Kenney Ruling Underscores Importance of Diversifying Investments

Executor who failed to act after gaining control of decedent's portfolio liable for $3.5 million surcharge.

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Assume that an individual dies with a multi-million-dollar stock portfolio. One of the first things an executor should do is review the portfolio and decide whether to sell all of the securities, only some or none. The law requires an executor to protect the estate's value for the beneficiaries, and a prompt review of the securities is essential.

When must the review be done? There's no fixed date; the time can vary according to the size and the holdings in the portfolio. But what if there's a long delay, or a review is never done—or is done but no action taken? What's the executor's liability? What happens if the value of the portfolio declines?

The problem is particularly serious when the portfolio is concentrated in one or a few securities. With the enactment of the Prudent Investor Act, effective in 1995, New York codified an almost unconditional duty to diversify concentrated positions. The resulting jurisprudence has created grave danger for fiduciaries who fail to diversify promptly. There are respectable expert witnesses who've been willing to testify that it's a breach of fiduciary duty, under certain circumstances, not to diversify immediately on gaining control of the assets—in as little as a week or less. Courts have assessed damages against fiduciaries using a model where the portfolio's actual performance is measured against what the estate would have received if the fiduciary had liquidated the concentration the very day of gaining control of the asset and then adding to the resulting difference interest compounded at 9% per annum. Because the estate's assets received a date of death step-up in basis, there would be no concern regarding capital gains tax.

Matter of Kenney

A recent example of the danger of failing to promptly diversify is the case of *Matter of Kenney*. This case dealt with the estate of Marjorie Kenney, who died in June 2007. Both Marjorie's husband and only daughter, Alice, predeceased her; and Marjorie left her estate to the Alice P. Kenney Memorial Foundation (the Foundation).

Marjorie's investment portfolio was valued at approximately $4.7 million at the time of her death. About 86% of the securities in the portfolio, however, consisted of General Electric stock. The executor was the family's longtime attorney and knew of the concentrated stock holding but decided not to diversify. In fact, it wasn't until 2016—nine years after Marjorie's death—that he sold most of the stock for a loss compared with what he would have gotten had he sold shortly after Marjorie's death.

The New York state attorney general (AG), acting on behalf of the Foundation, objected to the executor's failure to diversify and sought to surcharge him, in other words, to charge him with damages attributed to the loss. The AG noted that the nine-year return on the General Electric stock was negative. It was -0.53% as compared with the stock market's positive return of 5.9% (based on the S&P 500).

According to the AG, the executor should have sold the GE stock far earlier. The AG argued that the executor should have sold by Sept. 7, 2007, which was just two and one-half months after the death, and which was when a small amount of the stock was sold.

Coincidently, this wasn't long before the stock market crash in 2008-09. While courts say that fiduciaries aren't held to a standard of foreseeing the future and aren't to be judged with the benefit of hindsight, the unpredictability of securities markets makes it dangerous to hold concentrated positions, because diversified portfolios are much less vulnerable to retrospective attack when the whole market drops.

The Surrogate's Court agreed that the account should have been diversified, and it accepted the AG's proposed deadline of two and one-half months after death. The court calculated that if the executor had sold 95% of the stock on Sept. 7, 2007, the sales proceeds would have been approximately $3.35 million. The court then imposed 9% compound interest on that sum, which amounted to approximately $3.4 million for a total of $6.75 million for which the executor was held responsible. This amount was offset by actual sales of General Electric and other adjustments, with the result that the executor was surcharged $3,513,800, for the total "lost capital damages."

However, the AG sought more. The office argued that by failing to sell the stock, the executor deprived the Foundation of the benefit of reinvestment in a rising stock market. The court stated that by retaining the GE stock, the estate "lost the opportunity to reinvest the proceeds during a time when there was significant growth in the market."

This issue of "lost opportunity cost" will be decided later, but whether or not the court imposes an additional charge, the message is clear: An executor acts at his own peril if he doesn't promptly diversify concentrated holdings in a decedent's portfolio.