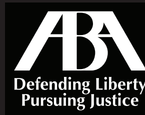
TRIAL PRACTICE JOURNAL



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From the chairs...

By the time you receive this edition of the *Trial Practice Journal*, another ABA year will have come to a close. During the past year our dedicated editors—Jason Pickholz, Nash Long and James Shelson—have worked hard to make the *Trial Practice Journal* even better. This year, for the first time, we published four editions of the *Journal*, each filled with practical articles on trial practice. With the invaluable assistance of our senior website editor Frank Knowlton, we have revamped our Committee's website. On our website you will now find program materials from past ABA Annual meetings and Section Annual CLE Conferences, prior editions of the *Journal*, links to important articles on trial practice, and tips to help you in your practice. As always, we have organized and participated in CLE programs on trial practice. At the Section Annual CLE conference subcommittee co-chairs Erin Asborno and Jeff Crockett organized a program for our Committee breakfast meeting on the use of jury consultants and the Committee hosted its Third Annual dinner for all Committee members. Thanks to all of our subcommittee co-chairs who helped to make this such a successful year.

As the new ABA year begins, there will be changes at the Trial Practice Committee. Linda Listrom, who has co-chaired the Committee for four years, will be leaving the Committee for a new position as co-chair of the Trial Evidence Committee. Brooks Burdette, who is a partner with Schulte Roth & Zabel LLP, will be joining Victor and Rich as a co-chair of the Trial Practice Committee. Under the leadership of Victor, Rich and Brooks, the Committee looks forward to even more success in the coming year.

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Editors' Notes

As noted in the last edition of the Journal, we are implementing suggested themes for each issue of this volume of the Journal. The theme of this issue is the use of documents at trial. In keeping with this theme, the Junior Brief column (on page 26), written by one of the Editorial Board, discusses basic tips for using exhibits. The article by Messrs. Munford and Shelson gives several examples of how to brief your trial motions. Finally, in their article on spoliation, Messrs. Stone and Klaus explain how the absence of documents can impact your case. Demonstrating our commitment that our suggested themes are not straightjackets, we have also included the second part of a series on modern portfolio theory. The suggested theme for our next issue (Fall 2006) is effective oral advocacy. Of course, the Editorial Board will also accept additional articles on topics of interest to the busy trial practitioner. Simply submit your article (8-12 pages) in MS Word format (with endnotes, not footnotes) to the editors at their addresses below.

Even if you do not have an article to submit, the members of the Editorial Board are soliciting suggestions for future themes to feature in the Trial Practice Journal. Please contact us with any suggestions or feedback! You can also stay connected to the Committee and Section activities through the Committee website, found at http://www.abanet.org/litigation/committee/trial_p.

Finally, the Editorial Board wants to give a big "Thank You" to Committee Co-Chair Linda Listrom, who is rotating off as Co-Chair with the close of the ABA year. Reviving the Trial Practice Committee periodical was one of her goals in taking on the position of Co-Chair. She made the Journal a priority of the Committee and allocated resources within the Committee and at her firm of Jenner & Block to make that happen. In short, she has been our biggest booster, coach and best critic. Thanks, Linda!

The *Trial Practice Journal,* published four times per year, prints articles, news, and book reviews on matters of interest to trial lawyers and trial judges. Send article submissions to any one of the following editors:

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TRIAL PRACTICE
Journal

Effective Motion Practice In Trial Courts

By Luther T. Munford and James W. Shelson

You only win the case for your client if you ask the court for relief and get it. You ask by submitting your request in a motion. This article discusses both how to write persuasive motions and supporting briefs, and how to persuade a judge that you are right—that you should win.

I. PERSUASIVE MOTIONS AND BRIEFS

1. The Purpose of Motions and Briefs is to Persuade

The motion and brief should state your legal theory and the reasons why your client should prevail. Persuasion depends on what you have to say, whether you say it in a professional manner that bolsters your credibility, and whether the judge is willing to listen. Make what you send a judge accurate, complete and "reader friendly." As Judge Richard Posner has said, the receptiveness of the judge depends on the distance he has to move philosophically and his resistance to moving that distance. Narrow arguments narrow the distance. A short, accurate brief lowers the resistance.

2. The Contents of Persuasive Motions and Briefs

a. Tell the judge immediately what you want and why you should win

You should tell the judge immediately what relief you want and why you are entitled to that relief. Do this in the first paragraph if possible, and certainly no later than the first page. The court can understand what comes next if it first gets the big picture. These examples illustrate sloppy introductions and suggested improvements:

EXAMPLE NO. 1
Defendant Washington County School District's Motion For Partial Summary Judgment

In accordance with Rule 56 of the Federal Rules of Civil Procedure, Defendant Washington County School District ("WCSD") moves for Partial Summary Judgment regarding the claims of Plaintiff John Smith as follows:

1. This is a personal injury action in which Sharon Smith, a minor, alleges that WCSD negligently supervised a high school athletic banquet, allowing John Doe, a coach at the school, to "entice" her away from the banquet and engage in sexual intercourse at a local hotel. The Complaint also alleges WCSD knew or should have known of alleged past similar conduct of Doe, and failed to supervise him or to protect the students from him.

2. Both Sharon Smith and her father, John Smith, claim actual, compensatory, and punitive damages for "mental pain, mental anguish, mental suffering, emotional damage, fees paid for counseling and medical treatment, future medical treatment and fees, counseling and fees, a fear of being subjected to such treatment again and again, fear of a party or parties who have held themselves out to be in a position of trust."

3. With limited exception, Mississippi follows the "zone of danger" rule with regards to emotional distress-type injuries, and a father who was not present for the sexual activities of his daughter cannot recover for damages allegedly resulting from these activities. WCSD should not be forced to bear the burden and costs of extensive discovery regarding the claims and alleged damages of John Smith when no facts would make them legally viable. No amount of discovery will raise genuine issues of material fact with regards to Mr. Smith, and WCSD is entitled to summary judgment on the claims of Mr. Smith as a matter of law.

SUGGESTED REVISION NO. 1
Washington County School District's Motion For Judgment Against The Student's Father

Defendant Washington County School District moves under Fed. R. Civ. P. 56 for a summary judgment that dismisses the claims of plaintiff John Smith, the father of plaintiff Sharon Smith. The father did not witness the abduction and seduction that gives rise to his daughter's claims and so was not within the "zone of danger." In more detail:

1. Plaintiff Sharon Smith, a minor, has sued the School District and Coach John Doe in tort. She alleges that, because the School District negligently supervised a high school athletic banquet, the coach was able to entice her to a motel where he seduced her.

2. Her father has also sued for his own mental suffering caused by the coach's actions.

3. It is undisputed, however, that he did not witness either the enticement nor the seduction that are the basis for the daughter's suit.

Continued on page 4

***Luther T. Munford** and **James W. Shelson** are partners at the law firm of Phelps Dunbar, LLP in Jackson, Mississippi.*

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EXAMPLE NO. 2
Defendants' Response To Plaintiff's Objections To Magistrate Judge's Rulings And Application For Review

Introduction
Plaintiff Jerry Jones ("Carpenter") has filed Objections to the Magistrate Judge's Rulings and Application for Review ("Application for Review") requesting that this Court vacate or modify the July 18, 2005 Order staying discovery. Plaintiff requests relief from the Magistrate Judge's Order to allow plaintiff to conduct discovery to support his allegations of personal jurisdiction against the various defendants in this matter. Defendants submit that the basis for the Magistrate Judge's Order is sound, although not reflected in the Order, and therefore the Magistrate Judge's Order staying discovery should be left in place. In order for this Court to make an informed decision on the Application for Review, an explanation of the procedural history of this matter may be helpful.

SUGGESTED REVISION NO. 2
Defendants' Response To Plaintiff's Objections And Application For Review

Introduction
Plaintiff Jerry Jones erroneously asks this court to vacate or modify the magistrate judge's July 18, 2005 Order that stayed discovery. In this breach of contract case, he asks for more discovery to support his allegations of personal jurisdiction over individual defendants with whom he never dealt.

But the first issue before the court is not personal jurisdiction. Rather it is subject matter jurisdiction. Plaintiff does not request any discovery on the subject matter jurisdiction question, nor does he need any. This court should hold that it has no subject matter jurisdiction and dismiss the case. It need not reach either the personal jurisdiction question or any right to discovery relevant to that question.

b. Think about how you present the facts

Judges know, or think they know, the law. What they readily concede they don't know is the facts. So tell them. Stick to the relevant facts. Add record citations. Doing these things makes the judge's job easier and enhances your credibility. Most of the time, chronological order works best. Some courts may, however, prefer witness by witness summaries. If there are a lot of facts, break them down into groups with headings that will help the judge understand them. Just say the facts, don't argue them. Obvious overreaching raises a question as to whether or not the judge can trust what you say.

c. Speak plainly and be brief

Use simple words and plain English. Use short sentences. Use short paragraphs. Be concise. Try to read a paragraph that covers a whole page. Then break it up. You will find it much easier to read. The following example and suggested revision illustrate this point.

EXAMPLE NO. 3
Memorandum Brief In Support Of Taxpayers' Appeal Of Denial Of Request For Refund Of Income Taxes From Review Board Order No._7999

Introduction
This Brief is prepared in support of Petitioner's position with regard to the denial of the refund of income taxes requested for the calendar years 1999 and 2000 (the "Refunds") by the Mississippi State Tax Commission (the "Commission") with regard to Thomas and Margaret Dumas (the "Taxpayers"). The Refunds are as follows:

As part of the Firm's liquidating distributions to the Taxpayers, the asset representing a potential fee recovery in asbestos litigation (the "Contract") was distributed to the Taxpayers. However, because the Asbestos Arbitration Panel had not yet ruled on the amount of the fee recovery, if any, the Contract did not have an ascertainable value on the date of liquidation, November 5, 1998. At the time of liquidation, the amount of the anticipated fee award was only speculative, and thus, the Contract was not capable of valuation. Because the Contract could not be valued, that portion of the Taxpayers' capital gain resulting from the liquidating distribution and associated with the Contract could not be determined on the date of liquidation. Therefore, the Taxpayers treated the receipt of the 1999 and 2000 fee recovery payments made to the Taxpayers as part of the liquidation transaction. As such, the fee payments were reported as capital gains on their 1999 and 2000 Individual Income Tax Returns (see attached Exhibit I). However, because gains from the sale of stock in domestic corporations held for more than one (1) year are not recognized pursuant to Miss. Code Ann. §27-7-9(f)(10)(A), the Taxpayers have requested a refund of the income tax paid on the reported capital gains resulting from the liquidation of the firm. The Commission has denied the Taxpayers' request for refund of income taxes from which Taxpayer hereby appeals.

SUGGESTED REVISION NO. 3
Memorandum Brief In Support Of Taxpayers' Appeal Of Review Board Order No. 7999 Which Denied Them A Refund

Introduction
The taxpayers made a mistake on their 1999 and 2000 returns. Because they have sought to correct that mistake in a timely fashion, state law gives them the right to a refund. Miss. Code Ann. §

27-7-9. The Review Board's ruling that denied them a refund is wrong as a matter of law. The Commission should reverse that ruling and give them the refunds. The future payments they are to receive are capital gains from the liquidation of a domestic corporation, and should not be treated as interest or rent.

In 1998, the taxpayers liquidated the corporation formed for their legal practice. They took from the liquidation a contract to receive future payments from the settlement of a case against several asbestos companies. But the amount of the annual payments is subject to various contingencies, and so the exact amount will not be known until each payment is made.

In the years in question, the taxpayers properly treated these payments as capital gains from the sale of stock. But they failed to assert their rights under Miss. Code Ann. § 27-7-9(f)(10)(A), which allowed them not to recognize those gains for tax purposes. The commission staff wrongly claims they are interest or taxes and so are not eligible for non-recognition.

But the payments are capital gains. Several things support this conclusion. The treatment given claims for subsequent years, federal law, and common sense. The payments are a return on the liquidation. Nothing more has to be done to earn them. Each payment diminishes the amount the taxpayers are entitled to receive and, when the last payment is made, the taxpayers will not have anything left.

Legalese does not show the court you are a "real lawyer." Instead, it diminishes your work product. Judges, we hope, think in plain English, or at least they are more likely to do so. Study has shown that they find plain English more credible. So use it. The following is an example of legalese and a suggested revision:

Example No. 4
Plaintiff's Rebuttal To The Defendant's Response To Plaintiff's Motion For Judgment On The Pleadings

Comes now the Plaintiff, New Day Credit Company, LLC ("Plaintiff"), by and through counsel, and pursuant to Rule 12(c) of the Mississippi Rules of Civil Procedure, and files this Rebuttal to the Defendant's Response to the Plaintiff's Motion for Judgment on the Pleadings, and would show unto the Court as follows:

On or about November 8, 2004, the said Plaintiff filed with the Court its Complaint in Replevin against Crossbow Farms ("Defendant"), alleging default under certain Retail Installment Sales Contracts and Security Agreements ("Contracts"), and seeking a judgment of possession and an award of interest, costs and attorneys fees. On or about February 10, 2005, the said Defendant filed its Answer and Affirmative Defenses ("Answer"). On or about August 8, 2005, the said Plaintiff filed its Motion for Judgment on the Pleadings ("Motion"), alleging that the said Defendant had created no issue of material fact and that the said Plaintiff is entitled to judgment as a matter of law. On or about August 18, 2005, the said Defendant filed its Response to the Motion ("Response"), alleging that due to unforeseen circumstances it is not in default and asserting its right to assert affirmative defenses.

Suggested Revision No. 4
Plaintiff's Reply In Support Of Its Motion For Judgment On The Pleadings

Plaintiff New Day Credit Company, LLC asks this court to grant its motion for judgment because the response submitted by Crossbow Farms has no legal merit. The response admits the debt, but offers the novel defense of "unforeseen circumstances." Because on the facts pled here there is no such defense, the motion for judgment in favor of New Day should be granted.

Plain language communicates best. "Would show unto the court" and "said plaintiff" belong to the Dark Ages. Let them stay there.

d. Use argumentative headings

Use argumentative headings to outline the structure and progress of your argument. Say "The skid marks, the affidavit, and the expert report establish the defendant driver's fault." Do not say "Point Three," or "The evidence entitles plaintiff to summary judgment." The use of headings and sub-headings to set off separate points makes it easier for the judge to follow the argument.

e. Case citations

Motions or supporting briefs must cite cases, statutes and other legal authorities before a judge will find the argument credible. But some citations are better than others. For example:

First, cite a few authorities that directly support the argument. If you go beyond three, the judge's interest begins to decline dramatically. Rather than simply list citations without explanation, make it easy on the judge. Add a parenthetical that explains the citation's importance.

Second, if you must use string citations, put them in footnotes.

Third, if you can paraphrase a poorly written legal quotation, do so.

Fourth, say what the block quotation says before you quote it. Some judges skip over block quotes. But the selective use of block quotations can convey the importance of the cited authority and convince the judge that it really does say what you say it says. Try

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a lead-in that makes a substantive point, such as:

> The court recognized that there are nine elements of a fraud claim, and held that they must be established by clear and convincing evidence:

> The statute establishes that no claim is permitted against a state hospital unless the injured party first notifies the hospital of the claim ninety days before filing suit:

> Because the plaintiff did not file his claims within three years of the accident, the court held that his claims were time barred:

f. Visual aids

A picture may be worth a thousand words. Do not hesitate to include an important photograph, diagram, chart or other drawing in the text of your motion or brief. The following is an example of the use of a chart to summarize an argument regarding the statute of limitations:

A three-year statute of limitations applies to plaintiffs' claims. Plaintiffs have each identified the date on which they discovered the alleged product defect. The date on which plaintiffs filed their complaint is a matter of record. Given this information, Chart F.1 [below] demonstrates that plaintiffs' claims are time barred because plaintiffs did not file their complaint within three years of when they discovered the alleged product defect. This lawsuit should be dismissed with prejudice.

g. Reserve time for editing

Write your motion and brief and set it aside for a day or so before giving it a final edit. This period of detachment will improve your editing, and will result in a better work product.

II. PERSUASIVE ORAL ARGUMENT

1. Tell the Judge Immediately What You Want and Why You Should Win

As with motions and briefs, you should tell the judge immediately what relief you want and why you are entitled to that relief.

2. Do not Merely Repeat What is in Your Motion or Brief

You don't have time. Try to figure out what the one point is that the case is most likely to turn on. Then attack it like a bulldog. You might even get time to make three points, but no more. If you discover some important fact in the record while you are preparing for argument, share it with the court. Judges like to hear something extra, so long as it is related to the arguments made in the briefs.

3. Do not read to the Judge

Do not read your argument to the judge. Likewise, few things are less well received than reading a lengthy quote to the judge. If you don't believe us, try having a lawyer in your office read a lengthy legal quote to you.

4. Respond Directly to the Judge's Questions

If the judge asks you a question, answer it directly. Do not attempt to avoid the question, or to give an answer that is not responsive to the question that the judge asked. Do not tell the judge that you will answer his or her question later. And do not interrupt a judge. You are there to please the judge. The judge is not there to please you.

5. Use Simple Visual Aids

Show the judge. The selective use of photographs, charts and diagrams can enhance your argument. If possible, show the judge the actual object at issue. For instance, in a products liability case, if the product is small enough, show it to the judge. Like jurors, judges will better remember what they see over what they hear.

6. Be professional

Be civil and courteous. Do not personally criticize your opponent. Do not berate him or her. Address the judge, not counsel opposite. Be professional at all times. Judges genuinely like that.

Chart F.1

Plaintiff	Date Plaintiff Discovered Defect	Date that Claim is Barred by the 3-Year Statute of Limitations	Date Complaint Filed
Jim Williams	June 7, 1996	June 7, 1999	May 17, 2004
Steve Smith	September 1, 1997	September 1, 2000	May 17, 2004
Chad Morrison	December 22, 1999	December 22, 2002	May 17, 2004

TRIAL PRACTICE
Journal

A Case Study In The Developing Law Of Spoliation

By Gregory P. Stone and Kelly M. Klaus

Spoliation, a doctrine with deep historical roots, is assuming front-and-center status in contemporary commercial litigation. Nearly three centuries ago, the English courts decreed "*contra spliatorem omnia praesumuntur*"—"all things are presumed against a spoliator"[1]—and the law of spoliation developed from the paradigm case of one party having lost a potentially critical piece of evidence. From that paradigm emerged the general rule that the fact-finder could draw a negative inference against that party—namely, that the evidence would have harmed its case.[2] And for many years, that was the focus of spoliation law, building on cases involving particular pieces of evidence that were lost or destroyed and therefore unavailable for trial, and usually involving litigation about whether to apply adverse inferences to ameliorate the loss of that evidence.[3]

That limited scope for the spoliation doctrine is rapidly becoming a thing of the past. Today's spoliation issues are as likely to involve the widespread loss of hundreds of thousands of pieces of information as they are individual items of evidence. And the remedies now in play extend far beyond adverse inferences, and include requests for terminating sanctions and criminal prosecution. This is the stuff of *Wall Street Journal* headlines and *American Lawyer* exposés: Arthur Andersen's document shredding amidst the unfolding Enron scandal, leading to the accounting firm's criminal conviction (later reversed by the Supreme Court[4]) and ultimate dissolution; Morgan Stanley's late discovery of computer backup tapes, which the trial judge cited as grounds for a default judgment[5]; and the obstruction of justice conviction (also reversed) of investment banker Frank Quattrone for forwarding an email urging his colleagues to comply with the firm's document retention policy.[6] Litigation involving charges of widespread spoliation has not been limited to the high finance arena. Such charges have been raised across a wide spectrum of cases, including a series of patent cases discussed in this article. In short, spoliation is rapidly becoming a fixture in contemporary litigation.

The confluence of these factors—data creation, storage and deletion—practically guarantees that some documents that might be considered to be relevant in some downstream litigation will ... be destroyed

There are some obvious explanations for this upsurge in large-scale spoliation claims. Most of them relate to the nature of data creation, storage, and management in businesses worldwide. First and foremost, the ubiquity in nearly every business enterprise of computers, email and electronic data has caused the total amount of documents at any one workstation—not to mention company-wide—to mushroom to mind-boggling proportions.

Second, businesses have had to find a way to manage all this data—a process that necessarily involves decisions about data storage and retrieval on computer hard drives and servers. The process of deleting data becomes both facially simpler—and potentially more consequential for purposes of evidence preservation—when clicking the cursor several times has the potential to delete millions of lines of information stored electronically.

Third, and also related, has been the increasing tendency of businesses to adopt and then implement official policies regarding when they will save documents and when they will destroy them—the increasingly ubiquitous "document retention policy." The confluence of these factors—data creation, storage and deletion—practically guarantees that some documents that might be considered to be relevant in some downstream litigation will at some point be destroyed, whether on a piece of computer media or in a paper shredder or recycling bin. And that scenario is fertile ground for litigation regarding the propriety of—and consequences for—that loss of data.

This article, however, is not concerned

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with *why* the number of large-scale spoliation claims seems to be increasing, but rather with *how* that process is unfolding. In a nutshell, the law is evolving here—as it does in many areas—in common law fashion. There is no code specifying the law of document retention and destruction. While certain issues are likely to be circumscribed by changes to procedural rules—the newly effective amendments to the Federal Rules of Civil Procedure concerning electronic discovery are among the most visible examples of late—the law here is likely to develop as it does elsewhere: with disputes, the presentation of evidence, and judicial decisions applying general legal standards to unique factual scenarios. This likely will be an active area for practitioners in all areas of complex civil litigation—and a source of frustration, expense and uncertainty for clients who are faced with charges of spoliation and who try to conform their conduct to the law.

What is "spoliation"?
Like many other legal standards, the test for spoliation can be stated simply but subsumes within it multiple sub-issues. As described by the Second Circuit, it is "the destruction or significant alteration of evidence, or the failure to properly preserve property for another's use as evidence in pending or reasonably foreseeable litigation."[7] Under this formulation, any spoliation issue is likely to raise issues involving (a) when a *duty* to preserve evidence arises; (b) what must be done to *satisfy* that duty, once it is triggered; (c) what role corporate document retention policies play in complying with a party's duties; and (d) what *remedies* are available to ameliorate the potential for prejudice to the party claiming spoliation.

When is a party obligated to preserve evidence?
The threshold question in any spoliation controversy is likely to involve whether the party asserted to have destroyed evidence was under an obligation to preserve it at the time. "It goes without saying that a party can only be sanctioned for destroying evidence if it had a duty to preserve it."[8]

... any spoliation issue is likely to raise issues involving (a) when a duty to preserve evidence arises; (b) what must be done to satisfy that duty, once it is triggered; (c) what role corporate document retention policies play in complying with a party's duties; and (d) what remedies are available ...

The timing question will most often relate to events *before* the lawsuit was filed. Once involved in litigation, a party will generally be under a duty to preserve materials relating to relevant issues. But where documents or other items were destroyed *before* trial, the key issue will be whether litigation was (as courts have phrased it) "reasonably foreseeable." What constitutes "reasonably foreseeable" litigation has been and will continue to be a hotly disputed question in much spoliation litigation.

In 1999, the ABA Section of Litigation observed that "[t]he more common rule is that the duty is triggered when a party becomes aware that litigation has commenced, and arises even earlier where the party has notice that litigation is likely to take place. For the duty to attach before a suit has been filed, however, the litigation must be probable, not merely possible."[9] Particularly in the case of corporations, the reason for requiring more than a theoretical possibility of litigation for a duty to attach is that litigation "is an ever-present possibility in American life."[10]

An important precedent for this and other spoliation issues in the electronic discovery context is *Zubulake v. UBS Warburg LLC*, from the Southern District of New York. *Zubulake* involved employment discrimination claims filed by a former employee of UBS Warburg. The plaintiff contended that the company should have retained computer backup tapes containing potentially relevant email and other documents prior to the time that she filed a discrimination charge with the EEOC. The plaintiff had had a history of making complaints about her treatment at the company. The court said that "[m]erely because one or two employees contemplate the possibility that a fellow employee might sue does not generally impose a firm-wide duty to preserve."[11] But, the court said, that was not the case before it. Rather, the court said, the evidence showed that nearly *everyone* who had dealt with the plaintiff had been aware that she might sue the company. In particular, the court cited an email message calling for the plaintiff's termination and forwarded among a number of her co-workers and superiors; the court held that the firm had been in reasonable anticipation of litigation involving the plaintiff at least as of the date of that email.[12]

What does a party have to do once its duty to preserve evidence is triggered?

Once litigation is "reasonably foreseeable," a party is under an obligation to preserve documents or other materials that may be relevant to that anticipated litigation. The party should take steps to ensure that those documents are maintained and preserved until the risk of litigation is no longer foreseeable.[13]

Where the dispute is relatively narrow and the universe of potentially relevant documents is small, the obligation is relatively easy to state and to comply with. Suppose there is a supplier who thinks it is reasonably foreseeable it will be in litigation with one of its buyers over a disputed invoice. At that point, the supplier should take steps to preserve any documents related to that invoice, including (most obviously) the invoice itself, but also any communications or other documents relating to the same dispute.

Things get complicated where a party believes that litigation is reasonably foreseeable involving not just one potential counter-party, but several, or where the likely dispute will concern not a single bilateral transaction but scores of dealings and interactions that cover large time periods and involve numerous employees and/or customers. When thousands if not millions of pieces of paper—or electronic data—may be relevant to reasonably anticipated litigation, how should a company comply with the duty to preserve evidence?

It is clear that a party is not required to retain every piece of information in its possession once it is on notice of probable litigation.[14] But parties are required to exercise reasonable efforts to ensure that potentially relevant evidence is not lost or destroyed.[15] Hence, if identical copies of an intra-corporate memo were distributed to 100 employees, and if the company later determined that the memo was potentially relevant to anticipated litigation, the company probably would not be required to ensure that 100 copies (identical in all respects) were collected and handed over to the general counsel for safekeeping. At the same time, the company once on notice of the threatened litigation would be obligated to exercise reasonable efforts to ensure that any employees who were "key players" regarding that litigation maintained their copies of the memo and other relevant documents.[16]

It is clear that a party is not required to retain every piece of information in its possession once it is on notice of probable litigation. But parties are required to exercise reasonable efforts to ensure that potentially relevant evidence is not lost or destroyed.

The significance of document retention policies and "litigation holds."

This last example highlights the importance of two features of contemporary life in many American corporations: the *document retention policy* and the *"litigation hold."* A document retention policy generally does just what its name suggests: it sets corporate policy for retaining certain types of documents. Typical policies may include specifications for some or all of the following subjects: what must be retained, for how long, and where the documents should be retained. For example, a company may say that its tax documents have to be retained for at least the length of time that a statutory audit period remains open and that the documents should be maintained in the company's accounting office. The categories of documents subject to such a policy may be as varied as the business activities of the company itself.

Document retention policies may not only specify the guidelines for retaining documents, but may also discuss the procedures for discarding documents not intended to be retained. There are numerous reasons why a company would not want to retain every last piece of paper or bit of electronic data. For example, companies are perpetually concerned with space management. This includes not only concerns about limits on physical space—most companies will want to keep their file drawers in a manageable (and searchable) form, and will not want to incur the costs of storing every piece of paper the company ever created—but also the space on the company's computer network. The exponential growth of electronic data on central servers places limits on the operation and efficiency of computer networks. Many companies deal with limitations on their networks by directing employees to store only work-related materials on the network and by setting space limitations on the amount of email and other electronic documents that employees should retain. Companies also routinely store their data on backup tapes or other electronic storage media in order to be able to retrieve them in the event of a system failure or disaster. However, technological changes may

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make it prohibitively expensive to restore earlier generations of backed-up data, and old tapes and storage media may be unreadable or corrupted. As a consequence, document retention policies may call for the overwriting or disposal of storage media after a certain period of time.

Maintaining control over physical and electronic space is not the only reason that companies adopt document retention policies. The Supreme Court recognized in the *Arthur Andersen* case that document retention polices "are created in part to keep certain information from getting into the hands of others, including the Government[.]"[17] With litigation a ubiquitous reality in modern corporate America, most companies will have a general concern that documents created years earlier by widely dispersed employees might come back to haunt them in unforeseen litigation. To that end, many companies are motivated to adopt document retention policies, at least in part, in order to control the amount of documents and data they will have to search, and that may be produced to unknown litigation adversaries, at some unknown future time.

Where litigation is reasonably foreseeable, and the duty to preserve potential evidence is triggered, the calculus changes. At that point the company is obligated to maintain potential evidence, and that is where the "litigation hold" comes into play. A "litigation hold" is a corporate directive, usually issued by the general counsel or some other responsible manager, that directs those persons reasonably likely to have relevant documents in their possession to maintain or transfer custody of the same for preservation and potential review. To the extent necessary to achieve this objective, a "litigation hold" may also require that the same people suspend their compliance with any document retention policy insofar as potentially relevant categories of documents and information are concerned. The failure to institute a "litigation hold" at the point the preservation duty is triggered may justify adverse inferences or other sanctions for violation of the preservation duty.[18]

What are the remedies for a violation of the duty to preserve evidence?

The law recognizes a wide range of potential remedies where a party is found to have violated an obligation to preserve potential evidence. In some states, the violation may give rise to an independent cause of action for the tort of spoliation.[19]

Federal law has not recognized an independent claim for spoliation, but federal courts have held that they have broad authority to remedy the spoliation of potentially relevant evidence under the Rules of Civil Procedure, equitable defenses, and the courts' inherent authority to regulate the conduct of litigation. The courts have found that the potential remedies may include issuing adverse jury instructions or inferences (*e.g.*, that the fact finder may presume that the lost evidence was harmful to the case of the party who lost or destroyed that evidence), excluding evidence, striking witnesses, granting dismissal or default judgment, or paying the other side's attorneys' fees.[20]

In weighing the appropriate remedy for a violation of the preservation duty, courts will look to a variety of relevant factors, chief among these being the degree of prejudice to the other side from the loss of evidence and the level of culpability of the party found to have violated its duty.[21] Regarding prejudice, the party seeking sanctions generally is required to make a reasonable showing that the lost evidence would have been favorable to its case.[22] The culpability of the party found to have breached its preservation duty typically will be relevant where dispositive or terminating sanctions are sought. Courts generally will impose these most extreme sanctions only where the party acted willfully or in bad faith in failing to preserve evidence.[23]

The *Rambus* litigation: the application of developing spoliation principles in the context of a document retention policy.

The general principles in the law of spoliation play out in the context of specific cases with particular and unique facts. One such case (actually a series of cases), in which the authors have served as counsel, involves Rambus Inc., a technology company based in California that for several years has been involved in a series of patent infringement cases with manufacturers of dynamic random access memory ("DRAM") devices. DRAMs are computer chips that comprise a computer's main memory.[24] As discussed below, Rambus's adoption and implementation of a document retention policy has been the subject of litigation, with Rambus's adversaries asserting that its claims of patent infringement should be dismissed under the equitable doctrine of unclean hands. That issue has been the subject of two evidentiary hearings conducted before federal courts in Virginia and California, and a lengthy set of factual findings and legal conclusions issued by the court in California in Rambus's patent infringement dispute with Hynix Semiconductor, Inc., a DRAM manufacturer based in Korea.

1. **Background of the *Rambus* litigation.**

Rambus was founded in 1990 by two professors, Dr. Michael Farmwald and Dr. Mark Horowitz, who had been

working together to address the increasing gap between microprocessor performance and DRAM performance. In 1990, Professors Farmwald and Horowitz filed a patent application that contained numerous claims relating to their efforts to solve this performance gap problem. The first U.S. patent claiming priority to this application issued in 1993, and Rambus also filed a number of continuation and divisional applications based on the original application. Rambus was granted a number of additional patents based on these subsequent applications.

During the mid-1990s, Intel Corporation announced that it planned to use a version of Rambus's technology (called "RDRAM") in its next generation of microprocessors. A number of DRAM manufacturers took licenses to Rambus's patents to be able to produce RDRAM chips. In late 1999, Rambus began to approach DRAM manufacturers about licenses under Rambus's patents for the production of DRAM chips that were not RDRAM. While a number of manufacturers agreed to license Rambus's patents for this purpose, several of them did not and asserted, among other things, that Rambus's patent coverage should be construed narrowly. Rambus thereafter was involved—either as an infringement plaintiff or as a declaratory judgment defendant (with an infringement counterclaim)—in litigation against several of the largest DRAM manufacturers, including Hynix, Infineon Technologies and Micron Technology Corp.

The first of these cases to proceed to trial—*Rambus v. Infineon*—involved both Rambus's claims for patent infringement and a counterclaim charging that Rambus had engaged in fraudulent conduct in connection with its participation in the early 1990s in a standard-setting organization called the Joint Electron Device Engineering Counsel ("JEDEC"). The district court gave Rambus's patents a narrow construction and then granted Infineon judgment as a matter of law on Rambus's infringement claims. The jury then returned a verdict for Infineon on its fraud claim, holding that Rambus violated a duty to disclose then-pending patent applications while it was a JEDEC member. The Federal Circuit reversed both rulings, holding that the infringement judgment was based on an erroneous construction of Rambus's patent claims and that there could be no finding of fraud because the evidence did not show Rambus had violated any duty to disclose its patent applications.[25] Similar issues have been the subject of litigation in Rambus's separate lawsuits with the other DRAM manufacturers.[26]

... the Infineon *district court permitted discovery of Rambus's privileged communications relating to certain topics concerning its adoption and implementation of its document retention policy.*

2. Rambus's adoption and implementation of its document retention policy.

Another issue raised in Rambus's patent litigation has concerned the charge by its opponents that Rambus adopted and implemented a document retention policy in order to destroy documents that would be harmful to Rambus in what was claimed to be planned litigation against the DRAM manufacturers. This issue was the subject of discovery and an attorneys' fees ruling in the original *Infineon* district court proceedings,[27] and also following remand from the Federal Circuit. In mid-2004, the *Infineon* district court permitted discovery of Rambus's privileged communications relating to certain topics concerning its adoption and implementation of its document retention policy.[28] Both Infineon and Hynix sought to have Rambus's claims dismissed under the equitable doctrine of unclean hands based on allegations related to Rambus's document retention policy.[29] The following facts regarding that policy are drawn from the evidence presented at the evidentiary hearing involving Hynix's defense and from the district court's opinion rejecting that defense.[30]

Rambus adopted its document retention policy in 1998, following the advice of outside counsel. The prior year, Rambus had hired a gentleman named Joel Karp to assess its patent portfolio, to determine if chips manufactured by others infringed Rambus's patents, and to develop licensing and negotiation strategies for dealing with companies that built and sold such chips. Mr. Karp contacted outside counsel from the law firm of Cooley Godward to advise him regarding these tasks. One of the Cooley lawyers who met with Mr. Karp (Dan Johnson, later of Fenwick & West), learned that Rambus did not have a document retention policy and advised Mr. Karp the company should adopt one. Mr. Johnson advised Rambus to adopt a document retention policy for three principal reasons. First, a document retention policy would reduce search costs in the event that Rambus

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was someday required to respond to subpoenas or document requests that might possibly be issued in connection with future lawsuits or investigations. Second, a document retention policy would also reduce the expense of retrieving electronic data stored on obsolete or corrupted back-up media. Third, Mr. Johnson felt it would be useful for Rambus to have a company-wide policy for the retention and destruction of documents, because the absence of such a policy might be cited by a future litigant as evidence of spoliation. Mr. Johnson testified that the advice he gave Rambus regarding document retention was "commonplace" and that he probably gave similar advice to at least eight to ten startup companies in Silicon Valley.

Mr. Karp drafted a written document retention policy for Rambus based upon this advice; he used a Cooley Godward memorandum on document retention policies as a template. The Rambus policy provided with respect to "Electronic Mail and Documents" that: "Rambus maintains complete system tape back-ups for a period of 3 months. Employees should not utilize email as a place to save documents beyond 3 months. Email that is required to be saved more than 3 months can be kept either in paper or a separate file on your hard drive." On the subject of contracts, the Rambus policy provided that "Final, executed copies of all contracts entered into by Rambus are kept for at least 5 years after expiration of the agreement, and longer in the case of publicly filed contracts. All drafts ... should be destroyed or systematically discarded." With respect to lab notebooks and other design documents, the Rambus policy provided that "Engineering and development documents are often subject to intellectual property protection in their final form (e.g. patents, copyrights, trade secrets, proprietary information). The documents, notebooks, computer files, etc., relating to patent disclosures and proof of invention dates are of great value to Rambus and should be kept permanently." The terms of Rambus's document retention policy referred to categories of documents and did not direct the retention or destruction of documents depending upon whether their content was deemed positive or negative.

In presenting its unclean hands defense, Hynix charged that Rambus had adopted its document retention policy as part of an overall planned strategy of instituting patent infringement litigation...

In mid-1998, Mr. Johnson gave a presentation to Rambus's managers about the need for a document retention policy and the legal requirements involving such policies. As part of his July 1998 presentation, Mr. Johnson recounted what he referred to as "horror stories" of cases where deleted e-mails had been used to prove age discrimination and sexual harassment. Mr. Johnson also specifically warned Rambus managers that destroying relevant documents "once litigation started" would be improper. After Mr. Johnson's presentation to the Rambus managers, Mr. Karp made presentations to various groups of Rambus employees using a different set of overhead slides, which were based on the written policy and the Cooley Godward memorandum, and which encouraged Rambus employees to "look for things to keep."

In connection with the implementation of its policy, Rambus held company-wide housecleanings—referred to colloquially in internal emails as "shred days"—in fall 1998 and 1999. Rambus employed an outside company to provide on-site document shredding services for that day. Employees were instructed to follow the document retention policy guidelines to determine what to keep and what to throw away.

Mr. Johnson had also advised Mr. Karp that Rambus should clean out its patent prosecution files so that the files mirrored the files in the Patent and Trademark Office ("PTO")—a recommendation that Mr. Johnson characterized as "standard advice" in the field. In April 1999, Mr. Karp instructed his outside patent counsel to clean his firm's patent prosecution files for issued patents. Patent counsel was not instructed to, and did not, clean any "general" Rambus files, which contained counsel's notes and other documents relating to, *inter alia*, his advice concerning JEDEC's disclosure policy. When cleaning Rambus patent prosecution files for issued patents, counsel retained, *inter alia*, communications with the PTO and prior art.

3. Hynix's unclean hands charge and the court's ruling.

In presenting its unclean hands defense, Hynix charged that Rambus had adopted its document retention policy as part of an overall planned strategy of instituting patent infringement litigation against DRAM manufacturers (including Hynix), and that the intended and actual result of that policy was the

destruction of massive amounts of evidence relevant to Rambus's dispute with the DRAM manufacturers. The federal court in California conducted a two-week trial on Hynix's defense, during which time it heard testimony from more than a dozen witnesses and received hundreds of exhibits.

The court ultimately issued a lengthy written opinion containing more than 120 factual findings and a number of legal conclusions. The court's bottom-line conclusion was that Hynix had failed to prove that the application of the unclean hands doctrine was warranted. In particular, the court held that:

> the evidence presented does not bear out Hynix's allegations that Rambus adopted its Document Retention Policy in bad faith. The evidence also does not demonstrate that Rambus targeted any specific document or category of relevant documents with the intent to prevent production in a lawsuit such as the one initiated by Hynix. The evidence here does not show that Rambus destroyed specific, material documents prejudicial to Hynix's ability to defend against Rambus's patent claims.[31]

The subsidiary findings and conclusions that the court emphasized in its decision included whether litigation was reasonably foreseeable when Rambus adopted and implemented its document retention policy, and whether Hynix was prejudiced by the loss of any documents as a result of that policy.

a. The foreseeability of litigation and the question of Rambus's intent in adopting and implementing its document retention policy.

The first legal question the court considered was whether Rambus had a duty to preserve evidence at the time it adopted or implemented its document retention policy. The court agreed with Hynix's position that the question whether litigation is "probable" "must be viewed from the perspective of a plaintiff, who is in control of when the litigation is to be commenced."[32] Hynix had argued that Rambus believed litigation was probable as of early 1998, when Mr. Karp started consulting with the Cooley Godward lawyers about formulating a patent licensing strategy. Hynix claimed that because litigation was a possible outcome in the event of unsuccessful licensing negotiations, litigation was reasonably foreseeable to Rambus, and it should have taken specific steps to preserve potentially relevant evidence prior to the "shred days" in 1998 and 1999.

The court disagreed with Hynix. In particular, it held that "the path to litigation was neither clear nor immediate" as of early 1998, because "several contingencies had to occur before Rambus would engage in litigation," such as the issuance of the relevant patents, a determination that the manufacturers' chips infringed those patents, a decision to initiate a licensing program, and a decision by the manufacturers to reject Rambus's licensing terms.[33]

The court also found it "telling" that Rambus had not started to budget for actual litigation expenses as of August 1999, when its Board of Directors gave approval to begin licensing negotiations.[34] The court found that while Rambus may have viewed litigation as a possibility as early as 1998, it was not until late September 1999 that Rambus "appear[ed] to be ready to seriously consider actually filing suit against someone."[35] The court cited a September 24, 1999 presentation to Rambus's Board that discussed an attempt to substantiate Rambus's patents either by settling with "an industry powerhouse" or by "winning in court." The court called it "notabl[e]" that "this presentation occurred after the Shred Day in August 1999."[36] The court ultimately concluded that "[t]he destruction of documents on the 1998 and 1999 Shred Days pursuant to the [document retention] policy did not constitute unlawful spoliation."[37]

The court also noted that in order to justify an unclean hands defense, Hynix would have to have shown that any destruction of relevant documents was undertaken in bad faith.[38] Here, too, the court found Hynix's evidence wanting. The court found that "[w]ith regard to patent-related materials within Rambus, the document retention policy and Karp's presentation emphasized that engineering notebooks and other patent-related documents were important to keep."[39] Regarding JEDEC-related materials, the court cited both testimony from Mr. Karp that in adopting the document retention policy he did not believe there was any issue with respect to Rambus's disclosures, as well as the Federal Circuit's holding in the *Infineon* litigation "that Rambus was not obligated by virtue of its membership in JEDEC to disclose any of the patents or patent applications that were issued or filed while Rambus was a JEDEC member."[40] The court also noted that the document retention policy did not single out JEDEC documents for destruction, and that Rambus had produced numerous documents related to the JEDEC issue.[41]

The court also considered the question of Rambus's intent in connection with its implementation of its counsel's recommendation to have its patent prosecution files conform to the official PTO file. The court noted that Hynix did not challenge the practice of conforming files in this matter, but rather had only challenged the manner in which Rambus had followed the advice. In this regard, the court found

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that there was "no indication that Rambus had particular concerns regarding the contents" of its outside counsel's patent prosecution files, only that Rambus "wanted Attorney Johnson's recommendation carried out,"[42] and it found that this practice was not evidence of bad faith on Rambus's part.[43]

b. The question of prejudice to Hynix.

The court next turned to the question of whether Hynix had made a showing of prejudice sufficient to justify the defense of unclean hands, and held it had not. As a threshold matter, the court held that Hynix had shown "that some relevant documents were probably destroyed pursuant to the document retention policy[,]" and that this showed at least some nexus to the patent claims.[44] This was, the court held, a necessary, but not sufficient, requirement for the application of the unclean hands defense.[45] In order to prevail on its unclean hands defense, Hynix had to show in addition that Rambus's conduct had materially prejudiced Hynix's ability to litigate its claims.[46] The court held that Hynix had failed to meet its burden. Among other things, the court pointed to the fact that Rambus had produced "a large volume of relevant and material documents," and that Rambus had shown that documents that were retained were similar to documents that may have been destroyed.[47] The court also found that "for each category of documents material to the validity or enforceability of Rambus's patents that Hynix argued Rambus did not preserve and produce, Rambus ha[d] shown by clear and convincing evidence that documents in the category were in fact produced."[48]

In sum, the court concluded that Hynix had "not been prejudiced by the destruction of Rambus documents."[49] Based on this conclusion, and its conclusions that Hynix had not shown that Rambus's adoption or implementation of its document retention policy was in bad faith or amounted to spoliation, the court rejected Hynix's unclean hands defense.

Lessons for practice.

As noted, the litigation concerning Rambus's document retention policy is part of a larger phenomenon of courts and parties focusing on the large-scale destruction of documents pursuant to company-wide policies. The law in this area likely will continue to develop based on the application of general principles to particular cases. But the case provides some lessons for practitioners advising clients with respect to the various aspects of document retention policies.

First, when advising a client about adopting a document retention policy, it may be important to understand whether particular litigation either by or against that client is being contemplated. The client is not precluded from adopting a document retention policy just because litigation is foreseeable. But the client should be made aware that if litigation is likely, steps should be taken in the adoption and implementation of any

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retention policy to ensure that potentially relevant materials are retained.

Second, even if litigation does not appear to be on the client's horizon, consideration should be given to building into the policy a mechanism for a "litigation hold" once litigation does become reasonably foreseeable. This may not require an elaborate intra-corporate communication network, but the client may wish to communicate to employees that if they become aware of a real threat of litigation, they communicate that fact to the general counsel (or other responsible officer). It may also be good practice for the policy to outline a general framework for preserving physical and electronic copies of documents in the custody of relevant personnel when such a threat exists.

Third, the litigator advising a client about a prospective litigation matter may wish to pay particular attention to the client's existing or planned document retention policies and practices, and to confirm that appropriate steps are being taken to institute and maintain a "litigation hold." Litigators should recognize that document retention and potential spoliation issues are likely to be examined from the very start of discovery, and it behooves counsel to understand what the relevant facts are with respect to those issues.

Finally, litigation over document retention practices will place a premium on a litigator's understanding of the documents its client has produced. As discussed above, the court may pay particular attention to the question whether an adversary has been prejudiced by a litigant's claimed failure to retain documents. Being able to prove that your client retained and produced a large amount of documents that were similar to the documents that were allegedly destroyed may make the difference between a client that is able to present its case on the merits and one that suffers evidentiary or even terminating sanctions.

Endnotes

1. *Armory v. Delamirie*, 93 Eng. Rep. 664 (K.B. 1722).

2. *See, e.g.*, *Kronisch v. United States*, 150 F.3d 112, 126 (2d Cir. 1998).

3. *See, e.g.*, *Vodusek v. Bayliner Marine Corp.*, 71 F.3d 148, 156 (4th Cir. 1995) (affirming adverse inference instruction where plaintiff's agents rendered key piece of evidence – the boat involved in the underlying accident – unavailable for testing by defendants' experts).

4. *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005).

5. *See Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co.*, No. 502003 (15th Jud. Cir. Fla.) (orders of March 1 and March 23, 2005).

6. *See United States v. Quattrone*, 441 F.3d 153 (2d Cir. 2006).

7. *West v. Goodyear Tire & Rubber Co.*, 167 F.3d 776, 779 (2d Cir. 1999).

8. *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 216 (S.D.N.Y. 2003). *See also Kronisch*, 150 F.3d at 126 ("the party having control over the evidence must have had an obligation to preserve it at the time it was destroyed"). This article is concerned with common law duties to preserve evidence for another's potential use in litigation. Preservation obligations may also be imposed by federal or state record-keeping requirements under statute or regulation.

9. American Bar Association, Section of Litigation, Civil Discovery Standards, August 1999, Commentary to Standard No. 10 (emphasis added). *See also* Jeffrey Kinsler and Anne Keys MacIver, *Demystifying Spoliation of Evidence*, 34 Tort & Ins. L. J. 761, 764 (1999) ("[T]he duty to preserve evidence prior to the filing of a lawsuit typically arises when the party is on notice that the litigation is 'likely to be commenced.'").

10. *National Union Fire Ins. Co. v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992). *See also Concord Boat Corp. v. Brunswick Corp.*, 1997 WL 33352758, at *4 (E.D. Ark. Aug. 29, 1997) ("Whether it be patent, trademark, labor or antitrust suits, the threat of litigation is ever present for large, successful corporations.").

11. *Zubulake*, 220 F.R.D. at 217.

12. *Id*.

13. *See, e.g.*, *William T. Thompson Co. v. General Nutrition Corp.*, 593 F. Supp. 1443, 1455 (C.D. Cal. 1984).

14. *Id*. *See also Zubulake*, 220 F.R.D. at 217 ("Must a corporation, upon recognizing the threat of litigation, preserve every shred of paper, every e-mail or electronic document, and every backup tape? The answer is clearly, 'no.' Such a rule would cripple large corporations, like UBS, that are almost always involved in litigation.").

15. *Zubulake*, 220 F.R.D. at 217-18.

16. *Id*.

17. *Arthur Andersen*, 544 U.S. at 704.

18. *See, e.g.*, *Reingold v. Wet 'N Wild Nevada, Inc.*, 944 P.2d 800 (Nev. 1997) (reversing trial court's refusal to give adverse inference instruction where compliance with company's document retention policy resulted in loss of potentially relevant records at a time

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when company had obligation to preserve such records); *Zubulake*, 220 F.R.D. at 218-19 ("Had [litigation hold] directives been followed, UBS would have met its preservation obligations by preserving one copy of all relevant documents that existed at, or were created after, the time when the duty to preserve attached.").

19. *See* Koesel & Turnbull, *Spoliation of Evidence: Sanctions and Remedies for Destruction of Evidence in Civil Litigation* at 53 n.3 (collecting cases) (2d ed. 2006) (American Bar Association).

20. *See generally id*. at 62-79 (surveying remedies found appropriate by courts).

21. *See, e.g., Gates Rubber Co. v. Bando Chem. Indus.*, 167 F.R.D. 90, 102-06 (D. Colo. 1996).

22. *Id*. at 104.

23. *Id*. at 103.

24. *See generally Rambus Inc. v. Infineon Technologies AG*, 318 F.3d 1081 (Fed. Cir. 2003).

25. *Rambus Inc. v. Infineon Technologies AG*, 318 F.3d 1081 (Fed. Cir. 2003).

26. The issues relating to Rambus's participation in JEDEC were the subject as well of an unfair competition complaint and several month trial before the Federal Trade Commission's Chief Administrative Law Judge. Following the conclusion of that trial, the Chief Administrative Law Judge issued a several-hundred page opinion dismissing the complaint against Rambus in its entirety. Complaint Counsel's appeal of that ruling is presently pending before the full Commission.

27. *See Rambus Inc. v. Infineon Technologies AG*, 155 F. Supp. 2d 668, 682 (E.D. Va. 2001), *vacated*, 318 F.3d 1081 (Fed. Cir. 2003).

28. *See Rambus Inc. v. Infineon Technologies AG*, 222 F.R.D. 280 (E.D. Va. 2004) (piercing Rambus's privileges concerning certain topics under crime-fraud exception to attorney-client privilege and discussing separate unpublished alternative ruling finding subject-matter waiver concerning same communications).

29. Infineon had based its request for dismissal on charges of litigation misconduct in addition to allegations regarding Rambus's document retention policy. At the conclusion of an evidentiary hearing on Infineon's defense, the district court announced that it would rule for Infineon on its unclean hands defense and would dismiss Rambus's patent claims. Rambus and Infineon thereafter settled their lawsuit before the district court issued its findings and conclusions.

30. *Hynix Semiconductor Inc. v. Rambus Inc.*, Case No. C-00-20905-RMW (Jan. 6, 2006).

31. *Id*. at 41.

32. *Id*. at 31.

33. *Id*.

34. *Id*. at 33.

35. *Id*. at 34.

36. *Id*.

37. *Id*. The court also concluded that "Hynix did not demonstrate that any documents material to Rambus's patent claims were destroyed in conjunction with the 2000 move." *Id*. at 34-35.

38. *Id*. at 36 (citing *Dollar Sys. v. Avcar Leasing Sys.*, 890 F.2d 165 (9th Cir. 1989)).

39. *Id*. at 36.

40. *Id*. at 36-37 (citing *Rambus*, 318 F.3d at 1105).

41. *Id*. at 37.

42. *Id*.

43. *Id*.

44. *Id*. at 38.

45. Citing the Supreme Court's landmark discussion of the subject, the court explained that courts "'do not close their doors because of plaintiff's misconduct, whatever its character, that has no relation to anything involved in the suit, but only for such violations of conscience as in some measure affect the equitable relations between the parties in respect of something brought before the court for adjudication.'" *Id*. at 37-38 (quoting *Keystone Driller Co. v. General Excavator Co.*, 290 U.S. 240, 245-46 (1933)).

46. *Id*. at 38.

47. *Id*. at 39. The court pointed out that Hynix's own counsel had testified that Rambus produced approximately 1.2 million pages of documents in response to Hynix's requests. *Id.*

48. *Id*. at 39.

49. *Id*. at 40.

Using a Trust's Investment Policy Statement to Develop the Portfolio's Appropriate Risk Level[1]

By Edward A. Moses, Ph.D., J. Clay Singleton, Ph.D. and Stewart A. Marshall III, Esq.

Editor's Note: Modern Portfolio Theory, which is inextricably intertwined with the Prudent Investor Rule, has become widely used by investment professionals and, as such, is a tool that, if understood, can be of substantial assistance to a trial lawyer in preparing to and cross-examining an opposing party's expert, or in proving or disproving a damages claim. Below is the second of a four part series of articles that we hope will prove useful and informative to our readers on this complex subject. The first article, "Modern Portfolio Theory and the Prudent Investor Act", which appeared in the ABA Trial Practice Journal, Vol. 20, No. 1, discussed the background of Modern Portfolio Theory and its application to the Prudent Investor Rule. In connection with this article, the reader is invited to refer back to that article as published in the print edition of the Trial Practice Journal *or on-line by logging on to the Trial Practice Committee's website.*

I. INTRODUCTION

Lawsuits against fiduciaries develop quite often due to lack of an appropriate investment policy statement (IPS), failure of the trustee to follow the IPS after it has been developed and agreed to by the interested parties, or failure to communicate clearly realistic expectations. While development of an IPS is not required specifically by either the Restatement (Third) of Trusts (Restatement) or the Uniform Prudent Investor Act (Act), an agreed upon and appropriately constructed IPS can provide the trustee with a guide for portfolio formulation and management that is suitable for the trust.[2] For the IPS to be considered appropriately constructed, its contents must be consistent with tenets of the Prudent Investor Rule (Rule) and Modern Portfolio Theory (MPT).[3] Additionally, a well-constructed and clearly communicated IPS can assist in the defense of a trustee against unsuitability claims and potential damages.[4] Section II of this article will provide the rationale for developing an IPS and discuss in some detail three important elements that should be included.

A very difficult issue facing a trustee is the assessment of an appropriate risk level for a trust portfolio. Section III presents an approach to determining a trust's risk tolerance using the IPS's stated required rate of return based on the trust's income/spending level needs. This approach employs a simulation to demonstrate the probabilities of expected outcomes and demonstrates the impact of different risk level assumptions. Sections IV and V utilize a case example to show how this approach to risk tolerance can be used to develop and calibrate a trust's appropriate risk level. Section VI summarizes how the IPS can function as a management plan for the trust, the necessity for the IPS to be consistent with the Rule, (and, thus, its conformity to MPT), and the IPS's usefulness in reconciling the trust's desired rate of return with an appropriate risk level.

II. THE INVESTMENT POLICY STATEMENT

A. The Rationale for an Investment Policy Statement.

As indicated above, neither the Restatement nor the Act specifically requires the creation of an IPS. However, the Act says:

> Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.[5]

One author states:

> Restatement Commentary notes that compliance with the standard of prudence is determined by the *trustee's conduct* in establishing and following the investment and management process required by the Act, not the *trust portfolio's performance*. In short, trustee liability hinges on process, not performance. The trustee ordinarily will be able to demonstrate prudence by addressing the considerations set forth in the Act and then documenting the reasonableness of its decision-making in response to them. This protects the trustee from surcharge when there's a subsequent decrease in trust portfolio performance. On the other hand, regardless of how successful portfolio performance, the trustee risks liability for failure to demonstrate that it established and followed the process required by the Act.[6]

Documenting the "facts and circumstances existing at the time of a trustee's decision or action" and

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"establishing and following the investment and management process required by the Act" are appropriate actions to be undertaken by the trustee. What better way for a trustee to document the investment and management process than creating a comprehensive, well-considered IPS and use it as the guide in making decisions related to the trust?

Aside from the issue of potential liability associated with the lack of an IPS, a poorly constructed IPS, or not following the guidelines established by the document, there is the important issue of the best way to manage effectively a trust's investments. An IPS can be likened to the strategic plan of a business. This plan, based on the business' Mission Statement, sets out the objectives of the company and the steps or processes necessary to achieve these objectives. This blueprint guides operational decisions that manage the business. The plan does not change, particularly in the short run, unless the facts and assumptions upon which the plan was formulated change significantly. The IPS serves the same function as the business' strategic plan, providing a guide for the consistent implementation of an investment strategy and preventing emotional reactions to events in the market place. This is not to say the IPS, like a strategic plan, never changes. It should be reviewed periodically and modified if the facts and assumptions warrant a change.

Finally, it should be stressed that "one plan does not fit all." Each trust, like each business, has a unique set of circumstances that warrant the development of an IPS tailored specifically to the needs of the trust. To use a "standard plan" approach or even a slight modification to a standard plan in developing an IPS for an individual trust is a recipe for mismanagement and disaster. The IPS must be individualized for each trust to reflect its unique characteristics.

B. The Contents of an Investment Policy Statement.

Numerous articles and books have been written about the development and maintenance of an IPS.[7] Many of them are excellent guides for determining the contents of the IPS.[8] As indicated above, every trust has its unique characteristics and the IPS for the trust should be developed with these unique features in mind. For example, the content of an IPS for defined benefit plans, endowments, or foundations will differ markedly from the content of an IPS for an individual trust. Given the wealth of articles and texts available as a guide for developing an IPS, we will not elaborate here on the overall content of a well-constructed IPS. Section 2 of the Act provides an appropriate guideline for the necessary content. However, there are three components of an IPS that deserve elaboration and insight. Additionally, the order in which these specific components are developed is crucial. The three components listed below are arranged in the order in which decisions should be made.

1. Selection of Asset Classes Included in the Portfolio.

Perhaps one of the trustee's most important investment related decisions is determining the appropriate asset classes to be considered for the trust. If the choices selected are too few, the probability of achieving a well-diversified portfolio is extremely low. As illustrated in the first paper in this series, the selection of asset classes to be considered for the portfolio creates the attainable set used in the construction of the Efficient Frontier.

Quite often after asset classes are identified, the trustee determines a strategic asset allocation among these asset classes without the benefit of an Efficient Frontier analysis and establishes the allowable deviations from that allocation. This approach is problematical because it can limit the Efficient Frontier and force the trustee's portfolio choices into too narrow a range of expected returns and risk levels.

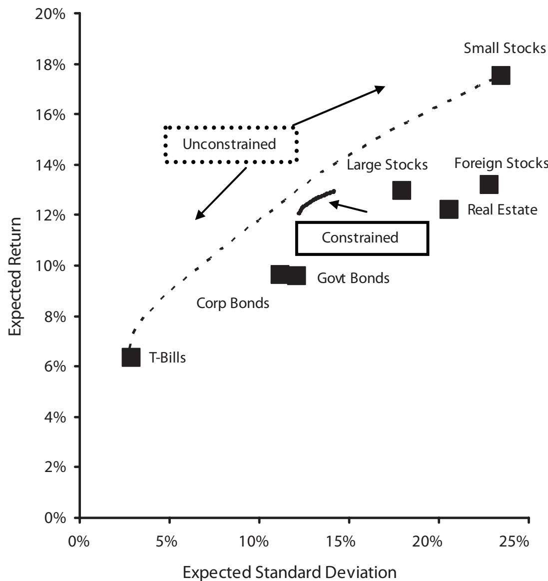
Assume the trustee selects the asset classes in Chart II.1 and uses these asset classes to construct the Efficient Frontier. The result is the Unconstrained Efficient Frontier shown in Chart II.2. Alternatively, assume the trustee begins by selecting the seven asset classes in Chart II.1, establishes the strategic allocation, and assigns the lower and upper deviations shown.

Chart II.1
Strategic Asset Allocation and Allowable Deviations

	Lower Limit	Strategic Allocation	Upper Limit
Small Stocks	12%	15%	18%
Foreign Stocks	9	12	15
Large Stocks	30	35	40
Real Estate	8	10	12
Corp. Bonds	10	13	16
Govt. Bonds	8	10	12
T-Bills	3	5	7

Using these allowable deviations as constraints (e.g. the 15% allocation to small stocks is limited to between 12% and 18%), a different Efficient Portfolio (labeled Constrained in Chart II.2) is generated. The Constrained Efficient Frontier is very short and the opportunities available to the trust are limited with respect to the portfolio's expected return and risk.

Chart II.2
Constrained and Unconstrained Efficient Frontiers



The better approach is to establish upper and lower limits *after* the optimum portfolio is selected from the Unconstrained Efficient Frontier. After all, upper and lower limits associated with the strategic asset allocation decision are nothing more than a guide to portfolio rebalancing.

2. Determination of the Target Rate of Return for the Trust Portfolio.

Many factors enter into the selection of the target rate of return, some controllable by the trustee and others dependent on factors outside the trustee's control. Examples of the latter include expected inflation and a minimum level of administrative expenses. Controllable factors include the: withdrawal rate, desired real growth in asset value (return above the rate of inflation and after withdrawals), and, ultimately, risk. As will be shown, determination of the target rate of return is subject to change once the risk level associated with this return is estimated.

3. Determination of the Risk Tolerance for the Trust Portfolio.

Perhaps there is no more vexing problem for a trustee than determining an appropriate risk level for a trust portfolio. It is well known that trust beneficiaries desire high returns and low risk. It is an axiom of finance that return and risk move together; the higher the desired return, the higher the necessary exposure to risk. Thus, there is a tradeoff between desired return and risk. As demonstrated in the following sections of this paper, a trustee can estimate risk tolerance of the trust beneficiaries through an iterative process. This process involves determining initially the desired rate of return and then assessing the risk level required to achieve that return. If the risk is higher than a tolerable level, then the required return must be adjusted downward to accommodate a lowering of the risk. It is possible the opposite occurs. The initial required rate of return may suggest a risk level that is too low once consideration is given to "the purposes, terms, distribution requirements, and other circumstances of the trust." In this instance, elements of the return controllable by the trustee can be increased.

III. THE APPROPRIATE LEVEL OF RISK FOR A TRUST PORTFOLIO

A. The Trust's Target Rate of Return.

Let us assume we have a well-considered IPS. This document would specify the trust's target rate of return consistent with the trust's goals and objectives. For example the investment policy of a trust with a single income beneficiary and remainder beneficiaries would be designed to provide as much periodic income as was consistent with the expected life of the trust, specific provisions and restrictions, the beneficiaries' needs, and the trustee's duty of impartiality. To be sustainable, the income target would also have to be consistent with both the corpus and the expected rates of return on the constituent asset classes to produce the specified level of income. Most income beneficiaries would like to have as much income as possible but that desire is limited by the amount of the corpus, the available rates of return, and the risk required to reach those rates. Assuming all parties have agreed on the trust's target rate of return, we can proceed to analyze the appropriate risk level. The risk level, in turn, provides feedback for the trustee's construction of the investment portfolio.

B. Risk and Rate of Return.

In the first article in this series we introduced the Efficient Frontier. This technique finds the best possible combination of asset classes – best in the sense they all offer the lowest risk for their level of expected return. This collection of best portfolios is produced by examining all combinations of assets in the feasible set – those asset classes the trustee deems suitable possible investments. Although trustees who are experienced investment professionals could forecast and justify their own independent asset class returns, risks, and correlations, historical records are probably the best source for these forecasts. The same history of asset class performance is widely available to everyone. For purposes of this article we will assume the trustee has determined departures from these numbers are unwarranted.

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C. Using the Historical Record.

Historical rates of return on seven popular asset classes are shown in Chart III.1. The column labeled average return shows the average annual return produced by the seven asset classes listed.

Chart III.1
Annual Historical Returns on Seven Indices*
All statistics in %

	Average Return	Standard Deviation
Small Stocks	17.52	23.47
Foreign Stocks	13.20	22.85
Large Stocks	12.94	17.97
Real Estate	12.19	20.59
Corp Bonds	9.62	11.21
Govt Bonds	9.56	12.11
T-bills	6.35	2.90

* Chart III.1 is based on actual annual returns from 1972 through 2003.

This Chart makes three main points:

1. Lessons from the Historical Record.

First, this historical experience sets the range of returns that have occurred and, therefore under our assumptions, are likely to occur on average in the future. Trustees seeking a17.5% rate of return, for example, would have to invest the entire portfolio in small stocks. This approach, of course, would be contrary to the Rule's emphasis on diversification. A diversified portfolio would have to accept a more modest return objective.

2. Asset Class Risk and Return.

Second, every target rate of return carries some risk. Even a portfolio dedicated to Treasury bills carries some risk, as the standard deviation column in Chart III.1 suggests. The standard deviation indicates the amount of variation around the annual average return. Every asset class has a standard deviation. Common investment practice is to take this standard deviation statistic as a measure of risk. This statistic produces an intuitive ranking of returns to these asset classes in that most people recognize bonds are more risky than Treasury bills, real estate is more risky than bonds, and stocks become more risky as one moves from large stocks, to foreign stocks, to small stocks.[9] Experience with the capital markets reflects the interaction of millions of investors and billions of dollars over many years. We can, therefore, use this historical information to translate the trust's expected return requirement into a risk level.

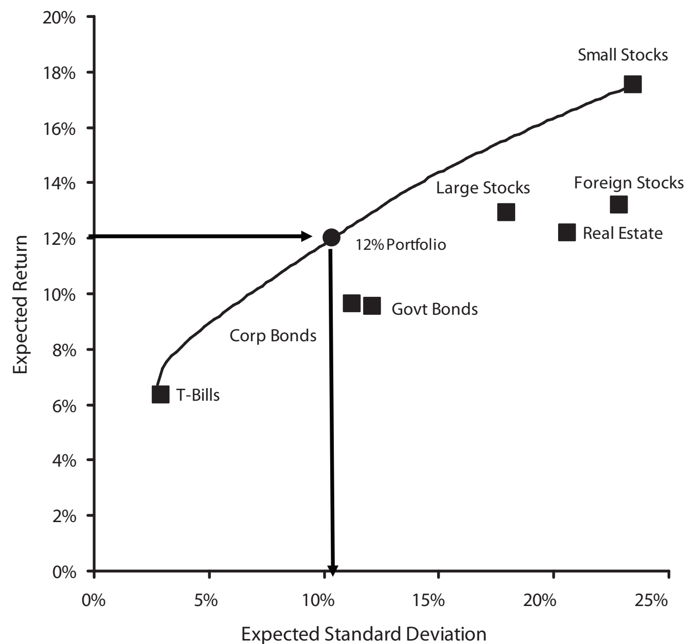
3. An Alternative Portfolio.

If we assume the trust's target rate of return is 12% per year we could construct a portfolio that was invested 93% in real estate and 7% in corporate bonds (.93 x 12.19% + .07 x 9.62% = 12%). This portfolio, however, would carry more risk (i.e., be less efficient) than other portfolios that are expected to produce a rate of return of 12%. The trustee should use the Efficient Frontier to discover the portfolio that provides the least risk with an expected return of 12%. Chart III.2 shows such an Efficient Frontier.

D. Using an Efficient Frontier.

The Efficient Frontier shown in Chart III.2 was developed following the process discussed in the first article of this series. To find the risk level associated with the efficient portfolio that produces an expected return of 12%, locate the portfolio on the Efficient Frontier that produces 12% (labeled "12% Portfolio") and read down to determine the risk level. In this example the 12% Portfolio has the asset allocation shown in Chart III.3 with an expected standard deviation of 10.4%.

Chart III.2
Efficient Frontier Using Historical Annual Returns for Seven Indices*



* Chart III.2 is based on actual annual returns from 1972 through 2003.

Chart III.3
Allocation of the Efficient Portfolio with an Expected return of 12%

Asset Class	Allocation
Small Stocks	34%
Foreign Stocks	10%
Large Stocks	0%
Real Estate	0%
Corp Bonds	0%
Govt Bonds	37%
T-bills	19%

This portfolio is diversified and may be judged by the trustee to be suitable.[10]

E. Calibrating the Trust Portfolio.

The trustee can now review the efficient portfolio and judge whether the risk implied by the target rate of return is suitable. For many trustees and beneficiaries the concept of risk is more difficult than the concept of return. Chart III.4 shows how the portfolio displayed in Chart III.3 can be helpful in calibrating the risk.

Chart III.4
Forecast Range of Efficient 12% Portfolio Returns from One to Twenty Years in the Future

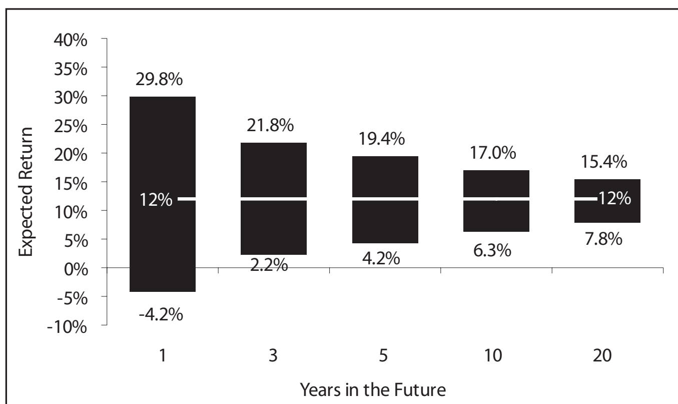


Chart III.4 shows forecast returns for one, three, five, ten and twenty years into the future for the 12% Portfolio shown in Chart III.3. The heights of the bars above each year represent a likely range of returns. This range covers 90% of possible outcomes, *i.e.*, from the 5th to the 95th percentile of the simulated distribution. The top and bottom of each year's range are labeled, as is the expected return of 12%. For example, forecast returns one year hence are expected to range from -4.2% to 29.8% with an expected return of 12%. These numbers were developed using a mathematical process that takes the forecast return (12% per year) and standard deviation (10.4% per year) of the portfolio in Chart III.3 and simulates how this portfolio might perform in the future. The expected return becomes more likely as time passes while the absolute variance of possible results also grows.[11] Using this information the trustee can calibrate the portfolio's risk.

F. Making Risk More Real.

Measuring risk with statistics like standard deviation is not easily understood by most people. The forecast range of portfolio returns, however, is easier to understand. In Chart III.4 we see within the forecast range of returns a negative return is likely only for the first year.[12] Certain situations, however, would define a return less than cash (or Treasury Bills) as a relative loss. Trustees with investment experience, for example, might be expected not only to avoid losses but to earn a return greater than Treasury Bills, the lowest risk alternative. In these cases, and using the average return in Chart III.1, the trustee might look at a return of 6.35% or less as a loss. Chart III.4 suggests that under this definition of loss, this portfolio carries considerable risk.

G. Finding an Acceptable Portfolio.

While the portfolio in Chart III.3 is not immune from negative returns, a trustee should at least begin with an examination of the efficient portfolio. If this portfolio is not satisfactory the trustee should look at other efficient or near efficient portfolios that have returns somewhat less than 12% as they will entail less risk. Through a process of trial-and-error the trustee can find a portfolio that has acceptable levels of both risk and return. Because these two factors are inextricably linked, compromises are almost always necessary. The following section describes a case scenario that illustrates these points.

IV. CASE SCENARIO

Husband (H) was divorced from his first wife (W1) during 1994. He has three living adult children from his first marriage to W1. He made a cash settlement with W1 and pays no alimony nor does he have any continuing financial obligations to her.

During 1998, H marries his second wife (W2). At that time, his net worth approximates $5 million exclusive of his home (valued at $500,000) and tangible personal property including mostly household effects and automobiles worth approximately $100,000.

H and W2 have a prenuptial agreement that provides, inter alia, for the following testamentary dispositions. After distributions of tangible personal property (including household effects and

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automobiles) and excluding any principal residence (homestead), H may use the full amount of his remaining unified credit as he chooses but subject to the lesser of a minimum of $4 million or all of H's remaining estate (*i.e.*, mostly listed securities) being funded into a QTIP trust. He will create a QTIP trust with an independent trustee. As is required, W2 will receive all income from the QTIP but distributions of principal will be in the trustee's discretion for her health, education, maintenance, and support. At W2's demise, any remainder may pass as H directs in his testamentary document. W2 may use the homestead during her lifetime unless unoccupied for more than six months. She is to maintain the homestead during her occupancy. She will receive also the household effects and any vehicles owned by H.

W2 and H live happily thereafter until H dies unexpectedly during 2004 at the age of 75. W2 is 64 years old. She has approximately a twenty year life expectancy.

V. THE ROLE OF THE TRUSTEE

A. The Initial Portfolio.

The trustee in this scenario as part of the development of an IPS must determine the feasible set of asset classes, make forecasts of return, risk, and correlation, and decide on an appropriate portfolio. For purposes of illustration we will continue to assume the seven asset classes in Chart III.1 constitute the feasible set and that the historical record of asset class returns is an appropriate forecast. To help W2 better understand the implications of the trustee's decisions, the situation is recast in terms of dollars. The trustee starts with the efficient portfolio in Chart III.3, based on an initial interpretation of W2's desire for income from the trust. The trustee includes an annual withdrawal from the trust and calculates how this portfolio will behave to show to W2 and the children of W1.

B. Choices Available to the Trustee.

The ability of any portfolio to provide income to the beneficiary and principal to the remainder beneficiary is a function of three choices:

- The amount of investment risk in the portfolio. The more risk the portfolio takes on, the higher rate of expected return and the wider the range of possible portfolio values. Risk is expressed through the range of values.

- The income distributed from the portfolio. The more income distributed, the less likely the portfolio will be able to sustain that income and maintain principal.

- The time horizon. The longer the time horizon the more opportunities to build principal but also the more likely the portfolio will be dissipated by income demands, risk or both.

C. Calibrating the Risk and Return of the Trust Portfolio.

For the purposes of illustration we will assume the income distributions and time horizon are fixed. The trustee must then calibrate the portfolio's risk to balance desires of the income and remainder beneficiaries. To simplify the presentation we will assume W2 requests $480,000 annually.[13] In an ideal world with perfect forecasting, therefore, the portfolio would be returned to $4 million at the beginning of the second (and every) year and the income beneficiary would receive $480,000 (12% x $4 million) at the end of the first (and every) year. Under our assumptions at the end of the first year the portfolio would have a 5% chance of being above $5.194 million ($4 million growing at 29.5 percent from Chart III.4) before the year-end distribution of the $480,000 and a 5% chance of being below $3.832 million ($4 million falling at 4.2 percent from Chart III.4) before the year-end distribution of the $480,000. These extreme values are calculated from the expected return (12%) and risk (standard deviation) of the portfolio.[14] Continued withdrawal of $480,000 might be acceptable if the portfolio ends up on the high side, at $5.194 million before the year-end distribution of $480,000 because the portfolio is expected to earn 12% the following year, ending the second year at $4.799 million after the withdrawal. Alternatively the $3.832 million portfolio will not earn enough to cover the withdrawal of $480,000, ending the second year at $3.274 million after the withdrawal.[15] A few bad years in a row and it is highly unlikely the portfolio will ever return to $4 million.

D. Helping the Beneficiaries Understand the Implications of their Choices.

At this point the trustee should present these forecasts to the beneficiaries. In all likelihood the remainder beneficiaries will not be happy about endangering principal. Under our assumptions the only choice left open to the trustee is to reduce the portfolio's risk, which reduces the expected return. Selecting a portfolio with an expected return of 10%, for example, reduces the risk to principal.

E. Components of the Rate of Return.

The rationale for changing the expected rate of return can be found in the origins of the rate of return itself.[16] Expected returns on default risk-free instruments (*e.g.*, short-term government bonds) are generally assumed to be the combination of a real risk-free rate[17] (also called the time value of money) and expected inflation. Expected returns on risky assets, like those in the portfolios in which most trustees invest, are assumed to carry risk premiums above the default-free rate. These risk premiums vary depending on the extra risk

presented by each asset class. High quality corporate bonds, for example, would carry a small risk premium compared to the risk premium for common stocks. The expected return on the 12% portfolio used here for illustration carries a risk premium above the real return and expected inflation. If the sum of these two factors is 5% then a 12% portfolio would have a risk premium of 7%.

As beneficiaries consider alternative portfolios they usually focus on expected return. In our example if the trustee explains that the 12% expected return has at least three parts (default risk-free, expected inflation, and risk premium), the beneficiaries may be better able to understand how lowering their expected return also lowers the risk premium. Lower risk means lower and more stable returns, as the 10% portfolio identified in Chart V.1 illustrates.

F. The Optometrist Approach.[18]

The efficient portfolio with an expected return of 10% selected from the Efficient Frontier shown in Chart V.1 has a 5% chance, before the $400,000 distribution (10 percent of $4 million), of ending the year above $4.861 million and a 5% chance of being below $3.968 million.[19] By the same assumptions we used earlier the income beneficiary withdraws the expected return or $400,000 at the end of every year.

Chart V.1
Efficient Frontier with 10% and 12% Portfolios*

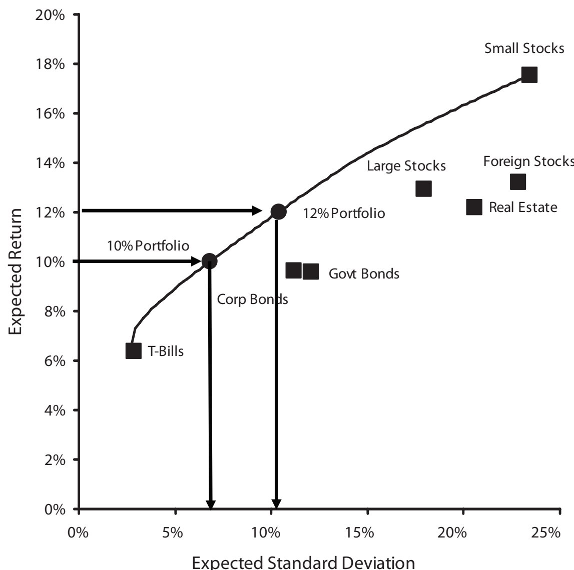
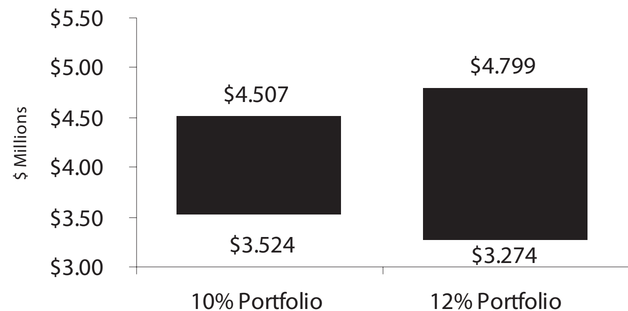


*Chart V.1 duplicates Chart III.2 with the addition of the 10 % Portfolio

In this case the portfolio will be worth either $4.507 or $3.524 million at the end of the second year.[20] Like an optometrist asking, "Can you see the chart better now?" the trustee can ask the beneficiaries: "The higher expected return portfolio carries the possibility of a higher dollar value if things go well but a lower dollar value if things go poorly. Which do you like better, the 12% or the 10% portfolio?" Chart V.2 shows the results graphically.[21]

Chart V.2
Comparison of the Forecast Range of Values at the End of Year Two for the 12% and 10% Efficient Portfolio Returns*



*The end of year two values are after the year-end distributions for year two.

The 10% expected return portfolio has lower forecast highs and higher forecast lows and a better chance of preserving the principal over time at a sacrifice of $80,000 in annual income for W2.

G. Communicating with the Beneficiaries.

We present this discussion about calibrating portfolio risk not because most trustees use this process but because they should. Communicating return to beneficiaries is generally less difficult than helping them understand risk. Using a dollar range of possible future wealth can be effective in documenting that the trustee has discussed the implications of the asset allocation decisions, risk level, time horizon, and withdrawal rates with all interested parties. Failure to do so may leave beneficiaries without a solid understanding about the implications of the trustee's choices. A lack of understanding can lead to disappointment, recrimination, possible litigation cost, and potential liability for the trustee.

VI. CONCLUSIONS

A. The Investment Policy Statement.

A well constructed and implemented IPS is an important, albeit not legally required, step in a trustee's conduct in managing a trust's investments. It provides a guide for consistent implementation of an investment strategy based on circumstances associated with that particular trust and prevents irrational reactions to events in the market place. An IPS also provides a blueprint for documenting decisions and an

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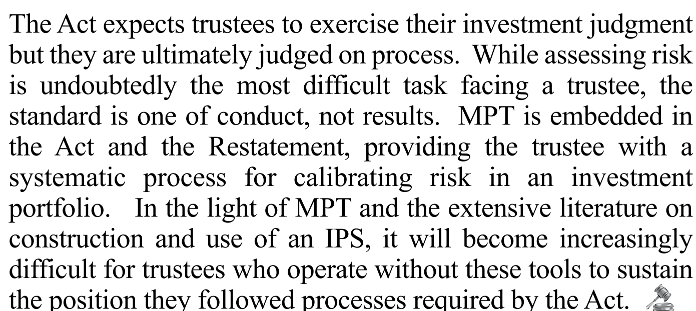
effective means of communicating with the trust's beneficiaries. The appropriate contents of an IPS are well documented in the literature. When constructing an IPS, the trustee should pay particular attention (in the following order) to selection of potential assets to be included in the portfolio, determination of the target return and assessment of the appropriate risk tolerance. The selection of the portfolio's potential assets determines the attainable set which in turn determines the Efficient Frontier. Estimation of the target return identifies the appropriate portfolio on the Efficient Frontier. This efficient portfolio defines the initial strategic asset allocation. The location of the portfolio on the Efficient Frontier can be used to assess the portfolio's expected risk for that return. Upper and lower limits around this strategic allocation can then be used to establish when portfolio rebalancing should be undertaken.

B. Determining the Appropriate Level of Risk.

The desired return and risk are inextricably related; the higher the required return of a portfolio the higher the risk exposure of the portfolio. Using this return to locate a suitable portfolio on the Efficient Frontier allows the trustee to identify the expected risk of the portfolio expressed in terms of its standard deviation. While the standard deviation is a common indicator of risk used by academics it can be difficult for a beneficiary to appreciate its significance. Using a simulation it is possible to convert this risk measure into potential ending dollar values for the portfolio. The higher the risk level the larger the potential future fluctuations in the portfolio's dollar value. The trustee, in consultation with the trust beneficiaries, can determine whether these potential ending dollar values are acceptable. If the potential loss of portfolio value is deemed to be unacceptable, then the target return of the trust must be reduced in increments until an acceptable level of risk is determined. It is also possible the initial target return estimation results in potential portfolio fluctuation estimations that are below a level of tolerance. In this case, the target return can be increased resulting in higher portfolio risk.

C. The Act, MPT, IPS, and the Trustee.

The Act expects trustees to exercise their investment judgment but they are ultimately judged on process. While assessing risk is undoubtedly the most difficult task facing a trustee, the standard is one of conduct, not results. MPT is embedded in the Act and the Restatement, providing the trustee with a systematic process for calibrating risk in an investment portfolio. In the light of MPT and the extensive literature on construction and use of an IPS, it will become increasingly difficult for trustees who operate without these tools to sustain the position they followed processes required by the Act.



Endnotes

1. This article was previously published in the *ACTEC Journal*, Vol. 30, No. 4, (2005) p. 251 - 260 and is reproduced with the permission of the *ACTEC Journal*. Copyright 2005, Edward A. Moses, J. Clay Singleton and Stewart A. Marshall, III.

2. The Employee Retirement Income Security Act of 1974 (ERISA) Sec. 402(b)(1) requires the establishment of a written funding policy but does not specifically require the development of an IPS.

3. A discussion of the underpinnings of Modern Portfolio Theory and its basis in trust law appears in the first article in this series, Edward A. Moses, J. Clay Singleton and Stewart A. Marshall, "Modern Portfolio Theory and the Prudent Investor Act", *ABA Trial Practice Journal*, Vol. 20, No. 1.

4. Assessing damages are discussed in detail in the next article in this series, "Computing Market Adjusted Damages in Fiduciary Surcharge Cases using Modern Portfolio Theory."

5. Uniform Prudent Investor Act, §8.

6. Wendell Scott Simon, *The Prudent Investor Act: A Guide to Understanding*, 2002, Camarillo, CA, Namborn Publishing Co., p. 73.

7. A search of Google.com, using the search term, "Investment Policy Statement", results in 3.96 million "hits." A search done within these results using the term, "IPS," provides 29.4 thousand references. Not all of these references are directly pertinent for developing an IPS; however, a sampling of these references indicated that many had appropriate content for this purpose.

8. For an excellent reference on developing an IPS see Donald B. Trone, William R. Allbright and Philip R. Taylor, *The Management of Investment Decisions*, 1996, Chicago, Irwin Professional Publishing, Chapter 5.

9. Chart III.1 shows the historical standard deviation for government bonds is slightly larger than the standard deviation for corporate bonds. Intuitively, however, government bonds should be less risky (i.e., should have a smaller standard deviation). This anomaly in standard deviation as a risk index is probably due to the underlying characteristics of the asset class index. In this case corporate bonds are represented by only the most credit-worthy bonds, only slightly more risky than government bonds. This result also shows that working with history does not always produce intuitive results. The absolute difference in standard deviation between government and corporate bonds, however, is small, much smaller than the difference between Treasury Bills or between bonds and real

estate. Despite this drawback in working with historical data, the benefits to the trustee of verifiability and documentation far outweigh occasional counter-intuitive anomalies.

10. In this discussion we ignore portfolios in the neighborhood of the Efficient Frontier. These portfolios are covered in the first article in this series. Our discussion here would not change materially if we chose a neighboring portfolio that might have a more intuitive asset allocation.

11. Imagine tossing a coin. After four tosses, despite the fact that probability of heads and tails is equal, you would not be surprised if the number of heads was not exactly four. The number of heads, however, cannot be much different than two. After four hundred tosses the number of heads should be close to two hundred but the difference can be much greater than two.

12. We use "likely" to imply within the confidence interval from 5% to 95%. Negative returns are possible in any year. In this example only in the first year is there greater than a 5% probability of a negative return. We apologize if this generalization of probabilities offends statisticians but we believe a detailed treatment of the underlying distributions and associated probabilities is unnecessarily confusing in this context.

13. For the purpose of this illustration W2 has requested an annual constant withdrawal rate equal to $480,000, based on H and W2's spending patterns during their marriage. This amount is anticipated to be in excess of the annual income earned by the trust. Appropriate and fair withdrawal rates are the focus of the fourth article in this series, "The Appropriate Withdrawal Rate: Comparing a Total Return Trust to a Principal and Income Trust."

14. This calculation assumes the returns are randomly drawn from a lognormal distribution, a standard assumption in finance.

15. $5.194 million minus $480,000 = $4.714 million returning 12% = $5.279 million less the withdrawal of $480,000 = $4.799 million. $3.832 million minus $480,000 = $3.352 million returning 12% = $3.754 million less the withdrawal of $480,000 = $3.274 million.

16. The theory of the expected rate of return is attributed to Irving Fisher and is called the Fisher equation. This equation says that the expected rate of return on default-risk free (government) bonds is the sum of the real risk-free rate of interest and expected inflation. Although the ability of this theory to forecast interest rates is the subject of continued debate, it is widely accepted as descriptive.

17. "Real" is used here in the sense of the pre-inflation return and "risk-free" denotes no possibility of default *(i.e.*, government bonds).

18. This characterization of the portfolio problem as analogous to being fitted for glasses was originated by Richard Thaler.

19. The estimate of the efficient portfolio's year-end high and low values followed the same procedure used earlier for estimating these values for the portfolio with a 12% expected return. The standard deviation of the portfolio with the 10% expected return is 6.8% compared with the standard deviation of the 12% portfolio, 10.4%.

20. $4.507 million = $4.861 million minus $400,000 = $4.461 million returning 10% = $4.907 million less the withdrawal of $400,000 and $3.524 million = $3.968 million minus $400,000 = $3.568 million returning 10% = $3.924 less the withdrawal of $400,000.

21. In Chart V.2 we used the upper and lower 5% probability limits of the distribution similar to Chart III.4 except here we used one year instead of one through twenty years and dollars instead of returns in percent. We use a one-year instead of a twenty-year context to reduce the complexity of the time horizon and focus on what happens when the trustee asks the beneficiaries whether the expected outcomes are acceptable. We use dollars because they are usually easier for beneficiaries to understand.

TRIAL PRACTICE
Journal

The Junior Brief: A Column By and For Young Trial Lawyers

Five Tips for Using Documentary Evidence

by Nash E. Long, III

For those who are just "getting their feet wet" with trial practice, I present the following five tips on using documents at trial. I have developed this list based in part on my direct experience and in part on the collective wisdom of those with whom I practice. Following these five rules for the use of documents at trial is essential in moving past the science of the law to the art of persuasion.

1. Know your rules of evidence.

This almost goes without saying. Almost. The rules of evidence, like the rules of procedure, are to the lawyer what paintbrushes are to the painter. They are the mechanism by which we take the facts (i.e., the paint) from the record (i.e., the palette) and paint a picture for the jury that will move them. If you do not know how to use these tools, your picture will not look like what you had intended to create. What is more, stumbling around and wasting time will aggravate both judge and jury and predispose them to reject your story.

It is often simpler to admit documents into evidence, with fewer foundational questions, than attorneys make it. Michael Tiger, former Chair of the Section of Litigation, cites the "MIAO" acronym for admitting evidence. First, **Mark** the document with an exhibit sticker. Second, ask the witness to **Identify** the document. Third, elicit testimony to **Accredit** the document. Fourth and finally, **Offer** the document into evidence. M. Tigar, *Examining Witnesses* (2d ed. 2003) at 154. Testimony to accredit the document need only show that the document: 1) is authentic; 2) satisfies the "best evidence" rule (or, in the case of a summary, Rule 1006); 3) is not hearsay or fits an exception to the hearsay rule; and 4) is relevant. *Id.* at 149-50. In laying this foundation for admissibility, remember that it is permissible to use leading questions on preliminary matters.

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A good trial lawyer will seek to remove potential objections to the admissibility of exhibits prior to trial. This makes for a smoother and more tightly focused witness examination before the jury. The procedures for pretrial disclosures of exhibits and objections in Federal Rule of Civil Procedure 26(a)(3) provides one means by which this can be done. In other jurisdictions, you should consider stipulating to the admissibility of exhibits in the pretrial order. If you cannot ensure admissibility of exhibits prior to trial, however, remember these simple rules.

2. Understand how you will present your documents to the jury.

Once you have your document in evidence, you are ready to examine your witness on its substance. To do this effectively, you will need some way for both judge and jury to see the document as you examine the witness. Nothing turns off an audience more quickly than a conversation between lawyer and witness about something the audience cannot follow. M. Drummond, "What Judges Want," *Litigation*, Vol. 34, No. 4 (Summer 2005). You will therefore need to display or "publish" the exhibit as you examine the witness.

There are several kinds of ways to publish exhibits to a jury. You can pass them out to the jury (a copy for each juror, so there is no down-time while it is being examined by one juror at a time); you can blow them up on oversized boards; you can display them on the overhead projector or ELMO; and you can use a trial presentation software that displays them electronically. Just because you *can* use the high-tech trial presentation software, however, does not mean that you *should* do so. Think about how the high-tech presentation will appear to the jury. Is it too slick? Does it get in the way of the message? According to Michael Tigar, the electronic presentation of documents actually diminishes their power. Tigar, *Examining Witnesses Id.* at 149. By visibly handling exhibits as the witnesses had done and as the jurors would do in deliberation, an attorney is making the process more transparent to the jury and empowering them to act. *Id.* The real document can have a talismanic significance that an electronic image of it does not. In a patent infringement case, for example, the plaintiff will want to have the original or a certified copy of the patent for use at trial, ribbons and all.

3. Know how your judge likes to receive evidence.

How will you use the exhibit to make your point in the examination of the witness? Some judges will not let you read from a document on display to the jury: "Counsel, the jury and I can read. Ask your next question." The problem with such a rule is that the jury needs to know *why* you have gone to the time and trouble of admitting and publishing the document. Why is this document important, and how does it fit with the theme and theory of your case? You cannot wait until summation to make

those points. Expert jury consultants advise that the typical juror will make up his or her mind about what is the correct outcome well before closing arguments, and once they make that decision he or she is quite resistant to change. So, if your judge is one who enforces the "don't read from the document" rule, you must find other ways to direct the jury's attention in the course of witness examination. "Mr. Witness, let me direct you to the sentence which reads '[insert relevant language].' Why did you write that?" Another way to direct attention is with highlighting or call-outs of the relevant language. If you are using a trial presentation software to do such things "on the fly," your verbal cues to an assistant running the software in the courtroom will also direct the jurors' attention. Pre-set highlights or call-outs in the presentation software are another option.

4. Know whether you need a document to prove your point.

A trial is not a contest to see which side can introduce the most documents in evidence. If you lose sight of that, you will likely lose your trial. Instead, the primary contest in a trial is one of credibility between adversaries. That credibility is best established by what is said and done in the courtroom, not on the dry record of exhibits. For that reason, you cannot let the admission of documents and their use at trial detract from the flow of the examination of witnesses. Furthermore, too many documents can obscure the story you are telling to the jury. A lawyer who overdoes it on trial exhibits is like the chef who over-seasons his dishes: neither gets much repeat business.

You will want to apply strict scrutiny to the potential exhibits to see which of them make the cut as actual trial exhibits. It is not unusual for a document to have both "good" and "bad" language within it. Under the rule of completeness, *e.g.*, Fed. R. Evid. 106, if you publish a portion of a document in an examination of a witness, your adversary has the right to interrupt and request the publication of additional portions of the document. If you highlight and publish the "good" part of the document out of context, it gives your adversary a chance to jump in and attack your credibility in the middle of the examination. Furthermore, documents can be subject to alternative readings. One of the favorite moves of the trial lawyer is to take something sponsored by your adversary (whether it is an exhibit, an analogy, or a witness) and show how it actually supports your position rather than that of its sponsor. Therefore, you should use a document as an exhibit only if it truly helps your case and does not undermine it. Finally, even if all your potential exhibits are unimpeachable and cannot be spun against your, remember that jurors—like the rest of us—have a limited capacity to absorb information. The more documents you throw at them, the less important any one of them can seem. Narrow down the exhibit list to a manageable number and remember that sometimes less is more.

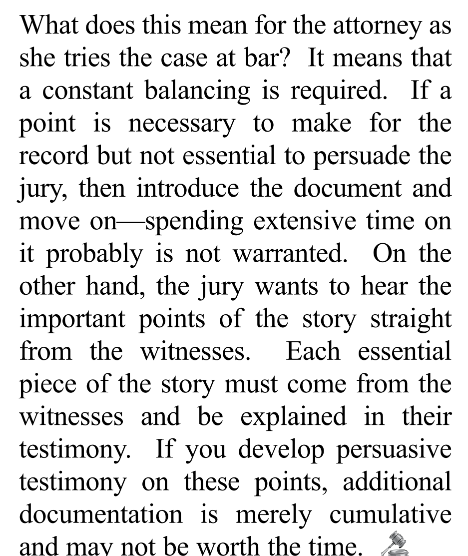
5. Know your audience(s).

At each instant in a trial, you as trial lawyer are addressing up to three audiences: 1) the jurors who will decide the facts; 2) the judge who will decide what issues to submit to the jury, what instructions to provide them, and what to do with any post-trial motions; and 3) the appellate court. This can affect decision-making on what exhibits to offer into evidence, what admitted exhibits to publish, and what admitted exhibits to use in argument.

I have found that jurors place great weight (either consciously or subconsciously) on what *they* witness in the courtroom: the demeanor and behavior of witnesses and the testimony delivered under oath. If you don't believe this to be true, go back and read the transcript of a trial (or deposition) you attended where you recall the witness to have performed particularly well or badly. The chances are that any judgment of the witnesses' performance based on a reading of the "cold record" will be much different from your memory of the actual event. Why this cognitive dissonance? The cold record does not capture rhythm, tone, posture, facial expressions, eye contact, or any type of non-verbal communication. We better remember what we see than what we hear. The impressions jurors have are therefore shaped to a greater degree by the action which unfolds before them than by what is read to them out of a document.

In contrast to the jury, I have found that judges tend to place greater weight on documentary evidence. Perhaps this is because courts deal more with documents than with testimony these days, as motion practice in the courts far outpaces trial practice. Perhaps it is a reflection of the familiar homily that "documents don't change their story." For whatever reason, post-trial motions and orders tend to rely more on the exhibits than the testimony. The bias in appellate decision-making towards exhibits and documentary evidence can be even more pronounced.

What does this mean for the attorney as she tries the case at bar? It means that a constant balancing is required. If a point is necessary to make for the record but not essential to persuade the jury, then introduce the document and move on—spending extensive time on it probably is not warranted. On the other hand, the jury wants to hear the important points of the story straight from the witnesses. Each essential piece of the story must come from the witnesses and be explained in their testimony. If you develop persuasive testimony on these points, additional documentation is merely cumulative and may not be worth the time.



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