The Legal Duties of Fiduciaries to Manage Stock Concentration Risk

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The legal duties of fiduciaries to appropriately manage the risk of a concentrated stock position generally are broader and expanding much quicker than most professional fiduciaries and investors realize. Unfortunately, fiduciaries often are unaware of the extent of their exposure to this array of duties.

There has been an increase in the number of lawsuits initiated by beneficiaries claiming that the trustees failed to diversify or hedge their portfolios by holding onto stocks even as the value of their stocks declined precipitously. As one commentator aptly put it, "Diversification of risk is the mantra of modern-day investing and the law of prudence governing trustees has evolved to incorporate that knowledge."[1] Fiduciaries, trusts and estates lawyers, and litigators are sitting on pins and needles as they await the result of several high-profile cases involving prominent banks that are winding their way through the courts.[2]

Although the details of a trustee's investment-related duties are defined and governed by state law (which, of course, will vary from state to state) and the language of the trust instrument itself, certain key principles of fiduciary responsibility generally are applicable. This article outlines the basic elements of a trustee's duties as they relate to managing stock concentration risk and proposes a framework that should enable fiduciaries to satisfy these duties.

Most states have adopted some version of the prudent investor rule. The prudent investor rule adopts modern portfolio theory (MPT). As most of our readers know, the critical underpinnings of MPT were developed by Harry Markowitz, whose key insight was that the variance of returns (one measure of risk) could be decreased through diversification. By increasing the number of assets held in a portfolio and by investing in different asset classes (uncorrelated or ideally negatively correlated), investors can reduce risk without sacrificing returns.

The prudent investor rule has been codified by the Uniform Prudent Investor Act (UPIA), which has been adopted in whole or in substantial part by the vast majority of the states. Even states that have not adopted the UPIA look to the rules set forth therein as persuasive authority. The UPIA imposes seven distinct and separate duties upon fiduciaries with respect to managing stock concentration risk.

1st Duty: Mitigate Undue Stock Concentration Risk. The UPIA states that a trustee shall diversify the investments of a trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.[3] Similarly, the Restatement (Third) of Trusts, which has been cited by many courts in assessing whether a trustee has a duty to diversify, provides that a trustee is under a duty to diversify the assets of a trust unless it is prudent not to do so.[4]

Both the UPIA and the Restatement (Third) of Trusts take the significant step of integrating the diversification requirement into the concept of prudent investing. In addition, the case law overwhelmingly supports the duty to diversify.[5] Thus, prudent investing ordinarily requires diversification and fiduciaries clearly have an affirmative duty to mitigate undue stock concentration risk.[6]

2nd Duty: Consider Hedging Strategies in Addition to Either Holding or Selling. Over the past decade or so there has been a changing mindset among the courts, fiduciary litigators, and legal scholars regarding whether a trustee may be held liable for breaching the duty to invest prudently by failing to hedge a concentrated position.

The current state of fiduciary law in most instances will require fiduciaries to fully understand and be able to implement various hedging, monetization, and tax deferral strategies.[7] This duty requires the fiduciary to consider these hedging strategies as a possible alternative to either an outright sale or a continued holding of the concentrated position.[8]

This emerging duty to be informed about and be able to implement the intricacies of various hedging strategies is a perfectly logical development given the rapid development of the derivative markets over the past decade, the ease of accessibility to information describing these techniques, and the regular and routine use of derivatives and other risk-management strategies by most corporations and institutional investors to manage their risks.

3rd Duty: Evaluate Expected Tax Consequences of the Alternative Strategies. The UPIA requires that trustees consider "the expected tax consequences of investment decisions or strategies."[9] The comments to the UPIA go on to state that under our current federal income tax system, taxable

investors, including trust beneficiaries, are in general best served by investment strategies that minimize the recognition of income taxes.[10]

This is very significant because, as the put/call parity equation proves, various combinations of financial tools can be assembled to have financial equivalency to each other. For instance, the economics of a collar and a loan (e.g., to achieve hedging, monetization, and deferral of the capital gains tax) can be achieved through the following tools or combination of tools:

- prepaid variable forward contract
- over-the-counter options-based collar combined with a margin loan
- exchange-traded options-based collar combined with a margin loan
- equity swap with embedded collar combined with a margin loan
- nonrecourse loan combined with the sale of call options

It is absolutely critical to note that each of these five strategies is economically equivalent, yet their tax treatment can differ significantly.[11]

How should this impact the action of fiduciaries charged with managing concentrated stock positions? Let's look at a common fact pattern. Assume a trust holds a concentrated position in a single stock and the trustee has determined that disposing of the stock might be prudent. Most professional fiduciaries today probably would engage in an analysis that simply compares the tax implications of an outright sale to the use of a prepaid variable forward contract (PVF), which would allow the position to be hedged and monetized without triggering a current taxable event.

The comparison of an outright sale to the PVF (and not to any of the other tools previously mentioned) probably would be made simply because Wall Street has heavily promoted the PVF as the "premier tool" to hedge and monetize a concentrated stock position (based primarily on certain non-tax considerations) and most professional fiduciaries are somewhat familiar with the concept of a PVF. In fact, of the tools mentioned previously, in most situations the PVF is the *least* tax-efficient tool that is available.[12] Therefore, merely comparing an outright sale to a PVF, which currently is what most professional fiduciaries do, clearly is a deficient analysis and does not go nearly far enough to satisfy the requirements of the UPIA.

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Again, each of the five strategies that previously were mentioned is economically equivalent, but their tax treatment can differ significantly. Given that the UPIA requires that trustees consider the expected tax consequences of investment decisions and strategies, it seems perfectly clear that fiduciaries should compare and contrast the expected tax consequences of each of these five strategies (and not just a PVF) to an outright sale. The objective, of course, should be to select and utilize the tool that has the greatest likelihood of delivering the optimal after-tax result.

It also is worth mentioning that, because each of these five strategies is economically equivalent, the dealer's hedge will be almost exactly the same under each case. In addition, the dealer will be subject to a "mark to market" taxation regime. Therefore, the dealer typically will be indifferent as to how a particular hedging transaction is documented.

4th Duty: Evaluate Non-Tax Consequences of the Alternative Strategies. In addition to considering the potential tax advantages and disadvantages of the various tools, prudence requires that the trustee also engage in a thorough analysis of the potential non-tax advantages and disadvantages of these tools.

The UPIA states that the trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.[13] Thus, in the context of selecting the most appropriate hedging tool, non-tax considerations such as those listed below should be considered:

- impact of the margin rules
- counterparty credit risk
- ability to close out a transaction prior to its stated expiration
- pricing transparency
- fees and expenses
- required documentation (terms and conditions)

Yet, based on the author's extensive experience working with fiduciaries, this type of thorough analysis (e.g., comparing and contrasting both the tax and non-tax advantages and disadvantages of the various tools that could be used) generally is not done *until* the fiduciary is made aware of the possible implications of not doing so.

5th Duty: Apply Special Skills. In general, the standard of prudence for a professional fiduciary is that of a prudent professional fiduciary. However, both the UPIA and the Restatement (Third) of Trusts make clear that a fiduciary who has special skills or expertise, or who is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.[14] As a result, a trustee will be held liable for a loss resulting from the failure to use such skill. The case law strongly supports the concept of a higher standard of care for a trustee representing itself to be expert in a particular area.[15]

Many, if not most, professional fiduciaries market and hold them-

>> "FIDUCIARIES" CONTINUED

selves out as having acquired special expertise in the area of managing stock concentration risk. Assuming this is true (unfortunately it is not in most instances), too often this special skill either is not applied at all or is applied inconsistently to the fiduciary's client base.

Therefore, if the fiduciary holds itself out as having special skills in this area, formalizing or institutionalizing the delivery process (as discussed in the final section of this article) should assure that these special skills are applied to each client through a uniform and consistent methodology, and the trustee therefore should not be held liable for a loss resulting from the failure to use such special skills.

6th Duty: Maintain Loyalty to Beneficiaries. The UPIA imposes a duty of loyalty upon the trustee. Put simply, the trustee must work solely in the best interest of the beneficiaries, as opposed to acting for its own interest or that of third parties.[16] Thus, any action smacking of either self-dealing or conflict of interest is strictly prohibited.

Professional fiduciaries that have in-house derivative desks and rely on their internal desks to execute hedging transactions on their behalf need to be especially cautious. At a minimum, the fiduciary should procure competing bids from a number of dealers to assure that full price discovery in fact has been achieved and should be prepared to execute a transaction with an outside dealer if the pricing, terms, and conditions of their in-house desk are not as favorable.

7th Duty: Minimize Transaction Costs and Fees. The UPIA specifically addresses investment costs and states that a trustee may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. Wasting beneficiaries' money is imprudent.[17] In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.[18] In particular, it is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio.[19] Therefore, achieving full price discovery is not optional; it is required by both the UPIA and the Restatement (Third) of Trusts.

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Survey of Current Best Practices

The author recently conducted an informal survey of professional fiduciaries to determine current best practices in the area of managing stock concentration risk. The institutions surveyed ranged from small independent trust companies to some of the largest financial institutions in the world.

Perhaps surprisingly, most institutions use a very informal, ad hoc approach to managing stock concentration risk. Portfolio managers and trust administrators periodically are reminded to be on the lookout for highly concentrated positions. A portfolio manager or an employee who has some background in either options or taxation might be anointed as the firm's stock concentration expert and expected to develop the necessary expertise to handle these situations. Or a small group might be formed in an attempt to develop the necessary expertise. Sometimes each client-facing investment professional or team within a firm is expected to have the necessary expertise to address these situations as they arise.

It is disconcerting that the entire process remains quite informal and has not yet been systematized to any significant degree by even the largest organizations. Although professional fiduciaries certainly attempt to keep themselves apprised of highly concentrated positions, no uniform and consistent analysis is applied to each situation. Rather, each is treated as a "one-off" situation, which can lead to great danger.

Clearly, no best practices have evolved in this area. Most of the practices and procedures followed have been put into place with apparently little regard as to how that particular practice enables the fiduciary to satisfy its fiduciary duties.

Proposed Best Practices—A Framework for Fiduciaries to Use to Satisfy Their Duties to Manage Stock Concentration Risk

To satisfy their fiduciary duties, it is vital that stock concentration risk management services be rendered by professional fiduciaries through a *uniform and consistent delivery process*. The author suggests that the following procedures be periodically and systematically applied to each situation of stock concentration risk that a fiduciary faces.

Step 1: Identify and Establish Objective. The precise objective (or combination of objectives) of the trust must be identified and established. Possible objectives include the following:

- hedging
- monetization (generate cash for reinvestment)
- yield enhancement
- wealth transfer
- charitable planning

Step 2: Identify Tools and Techniques That Can Satisfy These Objectives. All of the investment tools (or combinations of tools) that potentially can be used to satisfy the objectives need to be identified.

Currently available techniques in addition to an outright sale and continued holding of the security include the following:

- Various types of equity derivatives such as
  1. exchange-traded options, including equity-flex options
  2. over-the-counter derivatives:
     a. options
     b. swaps
     c. forwards
- Various forms of borrowing such as
  1. margin loans
  2. nonrecourse loans
  3. loans embedded within a derivative (e.g., prepaid variable forward)
  4. fixed or floating rate

Other tools including

1. exchange funds
2. certain forms of short sales not prohibited by the constructive sale rules
3. restricted stock sales
4. certain risk-pooling methodologies to inexpensively hedge stock
5. capital markets-based transactions such as DEC offerings

Step 3: Identify Tax Advantages and Disadvantages of Each Tool. It must be pointed out again that there is financial equivalency among different combinations of the tools mentioned above, but the tax results can differ significantly depending upon which tool (or combination of tools) is used and the factual situation of a particular trust.

Going back to our previous example, we saw that the economics of a collar and a loan (e.g., to achieve hedging, monetization, and deferral of the capital gains tax) could be achieved through five different combinations of tools. However, the tax treatment of these five techniques can differ significantly.

Therefore, the tax advantages and disadvantages of each tool (or combination of tools) need to be identified. All other things being equal, it would be prudent, for instance, to implement the collar and loan strategy described above by using the tool that is expected to minimize the income tax consequences to the trust and its beneficiaries.

Step 4: Identify Non-Tax Advantages and Disadvantages. Non-tax considerations such as the following need to be considered:

- impact of the margin rules
- counterparty credit risk
- ability or inability to close out a transaction prior to its stated expiration
- pricing transparency
- fees and expenses
- required documentation (terms and conditions)

Step 5: Achieve Full Price Discovery. If the trustee determines that the implementation of a particular transaction is prudent, full price discovery must occur for the fiduciary to satisfy its duty of loyalty to beneficiaries as well as its duty to minimize transaction costs and fees.

It would seem prudent for professional fiduciaries to institutionalize the five-step delivery process described above (or something similar to it) by formalizing a stock concentration risk management program or process. Once put in place, each and every case regarding managing stock concentration risk runs through the same process and receives exactly the same analysis. Nothing then should slip through the cracks.

It should be noted that certain investment firms specialize in stock concentration risk management and work closely with professional fiduciaries to enable them to cost-effectively deliver these critical analytical services. These firms also facilitate full price discovery should a particular transaction be deemed prudent to implement. This enables a professional fiduciary to significantly limit the amount of capital, staff time, and other resources that the fiduciary otherwise would have to devote to this area.

Conclusion

The legal duties of fiduciaries to appropriately manage stock concentration risk are significantly broader than most professionals realize and continue to expand. Fiduciaries must satisfy at least seven separate duties identified under the Uniform Prudent Investor Act or the Restatement (Third) of Trusts.

Most professional fiduciaries use an informal, ad hoc process to manage stock concentration risk. It is disconcerting that the necessary processes and procedures have not been systematized to any great degree in even the largest organizations. Put another way, no uniform and consistent analytical framework is applied to each situation. Rather, each is treated on a "one-off" basis, which can lead to great danger.

Clearly, no generally accepted best practices have evolved in this area. In light of this gap, the author proposes a best practices framework and suggests that the use of this or a similar methodology should allow professional fiduciaries to systematically manage stock concentration risk in a uniform and consistent process and thereby satisfy fiduciary duties. The author hopes that a healthy dialogue will ensue. M

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Endnotes

1. Karen Donovan, (2006) "SunTrust's Woes: It's The Real Thing," *Trusts & Estates* (March): 49.

>> "FIDUCIARIES" CONTINUED

2. See Hitz v. SunTrust Bank, 05-CV-1413 (N.D. GA, 2005) filed May 31, 2005, Matter of Dumont, 4 Misc. 3rd 1003 (NY Surr. 2004) and Matter of Dumont, CA 04-02319, 2006, NY Slip Op. 00866 (N.Y. App. Div. 2006).

3. UPIA Section 3 (1995).

4. Restatement (Third) of Trusts, Section 227.

5. UPIA (1995) comment to Section 3. See also P. G. Guthrie, Annotation, "Duty of Trustee to Diversify Investments, and Liability for Failure to Do So," 24 ALR 3rd 730 (1969). Matter of Janes, 165 Misc. 2nd 743 (Monroe Cty., Surr. 1995), Matter of Janes, 90 N.Y.2nd 41 (1997), Levy v. Bessemer Trust Co., 197 WL 431079 (SDNY, July 30, 1997), Matter of Dumont, 4 Misc. 3rd 1003 (NY Surr. 2004), Matter of Dumont, CA 04-02319, 2006, NY Slip Op. 00866 (N.Y. App. Div. 2006), In re Rowe, 712 NYS 2nd 662 (3rd Dept, 2000), In re Saxton, 712 NYS 2nd 225 (3rd Dept., 2000), Robertson v. Central Jersey Bank & Trust Co., 47 F3rd 1268(CA-3, 1995), Donato v. Bank of Boston, 110 F Supp. 2nd 42 DC RI, 2000), Atwood v. Atwood, 25 P 3rd 936 (Okla. Ct. App., 2001).

6. UPIA (1995) comment to Section 3.

7. See Levy v. Bessemer Trust Co., 197 WL 431079 (SDNY, July 30, 1997). See also Brane v. Roth, 590 N.E. 2nd 587 (Ind. Ct. App. 1992).

8. See Randall H. Borkus, "A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivative Techniques," 36 *ABA-RPPT Journal* 127 (spring 2001); George Crawford, "A Fiduciary Duty to Use Derivatives," 1 *Stanford Journal of Law, Business & Finance* 307, vol. 1, no. 2 (spring 1995): 328–32; and Mark A. Miller, "Protecting Appreciation in Taxable Investment Securities and Portfolios with Hedging Strategies," *Journal of Wealth Management* 5, no. 2 (fall 2002): 31–48.

9. UPIA (1995) Section 2(c)(3).

10. The comments to UPIA (1995) Section 2(c)(3) cite Robert Jeffrey and Robert Arnott, "Is Your Alpha Big Enough to Cover Its Taxes?" *Journal of Portfolio Management* 15 (spring 1993). The comments relating also recognize that tax considerations, such as preserving the stepped-up basis on death under Code Section 1014 for low basis assets, have been very important in estate planning for the affluent.

11. See Thomas J. Boczar and Lawrence Hawkins, "Stock Concentration Risk Management Strategies," *The Monitor* 18, no. 6, (November/December 2003): 8–12. This article was the first-place winner of the IMCA® 2004 Stephen J. Kessler Writing Award. See also M. Fichtenbaum, "The Forms of Equity Investments Produce Disparate Tax Effects," *Journal of Taxation of Investments* 14, no. 1 (fall 1996): 12–19; Edward D. Kleinbard, "Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System," 69 Texas Law Review 1319 (May 1991); and Alvin C. Warren, "Financial Contract Innovation and Income Tax Policy," 107 Harvard Law Review 460 (December 1993).

12. See Boczar, Thomas, "Stock Concentration Risk Management Strategies," *The Monitor* (November/December 2003): 8–12.

13. UPIA (1995) Section 2 (d).

14. UPIA (1995) Section 2 (f); Restatement (Second) of Trusts Section 174. See also Uniform Trust Code Section 806 (2005).

15. UPIA (1995) comment to Section 2(f), citing Annotation, Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 ALR 3d 904 (1979) & 1992 Supplement at pp. 48–49.

16. UPIA (1995) Section 5; Restatement (Third) of Trusts Section 4.

17. UPIA (1995) Section 7.

18. UPIA (1995) comments to Section 7.

19. UPIA (1995) comments to Section 7, citing Restatement (Third) of Trusts Section 227, comment m at p. 58.