PASSING ON "A FREE LUNCH" IS NOT "ACTING WITH CARE, SKILL, PRUDENCE, AND DILIGENCE"

By Stewart Frank CPA/PFS AIFA
and
J. Ben Vernazza CPA/PFS TEP emeritus

The US Supreme Court has just handed down its second unanimous decision defining fiduciary legal requirements to "act with care, skill, prudence, and diligence" when selecting portfolio investments. Although both cases involved ERISA, the opinions clearly apply to all fiduciary laws in the USA.

In both Supreme Court cases, the respondents alleged to have breached their fiduciary duties by offering investments in higher priced mutual funds to Plan participants when materially identical lower priced institutional-class mutual funds were available. Had the lower priced funds been available to the Plan participants, their investment returns would have been better.

In *Hughes v Northwestern,* the newly decided Supreme Court case, Justice Sonia Sotomayor, writing for the unanimous court stated that *"… plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options."*

In the earlier case, *Tibble v. Edison International,* Justice Stephen Breyer writing for the unanimous court noted that ***"ERISA's fiduciary duty is "derived from the common law of trusts'"*** and that an ERISA fiduciary must discharge his responsibility "with [the] care, skill, prudence, and diligence," that includes … *"a continuing duty to monitor trust investments and remove imprudent ones"*… *"This continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset."*

Both cases were unanimous, which is unusual, and now is Law of the of The Land. Under this Supreme Court's standard, failure to take advantage of the "free lunch in investing" is a failure to "act with care, skill, prudence, and diligence" not to mention that the "common law of trusts", specifically requires diversification and failing to do so without examining the impact of special circumstances, is a material breach of fiduciary duty.

In Tibble Breyer says "**So long as a plaintiff's claim alleging breach of the continuing duty of prudence occurred within six years of the suit, the claim is timely (***i.e.* *the statute of limitations doesn't start to run until the imprudent actions stop and where imprudence continues the breach goes back to when it started, potentially to the inception of the fiduciary's stewardship and notwithstanding the statute of limitations***).**

Look for possible lawsuits regarding Common Law *"Failure to diversify on a reasonable basis in order to reduce uncompensated risk is ordinarily a violation of both the duty of caution and the duties of care and skill."* For the fiduciary to escape this fate it is important to have a procedural process showing how decisions were made including reasons why certain diversifiable assets were not utilized (e.g., category of investment was declined to be used by the settlor, other agreements or guidance, letter of wishes, EGT reasons, and so on).

The time has come for all fiduciaries to adapt a procedural process to diversify their portfolio(s) not only to avoid any future lawsuits, but primarily to achieve the money advantage expressed as *"The Only Free Lunch in Investing is Diversification"* by Nobel prize winners Markowitz, Fama, Booth, and other experts.

Stewart: sfrank@precisionfiduciary.com/ 248-227-8208 direct
` Ben: ben@benvcpa.com/ 831-239-6000 direct
Website: https://divtoolbox.com/