damages analyst may need to consider market-based fee and expense rates.

If the portfolio management fees and expenses are well defined in the IPS, then it may make sense for the damages analyst to use the fees and expenses as stated in the IPS. However, if the fees and expenses are not well defined in the IPS, then the damages analyst may consider using market rates for the fees and expenses.

The actual trust portfolio may be subject to AUM fees, performance fees, account fees, redemption fees, purchasing fees, transaction fees, and other fees/expenses. It is up to the damages analyst to understand whether the actual trust portfolio fees are applicable to the "but-for" investment portfolio.

If the fee structure is disputed, it may be beneficial for the damages analyst to incorporate a sensitivity analysis for the range of appropriate fees and expenses charged on the "but-for" investment portfolio.

Complex fee structures are not uncommon for trust investment portfolios, especially among actively managed funds and alternative investments. Complex fee structures add complexity to the construction of the "but-for" investment portfolio.

Let's consider the case of a hurdle rate performance fee, one of the more common complex fee structures. If the disputed portfolio contains a hurdle rate performance fee, the analyst's model should consider the possibility of the "but-for" investment portfolio clearing a hurdle rate. Upon clearing the hurdle rate, the manager of the fund is rewarded for surpassing expectations.

Therefore, the damages analyst may consider including the hurdle rate expense calculation in the damages model to avoid overstating economic damages. While the hurdle rate example is fairly straightforward, the fees and expenses are based on piece-wise structures, which can be more difficult to model.

Conclusion

The "but-for" test and its product (i.e., the "but-for" investment portfolio) are generally accepted methods for calculating economic damages. The "but-for" investment portfolio method may be particularly applicable in cases involving the allegation of a trustee breach of fiduciary duty with respect to investment portfolios.

While other methods for estimating economic damages in these cases exist, many of those alternative methods fail to properly account for opportunity costs.

The "but-for" investment portfolio in conjunction with the actual trust portfolio may be a useful method for measuring trustee breach of fiduciary duty damages and other damages. Due to the aforementioned complexities associated with the construction of the "but-for" investment portfolio, an experienced damages analyst should be involved in this process.

Damages analysts should have the following skills:

1. Thorough knowledge of financial markets to interpret investment suitability
2. Expertise in financial modeling
3. The ability to interpret results in a cohesive manner for finders of fact

Notes:

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