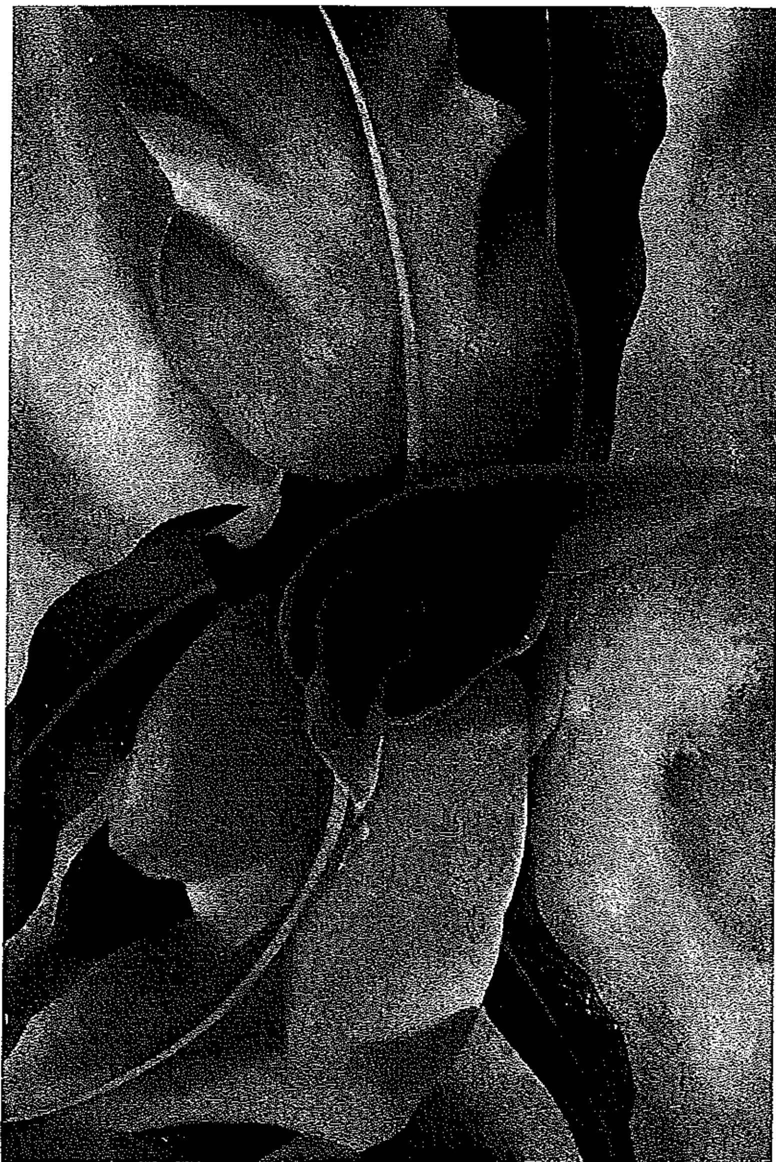
A PRIMEDIA Publication

Trusts&Estates

The Journal of Wealth Management for Estate-Planning Professionals—Since 1904



Georgia O'Keeffe's "Corn No. III" sold for $1.37 million at a recent Christie's auction, p.6

February 2006

BRIEFING

12 **Uncle Sam's Gift:** Roth 401(k) • **Keeping It Real:** *Estate of W. Hughes* • **Valuing Lottery Payments:** *Estate of Freeman* • **PLR 200550006:** Information enough • ***Senda*:** Affirmed • **Excess Business Holdings:** How not to ask for an extension • ***Rudkin*:** How deductible are investment advisory fees? • ***T&E* Board:** Appointments

FEATURES

20 **A Brass Ring for IRD:** Selling interests in trusts holding unrealized income might achieve capital gains treatment
By Michael J. Jones

28 **The Incapacitated Trustee:** Drafting trusts for protection in case a fiduciary becomes *non compos mentis*
By Maureen S. Bateman and Mark W. Smith

36 **Get FIT:** Family incentive trusts help trust fund babies shape up
By James E. McNair III, Gregory J. Rupert and Cynthia L. Gausvik

42 **The Buck Stops with You:** Fiduciaries must identify and file viable claims against brokers
By Craig D. Stein, Joshua S. Pinsky and Jonathan P. Cohen

COMMITTEE REPORT
PHILANTHROPY

50 **Stretch This:** Using CRTs to help heirs of employees at companies that liquidate retirement accounts at death
By Christopher R. Hoyt

54 **Scandal Is a Good Teacher:** Lessons from the King Foundation disaster
By Michelle D. Monse

PERSPECTIVES

61 **Wrestling with Decoupling**
By Jeffrey A. Cooper

The Buck Stops with You

When trusts or estates suffer investment losses, fiduciaries are obligated to identify and file viable claims against brokers

By **Craig D. Stein**, partner, **Joshua S. Pinsky**, associate and **Jonathan P. Cohen**, associate, Stein, Rosenberg & Stein, P.A., Boca Raton, Fla.

Trustees and estate representatives are often required to invest the assets of a trust or estate in securities markets. Depending on the jurisdiction, these trustees may have the power to fully or partially delegate this responsibility to an investment advisor or securities broker.

But what if there are investment losses because of the broker's or brokerage firm's misconduct? The trustee is obligated to find and pursue any viable claim that can recover such losses. While trustees are not expected to have a complete working knowledge of securities litigation, or to evaluate a securities claim thoroughly, it is possible for them—and within their power—to identify and file securities claims. It's therefore crucial for fiduciaries to understand exactly how to identify potential claims.

Initially, when a trustee reviews the current and past investment portfolios of a trust or estate, he should pay particular attention to investments that either lost money or significantly underperformed compared to standard market indicators like Dow Jones, NASDAQ and S&P 500. Trustees also should note when large concentrations of securities are held without any effort to diversify or apply hedging strategies. But just because an account or investment lost value doesn't necessarily

imply that a stockbroker or firm acted improperly. Also, irrespective of losses, trustees should look for any periods of high activity within an investment account, or frequently paid commissions or fees. If any of these circumstances are discovered, the trust or estate may have a cause of action based on common securities claims: unsuitability (including overconcentration), churning, unauthorized transactions, negligence, fraud, breach of fiduciary duty and negligent supervision, as well as any statutory claim that may apply.

DUTY OF BROKERS

A broker and an investor share a formal relationship based on trust and confidence. Not every jurisdiction agrees on whether or when a fiduciary relationship exists between a broker and an investor. But, as one Florida court put it: A broker must "act with the utmost honesty and good faith."[1] Generally, whether a broker is acting as a fiduciary relates to the functions he performs for the investor. Each situation involving a broker-investor relationship must be evaluated carefully in accordance with controlling law, and with respect to the nature of the specific relationship.

In *Lieb v. Merrill Lynch, Pierce, Fenner and Smith*,[2] a federal district court in Michigan provided a detailed analysis of the broker's fiduciary duties to investors. The *Lieb* court distinguished discretionary accounts (in which the broker has a continuous obligation to manage the account) from nondiscretionary accounts (in which the customer and broker confer as to a particular transaction, but the broker has no continuing duty towards the account once the transaction is complete).

While a broker's duty in a discretionary account is a bit more obvious—as the broker retains significant continuous control—his duty in a nondiscretionary account requires closer examination. In *Gochnauer v. A.G. Edwards & Sons, Inc.*,[3] the court used key factors set forth by the *Lieb* court to determine the following fiduciary responsibilities of an investment advisor in the one-time nondiscretionary account scenario: "(1) the duty to recommend [investments] only after studying it sufficiently to become informed as to its nature, price, and financial prognosis; (2) the duty to perform the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self dealing; (5) the duty not to misrepresent any material fact to the transaction; and (6) the duty to transact business only after receiving approval from the customer."

Questions may exist as to whether the responsibilities of investment advisors or brokers rise to the level of fiduciary duties. But within the industry, there's little doubt as to what many of those responsibilities are. The six fiduciary duties listed in *Gochnauer* are similar to the duties or responsibilities of a securities broker established by the Securities and Exchange Commission (SEC) and the rules of self regulatory organizations such as NASD and the New York Stock Exchange. While no independent cause of action exists for violation of industry rules, certain rule violations, such as unsuitability, overconcentration, churning, etc., typically form the basis for negligence or fraud causes of action. These "duties" or "responsibilities" promulgated by industry regulators appear to be equivalent to, or near equivalent to, the generally accepted definition of "fiduciary duty," even if not termed as such.

Not every jurisdiction agrees on whether or when a fiduciary relationship exists between a broker and an investor.

CAUSE OF ACTION

While violations of financial industry rules may not be used as an independent, private cause of action, they may form the basis for a negligence or fraud claim. In a negligence claim, the rules dictate the duty of the broker, and the broker's failure to follow those rules is a breach of this duty. Although violation of these rules may form the basis of a fraud claim, such claims often are controlled by statute and differ from state to state. For instance, under Florida's Securities and Investor Protection Act,[4] intent or knowledge

is not required to prove a fraud claim. Similarly, in *Newsom v. Dean Witter Reynolds, Inc.*,[5] a Florida state court held that simply making unsuitable trades constitutes fraud.

Once it is determined that a cause of action exsists, a claim should be filed in the appropriate forum. Previously, most securities claims were tried in either federal or state courts. However, the Supreme Court's 1987 decision in *Shearson/American Express, Inc., v. McMahon*,[6] held that claims under Section 10(b) of the Securities Exchange Act could be adjudicated under predispute arbitration agreements. Most securities cases involving customers who have claims against brokers and brokerage firms are brought before NASD (the NASDAQ regulator) or NYSE arbitration panels. Trying an arbitration case is different from civil litigation: Arbitration procedures disallow certain discovery mechanisms, limit the ability to appeal, and do not provide for jury trials.

BASIS FOR CLAIMS

There are five main causes that form the basis for fraud and negligence claims against brokers:

(1) **Unsuitability and overconcentration**: "Unsuitability" is the basis for many negligence and fraud claims against brokers. Once losing or underperforming investments are identified, each should be reviewed individually and relative to other investments in the account. The trustee also must assess the trust or estate portfolio for any securities holdings that appear to be overconcentrated or disproportionate to the rest of the portfolio.

Stockbrokers have a duty to know their customer's financial situation and to recommend suitable investments.[7] The NASD requires its members to make efforts to obtain specific relevant information about the customer. Brokers must evaluate the customer's financial status, tax status, investment objectives and, according to NASD Rule 2310, "other such information used or considered to be reasonable by such [NASD] member or registered representative in making recommendations to the customer."

Similar violations of industry rules often exist when brokers don't properly advise an investor who has an overconcentrated position in one company or one sector. A broker must advise such a client to sufficiently diversify or apply hedging strategies such as collars, forward sales or exchange funds. For instance, such a situation may occur when an investor who earns a modest salary,[8] suddenly has one investment appreciate exponentially in value to $10 million. As a result of the appreciation, the investor has the majority of his eggs in one basket. A prudent broker would have that investor diversify his portfolio, or apply a hedging strategy to protect the investor's new wealth.

> Two key elements in most churning cases are control and excessive trading. Even if the account profits, a churning claim can be won.

(2) **Churning**: In *Ruiz v. Charles Schwab & Co., Inc.*, the federal district court for the southern district of New York ruled that "[a]n investment advisor, as well as a broker-dealer, can be liable for 'churning' under Section 10(b) of the Securities Exchange Act of 1934."[9] In a similar case, *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[10] the U.S. Court of Appeals for the Ninth Circuit ruled: "Churning occurs when a securities broker buys and sells securities for a customer's account without regard to the customer's investment interests, for the purpose of generating commissions." Further, the court in *Newsom v. Dean Witter Reynolds Inc.*[11] described churning as a "particularly vicious and fraudulent course of conduct deserving of the severest condemnation."

Two key elements in most churning cases are control and excessive trading. Control of the account is determined from the circumstances surrounding the relationship, as in *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith*, and the excessiveness depends on the type of account. While frequent trading is expected in a trading account, it's not expected in an investment account that exists to preserve its principal.

Certain patterns are indicative of churning. One involves selling a security and immediately buying back either the same security or another security that isn't much different. For example, a broker sells a technology stock, and then uses those proceeds to buy another stock in the same sector.

Ratios have been developed to help detect if there was excessive trading and possibly "churning." The use of these ratios, however, is only applicable to accounts where there is at least some level of control on the part of the broker. Factors such as the broker's level of control, along with the investor's objectives and experience will determine whether use of these ratios is appropriate.

The "turnover ratio" can be used to determine how many times the full value of an account has been traded in a year. The turnover ratio is calculated by dividing the total cost of purchases by the average net equity in

the account. The Southern District of New York, in *Rolf v. Blyth, Eastman, Dillon & Co., Inc.*,[12], determined that a turnover ratio of six or higher (that is to say a complete turnover more than once every two months) is evidence of excessive trading, but not necessarily churning. In another Ninth Circuit case, the court found churning did exist for an account with a turnover ratio between eight and 11.5.[13].

A similarly applied "cost-to-equity ratio" divides the cost of the securities by the average net equity, determining the rate of return against the commissions and other charges. The cost of securities includes, for example, commissions paid and margin interest accrued. In other words, the cost-to-equity ratio measures the required rate of return to pay for the cost of the securities without turning a profit.

It's vital to note that churning can occur regardless of whether or not the account increased in value. Similarly, excessive trading can occur even when commissions are not earned.

(3) **Unauthorized transactions:** Unauthorized trading also can form the basis of a fraud claim. A broker can execute trades in a customer's account only when directly authorized or if the broker has been granted discretion by the customer prior to the purchase or sale. Any breach of this requirement amounts to unauthorized trading.

(4) **Misrepresentation:** Misrepresentation or omission of a material fact may be a foundation for a cause of action in negligence, fraud or other statutory claims.[14] If a broker misrepresents himself, his firm or an investment opportunity, and an investor relies on that misrepresentation to his detriment, the investor may have a claim against the broker and his firm. If that misrepresentation was, for example, due to careless research or poor communication on the part of the broker, the investor still may have a negligence claim based on the broker's failure to uphold his duty to properly research or communicate with clarity.

If the broker misrepresented material facts to induce a reaction harmful to the investor, a common law fraud claim may exist. It's important to note that each state may have different interpretations as to what constitutes fraud with regard to securities transactions. Some states have securities fraud statutes, which reduce fraud in a securities context to any misrepresentation inducing the sale or purchase of securities.

(5) **Failure to supervise:** Generally, securities claims are filed against the individual broker who serviced a customer's account, along with the firm the broker was working for during the relevant period. Claims against the firm can include any, if not all of the claims asserted against the individual broker.[15]

There are, however, some claims unique to firms or supervisory personnel that are not brought against the individual brokers. Firms and sometimes managers face claims of negligent supervision. The SEC and self-regulatory organizations have strict rules regarding supervision of brokers and accounts. Managers are obligated to sign-off on many documents and most transactions, and are ultimately responsible for allowing transactions to occur. If negligent or fraudulent transactions occur with supervision, firms and managers can be liable for allowing those transactions. The firm also can be held liable if there is a complete failure to supervise transactions.

DAMAGES

No cause of action is complete without some version of damages. Each securities claim is unique and requires careful evaluation not only of the extent of the damages, but also the nature of the damages. "In a securities claim, there is great flexibility in awarding damages," noted the Ninth Circuit in *Arrington v. Merrill Lynch*.[16]

Churning claims are different than most other claims in that the investor may have seen his portfolio grow despite the excessive trading—yet he still may claim a return of commissions for unnecessary transactions. Overall profitability does not excuse a broker of his liability.[17] If the investor lost money as a result of churning, he may claim those losses in addition to a return of commissions.

In suitability claims, the damages may be the losses incurred by an investor through investments that should not have been recommended under suitability rules. Similarly, if an investor should have been, but was not advised to sell an unsuitable investment, losses from those investments may be sought as damages.

The most common form of damages is referred to as "out-of-pocket." If an investor opens an account with $10,000 and never funds the account further, then his out-of-pocket damages could never exceed $10,000.

An investor also may claim more than just out-of-pocket losses. If an investor parlayed a $10,000 investment into $1 million, only to lose $800,000 later, he may claim damages of $800,000, though only $10,000 is out-of-pocket.

As with many claims, an injured investor may seek well-managed portfolio damages, prejudgment interest, post-judgment interest, attorney fees and expenses. "The well managed account measure of damages purports to allow a plaintiff to recover the difference between what his portfolio was worth at the end of the defendant's fraudulent conduct and what his portfolio should have been worth had it been managed without fraud."[18] Additional requests are dependent on the jurisdiction.

Punitive damages also may be considered. In *Mastrobuono v. Shearson Lehman Hutton, Inc.*,[19] the U.S. Supreme Court stated that puni-

tive damages are reasonable if the misconduct is willful and malicious.

It is widely understood that trustees and estate representatives owe a fiduciary duty to the beneficiaries and to the trust or estate itself. As a result of their duty and ability to bring a claim on behalf of the trust or estate, such fiduciaries must identify and pursue any securities claims if actionable. In *Jones v. Ellis*,[20] the Supreme Court of Alabama eloquently discussed the prudent advisor rule, holding that "a trustee is under a duty to the beneficiary to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property." The court also said that "unlike the good business judgment rule [applied to corporate directors], there is no presumption of good faith with the dealings of a trustee; consequently, a showing of fraud is unnecessary to impose liability, because a trustee is liable for losses occasioned by his mere imprudent management of the trust." A trustee has a duty to protect and serve the trust or estate, and therefore has a duty to evaluate if the trust or estate has a claim against a broker. While trustees may not be expected to thoroughly evaluate a securities claim, it is important that they understand how to identify a potential claim when it arises. ∎

Endnotes

1. *Hayden Stone, Inc. v. Brown*, 218 So.2d 230, 235 (Fla. 4th DCA 1969).
2. *Lieb v. Merrill Lynch, Pierce, Fenner and Smith*, 461 F. Supp. 951 (E.D.Mich. 1978).
3. *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042 (11th Cir. 1987).
4. Fl. St. 517, *et al.*
5. *Newsom v. Dean Witter Reynolds, Inc.*, 558 So.2d 1076, 1077 (Fla. 1st DCA 1990).
6. *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).
7. *See* NYSE Rule 405, which requires brokerage firms and associated persons to "be personally informed as to the essential facts relative to the customer and to the nature of the proposed account;" *see also* NASD Rule 2310, which states that "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his or her other security holdings and as to his or her financial situation and needs."
8. According to the U.S. Census Bureau report released in 2004, the median household income was $44,389.
9. *Ruiz v. Charles Schwab & Co., Inc.*, 736 F. Supp 461 (S.D.N.Y. 1990).
10. *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498, 1501 (11th Cir. 1985).
11. Further, the court in *Newsom v. Dean Witter Reynolds Inc.* 558 So.2d 1076-77 (Fla. 1st DCA 1990) cited *In re Behel, Johnsen & Company*, 26 SEC 163 (1947).
12. *Rolf v. Blyth, Eastman, Dillon & Co., Inc.*, 424 F. Supp 1021, 1039 (S.D.N.Y. 1977).
13. *Hecht v. Harris Upham & Co.*, 430 F.2d 1202, 1212 (9th Cir. 1970).
14. *Interstate Securities Corporation v. Hayes*, 920 F.2d 769 (11th Cir. 1991).
15. This is nothing more than a claim upon the theory of *respondeat superior.*
16. *Arrington v. Merrill Lynch*, 651 F.2d 615, 621 (9th Cir. 1981).
17. *Levine et al v. Futransky and E.F. Hutton Co.*, 636 F. Supp. 899 (N.D. Ill. 1986).
18. *Laney v. American Equity Investment Life Ins. Co.*, 243 F. Supp.2d 1347, 1352 (M.D. Fla. 2003).
19. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995).
20. *Jones v. Ellis*, 551 So.2d 396 (Ala. 1989).

COLLECTORS' SPOTLIGHT

American Masters: "Meat for the Tribe," an 1891 oil by American artist Charles Marion Russell, who's famous for his Wild West-themed paintings, sold for $1.5 million at Christie's "Important American Paintings, Drawings & Sculpture Sale" in New York on Dec. 1, 2005.

Wish you had someone to help resolve client social services issues?

You're probably an expert in a number of fields—but case management may not be one of them. That's why Intervention Associates is here. Since 1986 we've been serving older adults, the chronically mentally ill, and physically disabled adults and children by assisting with:

- Assessments
- Crisis Intervention
- Home or Facility Care
- Information/Referrals
- Advocacy

A subsidiary of The Friends Life Care at Home® system
1777 Sentry Parkway West, Suite 210 Dublin Hall
Blue Bell, PA 19422
(610) 254-9001 • 1-800-254-9708

www.interventionassociates.org