Application of the Sales Projection Method in Measuring Trustee Breach of Fiduciary Duty Damages

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The prudent investment of trust assets can minimize the potential for trustee fiduciary litigation risk, in addition to maximizing the trust beneficiaries' economic interest in the trust. However, trust beneficiaries may initiate a breach of fiduciary duty tort claim when they feel that the trustee has breached any investment management fiduciary duties to the trust. For trust beneficiaries, and their legal counsel, who have brought breach of fiduciary duty tort claims against a trustee, one of the issues is how to measure the "damage" to the beneficiaries as a result of the breach. This discussion addresses the role of the investment management trustee as a fiduciary to the trust beneficiaries. This discussion then presents an analysis that legal counsel, in collaboration with a damages analyst, can use in attempting to quantify the "damage" to the trust beneficiary as a result of the investment management trustee breach of fiduciary duty.

Introduction

When investing trust assets, a trustee has a fiduciary relationship to the beneficiaries of that trust. As presented in *Paul v. North*:

> A fiduciary relation exists between two persons when one of them is under a duty to act or to give advice for the benefit of another upon matters within the scope of the relation.[1]

Most business relationships/partnerships are not fiduciary relationships/partnerships. While most business relationships/partnerships have a degree of trust and confidence, a fiduciary relationship exists when:

1. one party is accustomed to being guided by the judgment and advice of another party or
2. one party otherwise believes that another party is acting in his or her best interest.

Potential fiduciary liabilities (i.e., breach of fiduciary duty tort claims) are possible when an investment management trustee does not adequately perform the required fiduciary duties.

These fiduciary liabilities generally arise from a breach of the "standard of care," as defined by the "prudent investor rule" ("PIR"). This means that the trustee standard of care and investment management fiduciary duties require a prudent investment of the trust assets. This duty typically includes both (1) competent initial investment and (2) continued monitoring of the performance of the trust assets.

It is common in breach of trustee fiduciary duty tort matters for the court to award economic damages in an amount necessary to make the beneficiary whole. However, quantifying the damages caused by the trustee breach of fiduciary duty can prove problematic. While there are several generally accepted methods available to measure economic damages, the sales projection method is one method to measure economic damages in a trustee breach of fiduciary duty tort matter.

While the sales projection method is commonly used to quantify lost profits economic damages for business operations, it can also be tailored to effectively analyze and quantify investment management economic damages as a result of a trustee breach of fiduciary duty.

This discussion:

1. provides a summary of investment management trustee fiduciary duties to beneficiaries, as well as some examples of a breach of those fiduciary duty;
2. discusses and addresses how the damages analyst can assist legal counsel in estimating the tort "damages" attributable to a breach of fiduciary duty by the trustee; and
3. includes an illustrative example of the sales projection method, which we simply call the "projection" method.

Trustee Fiduciary Duties

Common-law trusts separate legal and beneficial ownership, with the trustees holding legal title to trust property, which they in turn manage on behalf of the beneficiaries. The person who establishes a trust is referred to as the "trust settlor," "grantor," or "trustor."

Trustee fiduciary duties originate from the responsibility of having fiduciary powers—that is, the investment management fiduciary power to select the investments of a particular trust on behalf of the trust settlor, grantor, or trustor.[2]

As presented in the American Bar Association article "Trustee Bank's Breach of Investment Management Fiduciary Duties":

> The investment management fiduciary power, in conjunction with the duty of undivided loyalty, creates the standard of care and scope of the investment management fiduciary duties.[3]

As a result of these fiduciary powers, trustees are held to a high standard of care. As presented in the judicial decision *Meinhard v. Salmon*:

> [A fiduciary] is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.[4]

In selecting the investments of a particular trust, and considering the requirement of the trustee to continually monitor the performance of the selected trust investment assets, trustees should choose the extent to which the trust returns (and ultimately the beneficiaries' trust distributions) are subject to market risks and volatility. This is because trustees are required to provide a standard of care and act prudently in selecting and monitoring trust investments for the beneficiaries.

The PIR provides guidance to trustees with regard to fiduciary duties that are required by a trustee in managing trust investment assets. As presented in the *Restatement (Third) of Trusts (1992)* and the *Uniform Prudent Investor Act (1994)*, the PIR requires a trustee to utilize an overall investment strategy. Such a strategy should have risk and return objectives that are "reasonably suited" to the trust.

Further, the PIR requires that a fiduciary (i.e., trustee) invest trust assets as if they were his or her own assets. The fiduciary (i.e., trustee) should consider the needs of the trust's beneficiaries, the provision of regular trust income or distributions to the beneficiaries, and the preservation of trust assets.

The PIR also requires the trustee to:

1. diversify the investments of the trust,
2. avoid investments that are excessively risky, and
3. monitor investments and make portfolio adjustments on an ongoing basis.[5]

Fiduciary liabilities, that is, breach of fiduciary duty tort claims, are typically initiated as a result of the trustee not adequately performing his or her fiduciary duties. However, it's important to note that fiduciary liabilities, or breach of fiduciary duty tort claims, are not always dependent on the relative change in value of the trust assets. Rather, breach of fiduciary duty tort claims may be brought against a trustee as a result of a failure to prudently represent the beneficiaries of a particular trust.

For example, let's assume there is a $2 million trust that had been set up for two 20-year-old beneficiaries. The 20-year-old beneficiaries are:

1. unable to work,
2. expected to live approximately 50 years, and
3. anticipating the receipt of annual distributions from the trust of $100,000 (in aggregate) over the next 50 years based on the initial goal of the trust.

Further, let's assume that it is also the goal of the trust to ensure that the $2 million initial principal balance is available for the beneficiaries at the end of 50-year term.

Next, let's assume that the initial trust assets were comprised of dividend-paying common stocks. However, shortly after engaging the trustee to manage the trust, the trustee sold all of the dividend-paying common stocks and invested the entire proceeds in non-dividend-paying, growth-oriented common stocks.

If over the next three years there is insufficient income from the trust investment assets to meet the $100,000 annual distribution to the 20-year-old beneficiaries, then it may be inferred that the trustee has not prudently represented the beneficiaries of the trust.

Should legal counsel determine that the trustee has breached his or her fiduciary duty to the beneficiaries, the next step is to utilize a damages analyst to quantify any potential damages associated with the breach. It is important to note that the damages analyst should be consulted early on in the process.

This is because it may be advantageous to legal counsel for the damages analyst to:

1. assist with assessing the merits of the case (including providing some initial analysis to determine the scale of the potential economic damages associated with a breach of fiduciary duty),
2. assist with weighing the merits and risks of going to trial, and
3. assist with reviewing and critiquing other damages analyst's work that may be transmitted during the engagement.

Measuring Economic Damages in a Trustee Breach of Fiduciary Duty Tort Claim

There are several generally accepted methods to measure economic damages in a trustee breach of fiduciary duty tort claim. While the application of these methods are more commonly used to quantify lost profits economic damages for business operations, they can also be tailored to effectively analyze and quantify investment management economic damages as a result of a trustee breach of fiduciary duty.

The underlying theory of lost profits damages, as it relates to business operations, is that "but-for" the actions of the defendant (or "but-for" the damaging event) the plaintiff would have experienced a higher level of revenue and profits. Considering the example presented in the previous section, this method can be applied to trustee breach of fiduciary duty tort claims where, "but-for" the actions of the trustee, the beneficiary would have experienced (received) an appropriate level of trust distributions.

In addition to the sales projection method (referred to herein as the "projection" method), the following list presents the three other generally accepted methods to quantify lost profits and lost revenue for business operations:

1. Before-and-after method
2. Yardstick method
3. Market model method

As mentioned, while initially constructed to analyze lost profits and lost revenue for business operations, the above methods, in addition to the projection method, may be used to quantify economic damages attributable to trustee breach of fiduciary duty.

Before-and-After Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the before-and-after method is described as follows:

> The "before-and-after" method determines economic revenues for the damages period by comparing the performance of the business before the event occurred and after the effects of the damaging event are over. The underlying theory is that, "but for" the event, the plaintiff would have experienced the similar revenues and anticipated lost profits during the damages period before the event occurred and/or after the event has subsided.[6]

Many damages analysts refer to the "before-and-after" method as the "book ends" method. This reference is due to the fact that this damages measurement method uses historical financial information (before and after the damaging act) as proxies to quantify what would have happened during the wrongful act time period.

In order to correctly apply the "before-and-after" method, the damages analyst should identify and quantify any other factors that may have affected profitability or revenue during the damages period, as well as before and after the damages period (i.e., the "book ends" period).

For example, if the damages analyst is attempting to quantify damages for a real estate development company over a 2009 to 2010 damages period, the effects of the industry performance, as well as the performance of the regional, national, and global economy, should also be considered in measuring damages attributable to the wrongful act.

Yardstick Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the yardstick method is described as follows:

> The yardstick method utilizes guideline company or industry measures to serve as proxy for what the revenues and profits of the affected business would have been but for the damaging event.[7]

One component of the yardstick method is for the damages analyst to identify guideline companies (namely guideline publicly traded companies) that are reasonably comparable to the subject business.

The damages analyst should also appropriately consider any changes, other than the wrongful act, that may have affected the subject company performance over the damages period (such as changes in management, changes in product design, unrelated litigation, etc.).

Market Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the market method is described as follows:

> The fourth methodology for determining lost profits, the market model, is not used as often as the first three models already discussed. According to this methodology, the expert considers the plaintiff's market share prior to the defendant's alleged act to determine lost revenues/sales. For example, in a market in which the plaintiff and defendant are sole competitors, the plaintiff needs only to show "evidence defining the market, demonstrating what share of the market would have been but for the defendant's breach, and establishing the profit he would have earned on the increased sales."[8]

While this method is sometimes applied in patent infringement matters, it may be applied in other damages scenarios, if appropriate data are available.

As mentioned above, each of these methods can be tailored to measure trustee breach of fiduciary duty economic damages. For purposes of the following illustrative example, it is more appropriate to apply the projection method.

Projection Method

As presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, the projection method is described as follows:

> The sales projection method utilizes company-specific forecasts for certain items, preferably by using forecasts that the company has prepared in the ordinary course of business or for some purpose other than the litigation. Some businesses are more sophisticated than others, and their projections (formatted like a typical income or operating statement) may specify revenues by product lines, detailed expenses, income taxes, and miscellaneous income/expenses.[9]

Many courts have concluded that the projection method for calculating commercial economic damages is reliable. However, as presented in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*:

> [T]he challenge for the financial expert remains how to make the appropriate estimates and analyses and then relate them to the performance that the specific event impacted so the conclusions are reliable.[10]

Based, in part, on the court's view that the projection method is generally reliable, it is a common method used to estimate commercial economic damages. And, the projection method can be easily tailored to quantify other damages, such as trustee breach of fiduciary duty economic damages.

The following illustrative example presents the application of the projection method in measuring economic damages attributable to a trustee breach of fiduciary duty.

Illustrative Example

Let's consider an example of a trustee damaging act involving a $2 million trust that had been set up for two 20-year-old beneficiaries. Specifically, the example encompasses the following information:

- The beneficiaries are two 20-year-olds who are unable to work.
- The two 20-year-old beneficiaries are required to receive an annual $100,000 (in aggregate) distribution from the trust.
- The term of the trust was 50 years.
- A further goal of the trust was to ensure that the $2 million principal balance is available for the beneficiaries at the end of the 50-year term.
- The trust was initially invested in dividend-paying common stocks.
- The trustee, upon appointment, sold all of the dividend-paying common stocks and subsequently invested the entire proceeds in non-dividend-paying, growth-oriented common stocks.
- The trust was unable to distribute the required $100,000 in each year over the three years subsequent to the trustee appointment.

In tailoring the projection method to measure the trustee breach of fiduciary duty economic damages, the damages analyst should attempt to quantify the amount of income generated by the trust assets "but-for" the trustee damaging act. This analysis would entail:

1. holding the trust portfolio of assets at a "standstill" over the three years subsequent to the trustee appointment and
2. subtracting all income generated by the "new" trust portfolio investments (initiated by the trustee) over the three years subsequent to the trustee appointment.

The annual difference between the income generated by the "standstill" trust portfolio of assets and the income generated by the "new" trust portfolio assets would represent the damages attributable to the trustee breach of fiduciary duty.

Mathematically, this procedure would be:

	(Year 1 Standstill Assets Income – Year 1 New Assets Income)
+	(Year 2 Standstill Assets Income – Year 2 New Assets Income)
+	(Year 3 Standstill Assets Income – Year 3 New Assets Income)
=	Breach of Fiduciary Duty Damages

For purposes of the example, let's also assume that the three-year damages period is January 1, 2013, through January 1, 2016. Further, let's assume that the trust assets prior to the appointment of the trustee were investments in the common stock of (1) Ford and (2) AT&T.

Finally, let's assume that the investments made by the trustee (i.e., the new trust portfolio assets) resulted in zero dividends/income over the three-year damages period.

Based on these assumptions, the measurement of the trustee breach of fiduciary duty economic damages is summarized below.

As presented in Exhibit 1, let's assume the following:

1. The initial purchase amount for each dividend-paying stock was $1 million.
2. The initial share prices of Ford and AT&T on January 1, 2013, were $15 per share and $35 per share, respectively.
3. The annual dividend per share for Ford and AT&T was $1 and $2, respectively.

Based on the application of the projection method, as presented in Exhibit 1, the trustee breach of fiduciary duty economic damages are measured

Exhibit 1
Illustrative Economic Damages Analysis

Standstill Assets	Initial Amount	Initial Share Price	Number of Shares	Dividend per Share	Year 1 ($)	Year 2 ($)	Year 3 ($)
Ford	$1,000,000	$15.00	66,666.67	$1.00	66,667	66,667	66,667
AT&T	$1,000,000	$35.00	28,571.43	$2.00	57,143	57,143	57,143
				Total Standstill Assets Income	123,810	123,810	123,810
				Total New Assets Income	-	-	-
				Total Annual Indicated Economic Damages	123,810	123,810	123,810
				Total Economic Damages	371,429		

at $371,429. This simplified example is one of the many ways the projection method can be applied to measure economic damages based on a trustee breach of fiduciary duty.

Conclusion

This discussion presented an overview of investment management trustee fiduciary duties including how and when a damages analyst can be utilized to measure potential economic damages as a result of a trustee breach of fiduciary duty.

Legal counsel should consult the damages analyst early on in the process of reviewing a potential trustee breach of fiduciary duty claim. This early consultation is recommended because the damages analyst can:

1. assist with assessing the merits of the case (including providing some initial analysis to determine the scale of the potential economic damages associated with a breach of fiduciary duty),
2. assist with weighing the merits and risks of going to trial, and
3. assist with reviewing and critiquing other valuation analyst's work that may be transmitted during the engagement.

There are several generally accepted methods that can be used to measure economic damages, including:

1. the "before-and-after" method,
2. the yardstick method, and
3. the market model method.

The sales projection method may be the most common method to measure economic damages.

However, with appropriate considerations, all four measurement methods may be tailored to measure potential economic damages as a result of a trustee breach of fiduciary duty.

Notes:

1. Paul v. North, 191 Kan. 163, 380 P.2d 421, 426 (1963).
2. The trustee fiduciary duties are based on the rights conferred by (1) the purpose of the subject trust, (2) the subject trust terms, and (3) relevant state laws.
3. O.A. Ishmael, "Trustee Bank's Breach of Investment Management Fiduciary Duties," *Commercial and Business Litigation Articles*, americanbar.org.
4. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).
5. Ultimately, investment management trustees are expected to continually analyze investments that differ in their risk and return characteristics, with the optimal risk selection reflecting the financial resources, life situations, and risk tolerance of the beneficiaries who will ultimately receive the trust income and distributions.
6. Nancy J. Fannon and Jonathan M. Dunitz, *The Comprehensive Guide to Lost Profits and Other Commercial Damages* (Portland, OR: Business Valuation Resources, 2014), 219.
7. Ibid., 220.
8. Ibid., 226.
9. Ibid., 223.
10. Ibid., 225.

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