WACHTELL, LIPTON, ROSEN & KATZ                    January 13, 1975

To Our Clients:

<u>Total Return Concept Rejected. Each Security in a Portfolio Must Separately Meet the Prudent Man Test</u>

In a landmark decision which will have tremendous impact on the investment policies of trustees and other fiduciaries the New York Court of Appeals has held that each particular security in a portfolio must individually meet the prudent man test and that an overall increase in the total value of the portfolio will not excuse a single imprudent investment. <u>The Bank of New York</u> v. <u>Spitzer</u>, N.Y.L.J. Jan. 10, 1975, p. 1, col. 7. This rejection of the total return concept has special significance in light of the adoption of the prudent man test in the Pension Reform Act of 1974. While not binding on a court interpreting the Pension Reform Act, this holding of New York's highest court will undoubtedly be of great weight in such a case and it must be assumed that the total return concept will not excuse an investment attacked as imprudent under the Pension Reform Act.

The <u>Spitzer</u> case arose on the statutorily mandated quadrennial accounting of a common trust fund managed by The Bank of New York. The guardian appointed to review the accounting sought to surcharge the trustee bank for four security investments out of the many in the trust fund's portfolio during the four-year period under review. In rejecting the total return concept the Court said:

> "The fact that this portfolio showed substantial over-all increase in total value during the accounting period does not insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged . . . . To hold to the contrary would in effect be to assure fiduciary immunity in an advancing market such as marked the history of the accounting period here involved. The record of any individual investment is not to be viewed exclusively, of course, as though it were in its own water-tight compartment, since to some extent individual investment decisions may properly be affected by considerations of the performance of the fund

> as an entity, as in the instance, for example, of individual security decisions based in part on considerations of diversification of the fund or of capital transactions to achieve sound tax planning for the fund as a whole. The focus of inquiry, however, is nonetheless on the individual security as such and factors relating to the entire portfolio are to be weighed only along with others in reviewing the prudence of the particular investment decisions."

Following the popularization of the total return concept by the Ford Foundation in the mid-1960's and its wide acceptance during the bull market of 1967-69 by trustees and investment managers, it was argued that the application of the prudent man test to each individual investment in a portfolio was an antiquated concept which should be abandoned in the age of performance investing. The case was put forward most persuasively in an article published in 1971, Cohen, The Suitability Rule and Economic Theory, 80 Yale L.J. 1604 (1971). See also Belliveau, Discretion or Indiscretion, Institutional Investor 65 (August 1972). The legal validity of the total return concept became of great significance in the post-1968 bear market when, many of the earlier years' high-flyers proved to be the creatures of creative accounting, improper promotion and, in some cases, fraud.

The judicial test of the total return concept might have come in a widely noted case, Trustees of Hanover College v. Donaldson, Lufkin & Jenrette, Inc., Civil No. 71-C686 (S.D. Ind. 1971). The College alleged that the federal securities laws imposed a customer suitability requirement on brokers and investment managers and that this suitability requirement was violated by Donaldson, Lufkin with respect to 16 specific investment transactions out of a total of 1600 it undertook as the broker-manager for the College's endowment fund, despite the fact that during the period in question the total return on the portfolio averaged 6.5% per year. The Hanover College case was settled before trial and the precise question remains unanswered. However, the Spitzer case adumbrates what now might be expected in the suitability case when it arises. See, Lipton, The Customer Suitability Doctrine, PLI Fourth Annual Institute on Securities Regulation (1973).

With the increasing concentration of investment funds in bank trust departments and other professional managers subject to the prudent man rule, the rejection of the total return concept will likely have a major adverse effect on the availability of investment funds for venture capital and other speculative purposes. Trustees and investment managers will be reluctant to take a "flyer" in a venture capital deal with a small part of a portfolio, if they face the possibility of surcharge even though their overall investment performance is good. It is difficult to believe that the Court in Spitzer intended this result, but the Court's limitation of examples of total portfolio considerations to diversification and tax planning will most likely have such effect on the normally conservative bank trustees and investment managers.

The opinion in the Spitzer case contains some alleviation of the rejection of the total return concept through the Court's definition the standards determining whether the prudent man test has been met. The Court said:

> ". . . with respect to each investment the trustee acted in good faith and cannot be said to have failed to exercise 'such diligence and such prudence in the care and management [of the fund] as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs' . . . . It was not shown in any instance that the losses to the trust fund resulted from imprudence or negligence. There was evidence of attention and consideration with reference to each decision made. Obviously, it is not sufficient that hindsight might suggest that another course would have been more beneficial; nor does a mere error of investment judgment mandate a surcharge. Our courts do not demand investment infallibility, nor hold a trustee to prescience in investment decisions . . . .
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> "Whether a trustee is to be surcharged in these instances, as in other cases, must necessarily depend on a balanced and perceptive analysis

> of its consideration and action in the light of the history of each individual investment, viewed at the time of its action or its omission to act."

While this language would appear to protect the well researched, well considered venture capital investment, the Spitzer case will still deter many trustees and investment managers from all but the commonly accepted "sound" investments. In addition to drying-up venture capital, this could exacerbate the two-tier market problem for equities and along with the acturial disadvantages to equity investment built into the Pension Reform Act of 1974, could result in a long-term fundamental shift by institutional investors from equities to debt.

It is hoped that the next court to consider the total return concept will make it clear that even if it is rejected, such rejection is not intended to discourage properly chosen venture capital or speculative investments.

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