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Calculating Damages Over Mismanaged Assets

Once a fiduciary is found liable, how does 'Janes' formula work?

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THE NEW YORK Court of Appeals has addressed the issue, so how difficult can it be to calculate damages where a fiduciary is found liable for mismanagement of trust assets? As it turns out, very difficult.

The formula seems simple enough. In *Matter of Janes*, 90 N.Y.2d 41 (1997), the Court of Appeals held, "[i]n imposing liability upon a fiduciary on the basis of the capital lost, the court should determine the value of the stock on the date it should have been sold, and subtract from that figure the proceeds from the sale of the stock or, if the stock is still retained by the estate, the value of the stock at the time of the accounting." Id. at 55.[1]

As straightforward as the Court of Appeals' articulation of the "lost capital" formula appears, attorneys and courts have discovered that the simplicity of *Janes*' "lost capital" formulation is deceptive. Taken at face value, the Court's description would suggest that, if mismanaged assets were worth $1 million in Year 1, when a court determines the assets should have been sold, and the assets are later sold for $800,000 in Year 10, damages for "lost capital" would simply be the difference, or $200,000. Logically, the Court would then add discretionary simple or compound interest on the $200,000 over the relevant period.

If rigidly applied, however, the "lost capital" damages formula would leave some beneficiaries without an adequate remedy, particularly where trustee mismanagement results in no loss (or minimal gain) in the nominal value of trust assets over an extended period. Investment opportunities may have been lost in the intervening decades, or at a minimum, inflation may have eroded the real value of those assets. A strict reading of *Janes* would seem to provide a safe harbor for any trustee who maintained the nominal value of trust assets (investing solely in treasury bills or money market funds, for example), even though New York law ostensibly requires much more of a trustee.

Interestingly, the example cited above does not represent how the damage award in *Janes* itself was calculated, nor how other New York courts have traditionally or since calculated "lost capital" damages. In *Janes*, the court records reveal that the objectant's expert witness began calculating "lost capital" damages by taking the value of the negligently retained stock at the time of breach, adding in the interest on that higher amount through the period of breach, and subtracting the value of the stock when it was actually sold. Applying this method to the prior hypothetical would mean calculating interest on $1 million over 10 years before subtracting the value of the stock when sold ($800,000). Clearly, 10 years of interest, especially compound interest, on $1,000,000 will far exceed 10 years of interest on $200,000, so the distinction is important.

New York courts have applied the "lost capital" measure for decades. A classic—perhaps the classic—statement of the formula is found in *Matter of Kellogg's Trust*, 35 Misc.2d 541, 553 (Sup. Ct. Erie Co. 1962), where the court stated (in dictum) that "lost capital" damages "are measured as of the time the securities should have been disposed of; that is, damages consist of the value of the securities at that time, together with interest, less the value at the time of the accounting and less any dividends or other income received from the unauthorized securities."

Cases following *Janes* have specifically rejected the claim that the Court of Appeals' formulation in *Janes* was meant to alter the traditional method of calculating "lost capital" damages as articulated in *Kellogg's Trust*. See, e.g., *Matter of Saxton*, 274 A.D.2d 110, 121 (3d Dept. 2000); *Matter of Rowe*, 274 A.D.2d 87, 93 (3d Dept. 2000); *In re Will of Dumont*, 4 Misc.3d 1003(A) (Surr. Ct. Monroe Co. 2004). In *Rowe*, the Appellate Division, Third Department, acknowledged that, taken literally, the Court of Appeals' description of the "lost capital" damages calculation would suggest that interest should be calculated only on the difference between the value of the relevant assets

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when they should have been sold and their value when actually sold. 274 A.D.2d at 93. The Third Department, however, held that the Court of Appeals "was merely stating its view on [the] distinct characteristics of the computation process and that its chronology is not controlling." Id.

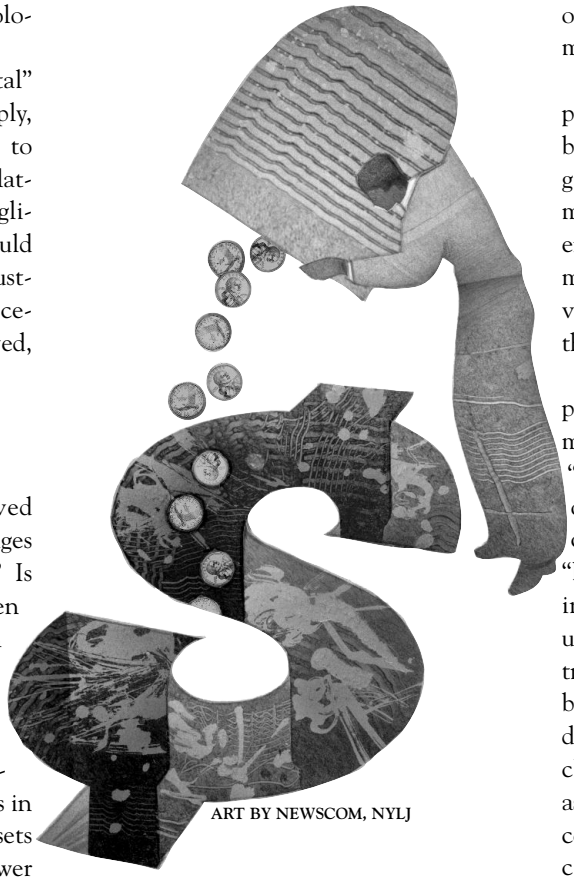
Thus, despite what the "lost capital" damages calculation in *Janes* might imply, courts may be expected to continue to measure "lost capital" damages by calculating interest on the full value of the negligently retained assets when they should have been sold and then making adjustments in accordance with case law precedent. But even if that issue may be resolved, other difficulties remain.

What Is 'Capital'?

Perhaps the most basic unresolved issue relating to the "lost capital" damages measure is the definition of "capital." Is "capital" the nominal value of a given amount of money (or assets that can be converted to money), or is "capital" the real value of a given amount of money? In other words, has a fiduciary lost "capital" if he fails to preserve the purchasing power of trust assets in the face of inflation, even if those assets maintain their nominal value? The answer has consequences, both for calculating and allocating damages and for determining the types of investments that will appeal most to trustees.

Unfortunately, the law provides little guidance on what is "capital." *Janes* suggests that "capital" is simply the nominal value of trust assets, but, as already shown, the Court of Appeals did not attempt to set forth a precise formulation of damages in *Janes*. In any event, the Court in *Janes* did not need to confront the issue of the time value of money, since the nominal value of the relevant assets in that case (Kodak stock) declined precipitously over the period of breach.

In fact, it appears that only the federal district court for the Southern District of New York has addressed the issue, and it developed its rationale over the course of two separate opinions. In *Williams v. J.P. Morgan & Co.*,[2] in which the authors' firm was counsel for the plaintiff, trust beneficiaries sued the trustee for failing to invest trust assets competently over a 25-year period. Plaintiff's complaint alleged that the trustee—in response to the concerns of the income beneficiary (a Brazilian citizen) in 1970 that Brazil and the United States would soon enter into a bilateral tax treaty—had liquidated the trust's stock holdings and invested the entire trust in tax-exempt bonds and cash. The trust was invested solely in tax-exempt bonds and cash from 1971 until 2001, soon after the action was commenced.



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Plaintiff alleged that the trustee knew or should have known no later than 1975 that any prospect that such a treaty would enter into force had disappeared. Plaintiff, citing stock market indices, alleged that the trust, worth roughly $1 million in 1971, would have been worth approximately $20 million in 2001 if the trustee had acted with ordinary prudence and skill and reinvested most of the trust in stocks by 1975.

J.P. Morgan & Co., the trustee, disputed plaintiff's allegations of mismanagement but sought summary judgment on the ground that, under the "lost capital" measure of damages, the beneficiaries were entitled to no damages because the trust maintained roughly the same nominal value from 1975 to 2001. In other words, there was no "lost capital."

In its first decision, the court rejected plaintiff's arguments that it should consider market indices and apply a "lost profits" or "total return" measure of damages, as opposed to "lost capital" damages. The court found *Janes* controlling and held that "lost profit" damages, based on market indices, would be too speculative and uncertain.[3] On a subsequent motion, the trustee sought a ruling dismissing the suit because, it contended, there could be no damages where there was essentially no change in the nominal value of trust assets over the relevant period. Plaintiff countered that there was, in fact, "lost capital," because the trust had lost 70 percent of its real value over the 25-year period due to inflation.

Considering the implications of its first decision, the court reasoned that adopting the trustee's position would essentially convert fiduciaries into "bailees" of money and would risk eroding the duties of fiduciaries to invest prudently with an eye toward, among other considerations, inflation.[4] The court in *Williams* noted that, "absent clear and controlling guidance from New York case law precisely on point," it saw no reason not to assume that the value of the trust under the trustee's care should have at least kept pace with inflation.[5]

As shown in the *Williams* decision, therefore, a good argument may be made that "lost capital" means more than a loss in the nominal value of trust assets. Under the right facts, including a long span of years where there has been substantial inflation, it may mean that there has been a loss in the real value, or purchasing power, of trust assets.

Awarding Interest

When should simple or compound interest be awarded, and who gets it?

The case law is clear that a beneficiary who establishes that a fiduciary has breached the duty to invest trust assets prudently may seek "interest" under CPLR 5001 on the capital lost by reason of the breach. What is less clear is when compound interest should be awarded, and how interest should be allocated among the remainder and income beneficiaries.

As to the first question, New York courts have routinely recited that "[w]hether interest is awarded, and at what rate, is a matter within the discretion of the trial court." *Janes*, 90 N.Y.2d at 55. Nevertheless, there are bounds on a court's discretion, and also some confusion as to when a court may award compound interest. For instance, in *Janes*, the Court of Appeals let stand the Fourth Department's adoption of a "lost capital" damages calculation that included compound interest, even though the trustee was guilty only of simple negligence. Id. at 55, 56.

Some older case law, however, ignored in *Janes*, suggests that compound interest may only be awarded where the trustee is guilty of "bad faith" or similar malfeasance. See, e.g., *Brown v. Knapp*, 79 N.Y. 136, 145 (1879); *Matter of Revson*, 86 A.D.2d 872, 875 (2d Dept. 1982). The result in *Janes* suggests there is no longer a "bad faith" requirement for awarding compound interest, but the issue is not firmly settled since the Court of Appeals did not specifically address the question or explicitly disapprove prior inconsistent case law.

The other part of the question—which beneficiaries are entitled to interest—is even harder to answer, but a plausible argument can be made that the answer should turn, at least in part, on whether the court awards compound or simple interest. Again, the case law does not provide much guidance.

The question of who is entitled to the interest is especially important where a court applies the traditional "lost capital" formula, which views the "lost capital" as the difference between the beginning and ending nominal values of relevant trust assets. Since remainder beneficiaries are entitled to trust principal, while income beneficiaries are entitled to any "income" earned on the principal, logic would seem to dictate that the remainder beneficiaries receive only the difference between the beginning and ending nominal values of relevant trust assets, while the income beneficiaries receive any interest awarded. Even then, allocation of simple interest at a statutory rate of 9 percent to the income beneficiaries, while the remaindermen collect only on their "money-back guarantee," seems to unduly favor the income beneficiaries. Where else in today's market could income beneficiaries earn a 9 percent income yield in their assets?

When compound interest is awarded, however, truly inequitable consequences may result. Allocating an entire compound interest award to the income beneficiaries would clearly give them a windfall to the detriment of remaindermen. Allocating some portion of a compound interest award to remainder interests, in contrast, may be seen as compensation for the trustee's failure to maintain the real value of relevant trust assets over the long term.

Neither New York case law nor any of the major secondary sources explicitly addresses this issue. Some commentators state that a court has discretion to allocate damages among remainder and income beneficiaries as fairness might require, without offering detailed guidance on the reasoning that should drive the court's allocation. See, e.g., George Gleason Bogert, "The Law of Trusts & Trustees," §705, at 238. A close analysis of the damages awarded in *Matter of Mendleson*, 46 Misc.2d 960 (Surr. Ct. Albany Co. 1965), however, reveals that the remainder interests were allocated only the difference between the nominal values of the misinvested trust assets (i.e., the nominal "lost capital"), while the income beneficiaries received all (simple) interest awarded. Id. at 978.

One source of the confusion over allocating damages may be certain conceptual tensions inherent in the "lost capital" damages formula itself. On the one hand, some courts seek to "restore" a trust and its beneficiaries to the position they would have been in if the fiduciary had not acted imprudently. This approach reveals an attempt, with the benefit of hindsight, to approximate the value of the trust if the fiduciary had not acted imprudently. See, e.g., *Saxton*, 274 A.D.2d at 121; *Matter of Acker*, 128 A.D.2d 867, 867 (2d Dept. 1986).

As the Court of Appeals in *Janes* made clear, however, New York law does not yet explicitly endorse a damages remedy that requires courts to speculate what returns might have been achieved had the fiduciary invested trust assets differently. Viewed from this conceptual frame, the "lost capital" remedy is, for better or worse, meant to be a simple, mechanical, bright-line formula that produces whatever result it produces. Seemingly, no desire to compensate trust beneficiaries for lost investment opportunities or the effects of inflation should influence the award of damages. Unfortunately, this second approach is capable of producing inequitable results, as the court recognized in *Williams*. It remains to be seen how these conceptual tensions will be resolved by the courts.

Calculating 'Income Credit'

How should the "income credit" in favor of the trustee be calculated?

The "lost capital" damages formula requires courts to apply certain credits in favor of the fiduciary that reduce the fiduciary's surcharge. The most commonly applied credit is for income (e.g., dividends, interest, rents) attributable to the negligently retained assets over the period of breach. So, returning to the earlier example, if negligently retained assets worth $1 million when a prudent fiduciary should have sold them, are then sold for $800,000 ten years later, any interest computed on the $1 million would be offset by any income earned over the 10-year period of breach. Thus, if a court awarded 9 percent simple interest, and the actual income attributable to the retained assets was $400,000, the net interest award to income beneficiaries would be $500,000.[6]

All is not as simple as it seems, however, especially where a court awards compound interest. One issue is whether "income attributable to the asset" means gross income earned by the asset that is paid into the trust, or whether it means net income distributed to the income beneficiaries

(after deducting for the payment, out of income, of certain trustee commissions, administration fees and taxes). The difference can be significant, especially over a long period of breach.

Moreover, where compound interest is awarded, should the income credit be applied in "real time" (i.e., as income from the negligently retained assets was paid to the trust), or simply be deducted at the end of the calculation, as a lump sum from the statutory interest calculated on the "lost capital"?

In other words, if compound interest at a statutory rate of 9 percent is calculated on $1 million over a 10-year period of breach, total interest would come to $1,367,364 (almost $500,000 more than simple interest on the same $1 million of principal). If the $400,000 actually received as income from the negligently retained assets was paid into the trust in annual installments of $40,000, the question then is whether the income credit should be deducted "annually" from the compound interest accruing year to year or deducted as a lump sum at the end of the calculation. There are sound economic and accounting arguments for both approaches, but there is no specific discussion in any New York case acknowledging the different methods, much less why one may be preferable to the other as a matter of law. In the end, the two methods will produce significantly different damage awards, so the issue is more than academic.

Looking again behind the scenes in *Janes*, we see a reality not reflected in the Court of Appeals' opinion. In *Janes* (and later in *Saxton* and *Rowe*), the objectant's expert witness' "lost capital" calculation applied the income credit "continuously" as it was paid. Consequently, although no New York case specifically required this method, the objectant in *Janes* actually calculated damages in a manner that reduced the net damages figure that would have been obtained had the literal instructions stated in the case law been followed. So, while beneficiaries may argue that the case law apparently instructs courts to deduct the income credit in a single lump sum, without interest, at the end of the damages calculation, trustees, by accessing the relevant court files, can demonstrate that the damages calculation actually adopted in *Janes* (and *Saxton* and *Rowe*) did otherwise.

To further complicate the analysis, courts may also take into account the federal and state capital gains taxes which would have been incurred by the beneficiaries had any negligently retained stock been sold. See, e.g., *Saxton*, 274 A.D.2d at121; *Matter of Dumont*, 4 Misc.3d 1003(A) (Surr. Ct. Monroe Co. 2004).

Commissions, Attorney's Fees

When may a court award a return of commissions and attorney's fees?

Yet another unresolved issue regarding damages in the trust context is whether a court may order the trustee to return commissions received by the trustee during the period of breach. Once again, *Janes* did nothing to clarify this issue and may, in fact, have compounded the confusion.

In *Janes*, even though the trustee was guilty of simple (as opposed to gross) negligence, the trustee was ordered to return commissions it had received during the period of breach. 165 Misc.2d at 758. There is significant New York case law, both pre-dating and post-dating *Janes*, however, which holds that, absent a finding that the trustee engaged in self-dealing or fraud, a court may not order a return of commissions. See, e.g., *Saxton*, 274 A.D.2d at 121.

With respect to whether a trustee may be ordered to pay a prevailing objectant's attorney's fees incurred litigating against the trustee, again there is authority on both sides of the issue. In *Saxton*, the Third Department held that New York law provides no basis for awarding an objecting beneficiary attorney's fees, absent bad faith or other egregious misconduct by the trustee. Id. In *Public Service Co. of Colorado v. Chase Manhattan Bank, N.A.*, 577 F.Supp. 92, 110 (S.D.N.Y. 1983), however, a corporate trustee was ordered to pay plaintiff's attorney's fees in an action where the trustee was found to have negligently supervised trust assets over a period of many years, even though there was no finding of bad faith or self-dealing.

Final Thoughts

Virtually all of the "lost capital" cases in New York involve a corporate trustee. While there is statutory authority in New York requiring corporate trustees to use their "special investment skills,"[7] this higher standard would seemingly come into play only when the finder of fact must determine whether the trustee has committed a breach. But when calculating damages and applying the various components of the formula discussed in this article, would a court view an individual trustee who has been negligent any differently than an errant corporate trustee? Again, the answer remains to be seen.

Although *Janes* is often cited as the definitive statement from the Court of Appeals concerning how damages should be assessed when a fiduciary mismanages trust funds, a close analysis reveals that many difficult issues remain unsettled. Until the Court of Appeals examines these issues, attorneys on both sides of a "lost capital" case will have good arguments to support their respective positions.

1. See *Matter of Janes*, 165 Misc.2d 743, 758 (Surr. Ct. Monroe Co. 1995), aff'd as modified, 223 A.D.2d 20 (4th Dept. 1996), aff'd, 90 N.Y.2d 41 (1997). In 1992, the Restatement (Third) of Trusts proposed the "total return" damages measure (i.e., damages based on the projected returns that would have been earned if the fiduciary had properly invested trust assets) as a replacement for the traditional "lost capital" measure. See Restatement (Third) of Trusts §205 et seq. (1992). Only a few states have adopted this measure, although federal courts routinely apply it in the ERISA context. See, e.g., *Donovan v. Bierwirth*, 754 F.2d 1049, 1056 (2d Cir. 1985).

2. The following discussion of the allegations in *Williams* are taken from the court's two opinions on the damages issue, reported at 199 F.Supp.2d 189 (S.D.N.Y. 2002), and 296 F.Supp.2d 453 (S.D.N.Y. 2003). The court subsequently vacated the latter decision with the consent of the parties.

3. 199 F.Supp.2d at 195.

4. 296 F.Supp.2d at 458.

5. 296 F.Supp.2d at 459.

6. In this example, the total damages awarded would be $700,000, calculated as follows: $1 million (value of the assets when they should have been sold) plus $900,000 (simple interest at 9 percent) minus $800,000 (the value of the assets when sold) minus $400,000 (the actual income attributable to the assets). If the net interest award of $500,000 is allocated to the income beneficiaries, $200,000 would be allocated to trust principal based on the nominal difference between the beginning value ($1 million) and the ending value ($800,000) of the assets.

7. EPTL §§11-2.2(a)(1), 11-2.3(b)(6).