PHILADELPHIA COURT OF COMMON PLEAS
ORPHANS' COURT DIVISION

Alexander McFadden, Testamentary Trust
O.C. No. 1129 ST of 1956

George McFadden, Testamentary Trust
O.C. No. 1756 ST of 2009

ADJUDICATION

Introduction

The objectants to the accounts filed for the George McFadden Trust and the Alexander McFadden Trust seek removal of the trustees, a split of each trust into separate trusts for each of three beneficiaries, and a surcharge of the trustees in excess of $9.5 million dollars for losses suffered by the trusts in the aftermath of the September 2008 stock market crisis. The claims of fiduciary breach and mismanagement are many and varied; for this reason a detailed discussion of the factual record is necessary.

On April 22, 2008, George McFadden died tragically—and unexpectedly—in a plane crash. During his lifetime, he had been a co-trustee and sole income beneficiary of two longstanding family trusts established under the wills of his grandfather, George McFadden ("George Trust") and his father, Alexander McFadden ("Alexander Trust). George's death came at a time of increasing financial distress and interfamilial discord. Just months before his death, in February 2008 he had been forced to sell a beloved Southampton home, resulting in a large tax liability.[1] Then in March, he sought to borrow money from one of the trusts for a business investment, but was rebuffed by his two co-trustees: his brother, John McFadden ("John") and BNY

Mellon, N.A. ("Mellon"). In one of their last conversations George told his brother that he would seek to have him removed as co-trustee of his trust. George's daughter from his first marriage, Lisa Melas, had filed a lawsuit seeking to recover millions of dollars from him. On the night George died, his widow, Carol McFadden, ("Carol") was so deeply upset by her belief that John had purposefully delayed in telling her of George's death that she refused to speak with him

[1] 2/14/11 a.m. N.T. at 5-6 (JM);11/16/10 p.m. N.T. at 59 (CM); 2/9/11 p.m. N.T. at 53-54, 65-66 (CF); 4/25/11 Petitioner's Brief at 6; 6/4/11 JM Brief at 68.

after that night. Sometime prior to his death, George had sold his insurance policies that named Carol as beneficiary.[2] Unfamiliar with the financial underpinnings of her family, Carol found herself inundated with debts upon George's death.[3] John conceded that he knew neither Willa nor Alex, George's minor children through his marriage with Carol and the new beneficiaries of the trusts he administered. 2/10/11 a.m. N.T at 62-63 (JM). These leitmotivs of financial strain, family discord and lack of communication plagued the administration of the trusts in the period following George's death.

For the many years that George and John served as co-trustees with Mellon of the two trusts, the brothers pursued an investment strategy focusing on long-term growth based on a small number of equities that could be carefully supervised. That strategy proved highly successful. It did not change in the months immediately following George's death. A mere 4 ½ months after George's death, however, the stock market plunged upon the announcement of the Lehman Brothers bankruptcy. The McFadden trust portfolios likewise suffered a decline. In May 2009, Carol, as parent and natural guardian of Willa and Alex, filed a petition on their behalf seeking to surcharge the trustees for the losses incurred during the discrete period of April 2008 to April 2009. The petitioners also sought to remove John and Mellon as trustees. Prolonged litigation followed, which was eventually pursued on the children's behalf by their New York court appointed guardian, Winfield Jones.

Upon consideration of the massive record, the surcharge claim is denied. The petitioners failed to prove that the trustees had breached their fiduciary duty as to the trust investments or that the alleged breach resulted in loss to the trusts. Likewise, the claim for punitive damages directed against John McFadden is denied for lack of basis on the record. Mellon and John, however, shall be removed as trustees of the trusts for the benefit of Willa and Alex for the reasons set forth within.

Factual Background

The Accounting Periods for the George and Alexander Trusts

With George's death, the income beneficiaries of these two trusts changed to his three children: Lisa Melas ("Lisa"), Alexander ("Alex") and Wilhelmina ("Willa"). Lisa is an adult

[2] Ex. T-4.
[3] 11/16/10 p.m. N.T. at 66, 85-86 (CM).

daughter from George's first marriage, while Willa and Alex are minor children from his second marriage to Carol McFadden ("Carol"). Carol is not a beneficiary of either trust. At the time of their father's death, Willa was 14 and attending school in London; Alex was nine. 11/2/10 a.m. N.T at 40(Willa); Ex. P-11. In May 2009, Carol filed a petition as parent and natural guardian of Alex and Willa seeking an accounting from Mellon and John as the two surviving trustees. The petition also sought to remove the two trustees and surcharge them for losses suffered by both trusts in the midst of the economic crisis signaled by the bankruptcy of Lehman Brothers on September 15, 2008.

On June 3, 2009, an account was filed in Philadelphia for the Alexander Trust covering the period May 2, 2006 to February 11, 2009 and an account was filed in Delaware County for the George Trust covering the period September 24, 1985 to June 4, 2009. By decree dated June 15, 2009, the Delaware County action was transferred to the Philadelphia Orphans' Court to be coordinated with the proceedings for the Alexander Trust involving the same issues. In the course of the ensuing litigation, two supplemental accounts were filed for each trust[4] bringing the accounting period up to October 31, 2010 for both trusts. Consequently, the accounting period for the George Trust is September 24, 1985 to October 31, 2010. The accounting period for the Alexander Trust is May 2, 2006 to October 31, 2010.

The George and Alexander Trusts Prior to April 2008

<u>The Genesis of the Trusts</u>

The trusts at issue in this litigation were created under the January 6, 1930 Will of George McFadden (Ex. P-1) and the March 10, 1942 Will of Alexander McFadden (Ex.P-2). By his will, George McFadden, who died on January 15, 1931, left his residuary estate in trust for the payment of net income to his designated heirs in the proportion of two parts for a male, and one part for a female. His son Alexander, who died on February 14, 1948, likewise provided that trust income was to be paid to his designated heirs in the proportion of two parts to a male, and one part to a female. Both wills provided that "there shall be at all times a corporate Trustee and two individual trustees. . . ."[5]

[4] For the Alexander Trust, an amended account was filed on March 2, 2010 covering the period February 12, 2009, to December 31, 2009 and a Second Supplemental Account was filed on January 25, 2011 covering the period January 1, 2010 to October 31, 2010. For the George Trust, an amended account (attached to the 3/2/10 Alexander Trust account) was filed for the period June 5, 2009 through December 31, 2009. On January 25, 2011, a second supplemental account was filed for the George Trust covering the period January 1, 2010 to October 31, 2010.

[5] Ex. P-1, Article Fourth (3) & Article Third; Ex. P-2, Article Third & Article Seventh.

The Investment Strategy of George and John Emphasizing Long-Term Growth

John became a co-trustee of the George Trust in 1973, followed a few years later by George. Eventually, the two brothers became co-trustees of both the George and Alexander Trusts together with Mellon as corporate trustee.[6] George and John, who had both attended Columbia Business School, shared a similar investment philosophy favoring long-term growth by investing in common stocks. As adherents of the Graham and Dodd school of value investing, they believed in the importance of studying the balance sheets of a company to determine its financial soundness and future prospects.[7] In the mid-1970's they transformed the portfolio of the George trust away from its preponderance of municipal bonds in favor of long-term investment in a portfolio of common stocks.[8] Most of the investment suggestions came from George,[9] but both brothers believed it best to have a small number of securities that could be painstakingly watched rather than investments in a wide array of virtually unknown companies.[10] The trusts followed that investment strategy of all equities throughout George's lifetime.[11] George's rationale for this long term investment horizon was to provide for his children for many years after his death.[12]

These trusts were amicably split in 1984 into three parts for the benefit of George (40%), John (40%), and Mary McFadden (20%), who were the three children of Alexander McFadden. At that time, Mary McFadden expressed an interest in having a higher level of tax free income from municipal bonds while her brothers sought to maintain their investment strategy of long-term growth. Hence, they split the trusts to allow these differing investment strategies but John and George remained as co-trustees of their sister's trusts.[13]

Mellon's Advocacy of the Modern Portfolio Theory

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6 2/10/11 a.m N.T. at 25-26 & 30 (JM)(noting that he and George became co-trustees of the George Trust in the mid-1970's); 6/13/11 JM Brief at 8.
7 2/10/11 a.m. N.T. at 40-41, 25-26 (JM).
8 2/10/11 a.m. N.T. at 23-26 (JM).
9 2/10/11 a.m. N.T. at 39 (JM); Ex. P-129 ("George McFadden was an investment professional who had his own private equity company and made most of the investment decisions").
10 2/10/11 a.m. N.T. at 39-40 (JM).
11 2/10/11 a.m. N.T. at 27 (JM), George and John eventually split their trusts individually for tax considerations. 2/ 10/11 a.m. at 28 (JM).
12 1/4/11 p.m. N.T. at 64 (MM).
13 2/10/11 a.m. N.T. at 27-29 (JM).

Mellon, as corporate trustee, had a different investment philosophy based on diversification. Michael McGrath, who served as portfolio manager of the McFadden trusts for Mellon beginning in 2006, consistently urged John and George to adopt a less concentrated portfolio.[14] McGrath was an advocate of the modern portfolio theory of diversification across all types of asset classes including equities and fixed income.[15] When he first began working with the individual McFadden trusts, he learned that for many years the trusts had "always been all equities with "small number of holdings, larger concentrations."[16] McGrath therefore began a dialogue with the trustees in an effort to diversify the trust portfolios by adding fixed income securities, a larger number of securities, and a greater variety of sectors.[17] Because of the McFaddens' emphasis on long-term growth, the trust portfolios were designated for aggressive growth which under Mellon's criteria could range from 85/15 (equity to fixed) or 80/20 or even zero to fifteen fixed income depending on various factors.[18]

The Stunning Success of the McFadden Brothers' Investment Strategy

The McFadden brothers, while respectfully considering McGrath's suggestions, followed their own investment strategy with stunning success. The Alexander Trust, for instance, which had an inception value in 1951 of $1,000,000, had increased to $22,000,000 at the time it split in 2005 and by July 2008, [his share] was worth $17 million.[19] A month after George's death in April 2008, [this share] of the Alexander and George Trust had a combined market value of $44,257,000.[20]

The benefits of an investment strategy emphasizing long term growth is illustrated by the comparative performance of the trusts for the 2 McFadden brothers on one hand and the trust for their sister, Mary, who in 1984 had requested an allocation that would provide more income. As a result of this more conservative strategy, Mary's trust portfolio did not grow as rapidly as her brothers' portfolio. While Mary's George trust had been worth one-half of their trusts in 1984, by August 1, 2008 Mary's George Trust had shrunk to one twelfth of their size.[21]

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[14] 2/10/11 a.m. N.T. at 39 (JM); 1/4/11 a.m. N.T. at 6-9, 28-29 (MM).
[15] 1/4/11 a.m. N.T. at 7-9 (MM); 2/10/11 a.m. N.T. at 39-40 (JM).
[16] 1/4/11 a.m. N.T. at 19 (MM).
[17] 11/3/10 p.m. N.T. at 15-17 (MM).
[18] 11/3/10 p.m. N.T. at 19-20 & 51 (MM); Ex. T-117. McGrath also testified that the range for aggressive growth could be 70/30 to 90/10. 1/4/11 p.m. N.T. at 40 (MM).
[19] Ex. P- 129
[20] Ex. P-11.
[21] 6/14/11 JM Brief at 9. See Ex. P-51; 2/10/11 a.m. N.T. at 27-29 (JM). In his brief, John appears to lump together the George and Alexander trust performance as between Mary, on one hand, and her brothers on the other.

In addition to these family trusts, the McFadden brothers had a partnership based in New York City called McFadden Brothers. George's daughter, Lisa, was a 99% limited partner; John was a 1% limited partner, while George was the general partner.[22]

Periodically, George brought investment opportunities in private companies for the trustees to review. On several occasions, Mellon, in its efforts to accommodate these very wealthy clients, sought court approval of this type of investment when it did not have sufficient information on the company or was concerned about potential conflicts of interest.[23] While John testified that he and George never disagreed over the investment strategy for the trusts, their relationship was damaged by a failed investment in a private company, Washington Furniture that ended in bankruptcy in 2001. John blamed this failure, in part, on George's taking large fees from the company.[24]

The Effect of the Uniform Principal and Income Act ("UPIA") on the Trustees' Investment Strategy

A consequence of the investment policy emphasizing long-term growth by relying on a concentrated portfolio of equities was that it produced a comparatively small rate of income. Since George had not emphasized income from interest or dividends, historically during his lifetime the portfolio earned less than 1% in interest and dividends.[25] The McFaddens were able to compensate for this around 2005 by using distributions pursuant to the Pennsylvania Uniform Principal and Income Act ("UPIA").[26] As John explained, the UPIA gave the trustees the ability to fix a rate of distribution from the trusts without limitation to its actual dividends or interest. In other words, instead of relying on traditional "accounting" income from dividends or interest, the UPIA gave the trustees the option for distributions based on total return on a percentage of the

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According to Ex. P-51, it was the George Trust that showed the greater difference in performance for Mary and her brothers. For instance, the George Trust for Mary by August 2008 had a market value of $2,635,155, while the George Trust for both brothers was 12 times as large: the George trust for George had a value of $24,298,161 and the George Trust for John a value of $25,355,034. With the Alexander Trust, in contrast, the trusts for the brothers outperformed Mary's trust but to a lesser degree. The Alexander trust for Mary, for instance, had a market value of $6,979,517 while the Alexander Trust for George had a value of $15,007,586 and for John of $14,136,480. Ex. P-51.

[22] 2/10/11 a.m. N.T. at 50 (JM).
[23] 2/10/11 a.m. N.T. at 45-46 (JM).
[24] 2/10/11 a.m. N.T. at 46-49 (JM)
[25] 1/5/11 a.m. N.T. at 36 (MM).
[26] 2/10/11 a.m. N.T. at 33 (JM)

value of the trust without regard to its income or dividend yield.[27] The decision to switch to total return reinforced the trustees' belief in the necessity for an investment strategy geared to growth. As McGrath explained, "if you are moving to a total return, which means interest and dividends plus capital appreciation, the portfolio should be positioned more for growth because your capital appreciation is—you are taking some of the growth out of the future, if you will, or anticipated growth and spending it now." 1/4/11 a.m. N.T. at 21 (MM).

Once this UPIA distribution option became available, the trustees converted Mary's portfolio away from municipal bonds and back to a portfolio similar to her brothers' trusts.[28] In the final years of his life, George received large distributions from the trusts of up to 4% by relying on UPIA distributions. While prior to 2005 George received distributions of net income only which was generally less than 1% of the trusts' market value, by relying on UPIA distributions he received a total of $115,044.81 per month from the trusts or $1,380,537.70 per year.[29]

George's Loans from the George Trust and the Issuance of Options to the Trust as Part of the Deal

As Carol testified, George sought to recoup his fortune after the Washington Furniture bankruptcy by investing in other private companies, in some cases, with money borrowed from the trusts.[30] Two of those ventures were Affordable Furniture and Crescent Drilling. When George borrowed $2 million from the George Trust to invest in Affordable, John, with the assistance of his attorney wife Lisa Kabnick, sought to protect the trust's interests by requiring a promissory note backed up with life insurance. To compensate the trust for the resulting loss of appreciation of the funds used for this loan, they also negotiated an option agreement with an anti-dilution provision that allowed the trust for a nominal price of $1,500 to exercise the option. Mellon agreed to this transaction and the loan was consummated in July 2006. A similar transaction was structured to enable George to borrow money from the George trust to invest in Crescent Drilling.[31] The exact implications of these options, however, became a source of bitter dispute and intense interfamilial conflict after George's death.

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[27] 2/10/11 a.m. N.T. at 33-38 (JM); see also 1/4/11 a.m. N.T. at 20 (MM)(by moving to total return, appreciation was "monetized").
[28] 2/10/11 a.m. N.T. at 32-33, 37-38 (JM).
[29] Ex. T-50; Ex. P-67.
[30] 11/16/10 p.m. N.T. at 71-73 (CM).
[31] 2/10/11 a.m. N.T. at 55-59 (JM). For a copy of the Affordable Option Agreement, see Ex. T-175.

A month before his death, in March 2008 George once again sought to borrow money from the George Trust to invest in Crescent Drilling. This time, John refused to agree to the loan for several reasons. The company, John believed, was not really a proper trust investment. In addition, George, as trustee, would be taking substantial fees out of Crescent; finally, George was no longer insurable and had sold various of his insurance policies for modest sums. Mellon, likewise, refused to agree. In what turned out to be one of their final conversations, George told John that he would seek his removal as co-trustee for his refusal to support the deal.[32]

Misunderstandings Caused by Events Surrounding George's Traumatic Death

The traumatic events surrounding George's sudden death had a devastating effect on John's relationship with George's wife Carol. In fact, it became the focal point of the initial petition she filed seeking John's removal. In her view, John had maliciously kept the news of her husband's death from her for nearly 8 hours to provide time, inter alia, for George's secretary Bill Muller to rifle through papers in his office.[33] In contrast, John convincingly testified that he first learned that George's plane was missing around 10 on the evening of April 22nd and approximately one hour later learned of George's death. Once that was confirmed, he called his sister Mary who lived in New York City and asked her to go directly to Carol's apartment with the tragic news. Such awful news, he believed, should be delivered in person by someone friendly with Carol.[34] After she learned of her husband's death, Carol called John but eventually: "I just hung up the phone on John. And those are the last words we ever had with each other."[35]

Administration of the Trusts After George's Death in April 2008

Failure to Appoint a Third Trustee to Replace George

The wills creating the George and Alexander Trusts clearly required that there be two individual trustees and one corporate trustee at all times. They differed, however, as to how the successor trustee was to be appointed. While the Alexander Will contained no provision for the appointment of a successor trustee, the George Will provided that "the remaining individual

32 2/10/11 a.m. N.T. at 60-63 (JM).
33 Ex. T-191 (7/28/10 deposition of Carol McFadden at 147-49). See also 11/16/10 p.m. N.T. at 61-64 (CM); Ex. T-70 (Laffend memo noting that "she [Carol] is very angry that he (John) was the first to find out about George's death, that he didn't inform her for 8 hours that her husband was dead, that he had Bill Mueller go to George's office that night and get and destroy documents, and no one will tell her what was going on. She resents that John is on Lisa's side").
34 2/10/11 a.m. N.T. at 63-67(JM).
35 Ex. T-191 (7/28/10 deposition of Carol McFadden at 155).

trustees may and shall appoint a successor to such trustee….[36] Under the George Will, therefore, only John had explicit authority to appoint a successor trustee for the George trust. Despite this clear mandate for three trustees, a successor trustee was not appointed until after a petition was filed on behalf of Willa and Alexander and this court by decree dated November 10, 2010 appointed Winfield Jones to serve as trustee for the individual trusts for Wilhelmina and Alexander after splitting the Alexander and George Trusts into three separate trusts for each of George's children as of November 1, 2010.

Mellon, through Jane Laffend, had raised the issue of appointing a third trustee as early as April 29, 2008. In a memo, she noted that both Lisa and Carol would like to be a trustee, but she suggested that a neutral party such as John Suria might be preferable.[37] Laffend confessed, however, that she did not consider this to be an urgent issue. 11/4/10 p.m. N.T. at 43-44 (JL). McGrath left the issue of finding a third trustee to Laffend. 11/3/10 p.m. N.T. at 70 (MM). Likewise, John told Laffend that there was no rush to appoint a third trustee and that it could wait until next summer. 1/5/11 p.m. N.T. at 46-47 (JL). She therefore decided that the best way to raise the issue of appointing a successor trustee was through the accounting procedure so that the court could approve the selection. 1/5/11 p.m. N.T. at 47 (JL); Ex. T-39 (7/30/08 e-mail from Laffend to Dimedio). John agreed that this issue should be raised in the context of an accounting so that the new trustee could serve without liability for antecedent actions by his or her predecessors.[38] Laffend emphasized that filing an account took a great deal of time. Although an account was ready for filing by November 2008, it was not filed until June 2009, a month after the litigation was commenced by Carol. John and Mellon excuse the delay by claiming that income accumulation accounts should be prepared for the minors since the inception of these accounts in June 2008. Once these were prepared, they had to be reviewed by trust counsel and the accounting unit. It was important to present these accounts to the court, Laffend suggested, because payments were being paid to minors pursuant to the UPIA in excess of actual income and deposited into the children's income accumulation accounts.[39]

According to Carol, no one solicited her opinion as to an appropriate replacement for George. 11/16/10 p.m. N.T. at 82 (CM). John testified, however, that shortly after George's

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36 Ex. P-1 (1/6/1930 George McFadden Will, Article Third); Ex. P-2 (3/10/1942 Alexander Will, Article Seventh).

37 Ex. P-7; 1/5/11 a.m. N.T. at 73; 1/5/11 p.m. at 46 (JL). Lisa had told Laffend that she wished to serve as trustee, while Carol's attorney Vaughn Williams informed her of Carol's interest. 11/4/p.m. N.T. at 39-40 (JL).

38 2/10/11 p.m. N.T. at 34-35 (JM).

39 11/9/10 a.m. N.T. at 70-77 (JL); 2/9/11 a.m. N.T. at 7-8, 12 (JL).

death he had asked her attorney, Vaughn Williams, if there was a member of Carol's family who might serve as trustee.[40]In selecting a third trustee, John thought it important to find a family friend who was also an investment professional. Sometime in October 2008, John had approached David Hamilton with the prospect of serving as trustee, but he was not willing to serve when told there was no provision for a fee. While John thought either Winfield Jones or David Hamilton would be suitable trustees, he ultimately sought to appoint George Melas as a successor based on his family relationship and impressive credentials including degrees in economics from Yale and the London School of Economics.[41] Carol, however, was "stupefied" by this suggestion since Melas's wife, Lisa, had filed suit against George's estate seeking millions of dollars.[42] Laffend, likewise, agreed that Melas would not be an appropriate trustee in light of the lawsuit.[43] Mellon had discouraged the selection of Melas based on feelings of discord within the family as to his selection.[44] There was nothing in either Will, however, that imposed any restriction as to the selection of an individual trustee.

<u>Distributions to Willa and Alex from the Trusts</u>

The George and Alexander Wills contained specific instructions for distributions to the income beneficiaries and to minors. First, both wills provided that a male beneficiary was to receive twice the distribution of a female beneficiary. Secondly, the wills contained provisions for discretionary distributions to minors. The George Will stated that during a child's minority, "my Trustees shall apply the income as they shall deem proper for the support, maintenance and education of such child or the issue thereof."[45] The Alexander Will provided:

> Any income payable hereunder unto any beneficiary who may be a minor shall be used and applied by my Trustees in and about his or her maintenance, education and support, directly, without the intervention of a guardian. Similarly, any portion of my estate falling in distribution unto any distributee who may be a minor shall be held In Trust by my Trustees and the income therefrom, and in the discretion of my Trustees any portion of the principal thereof, during minority, used and applied in and about his or her maintenance, education, and support, directly, without the intervention of a guardian.[46]

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[40] 2/10/11 a.m. N.T. at 72 (JM).
[41] 2/10/11 p.m. N.T. at 58-60 (JM); 2/14/11 a.m. N.T. at 38-41 (JM).
[42] 11/16/10 p.m. N.T. at 82 (CM).
[43] 11/4/10 p.m. N.T. at 89 (JL).
[44] 11/4/10 N.T. at 88-90 (JL).
[45] Ex. P-1 (1/6/1930 George Will, Article Fourth (3)).
[46] Ex. P-2 (3/10/1942 Alexander Will, Article Fourth).

To exercise the discretion granted to them under the Wills, the trustees requested Carol to prepare a budget. Because Carol had not previously paid the family's bills, she had to do considerable "detective work."[47] She did not keep a checkbook nor did she know how to use an ATM. Instead, she had relied on George's secretary, Bill Muller, who handled the family finances. She confessed that she had no idea of the source of the family's monthly income of $200,000.[48] She was also faced with staggering credit card bills and debts that came due at George's death in the "hundreds of thousands—millions."[49]

According to Laffend, before making a discretionary payment to the minors the Trust Administration Committee (TAC) would require a budget.[50] In light of the family's desperate need for money, however, the trustees decided to make an emergency distribution in early May 2008 of $10,000 which represented the amount of traditional net income the trusts would have generated. That amount as actual income would clearly have been permitted under the will.[51] On May 23, 2008, before she received Carol's budget, Laffend sent a memorandum to the Trust Administration Committee (TAC) recommending that the trusts continue to pay out 4%, this time to the children, with Lisa receiving her designated 25% of that amount. The distributions to the children would go into their income accumulation accounts which "would then remit whatever their mother's budget requires that they receive." Ex. T-13. Mellon's co-trustee, John, however, suggested paying out a considerably smaller amount: $3333 each month to Willa and Lisa; $6666 each month to Alexander, for a total of $159,984 for all three beneficiaries.[52]

Carol's initial budget was sent to Laffend by Carol's attorney, Barbara Lawrence, on May 30, 2008. Ex. P-15. In reviewing it, Laffend concluded there were gaps for such things as medical bills and taxes which she filled in to reach a total annual budget of $1.2 million.[53] John was concerned that there seemed to be a mix of expenses for the entire family.[54] Laffend sent a copy of the budget to McGrath, as portfolio manager of the trusts, to come up with an asset allocation that might produce a "normal" or traditional income for a trust this size to meet these

47 Ex. T-13; 11/16/10 p.m. N.T. at 90 (CM).
48 Ex. P-101A; 11/16/10 p.m. N.T. at 69 (CM).
49 11/16/10 p.m. N.T. at 86 (CM).
50 1/5/11 a.m. N.T. at 89-91 (JL)
51 1/5/11 p.m. N.T. at 8 (JL)
52 Ex. T-13; 1/5/11 a.m. N.T. at 93-95 (JL)..
53 Ex. T-18 (6/4/08 e-mail from Laffend to Lawrence).
54 2/10/11 a.m. N.T. at 83 (JM). John sent a copy of this budget to Lisa as "research," for expenses that seemed high and apologized for doing so at the hearing. 2/10/11 a.m. N.T. at 83 (JM).

needs.[55] Although Laffend initially did not think that traditional income would suffice to meet the children's needs, her experience told her that it was important to work through the numbers.[56] McGrath interpreted this request as seeking a yield based on net income rather than total return or UPIA distributions. His only consideration regarding the budget was the bottom line and how to meet it. He began his computations with a "Monte Carlo" simulation program by focusing on how to create a yield of 3% of the market value of the trusts or $1.3 million. He tried various investment scenarios but concluded that to reach the yield of $1.3 million in net income the portfolio would have to be invested in 85% fixed income and 15% equities. Such an asset allocation, however, would not have been prudent or acceptable according to McGrath because it would not provide for the growth desirable for such young beneficiaries. It would not have been approved by TAC. It would not have provided the assets the children would need when they were 25, 30 or 35.[57] John likewise found such a heavy reliance on fixed income unacceptable because it would destroy any prospects for long-term growth of the portfolio. This caused him to favor reverting back to UPIA distributions for the children.[58]

John did not agree with Laffend's initial proposal of a 4% UPIA percent distribution, but favored instead a 2 percent distribution of the trust account to avoid "building up in an accumulation account sums which might be inappropriate for 18 year olds." 2/10/11 a.m. N.T. at 81-82 (JM). Laffend did not agree that this would meet the children's needs but she ultimately yielded to John. 11/9/10 p.m. N.T. at 20-21 (JL). When she presented Carol's budget to TAC in June 11, 2008, she recommended a pay-out of 3-4% to the children,[59] but then Laffend sent a letter to Carol and her attorney informing them that the pay-out from the trusts would be based on a 2% yield. She told them that income accumulation accounts would be established for Willa and Alex into which $32,870 would be deposited for Alex and $16,435 for Willa with the plan that $30,000 would be distributed into an account for the children. In her mind, this would mark a beginning point and they would see how it worked. [60] To avoid micromanaging, however, the

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[55] Ex. P-15 (5/30/08 e-mail from Laffend to McGrath).
[56] 1/5/11 p.m. N.T. at 8-9 (JL).
[57] 1/4/11 a.m. N.T. at 46-56 (MM); Ex. T-121. Laffend likewise observed generally that TAC would not approve UPIA distributions unless the account was invested more for growth than income. There had to be a minimum 60% equities, 40% fixed income. 1/5/11 a.m. N.T. at 97-98 (JL).
[58] 2/10/11 p.m. N.T. at 30 (JM).
[59] Ex. P -24 (June 11, 2008 Memo by Laffend to TAC).
[60] 1/5/11 p.m. N.T at 6-7, 15-16 (JL). <u>See generally</u> Ex. T-27 (6/16/08 e-mail from Laffend to Lawrence and Carol).

trustees agreed to distribute a lump sum of $240,000 that day to the children's JP Morgan accounts.[61]

Carol's attorney, Barbara Lawrence, early on assumed a tough, antagonistic stance towards trustees' distributions from the trusts. Twice she insisted that the trusts were the children's only source of economic support. In a June 11, 2008 letter, for instance, she asserted that the "trusts are the sole source of support for Alexander and Willa McFadden." Ex. T-23. Again in September 2008, Lawrence wrote Laffend that "since these trusts represent the children's sole source of support, the family is in desperate need of additional funds." Ex. P-58B. She emphasized that the trusts had been a major source of support for George and his children by distributing to him more than a million dollars a year. She also complained that the initial $10,000 emergency distribution had been inadequate: "Conditioning further payment beyond that meager sum on a budget was, I suppose, a textbook response to a distribution request. Asking for it from the children's mother, whose husband had just died in a plane crash and was overwhelmed by newly pressing needs, was, in our view, grossly insensitive."[62] A more "refined" budget ("September 2008 Budget") was enclosed. It did not "prorate" the 2 children's expenses from those of the family as a whole totaling $2,177,212. As Lawrence explained: "The expenses have not been prorated for the family members as the trusts are the only means available to maintain the children's standard of living." Ex. P-58B. No income figures were set forth in the budget and none were expressly requested by either John or Mellon. Ex. P-58B

This new budget caused confusion among the trustees. McGrath sent an e-mail asking Lawrence to "please clarify whether you are suggesting that the trusts—in support of the minor children—should be solely responsible for the $2mm." Ex. T-43. John Suria of Mellon suggested that it might be time to have a guardian appointed since the mother may be conflicted. Ex. T-51. A new budget was requested that would differentiate the children's expenses from those of the family. Ex. T-50. By the end of October, Carol submitted another budget for 2009, that differentiated between total family expenses of $2,142,737.62 and discrete budget amounts for Alex ($527,312.10) and Willa ($525,516.44).[63] In early November, John Meigs raised questions with Lawrence about the various sources of support available to the children. Ex. T-61.

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[61] Ex. T-27; Ex. P-30.
[62] Ex. P-58B (9/8/08 letter from Lawrence to Laffend).
[63] Ex. P-92A (budget forwarded with 10/31/2008 e-mail from Lawrence).

In a subsequent November 11, 2008 meeting in New York with Laffend, Carol volunteered some details about her sources of income and general financial situation. She acknowledged receiving $50,000 a month from the Crescent Drilling Company, but she had to pay a minimum monthly mortgage payment of $23,000 and a condo fee of $X (actual amount unstated in the memo). Carol, who is executrix of George's estate, told Laffend that the estate did not have enough money to pay the taxes so she planned on selling her apartment and then lending the money to the estate to pay the taxes because she did not want to sell either Affordable Furniture or Crescent Drilling.[64]

On October 21, 2008, Lawrence requested an emergency distribution of $100,000 for the children. Ex. P-92. John asked for more details about the nature of the emergency, and then opposed making this distribution, sardonically stating: "I conclude there is no emergency (electricity to be cut off, chef about to run out of caviar)."[65] Mellon nonetheless eventually agreed to do so as a show of good faith. In making this distribution, Laffend observed, they were still under the proposed 2% distribution.[66] John reacted negatively to this decision and threatened Mellon. He brought up the "last unauthorized payment" that had been made regarding Washington Furniture that resulted in a complete loss for the trust "for which Mellon should have been surcharged."[67]

Although Barbara Lawrence consistently argued that the same level of distribution that had been given to George each year should have been continued for his children, Laffend observed that the trust documents made such distributions to minors discretionary.[68] More specifically, in a September 19, 2008 letter to Lawrence, Laffend emphasized that the trustees' concern was that the trust assets be available for the minors "long-term whether in trust or not." Ex. P-67.While George had been the primary source of income for the entire family during his lifetime, "with George's death the income interest in these trusts is no longer available to his entire household." In their view, "the trustees have the ability to distribute income for the support of two children, not for the support of the entire household." The letter concluded with the suggestion that a guardian or separate legal representation be obtained for Willa and Alex "as there are clear conflicts between their long-term interests and Carol's short-term interests." Ex. P-67.

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64 Ex. T-70 (11/13/03(sic) Memo by Laffend)
65 Ex. T-64 (11/5/08 e-mail from John to Laffend); Ex. T-63.
66 Ex. T-62; Ex. T-63; Ex. T-66. 1/5/11 p.m. N.T. at 85-86 (JL).
67 Ex. T-66 (11/9/2008 e-mail from John to Laffend and Suria).
68 1/5/11 p.m. N.T. at 24 (JL).

Documents submitted by the guardian ad litem that this court appointed for Willa and Alex show that over the course of May 1, 2008 through December 31, 2009 a total of $546,759 was distributed to Alexander's income accumulation account from the Alexander Trust and the George Trust. Willa over this same period received $463,328.17 from the Alexander Trust and the George Trust.[69]

In January 2010, Laffend sent a letter requesting Carol to submit her personal income tax return, the children's expenses and sources of income available to the children. Laffend testified that Carol never submitted the requested information and distributions to Willa and Alex ceased for 2010 "because we didn't have any information on which to base our exercise of discretion." [70] Payments continued, however, to the children's income accumulation accounts.[71] Carol testified that she did submit a budget for 2010. 3/14/11 p.m. N.T. at 85 (CM).

Alleged Breaches of Confidentiality by The Trustees

The requests for information about her family finances and budget raised Carol's concern that John would use this information against her. She saw John as an ally of Lisa McFadden Melas, who had filed suit against George's estate.[72] In fact, John sent a copy of Carol's budget to Lisa as "research" since she would have been familiar with some of the expenses, although he subsequently expressed regret for having done so.[73] By so doing, John breached a trustees' obligation of confidentiality, and Mellon became aware of this. Although Carol was not a trust beneficiary, Laffend testified that where a beneficiary is a minor Mellon considered the parent as the child's spokesperson.[74] In this case, by revealing Carol's personal family financial information to third parties—and especially to Lisa Melas—the trustees undermined her confidence or trust in them, which led to her refusal in 2010 to hand over her personal income tax returns. This breakdown in the relationship between the trustees and their beneficiaries'

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[69] See Exs. C-1 & C-2.
[70] 2/9/11 a.m. N.T. at 23, 20-23 (JL). See also Ex. T-104.
[71] Ex. T-105 (5/21/2010 memo from counsel for Mellon (James Mannion) to counsel for Carol (William Hangley). Mr. Mannion observed that he had been advised by Mr. Hangley that rather than sign a confidentiality stipulation, "Carol McFadden will not provide the Trustees with any information, and that she is prepared to 'foreswear' the regular monthly distributions on the children's behalf so long as John McFadden is a co-trustee." As a consequence, "the income from the George and Alexander Trusts will be added to, and held in, the children's income accumulation trusts." Id.
[72] 11/16/10 p.m. N.T. at 96-97 (CM); Ex. T-70 (11/13/03(sic) Memo by Laffend).
[73] 2/10/11 a.m. N.T. at 83 (JM). John reasoned that Lisa knew Carol, George and their children and could offer insight as to their expenses through her familiarity with their lifestyle.
[74] 11/4/10 p.m. N.T. at 48 (JL).

parent was exacerbated when the trustees subsequently discontinued the distributions to the parent.

In contrast to the dearth of direct communication between John and Carol, he communicated frequently with Lisa by e-mail or in actual meetings. On various occasions, he copied Lisa—and other nontrustees-- on letters involving the finances of Carol's family. When Barbara Lawrence on June 26, 2008 asked Laffend to pay her law firm bill for representation of Carol, Laffend forwarded the request to John, who then copied Lisa, who advised: "This is Carol's bill and thus payable by Carol and not the Trusts."[75] John solicited Lisa's advice concerning a "Dear Carol and Barbara letter" that the trustees were drafting in early June 2008 to which Lisa responded that the wills clearly state that a minor was to pay for his/her own expenses and not the expenses of the household.[76] On June 12, 2008, Lisa e-mailed John a few comments about her father's estate and Carol's involvement with it, which John then forwarded to Laffend.[77] In mid-June 2008, Laffend sent John an e-mail asking his opinion as to proposed distributions to Willa, Alex and Lisa. John forwarded this to Lisa McFadden, George Melas and Lisa Kabnick to solicit their opinions.[78]

Jane Laffend, likewise, on a few occasions divulged information about the finances of Carol McFadden's family to Lisa. In mid-June 2008, Lisa thanked Laffend for sending her information about her proposed distribution, but then raised a concern that Willa's distribution might not adequately provide for her school tuition. Laffend responded that this distribution based on 2% was just a beginning and could go up.[79] Later in July 2008, Laffend raised the issue of whether certain school fees should be paid in an e-mail to both John and Lisa.[80] Laffend subsequently testified that she included Lisa in this e-mail to alleviate the concerns she had previously expressed over the adequacy of Willa's distributions to cover school expenses.[81]

In mid-September 2008, an e-mail from Barbara Lawrence lamenting the trustees' failure to respond as "the beneficiaries go further into personal debt" was forwarded to Lisa who

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[75] Ex. P-38.

[76] Ex. P-19A; see also Ex. P-26 (John soliciting Lisa's comments on letter to be sent to Carol under Laffend's name).

[77] Ex. P-25 (6/12/2008 e-mail from Lisa).

[78] Ex. P-27.

[79] Ex. T-30.

[80] Ex. P-41

[81] 11/9/10 p.m. N.T. at 71 (JL).

mocked the notion that Willa and Alex faced personal debt when only three months ago the trust had given out $220,000.[82]

Communications Between Trustees and Beneficiaries

In addition to this e-mail communication, Lisa met personally with the trustees on April 30, 2008 and again in August. Laffend emphasized, however, that these meetings had been requested by Lisa and were not special consideration.[83] Laffend acknowledged that when the beneficiaries of a trust are minors, their parents are routinely treated as their spokesperson. But in this case, Carol had hired Skadden Arps to represent her in dealings with the McFadden trusts. Laffend stated that as a matter of policy, when a person is represented by counsel, she believed it appropriate to deal through that representation.[84] The record shows numerous communications between Carol's lawyers and the trustees. Laffend, in particular, wrote long, painstaking explanations of the distributions to Skadden or Carol.

During George's lifetime, monthly statements of the trust accounts had routinely been sent to his McFadden Brothers office. Carol subsequently testified that she did not receive these reports until nearly 6 months after his death in October 2008. Laffend, for her part, did not realize that Carol was not receiving those reports since Skadden never alerted her to this. Once alerted by Skadden, Laffend e-mailed and faxed copies of those statements.[85]

The Options Controversy and Division of the Trusts

Soon after George's death, John worked vigorously to obtain payment for the George Trust and for Carol from the life insurance policies that had been taken out to secure the two loans George had taken from the trust to invest in Crescent Drilling and Affordable Furniture. One policy was for $1.9 million; the other was for $1.3 million. The insurance proceeds, which were paid by June 6, 2008, paid off both loans, leaving $422,000 for Carol.[86]

When seeking these loans from the George trust, George sought to sweeten the deal and provide some long term growth to the trust by granting it an option to purchase 1500 shares in Affordable Furniture, a closely held company based in Mississippi that manufactured low cost furniture. After George's death, the trustees sought to exercise the Affordable options. As part of

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82 Ex. P-66.
83 1/5/11 a.m. N.T. at 66-67 (JL); 11/3/10 p.m. N.T. at 108-14 (MM)(recalling August 12, 2008 meeting with Lisa Melas, George Melas, John Suria and Laffend) ; see also Ex. P-52 (meeting notes by McGrath).
84 1/5/11 a.m.N.T. at 67-68 (JL); 11/3/10 p.m. N.T. at 114 (MM); 11/4 /10 p.m. N.T. at 48 (Laffend).
85 1/5/11 a.m. N.T. at 83-84 (JL); Ex. T-55; 11/16/10 p.m. N.T. at 82-84 (CM).
86 2/10/11 a.m. N.T. at 73-74 (JM); 1/5/11 a.m. N.T. at 87-88 (JL).

this process, John sought to obtain information about Crescent and Affordable such as operating costs and performance. The option agreement they negotiated had provided for such information to the option holder.[87] In Laffend's opinion, George had always intended that these options should be in the trust to benefit his children. The added advantage was that no inheritance tax would have to be paid if they were part of the trust. Ex. P-116; Ex. T-79. By letter dated September 24, 2008, however, Carol's attorney Vaughn Williams asserted that the Affordable options were not valid because they had not been signed by Mellon and they had terminated due to Mellon's inaction. Ex. T-174. In a subsequent letter, Williams clarified that he had been writing on behalf of Carol, as director of Affordable Holdings, Inc. Ex. T-192.

The trustees ultimately decided to file suit in Mississippi to exercise the options. In deciding whether to pursue litigation to exercise the Affordable options, the trustees sought advice from a Mississippi attorney.[88] By memorandum dated March 31, 2009 to TAC, Laffend recommended exercising the options since they would cost only $1,500 in a trust account valued at $12.5 million. Since the trustees lacked any current financial statements about the company due to Carol's refusal to honor requests for that information, Mellon's closely held group unit could not recommend this purchase.[89]

This options issue became entangled in proposals to split the McFadden trusts into three shares due to the differing investment needs of Lisa, Willa and Alex. Laffend early on suggested that the issue of division of the trusts should be presented in a trust accounting. [90] Carol strongly favored dividing the trusts. Since Carol believed John favored Lisa, splitting the trusts would be a first step in seeking his removal to end his involvement with her children's affairs. In fact, as early as June 2008, Carol's attorney had urged Laffend to pursue splitting the trusts to simplify the accounting.[91] Lisa consistently took a contrary position. She agreed that the options should be exercised but feared the litigation costs that would incur. She did not want the trusts split because she did not want her trust to bear those litigation costs alone. If the trusts were split, she believed, the successor trustees for Willa and Alex would decide not to pursue the options leaving her to fight by herself. Once the option issue was resolved, however, Lisa had no

87 2/14/11 a.m. N.T. at 31 (JM); Ex. T-19.
88 2/9/11 a.m. N.T. at 28 (JL); Ex. T-175.
89 Ex. T-89.
90 Ex. T-35; Ex. T-70.
91 Ex. P-16.

opposition to division of the trusts. She therefore opposed dividing the trusts even deferring further distributions until the options issue was resolved.[92]

By decree dated November 10, 2010, which issued during the hearing, this court ordered that the George McFadden Trust and the Alexander McFadden Trust, both for the benefit of George McFadden, should be divided as of November 1, 2010 into 3 separate trusts with 25% of the assets and obligations to the benefit of Elizabeth McFadden Melas, 25% to the benefit of Wilhelmina McFadden and 50% to the benefit of Alexander McFadden. Winfield P. Jones was appointed trustee of the trusts for Wilhelmina and Alexander.

Upon his appointment, Winfield Jones took the position that it was not in the best interests of Willa and Alex to continue participating in the litigation to exercise the Affordable options since by so doing they would incur 75% of the litigation costs.[93] Jones also concluded that it was not in his wards' interests to pursue this litigation because as heirs to George's estate they would inherit some portion of Affordable. He reasoned that because Carol exercised her right to elect against George's will, she owns 43% of Affordable, while his estate, whose beneficiaries are his three children, own 56% of that company. Because of an equalization clause in George's will, Jones surmised that Lisa would not be able to participate.[94] Jones conceded that in reaching his conclusion that litigation for the Affordable options was not in the best interests of his wards, he had not considered the possibility that George's estate is insolvent. If, in fact, George's estate is insolvent, Jones testified:

> Q: If the estate were in fact insolvent or likely to be insolvent as a consequence of the claims pending against it, your analysis as to the benefit to be obtained from the options for Willa and for Alexander would be incorrect. Is that not true?
> A: No, because on any suggestion on insolvency on the estate, as trustee, I would urge the two trusts to exercise the options immediately. I'm certain stock would be issued immediately.
> Q: So you—
> A: And that the trust that has 11,250 shares of Affordable stock. **It's, after all, their mother.**[95]

When pressed, Jones clarified his position, stating that if George's estate is insolvent, he would urge his wards' mother, who is the party opposing the exercise of the option, to issue the stock to

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[92] 11/4/10 p.m. N.T. at 61-62 (JL).; Ex. P-150; Ex. P-116.
[93] 3/14/11 p.m. N.T. at 33-34, 41-44 (WJ).
[94] 3/14/11 p.m. N.T. at 34-36 (WJ).
[95] 3/14/11 p.m. N.T. at 57-60 (WJ)(emphasis added).

her children.[96] Jones was also questioned as to the value of the outstanding options based on an appraisal commissioned by Mellon and John dated November 1, 2010. Ex. P-249. He initially stated that he did not recall computing the value of 11,250 shares at $78 a share, but he did not dispute that it would have a value of $877,500. He also did not recall if he computed the value if there was no minority discount, but did not dispute that it could be $ l.l million dollars.[97]

Investment Strategy of the Surviving Trustees After George's Death and the Economic Crisis of September 2008

McGrath responded to George's death as an opportunity to renew the dialogue with his co-trustee to move the trusts' concentrated portfolio towards more diversification. At the time of George's death, the George trust was invested 1.9% in cash, 11% in fixed income, and 87% in equities. Of the equity holdings, 81 % was in large cap investments in nine companies concentrated in energy and information technology sectors. Although the trust had a total market value of $ 26,274,424, its estimated income or yield was only $255,524.27 or 1%. The Alexander trust in April 2008 was also highly concentrated in equities with 92.6% of its assets invested in large cap securities with investments in eleven companies. While the Alexander trust had a market value of $16,053,298, its projected income was $64,206.67 or a yield of .4%.[98]

Because the portfolios were was so concentrated, however, McGrath favored diversification over a period of several tax years as advisable due to the potential capital gains tax implications.[99] With the change in the income beneficiaries of the trust, the trustees considered the specific needs of George's three children. At Laffend's suggestion, McGrath calculated the various allocation possibilities and reached the conclusion that distribution on a net income basis only was not feasible. Based on this analysis, he concluded that the proper investment strategy remained aggressive growth.[100]

At a June 17, 2008 meeting with John, McGrath made an investment proposal to sell some stocks and purchase many others. John rejected this, however, as too radical a transformation of the trust portfolio which had performed brilliantly over the years. John told McGrath that the existing portfolio was outstanding. What McGrath was suggesting was a grab

[96] 3/14/11 p.m. N.T. at 60 (WJ)
[97] 3/14/11 p.m. N.T. at 69-71 (WJ).
[98] Ex. T-120 (Mellon Meeting Booklet for April 30, 2008)
[99] 1/4/11 a.m. N.T. at 42 (MM)
[100] 1/4/11 a.m. N.T. at 61 (MM); 2/10/11 a.m. N.T. at 81 (JM).

bag of investments inconsistent with the past investment philosophy.[101] McGrath was undeterred by this response: while John did not agree to the changes he did agree to consider them. McGrath therefore continued to press for greater diversification with investment proposals for John to consider throughout the summer of 2008. In so doing, however, McGrath believed that John's investment approach was an acceptable investment theory.[102] Nothing happened in the financial markets during those summer months to change McGrath's recommendation of an aggressive growth portfolio and diversification.[103] In fact, in May 2008, the Alexander Trust increased in value more than 9% while the George Trust increased more than 6%. Similarly, in June 2088, the Alexander Trust increased in value more than 4% while the George trust increased 6%. Through the end of August, the values decreased only 3.8% and 4.9%.[104]

On September 15, 2008, however, McGrath recalled, the stock market opened very weak when the news hit that Lehman Brothers had filed for bankruptcy. This had not been expected and the stock market began a steep decline.[105] The McFadden trust portfolios also declined.[106] The cataclysmic magnitude of the ensuing financial crisis was vividly described by the petitioners' expert, Thomas Chapin, who observed:

> Worldwide equity and credit markets then contracted severely starting in September 2008 in the face of a liquidity crisis which resulted in a rash of major corporate bankruptcies (i.e. AIG, Lehman Brothers), hastily arranged mergers (e.g. Wachovia, Merrill Lynch) and massive government intervention in the financial markets. A pervasive sense of crisis persisted through much of the fall and early winter. Led downward by Financial sector stocks (-71%), the overall U.S. stock marked returned -45.7% from April 30, 2008 through the end of February 2009.
> Ex. P-189 at 13.

The trustees met the next day to discuss the implications of this market collapse, McGrath recalled favoring greater diversification as a long term goal but he did not recommend any sale of assets; that would have been imprudent when the market was so unstable. John

[101] 2/10/11 p.m. N.T. at 40-41 (JM); see Ex. T-124.
[102] 1/4/11 a.m. N.T.at 43-45; 65-66, 69-74, 76 (MM); Ex. T-124 Ex. T-127 (7/22/2008 investment proposal). According to McGrath, John did not think the investment strategy should change because of George's death; he did not believe in fixed income; he believed in investing in a small number of companies that he could watch closely. 1/4/11 a.m. N.T. at 43 (MM).
[103] 1/4/11 a.m. N.T. at 69, 81 (MM)
[104] Ex. P-189 at 21.
[105] 1/4/11 a.m. N.T. at 83 (MM); 11/3/10 a.m. N.T. at 20 (Chapin).
[106] 1/4/11 a.m. N.T. at 83-84 (MM).

testified that he agreed with McGrath that uncertain times were ahead but there was no need to cave in to panic selling.[107]

In October 21, 2008, Laffend sent McGrath an e-mail describing a conversation she had with John concerning the McFadden accounts. Barbara Lawrence had called to complain that nothing had been done on the accounts even though George had been dead for 6 months:

> John asked if you had any advice. I told him that I know that you have made various suggestions, in particular reducing the exposure to energy stocks and a number of other suggestions about reducing concentrations and diversifying. He grudgingly acknowledged those suggestions but did not want to do anything until they had capitulated on other topics. I think he may be regretting that now but would like to talk with you when you get in this afternoon.[108]

McGrath testified, however, that he had never experienced John as linking investment decisions to other considerations. Consequently, when he received Laffend's e-mail, he "got up and went over and talked to Jane."[109] Laffend told him that there were family issues with other investments. McGrath "made it clear to Jane that if it wasn't—if it didn't have to do with these trusts, then I'm not interested, so to speak."[110] When pressed, McGrath hypothesized that these other topics were related to private equity investments or Crescent and Affordable.[111] He stated that John had never told McGrath that he would not consider investment proposals until other topics are addressed.[112]

Throughout October, November and December 2008, McGrath continued to recommend diversification across asset classes with the addition of fixed income in meetings and discussions with John. By December 2008, John told McGrath that he was willing to consider diversification but he wanted to wait for the market to stabilize which McGrath thought was reasonable.[113] In fact, John agreed to sell 10,000 shares of China Mobile and 100,000 shares of Flextronics which was done on December 10, 2008.[114] John did not agree, however, to a suggestion to purchase as many as 80 or so stocks. Instead, his strategy was to build up cash reserves for buying opportunities at the beginning of the year once the market stabilized.[115] By

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107 1/4/11 a.m. N.T. at 83-83 (MM); 2/10/11 p.m. N.T. at 53 (JM).
108 Ex. P--81A.
109 1/4/11 a.m. N.T. at 89 (MM).
110 1/4/11 a.m. N.T. at 89-90 (MM).
111 1/5/11 a.m. N.T. at 10-11 (MM)
112 1/4/11 a.m. N.T. at 91 (MM).
113 1/4/11 a.m. N.T. at 95-100 (MM).
114 1/4/11 a.m. N.T. at 101(MM); Ex. T-148.
115 2/10/11 p.m. N.T. at 66- 67 (JM).

late January, John had agreed with some of McGrath's suggestions to diversify, reduce the concentrations and invest into more equities but not as to the suggestions to invest in fixed income. In February, March and April 2009, the trustees agreed to sell additional stocks to accomplish diversification within the large cap asset class.[116] At a meeting in April 2009, the trustees agreed that the investment objective for both trusts remained aggressive growth. As to the trusts' long-term performance, a McFadden Portfolio Review dated April 13, 2009 concluded that that the trusts had exceeded the S & P 500 at varying time spans:

> After the past few years of relative out performance versus the S & P 500 (large cap index) the portfolios underperformed the large cap index. The relative outperformance and subsequent underperformance can be mostly attributed to the high concentrations in the energy sector. (*This is a period that coincides with the price range between $40 and $145 per barrel finishing the year at just below $40).* The longer term, annualized performance of the portfolios is still above the S & P 500 for the 2yr, 3 yr, 5 yr and inception relative performance.[117]

While McGrath never obtained John's agreement as to the percentage of fixed growth for the portfolios, he testified that by 2009 they had diversified within the large cap holdings.[118] John steadfastly opposes introducing municipal bonds to the portfolio because they do not promote growth; he also does not believe that there should be an allocation of 20% fixed income.[119]

After prices in the United States stock market bottomed in March 2009, there was a rally for the next 13 months. Ex. P-189 at 13. The trust portfolios likewise benefitted from this market rally. By December 31, 2009, the two trusts increased more than $5.5 million in market value from their April 2009 values.[120] According to the accounts filed for the George and Alexander Trusts, both trusts experienced growth over their relevant accounting periods. To demonstrate this, Mellon presented an expert report by Eugene Maloney. [121] In addition, the guardian ad litem, Mary Jane Barrett, submitted a report analyzing the trusts' performance. The petitioners did not challenge—or address-- these economic analyses of the accounting periods. The

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116 1/4/11 p.m. N.T. at 14-16; Ex. T-159; Ex. T-160; Ex. T-164.

117 Ex. T-163.

118 1/4/11 p.m. N.T. at 44 (MM); see Ex. T-162 at BNY01347 to BNY01349..

119 2/10/11 p.m. N.T. at 70-72 (JM); 2/14/11 a.m. N.T. at 46-47 (JM).

120 Mellon Post-trial brief at 38, n. 41. See also Ex. P-250.

121 See, e. g., Ex. T-112. The 1983 Report of the Fiduciary Accounting Standards Committee, annexed to the Pennsylvania Orphans' Court Rules, notes the differences between a fiduciary accounting typically presented by a fiduciary seeking discharge and a performance accounting "which is directed toward an analysis of the investment performance of a fund." The assistance of an expert in analyzing a trust's performance based on fiduciary accounting in this case is invaluable.

accounting period for the George Trust began on September 24, 1985, and showed an inception value of $2,164,696.34. Ex. P-183 at 2. According to the guardian ad litem report, the George Trust over the course of the 25 year accounting period from September 1984 to the second supplemental accounting ending October 31, 2010 experienced significant gains: "At the end of the second supplemental accounting period, the market value of the principal balance on hand was $17,534,423, consisting of cash, securities and mutual funds. <u>The cumulative net gain on conversions was $23,583,462 over the 25 year accounting period.</u> Over that period of time, principal disbursements and distributions totaled $9,665,550."[122]

The relevant accounting period for the Alexander Trust is shorter since it begins on May 2, 2006 after an adjudication by this court Ex. P-182. As a consequence of this shorter accounting period, the Alexander trust portfolio was more severely buffeted by the effects of the September 15, 2008 economic crisis. Despite this shorter accounting period, the Alexander Trust likewise experienced growth as described by the guardian ad litem report: "At the end of the second supplemental accounting period (i.e. October 31, 2010, the market value of the principal on hand was $10,315,865, consisting of cash, securities and mutual funds. <u>The cumulative net gain on conversions was $1,564,955 over the 4 ½ year accounting period.</u> Over that period of time, principal disbursements and distributions totaled $2,527,889."[123]

Legal Analysis

A. The Petitioners Failed To Establish that the Trustees Should Be Surcharged for the Decline in Value of the George and Alexander Trusts in the Wake of the Economic Crisis of September 2008

1. Applicable Standard of Review in Surcharge Action

a. In a Surcharge Action, Petitioners have the Burden of Proof that the Trustees Alleged Breach of Fiduciary Duty Caused Economic Loss to the Trust

[122] 7/8/11 Guardian Ad Litem Report at 14 (emphasis in original). <u>See</u> 1/25/11 George McFadden Second Supplemental Account at 11. According to Maloney's report which focused on the period of the first account and the first supplemental account ending December 31, 2009, the George Trust earned "$24,009,236.27 of realized capital gains, and $4,883,518.44 in dividends and other income for a total return of $28,892,754.71." Ex. T-112 at 2. The total rate of return for the trust over this period was 10.79% compared to the equities market as reflected in the broad based S & P 500 Index which showed an internal rate of return of 8.62%. Ex. T-112 at 2.

[123] 7/8/11 Guardian ad litem Report at 14 (emphasis in original). According to the Maloney report, over the accounting period up to December 31, 2009, the Alexander Trust "earned $2,069,986.66 of realized capital gains, and $1,459,349.50 in dividends and other income for a total return of $3,529,336.16." Ex. T-112 at 3. This represented a rate of return of .77% which nonetheless compared favorably to the S & P 500 Index for the equities market which had a negative rate of return of -2.24%. Ex. T-112 at 3.

A surcharge is the penalty imposed on a trustee for failure "to exercise common prudence, skill and caution in the performance of its fiduciary duty, resulting in a want of due care." Estate of Pew, 440 Pa. Super. 195, 236, 655 A.2d 521, 541 (Pa.Super. 1994). The purpose of a surcharge is to compensate beneficiaries for the losses they incurred as a result of the trustee's failure to exercise the appropriate standard of care. In re: Scheidmantel, 2005 Pa. Super. 6, 868 A.2d 464, 492 (Pa. Super 2005). Under Pennsylvania law, those who seek to surcharge a trustee have the burden of proving both breach of fiduciary duty "and that a related loss occurred." Estate of Lychos, 323 Pa. Super. 74, 85, 470 A.2d 136, 142 (1983)(citing Estate of Stetson, 463 Pa at 84, 345 A.2d at 690). In other words, "a fiduciary who has negligently caused a loss to an estate may properly be surcharged for the amount of such loss." Id. To obtain a surcharge, the petitioner must prove "the particulars" of the trustee's "wrongful conduct." Killey Trust, 457 Pa. 474, 478, 326 A.2d 372, 375 (1974)..

Petitioners claim that the trustees have committed multiple breaches of fiduciary duty for which they should be surcharged. They assert, for instance, that the trustees favored Lisa's interests over those of the other beneficiaries; they failed to make appropriate income distributions to the beneficiaries; they failed to appoint a third trustee; they launched expensive litigation to enforce the Affordable options and they failed to realign the trust portfolios. In seeking a surcharge, petitioners appear to link these various alleged breaches indiscriminately as the basis for their claimed economic damages. In so doing, they rely on a misinterpretation of Stetson as will be discussed below.[124] Petitioners' scattergun approach distorts their burden of proof as to surcharge. Rather than lumping together all alleged breaches as the basis of a surcharge, each alleged breach must be analyzed to determine whether it, in fact, was related to the claimed economic damages. Under longstanding Pennsylvania precedent, a "trustee cannot be surcharged for a breach of fiduciary duty unless the breach caused a loss to the trust." Estate of Pew, 440 Pa. Super. 195, 240, 655 A.2d 521, 544 (1994), citing In re Mendenhall, 484 Pa. 77, 82 n.3, 398 A.2d 951, 954 n.3 (1979)(emphasis added). Other alleged breaches such as the failure to make adequate income distributions or the disclosure of confidential information relate to the issue of whether the trustees properly administered the trust or whether they should be

[124] 4/26/11 Petitioners' Brief at 64-67.

removed for failure to do so. The failure to appoint a third trustee potentially straddles both economic and administrative issues and will be analyzed accordingly.

Ordinarily, a trustee is "not liable when he acts in good faith as others do with their own property." Saeger's Estate, 340 Pa. 73, 75, 16 A.2d 19, 21 (1940). If a trustee professes having greater skill or expertise than a person of ordinary prudence, its actions must be evaluated according to the higher standard of that special skill. In other words, he will be "under a duty to exercise a skill greater than that of an ordinary man, and the manner in which investments are handled must accordingly be evaluated in light of such superior skill." Killey Trust, 457 Pa. 474, 477-78, 326 A.2d 372, 375(1974); Estate of Pew, 440 Pa. Super. at 236, 655 A.2d at 542. Based on the record, both John[125] and Mellon would be held to that higher standard. Significantly, however, the Pennsylvania Supreme Court has cautioned that a trustee will not be held liable "for the result of an intervening world calamity, beyond his power to foresee or prevent." Saeger's Estate, 340 Pa. at 75, 16 A.2d at 21. The propriety of an investment decision must be evaluated based on "as it appeared at the time it was made and not viewed in light of subsequent events." Id., 340 Pa. at 76, 16 A.2d at 21.

Investment decisions by a trustee are analyzed in terms of the trust document, the relevant statutes and the contemporaneous facts. Saeger Estates, 340 Pa. at 76, 16 A.2d at 21. Petitioners argue that John and Mellon should be surcharged in the millions of dollars for failing to realign the trust portfolios immediately after George's death in light of the settlor's intent and the circumstances of the new beneficiaries.[126] Radical portfolio changes, they assert, should have been made within days of George's death; consequently, they would calculate damages from April 30, 2008 to either May 1, 2009 (when they filed their initial petition) or November 1, 2010 (the date when the trusts were divided and an independent trustee appointed).[127] The

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125 Throughout the hearing, in his testimony John demonstrated a subtle mastery of investment theory and practice. Although he stated that he did not consider himself a full time investor and stated that Mellon—as an institution-- is more knowledgeable in the "art of investing," he testified that "I think Mr. McGrath and I have broadly similar levels of training and experience" in investing. 11/10/10 a.m. N.T. at 40-41. Hence, he shall be held to the higher standard.

126 4/26/11 Petitioners' Brief at 32 & 43.

127 4/26/11 Petitioners' Brief at 67. See also Ex.P-189, Table 12; Ex. T-111, Ex. I (Chapin expert report calculation of the trusts' shortfall from a starting date of April 30, 2008). As will be discussed within, petitioners present alternative theories for calculating surcharge damages. In their 4/26/11 brief at page 67, for instance, they suggest a surcharge based on the total loss (either $19,424,873 or $13,605,296) suffered by the trusts (i.e. the difference in market value of the trusts at the date of George's death to the "end date chosen by the court"). Later on page 78 (c) of their 4/26/11 brief and in their 3/21/11 amended petition, petitioners present an alternative surcharge amount: $9,573,235.50 which represents 75% of the George Trust's injury of $7,337,262 and 75% of the Alexander Trust's

petitioners' surcharge claim must be denied, however, because they failed to meet their burdens of showing a breach of fiduciary duty and the requisite resulting or related loss.

b.The Language of the Wills of Alexander and George McFadden As Well as Related Court Orders Established the Discretion Accorded to the Trustees in Making Investment Decisions

The Alexander Will Gave the Trustees Broad Discretion in the Management of Investments

Under Pennsylvania law, the settlor's intent is the polestar of every trust and that "intent must prevail." Estate of Warden, 2 A.3d 565, 572 (Pa. Super. 2010), app. denied, 17 A.3d 1255 (Pa. 2011).. The PEF code likewise provides that a trustee shall administer a trust "in accordance with its provisions and purposes… 20 Pa.C.S. §7771. Alexander McFadden in his Will gave his trustees broad discretion in making investment decisions. More specifically, Alexander empowered the trustees with the "right and authority to exercise any of the following powers:"

> 4. To retain in their discretion, without liability, any of my investments in the form in which they may be at the time of my decease.
>
> 5. To invest and reinvest, alter, vary, and change investments and reinvestments from time to time, at discretion, not being confined to what are known as "Legal Investments," any statute to the contrary notwithstanding, including specifically, the right and discretion to invest in the common and/or preferred stock of any corporation.[128]

To be sure, Alexander's will in Article Third required the trustees to "safely hold" the trust assets, but the specific provisions of Article Seventh accorded the trustees broad discretion in the management of the trust portfolios and are controlling. Conner's Estate, 302 Pa. 534, 537, 153 A. 730, 731 (1931)(a general clause gives way to a specific provision).

The Provisions in George's Will Limiting the Trustees' Investment Discretion Were Modified by Court Orders of the Delaware County Orphans' Court

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injury of $5,427,052 "attributable to the Trustee's mismanagement of that portfolio." 3/21/2011 Amended Petition, ¶ 126(b). This second alternative appears to be based on Chapin's calculations of "dollarized shortfalls" in Table 12 of Ex. P-189.

[128] Ex. P-2 (3/10/1942 Alexander McFadden Will, Article Seventh).

In contrast to Alexander, George McFadden placed certain restrictions on permissible investments in the Will he executed January 6, 1930 shortly after the stock market crash and depression. In Article Seventh, for instance, he authorized his trustees to retain the securities in his estate or to sell them to invest 50% in legal investments and 50% either in "bonds of corporations which have not defaulted in the interest for the five years prior" and/or in "preferred shares of stock of a corporation which has earned and paid the regular dividend thereon for the five years prior to making the investment." He further provided that no "investment in any one company or enterprise shall exceed one hundred thousand dollars ($100,000), except any investment in a corporation conducting the business of George McFadden & Bro. as above authorized." Finally, he placed special responsibility on the corporate trustee, stating that "all investments made for my estate shall be subject to and be made only on the approval of the corporate Trustee." [129]

In the past decades, however, the trustees have sought and obtained court permission from the Delaware County Orphans' Court to remove the specific limitations on the amount of investment in a particular company. By decree dated November 13, 1970, the George Trust was divided into three separate trusts for the benefit of Caroline Ewing, for life, for Emily Staempfil, for life, and for the descendants of Alexander McFadden for their respective lives. By decree dated August 15, 1984, the Delaware County Orphans' Court approved a petition for investments by the trustees of the trust for the descendants of Alexander McFadden in 18,000 shares of the common stock of Carraway county in the amount of $198,000. More generally, by decree dated May 27, 1998, the Delaware County Orphans' Court released the trustees of the George Trust "from limitations that no investments in any one company or enterprise may exceed the greater of $100,000 or 5% of the principal of each trust and that the Trustees of each trust are empowered to make investments in companies and enterprises in excess of those limitations."[130]

2. Petitioners Failed to Establish the Requisite Breach of Fiduciary Duty in the Investments for the Trust Portfolios by the Trustees to Support Their Claim for Surcharge

[129] Ex. P-1 (1/6/1930 George McFadden Will, Article Seventh).

[130] Ex. C-3. The May 27, 1998 court order applied to the "Trustees of the trusts under the Will of George McFadden for the benefit of George McFadden and his descendants, John H. McFadden and his descendants and Mary McFadden and her descendants." By decree dated September 8, 2004, the Delaware County Orphans' Court also authorized investments by the Trustees of $125,000 in the stock of Easton Coach Company and $300,000 in the stock of Smith System Driver Improvement Institute, Inc.

In seeking to surcharge the two trustees for breach of fiduciary duty for failing to realign the trust portfolios, the petitioners "must bear the burden of proving the particulars of the trustee's wrongful conduct." Estate of Pew,440 Pa. Super. at 240, 655 A.2d at 543. To support their claim for damages, petitioners presented testimony and an expert report by Thomas Chapin. For the reasons set forth below, both were fatally flawed.

a. ***Petitioners' Expert Applied the Wrong Standard of Review and Relied on Hindsight to Determine Whether the Trustees Had Breached Their Fiduciary Duty***

The petitioners assert that after the death of their father in a plane crash on April 22, 2008, John and Mellon violated their duties as trustees in various ways, including "[r]efusing to actively and prudently manage the ABM & GM Trusts' portfolios, with the result that the portfolios' values plummeted, declining at a rate that far exceeded any decline in the securities markets generally."[131]

In Pennsylvania, the propriety of the trustees' investment decisions must be evaluated under the Prudent Investor Rule, 20 Pa.C.S. §7201. That rule provides that a "fiduciary shall invest and manage property held in a trust as a prudent investor would, by considering the purposes, terms and other circumstances of the trust and by pursuing an overall investment strategy reasonably suited to the trust." In making investments for a trust, a fiduciary shall consider various factors such as:

(1) the size of the trust;
(2) the nature and estimated duration of the fiduciary relationship;
(3) the liquidity and distribution requirements of the trust;
(4) the expected tax consequences of investment decisions or strategies and of distributions of income and principal;
(5) the role that each investment or course of action plays in the overall investment strategy;
(6) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries….
(7) to the extent reasonably known to the fiduciary, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument, and;
(8) to the extent reasonably known to the fiduciary, the income and resources of the beneficiaries and related trusts.

[131] 3/21/11 Amended Petition, ¶ 6(a).

20 Pa.C.S. §7203(c).

The prudent investor rule requires a fiduciary to "exercise reasonable care, skill and caution in making and implementing investment and management decisions" and provides that a "fiduciary who represents that he has special investment skills shall exercise those skills." 20 Pa.C.S. §7212. Although the prudent investor rule requires that "a fiduciary shall reasonably diversify investments, unless the fiduciary reasonably determines that it is in the interests of the beneficiaries not to diversify," this provision does not apply to trusts that became irrevocable prior to December 25, 1999. 20 Pa.C.S. § 7404(a) & (b). Significantly, in evaluating a fiduciary's management of a portfolio, the prudent investor rule focuses on "standards of conduct and not of outcome and performance." 20 Pa.C.S. §7213. Moreover, whether a fiduciary has complied with the prudent investor rule "shall be determined in light of the facts and circumstances prevailing at the time of the fiduciary's decision or action and not by hindsight." Id. In fact, Pennsylvania courts repeatedly emphasize that "hindsight is not the test of liability for surcharge" because to "make after-sight the sole judge of the trustee's prudence would be manifestly unfair." Estate of Pew, 440 Pa. Super. at 240-41, 655 A.2d at 544.

To flesh out their allegation that the trustees breached their fiduciary duties by mismanaging the trust portfolios, petitioners presented the expert report and testimony of Thomas Chapin. In formulating his expert report, however, Chapin applied an improper standard both for determining whether the trustees had breached their fiduciary duty in managing the trust portfolio and then in computing the surcharge damages. As Chapin explained: "Broadly, I was asked to evaluate whether the remaining Trustees had acted in a manner that best served the financial interests of the Trusts' beneficiaries."[132] Chapin interpreted this as a directive to identify the best investment portfolio for the trusts. Armed with this imperative to isolate the "best" investment strategy for the beneficiaries, Chapin proposed a single pro-forma portfolio that the trustees should have adopted and measured the two trusts' performance against that rigid standard:

> After George McFadden's death, the Trustees should have reallocated the Trust's investments to achieve a "Balanced Allocation" (40% equities, 60% fixed income) portfolio allocation. Their failure to do so resulted in cumulative shortfalls in the Trusts for the period

[132] Ex. P-189 (7/30/10 letter to Mr. Hangley). See also 11/2/10 a.m. N.T. at 56-57, 61-62 (Chapin)(conceding that he applied the standard of determining if the trustees acted in a manner that best served the financial interests of the beneficiaries).

April 30, 2008 through April 30, 2009 totaling $ 12,764,314 ($5,427,052 in Account SU130 and $7,337,262 in Account WA246). Ex. P-189 at 4.

The broad methodology of Chapin's analysis did not apply the prudent investor rule to the trustees' management of the trusts. Instead, his analysis focused on the trust's performance and compared it to the performance of his pro-forma "best" portfolio to come up with a measure of damages. In numerous ways, moreover, his methodology is fatally infused with hindsight.

In establishing his pro forma "best" portfolio as a standard for reviewing the trusts' performance, Chapin followed four general steps. The first step in deciding the proper allocation for the trusts, according to Chapin, was to assess the payments needed to support or maintain the beneficiaries. Chapin did not, however, make such an independent evaluation of the income beneficiaries' needs based on information that would have been available to the trustees in April 2008 such as the $1.38 million in annual distributions from the trusts that George had been receiving prior to his death. Instead, Chapin—based on hindsight—relied on the amounts the trustees had decided to distribute to the beneficiaries in 2009, which was $1,142,640.[133] This is significant on a variety of scores. It undermines the basic premise of Chapin's analysis that the trust portfolios should and could have been quickly reallocated within days of George's death. It also failed to acknowledge the complex considerations that faced the trustees after George's death in determining the appropriate distributions for the new beneficiaries. Since, for instance, the prudent investor rule required them to consider the income and resources available to the new beneficiaries, 20 Pa.C.S. § 7203(c)(7)&(8), while the trust documents made distributions to the minors discretionary for their support and maintenance, the trustees properly sought from their mother budgeting information which took time to obtain.[134]

The next step in Chapin's analysis was to calculate the annual rate of return that was necessary to meet these income needs based on $41,590,000 (the trusts' assets as of April 30, 2008). He determined that a return of 5.25% (premised on 2.75% for payments and 2.5% for annual inflation) was necessary for payments to the beneficiaries and to "maintain the value of their corpus."[135] In so doing, however, he conceded that he was unaware of the trustees' duty of impartiality to balance the needs of the income beneficiaries for income with the needs of the

[133] Ex. P-189 at 6; Ex. T-111 at 6; 11/2/10 a.m. N.T. at 87 & 90 (Chapin); 11/2/10 p.m. N.T. at 80 (Chapin).
[134] McGrath, for instance, testified that his knowledge of the income needs of the minors depended on a budget that he believed was being prepared. 1/4/11 a.m. N.T. at 38 (MM).
[135] Ex. P-189 at 7; 11/2/10 a.m. N.T. at 90-92 (Chapin).

remaindermen for growth because he assumed that with the death of George the only duty facing the trustees was to provide income for George's three surviving children.[136] See, e.g., Estate of Pew, 440 Pa. Super. at 237, 655 A.2d at 542 (discussing trustee's duty to deal impartially with beneficiaries and remaindermen). He conceded, therefore, that he did not factor growth into his calculations.[137] To evaluate various combinations of equities and fixed income that would yield the desired 5.25% return, Chapin used the Zephyr AllocationADVISOR based on an 8 year horizon that coincided with Alexander's minority.[138] This 8 year time frame was arbitrary in various respects. It did not take into consideration the interests of the remaindermen. It was not related to any terms of the trust, such as the termination date of the George Trust. In fact, Chapin conceded that he did not know when the George trust terminated.[139] It was not linked to income needs of the beneficiaries since Chapin conceded those needs would continue after Alexander reached majority. Moreover, it related to only one of three beneficiaries.[140] In any event, after running his Monte Carlo simulator computations for a variety of generic asset combinations, Chapin concluded that with an allocation of 60% fixed income (bonds) to 40% equities, there was at least an 81% probability that there would be a 5.25% annualized return over an 8 year period.[141] To balance the goals of preserving the trust corpus by avoiding risk against the need to make the annual payouts to the beneficiaries, Chapin concluded: "in my opinion to a reasonable degree of professional certainty, the portfolio that would best balance these two divergent goals is one invested 40% in equities and 60% in bonds." Ex. P-189 at 9.

Chapin acknowledged that from "the information provided to me, I cannot ascertain whether the two remaining Trustees went through a comparable intellectual or analytical experience to determine how best to allocate Trust assets on behalf of the beneficiaries after George McFadden died." Ex. P-189 at 9. Undeterred, he nonetheless focused on trustee reports, to compute damages based on a comparison of the performance of his pro forma portfolio to the

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136 Ex. P-189 at 6 (noting that prior to George's death "the Trustees had to balance the needs of two separate classes of beneficiary," but upon his death the "Trustees needed only to balance the three beneficiaries need for current income against an objective of preserving, if not growing, the trust principal for their future benefit"). See also 11/2/10 p.m. N.T. at 87-89 (Chapin)(acknowledging he did not factor growth into his calculations); 11/2/10 p.m. N.T. at 97-99 (Chapin)(acknowledging unfamiliarity with the trustees' duty of impartiality).

137 11/2/10 p.m. at 85-89 (Chapin).

138 Ex. P-189 at 7; 11/2/10 a.m. N.T. at 102 (Chapin).

139 11/2/10 p.m. N.T. at 70 (Chapin).

140 11/2/10 p.m. N.T. at 94-95 (Chapin)(acknowledging Alex's need for income will remain high after he turns 18 and that Willa will turn 18 before Alex).

141 11/2/10 a.m. N.T. at 108 (Chapin); Ex. P-189 at 8 (Table 3).

performance of the two trusts over the discrete one year period of April 2008 to April 2009. The alternative proposals by Mellon for an aggressive growth portfolio were rejected by Chapin as too risky; significantly, Chapin did not offer a calculation of potential damages if that Mellon allocation had been adopted.[142] As part of his general methodology to maximize—based on hindsight—losses following the economic crisis after September 15, 2008, he compared the level of diversification of the trusts to other "professionally" managed portfolios. He presented a chart to outline the decline in value of the two trusts between April 2008 and April 2009. Finally, he compared the declines in value of the trusts to the lower level of decline that his pro forma portfolio would have suffered during this discrete period to come up with a total "short fall" of $12,764,314.[143]

In the end, the petitioners' expert fashioned a monolithic standard of review. He formulated a single pro-forma portfolio with the benefit of hindsight and measured the McFadden trusts' performance against it for a discrete one year period when, he admitted, "[a] pervasive sense of crisis persisted through much of the fall and early winter" until"[p]rices in the U.S. stock market bottomed in March 9, 2009." Ex. P-189 at 13. He thus failed to apply the prudent investor rule to the trustee's conduct. In so doing, Chapin's methodology is reminiscent of the improper standard of review so eloquently rejected by Judge Charles Klein:

> Experience has taught us that the prescience of the most dedicated and expert fiduciary can rarely match the hindsight of a disappointed beneficiary. The theory upon which the objectants base their claim for surcharge is unrealistic and unacceptable. They take the position that the accountant should have invested the trust res in unspecified common stocks and insist that the value of the stocks selected should have kept pace with various stock market indicators… The objectants are protesting the entire investment policy of the trustee for the period in question and attempting to substitute an investment form of their own which is highly uncertain and speculative…. If the performance of trustees were to be judged on the basis of whether or not the results obtained have matched the increase in the Dow Jones averages or similar indices, and trustees were subject to surcharge for failure to equal the performance of some omniscient super-investor, few responsible persons or corporations would accept the risk of managing a trust such as this, with broad investment powers.
> Killey Trust, 29 Fid. Rep. 437,440-441, 445 (Phila. O.C. 1979).

Instead of analyzing whether the trustees had prudently managed the trust investments, petitioners' expert formulated and imposed his own "best" pro forma portfolio as the sole acceptable allocation. This rigid standard infused by hindsight is not the applicable prudent

142 11/2/10 p.m. N.T. at 23-24 (Chapin).
143 Ex. P-189 at 14-15, Table 12; Ex. T-111 at Ex. I.

investor rule that would consider the trustee's conduct in light of the contemporaneous circumstances facing them. This fundamental shortcoming, in fact, is acknowledged in the expert report.

b. *Petitioners' Expert Report Did Not Address the Trustees' Actual Conduct and Decisions in Managing the Trust Portfolios*

According to Chapin, there was a logical process that trustees should follow to manage the trusts' portfolio to meet the needs of the beneficiaries:

1) Make a reasonable estimate of payments required to maintain, educate and support the minor beneficiaries as provided in the Trusts' governing documents;
2) Determine the required Trust payouts as required under the terms of the respective Trust documents (i.e. payments to any male beneficiaries are required to be twice the size of any payments to any female beneficiaries);
3) Determine the required annual rate of return on Trust assets required to both fund expected payments and maintain the "real" (inflation adjusted) value of Trust payments over the expected term of such payments;
4) Determine the least amount of investment risk that would need to be taken within the Trusts portfolios in order to deliver the required annual return and meet payout obligations with a reasonably high degree of certainty without putting the trust's assets at risk.

Ex. P-189 at 6

Later in his report, however, Chapin conceded that from "the information provided to me, I cannot ascertain whether the two remaining Trustees went through a comparable intellectual or analytical exercise to determine how best to allocate Trust assets on behalf of the beneficiaries after George McFadden died."[144] Chapin's outline of a process for determining the income needs of the beneficiaries touches on key elements of the prudent investor rule. It highlights the need for a prudent process by trustees for devising an appropriate trust allocation and investment strategy. Significantly, however, Chapin admits he did not analyze whether John or Mellon had followed such a process.[145] The testimony of Michael McGrath, Jane Laffend and John Mcfadden, however, demonstrates that the trustees adhered to a thoughtful, prudent process in deciding on the allocations and investment scheme for the George and Alexander Trusts as part of their administration of the trusts.

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[144] Ex. P-189 at 9; 11/2/10 p.m. N.T. at 20 (Chapin).
[145] Ex. P-189 at 9; 11/2/10 p.m. N.T. at 20 (Chapin).

c.Very Soon After George McFadden's Death, the Surviving Trustees Prudently Considered the Income Needs of the New Beneficiaries and the Portfolio Allocations

George and John McFadden, as trustees of the George and Alexander Trusts, had shared an investment philosophy favoring long-term growth over income. George's rationale for this long term investment horizon was to provide for his children for many years after his death.[146] As adherents of value investing, they favored investing in a small number of high quality equities that could be carefully watched while disdaining fixed income securities as a drain on the trust portfolios. They consistently adhered to this investment strategy throughout George's lifetime.[147] Mellon, in contrast, as an advocate of the modern portfolio theory, had repeatedly recommended greater diversification of the trust portfolios as well as the addition of fixed income, but neither George nor John were persuaded to do so.[148]

This emphasis on long-term growth proved stunningly successful. The Alexander Trust had an inception value in 1951 of $1,000,000 when it was one trust for three beneficiaries and that value increased to $22,000,000 by the time the trust split in 2005 into 3 shares. By July 2008, George's share of the Alexander Trust had a value of $17,000,000.[149] A month after George's death, his combined share of the Alexander and George Trusts had a combined estimated market value of $44,257,000.[150] The benefits of this emphasis on long term growth was demonstrated by the comparative history of the three McFadden trusts for Mary, John and George. One consequence of an emphasis on long-term growth was that the trust portfolios generated comparatively small income. For this reason, in the early 1980's the trusts were amicably split among George, John and Mary McFadden when she requested an allocation that would afford her greater income.[151] As a result, Mary's share of the George Trust portfolio did not grow as rapidly as her brothers' portfolios. While Mary's share of the George Trust had been worth one-half of their trusts in 1984, by August 1, 2008, Mary's share of the George Trust had shrunk to only one-twelfth of their size.[152]

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146 1/4/11 p.m. N.T. at 64 (MM) (noting George's rational (sic) for having it invested predominantly in growth was to grow capital and the corpus, because after he died, it would go to the kids").
147 2/10/11 a.m. N.T. at 39-41 & 27 (JM).
148 2/10/11 a.m. N.T. at 39 (JM); 11/3/10 p.m. N.T. at 15-20 (MM); 1/4/11 p.m. N.T. at 8 (MM).
149 Ex. P-129
150 Ex. P-11.
151 2/10/11 a.m. N.T. at 27-30 (JM).
152 See Note 21 supra.

Around 2005, the McFaddens were able to obtain greater income from their trusts while still investing for long-term growth by relying on distributions pursuant to the Uniform Principal and Income Act ("UPIA"). Instead of relying on traditional income from dividends or interest, the UPIA gave the trustees the option for total return based on a percentage of the value of the trust without regard to its income or dividend yield.[153] During the final years of his life, George received large distributions from the trusts of nearly 4 per cent by relying on UPIA distributions totaling $115,044.81 per month or $1,380,537.70 per year. In the years before relying on UPIA distributions, George's trust income had been limited to less than 1% of the trusts' value. [154] Within days of George McFadden's death, Jane Laffend asked Michael McGrath to run through various calculations to determine whether the trust portfolios should be reallocated to meet the income needs of the new beneficiaries: Alexander, Wilhelmina and Lisa McFadden. She also asked Carol for a budget since the Trust Administration Committee ("TAC") would require one before making discretionary distributions.[155] When she received an initial, sketchy budget from Carol, Laffend attempted to fill in some of the gaps and then sent a copy of it to McGrath asking him to come up with asset allocations that would meet the income needs of the three beneficiaries.[156]

In response, McGrath reviewed the trust assets to determine whether they were appropriate for the new, younger beneficiaries. In so doing, he considered such factors as cash flow, capital gains issues, time horizon of the trusts, and market volatility. Based on the budget he received, he concluded that the need for cash flow would be just as great for the new beneficiaries as for George. Moreover, because the beneficiaries were so much younger, their need for income—and hence growth of the trust corpus—would extend for a longer period of time.[157] McGrath and John therefore agreed that investment objective favoring long-term growth remained as viable for George's children as it had been for him.[158] They disagreed, however, on the need to diversify the trusts and the add fixed income securities to the portfolio.[159]

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[153] 2/10/11 a.m. N.T. at 33, 38-39 (JM); 1/4/11 a.m. N.T. at 20 (MM)(by moving to total return, appreciation was "monetized").

[154] Ex. T-50; Ex. P-67

[155] 1/5/11 a.m. N.T. at 89-91 (JL); Ex. P-15.

[156] Ex. P-15 (5/30/08 e-mail from Laffend to McGrath); 11/9/10 p.m. N.T. at 4-5 (JL); 1/5/11 p.m. N.T. at 15 (Laffend); Ex. T-16.

[157] 1/4/11 a.m. N.T. at 31-33 (MM).

[158] 11/3/10 p.m. N.T. at 29 (MM); 1/4/11 a.m. N.T. at 61 (MM).

[159] 11/3/10 p.m. N.T. at 32 (MM). McGrath pushed for greater diversification of the assets and the introduction of fixed income; John maintained that the trusts' successful investment strategy should be maintained.

Guided by these considerations, McGrath performed a variety of calculations to determine what asset allocations would yield the $1.3 million annual income based either on traditional net income or total return based on UPIA distributions. To reach a yield of $1.3 million based solely on net income, McGrath concluded, the portfolio would have to be invested 85% in fixed income, and 15% in equities.[160] This allocation, however, would not have been considered prudent for such young beneficiaries since it would not have achieved the requisite amount of growth to provide for their income needs later in life when they were in their twenties and thirties. Such an allocation, McGrath testified, would have been rejected by TAC.[161] John likewise rejected such an approach because it foreclosed essential long term growth for the beneficiaries. Jane Laffend testified that TAC would not allow UPIA distributions unless the account was sufficiently invested for the growth, with a minimum of 60% in equities and 40% fixed income.[162]

These varied calculations by McGrath, with his conclusion that it would take a mix of 85% fixed income and 15% equities to reach $1.3 million cast doubt as to Chapin's conclusion that a 60% fixed income and 40% equity allocation would meet the basic income needs of the beneficiaries.[163] Such an allocation, for instance, would not have met the criteria for UPIA distributions established by Mellon for the prudent administration of a trust which required that at least 60% of the portfolio be invested in equities.[164] It is not clear from Chapin's report how—or whether--UPIA distributions were factored into his analysis. More to the point, the process the trustees engaged in within months of George's death to determine an appropriate asset mix to meet the income needs of the beneficiaries was consistent with the prudent investor rule, except, as noted below, for the failure to include a third trustee in the process.

The petitioners assert, however, that after George's death the trust portfolios "needed careful attention and management" because, inter alia, the income from those trusts "now accounts for a larger and essential portion of the support and income available to the minor beneficiaries, Wilhelmina and Alexander."[165] Their expert's report, however, failed to acknowledge the significance of the UPIA distributions to maintain the income distributed first to George, and

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160 1/4/11 a.m. N.T. at 53 (MM); see also Ex. T-121.
161 1/4/11 a.m. N.T. at 46-56 (MM); Ex. T-121.
162 1/5/11 a.m. N.T. at 97-98 (JL).
163 Admittedly, Chapin's calculations were based on a need to distribute a lesser amount to the beneficiaries or $1.142 million. 11/2/10 a.m. N.T. at 90 (Chapin); Ex. P-189 at 6..
164 2/7/11 p.m. N.T. at 16 (Rowe).
165 3/21/11 Amended Petition, ¶78 (a).

then to his children. This failure to consider these distributions and the consequential need to factor a certain level of growth into a proposed portfolio seriously undermine the credibility of Chapin's critique of the trustees' process in administering the trusts. As McGrath observed, by taking the position to make UPIA distributions, the trustees had to carefully position the portfolio to attain an adequate level of growth because in effect UPIA distributions were taking some of the growth from the future.[166] The policies of TAC requiring this careful calibration of growth in light of UPIA distributions, likewise, demonstrated a prudent process for administering the trusts.[167]

d. After George's Death, the Trustees Engaged in a Prudent Dialogue Over Reallocation of the Trust Assets But They Failed to Include a Third Trustee as Required by the Wills; Nonetheless, Their Options for Significant Changes Were Limited by the Stock Market Crisis of September 2008

At the time of George's death, both the Alexander and George Trusts were highly concentrated in a small number of equities. The George trust with a market value of $26,274,424.90 was invested in 1.9% cash, 11% fixed income and 87% equities. These equity holdings consisted of nine companies concentrated in energy and information technology. The Alexander Trust in April 2008 with a market value of $16,053,298 likewise was highly concentrated in equities with investments in only 11 companies.[168]

Within days of George's death, McGrath evaluated whether Mellon's aggressive growth target was still appropriate for the trusts in light of the new beneficiaries. He concluded that greater efforts should be made to diversify the portfolio but, as required by the prudent investor rule 20 Pa.C.S.§ 7203(c)(4), he also factored in the expected tax consequences of investment decisions or strategies. Because the portfolios were highly concentrated, he was concerned about the capital gains that would be incurred if changes were made all at once. He therefore concluded it would be best to diversify over several tax years. Moreover, the children's budget forwarded to him by Laffend confirmed that the portfolio had to be oriented on capital accumulation. No particular events in April or May 2008 gave him any special concern to expedite this process or caused him to question the aggressive growth orientation.[169]

166 1/4/11 a.m. N.T. at 21 (MM). See also 1/5/11 a.m. N.T. at 97-98 (JL); 2/7/11 p.m. N.T. at 16 (Rowe)..
167 1/4/11 a.m. N.T. at 50-56 (MM).
168 Ex. T-120 (Mellon Meeting Book for April 30, 2008).
169 1/4/11 a.m. N.T. at 35-42,46, 48 (MM).

John, in contrast, saw no need to change the investment strategy, which he firmly believed was "outstanding" and had performed brilliantly. He consistently favored holding stocks in a small number of companies that could be watched carefully and opposed introducing fixed income to the portfolio.[170] Although McGrath decided to meet frequently with John to advocate greater diversification, he believed that John's investment strategy was acceptable.[171] In the months after George's death, therefore, John and McGrath met frequently to review the portfolio and consider investment options. In June 2008, for instance, McGrath presented an investment proposal for the sale of stocks in the George and Alexander Trusts for $21,993,234 and $15,442,000 respectively to facilitate the purchase of numerous other securities. In presenting his report, McGrath calculated the capital gains that would result. Ex. T-124. McGrath considered this but a first step in achieving diversification since John's agreement was necessary, and the capital gains tax implications would have to be considered in the overall transaction. John did not agree with the proposed sales, but he discussed and considered them.[172] In late July 2008, McGrath presented another investment proposal to John with fewer sales and purchases after John expressed disapproval of some of the Mellon funds.[173] He followed it up with an e-mail to which John responded with a request to discuss it further.[174] Significantly, John treated his own trusts in the same fashion and did not accept McGrath's suggestions for their diversification either.[175] Throughout much of this period, the trust portfolios generally outperformed the S & P 500.[176]

On September 15, 2008, McGrath recalled, the markets opened very weak with news of the Lehman Brothers bankruptcy, causing the market values of the McFadden Trusts to drop. In the ensuing months, McGrath continued to recommend diversification but both he and John concluded that it would not be prudent to sell in such a volatile market. It was better to wait for the markets to stabilize.[177] Petitioners' expert, Chapin, likewise agreed that if the trustees had made significant changes in the trust portfolios after September 2008, they would have recognized significant losses. More generally, Chapin acknowledged that, in fact, the trustees

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170 2/10/11 p.m. N.T. at 41; 2/10/11 a.m. N.T. at 39-40 (JM); 1/4/11 a.m. N.T. at 44 (MM)..

171 1/4/11 a.m. N.T. at 44-55 (MM) (John's investment policy was acceptable and "the impression he gave very clearly was he's willing to consider').

172 1/4/11 a.m. N.T. at 62-67 (MM).

173 Ex. T-127; 1/4/11 a.m. N.T. at 69-70 (MM).

174 T-128; 1/4/11 a.m. N.T. at 71-72 (MM).

175 1/4/11 a.m. N.T. at 90 (MM)

176 11/3/10 p.m. N.T. at 75 (MM); Ex. P-189, Ex. G (showing trusts outperformed S & P 500 until August 2008)

177 1/4/11 a.m. N.T. at 83-84 (MM); 2/10/11 p.m. N.T. at 52-53 (JM).

had had only a very narrow window for making significant investment changes: from the date of George's death in April 2008 until September 15, 2008.[178]

McGrath and John continued meeting through October to December to discuss the trust portfolios. In November 2008, John agreed to certain sales of stock recommended by McGrath. 2/10/11 p.m. N.T. at 61-62 (JM); Ex. T-145. Although they agreed in December 2008 to sell shares in China Mobile and Flextronics, it was at a loss; they therefore decided to hold off making any other sales for diversification until the market stabilized and so that they could build up cash reserves for future buying opportunities.[179] After a meeting in February 2009, the trustees executed numerous sales and purchases of stock. As John recalled, at that point the strategy was to "gingerly apply our cash" to purchase high quality common stocks.[180]

In their amended petition, petitioners accuse the trustees of "deliberate mismanagement of the portfolio," and complain, more specifically that "[b]etween April 22 and December 10, 2008, the Trustees made virtually no changes to the portfolios of the ABM & GM Trusts." Amended Petition at II & ¶80. Yet the record demonstrates that throughout this critical period, the two trustees actively reviewed the portfolios and considered various investment options. The stock market crisis in September 2008—as petitioners' own expert witness acknowledged—rendered any dramatic change in the portfolio imprudent until the markets stabilized.[181]

More generally, petitioners complain that due to the trustees' failure to realign the trust portfolios at the time of George's death the assets of the George or Alexander Trust were not "deployed in accordance with modern portfolio theory." 3/21/11 Amended Petition, ¶ 48. Under Pennsylvania law, however, there is no absolute requirement for diversification of trusts—like the McFadden trusts--that were irrevocable prior to December 25, 1999. 20 Pa.C.S. §7204 (b)(2). Moreover, recent precedent emphasizes that diversification of assets is not always prudent. In Scheidmantel, 2005 Pa. Super. 6, 868 A.2d 464 (Pa. Super 2005), a trustee who diversified a trust without considering the specific circumstances of the beneficiaries was surcharged. Alternatively, structuring a portfolio that fails to provide for the long term growth of young beneficiaries has been deemed imprudent. See, e.g., Scharlach, 2002 Pa. Super. 279, 809

178 11/3/10 a.m. N.T. at 24-25 (Chapin).
179 2/10/11 p.m. N.T. at 64-67 (JM); Ex. T-147; Ex. T-148.
180 2/10/11 p.m. N.T. at 88, 87-89 (JM); Ex. T-159; Ex. T-160.
181 11/3/10 a.m. N.T. at 24 (Chapin)(agreeing that there would have been significant losses if the trustees had made substantial changes in investment management policy after September 15, 2008).

A.2d 376 (2002)(corporate guardian should be surcharged for failing to follow investment plan to provide growth for incapacitated person's long term needs).

The record demonstrates that in the months following George's death and throughout the difficult period following the stock market crisis of September 2008, the trustees diligently and prudently sought to determine the beneficiaries' income needs, and structure an investment strategy that would meet those needs—both short term and long term-- while taking into consideration relevant tax considerations. Significantly, petitioners' expert conceded that his analysis had failed to factor the tax implications of the reallocation he advocated. As a consequence, a basic presumption underpinning his calculations of a starting value of $41 million in trust assets in April 2008 was faulty since if those highly appreciated assets were quickly liquidated the resulting taxes would have decreased the starting amount.[182] For these and other reasons, that standard cannot be applied to the trustees' conduct in the investment decisions.

Although the two trustees followed a prudent process in making investment decisions, this process did not include the third trustee that was required under both wills for George and Alexander McFadden. The requirement that there be 3 trustees at all times was an absolute requirement imposed by both trusts. As discussed in further detail below, a plethora of excuses were offered for failing to adhere to this simple but singularly important directive. It must be presumed that a third trustee would have acted prudently and therefore that the tie and split between the two trustees would have been resolved by the missing trustee. From the date of George's death in April 2008 until the financial markets collapsed in September 2008, the two trusts were invested almost entirely in equities, nine companies in the George Trust and eleven companies in the Alexander Trust and without any regard for market diversification in sectors of the economy. In short, these two portfolios were exposed to huge downside risks. That said, however, it is abundantly clear that the few months' time elapsing between George's death on April 22, 2008 and the September 2008 collapse did not allow time for a thoughtful and well considered realignment of the portfolios given the requirement to consider tax implications of the sale of securities and decisions regarding reinvestment of the proceeds. Moreover, the exact contours the trust portfolios would have taken under the guidance of three trustees is too speculative to support any calculation of surcharge damages.

[182] 11/2/10 p.m. N.T. at 90-91 (Chapin).

e. The Record Does Not Support Petitioners' Claim that John Improperly Linked Investment Decisions to Other Topics While Mellon Acquiesced

In seeking a basis for surcharging the trustees, the petitioners frequently lump together various alleged breaches such as favoring Lisa's interests over those of Wilhelmina and Alexander and failing to make proper income distributions to the minor beneficiaries.[183]Any link between these alleged breaches and the decline in value of the portfolios is nonexistent. One alleged breach, however, is relevant to the surcharge issues: petitioners' claim that "[p]erhaps most offensively of all, John admitted that he was willing to address the woeful condition of the portfolios only after Carol and her children 'capitulated on other topics.' And Mellon did nothing to put a stop to this conduct."[184]

This claim is unsupported on various fronts. First, although Petitioners state that "John admitted" this improper linkage of investment decisions, they provide no citation to support this claim. Instead, the sole source they cite for this "admission" appears to be an October 21, 2008 e-mail from Jane Laffend to Michael McGrath which stated:

> I spoke with John about the accounts, in particular the George account. I told him that Barbara was very upset that "nothing has been done and George has been dead 6 months." John asked if you had any advice. I told him that I know that you have made various suggestions, in particular reducing the exposure to energy stocks and a number of other suggestions about reducing concentrations and diversifying. He grudgingly acknowledged those suggestions but did not want to do anything until they had capitulated on other topics. I think he may be regretting that now but would like to talk with you when you get in this afternoon.[185]

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[183] See, e.g., 4/26/11 Petitioners' Brief at 64.

[184] 4/26/11 Petitioners' Brief at 64- 65.

[185] See 4/26/11 Petitioners' Brief at 16 (quoting Ex. P-81A/Ex. T-57; 11/10/10 p.m. N.T. at 23-24 (JM): 11/16/10 p.m. N.T. at 41-47 (JL). In the testimony cited by petitioners, John credibly stated that "portfolio decisions, as I say, had at all times been unrelated to administrative decisions" and he believed Laffend either misspoke or misunderstood his position. 11/10/10 N.T. at 24 (JM). In the Laffend testimony cited by Petitioners, she testified that she believed too much emphasis was being placed on the options issue, but that was no getting in the way of her administration of the trust. She further testified that she was not directly involved with the investments, but from what she had been hearing, there had been "standoff" as to the investments. 11/16/10 p.m. N.T. at 41-47 (JL). John acknowledged in his testimony that he "certainly on October 21st was concerned about the markets." 11/10/10 N.T. at 21 (JM). He drew clear distinctions between portfolio and administrative decisions, testifying with credibility that "the management of the portfolio is really quite independent of these topics, and I don't believe that I would have said, in the market conditions at that time that we would relate portfolio decisions to collateral issues." 11/10/10 p.m. N.T. at 23 (JM). John's testimony, combined with that of McGrath who was directly involved with portfolio decisions has greater weight and credibility than Laffend's surmises based on undisclosed sources.

Rather than "doing nothing" about any improper linkage of investment decisions, Laffend's e-mail demonstrated her sensitivity to the suggestion of any such impropriety. McGrath likewise stated that he was alarmed by this e-mail, because he had never perceived that John was linking investment decisions to extraneous factors:

> Q: And did you from the investment side perceive John as having linked or connected other issues to the investment issues?
>
> Mr. Hangley: Objection. That's pure speculation.
>
> Mr. Mannion: It's not speculation, whether or not he came to that conclusion.
>
> The Court: Overruled.
>
> A: (by McGrath) No. In fact, that's the reason I went to talk to Jane.
>
> 1/4/11 a.m. N.T. at 69 (MM).

McGrath went over to talk with Laffend who told him there were issues within the family about other investments. Since those issues did not relate to trust matters, McGrath told her that he did not want to hear about them. McGrath also testified that John had rejected similar suggestions for changing John's own personal trusts.[186] Mellon quickly called a meeting held on October 27, 2008 attended by John DiMedio, (Managing Director of the Wealth Management Group for Mellon's mid-Atlantic region), David Rowe, (Senior Director and Senior Fiduciary Officer for Mellon's mid-Atlantic region), Judith Stein (managing counsel for Mellon), and John McFadden for a "very serious discussion" to remind John of his fiduciary duties and to make sure that there was no improper linkage of investment decisions with other issues.[187] Despite the voluminous chains of e-mails and other documentation presented in the course of the days of hearings this is the sole reference to improper linkage; moreover, the October 21, 2008 e-mail dates from the period after the stock market crisis when the trustees as a matter of fact had little opportunity to make significant investment changes; and McGrath testified that he had never, in fact, perceived any linkage by John of key investment decisions. There is no doubt, however, that the reference to John's "linkage" relates to the distributions to the minors as will be discussed below.

[186] 1/4/11 a.m. N.T. at 89-90 (MM)

[187] 2/8/11 a.m. N.T. at 17-21 (DiMedio). DiMedio testified that one of the issues discussed was the linkage issues raised in Laffend's e-mail: "There was some concern articulated by Jane that John was linking issues which she communicated internally. That got to Judy; Judy got to me and that's why we had the meeting" to reinforce to John that "[c]an't do that." 2/8/11 a.m. N.T. at 21 (DiMedio).

f. ***The Trustees Prudently Protected the Trust Assets by Requiring George to Take Out Life Insurance Policies to Secure his Loans from the George Trust Resulting in the Recovery of those Loans by the Trust***

In analyzing the conduct of the trustees in their management of the trust portfolios, much emphasis was placed on the trustees' investment decisions. A striking example of their prudence in managing the trusts' assets, however, was their requirement that George secure the loans he took from the George Trust with life insurance policies. Because of this prudence, the trusts for the benefit of his three children were able to recoup those loans very soon after his death. Initially, George approached John, as trustee, with a plan to borrow $ 2 million dollars from the George Trust to purchase Affordable Furniture. In response, they worked out an agreement to allow the trust to advance that money without risk to the trust assets. First, there was a promissory note containing an amortization schedule that passed the interest on to George. This was backed up with the assignment of an insurance policy. According to John, to protect the trust from a loss in appreciation, they also agreed on an option for the trust to a $1,500 purchase price and anti-dilution provisions. Mellon agreed with this plan and the loan was consummated in July 2006, which falls within the accounting period of the George Trust. John helped structure a similar deal when George decided to invest in Crescent Drilling. Once again, George was required to sign a promissory note which was backed up with an insurance policy and the trust was granted an option to purchase an interest in Crescent.[188]

In March 2008, George sought to borrow additional sums to invest in Crescent, but John was concerned that this was not a proper trust investment and that George would be taking substantial fees from it. George no longer had any insurance policies to back up a loan, because he had sold them. In light of this, the trustees refused to approve the loan which severely strained John's relationship with his brother.[189] After George's death, John coordinated the process for obtaining the insurance payments. Not only did those payments cover the Affordable and Crescent loans from the trust, but in addition, $422,000 was left over for Carol, with an additional sum of $25,000.[190]

g. Allegations in the Amended Petition that Investment Decisions Made While George Was Alive Were Imprudent Raise the Specter of Liability for His Estate

[188] 2/10/11 a.m. N.T. at 55-59 (JM).
[189] 2/10/11 a.m. N.T. at 60-62(JM).
[190] 2/10/11 a.m. N.T. at 73-74 (JM).

On February 16, 2011, Winfield Jones, as guardian of the property of Willa and Alex, filed a petition seeking permission to amend their petition for various reasons such as reinstating Alexander as a formal party petitioner, asserting a claim for punitive damages against John, providing fees for Winfield Jones. This petition was granted in part and denied in part as set forth in decrees dated March 16, 2011 and March 23, 2011.

Whether intentionally or not, the amended petition filed on March 21, 2011 asserted new facts and theories that would extend surcharge liability not just to John and Mellon but also to petitioners' father, George McFadden. The theory underlying the initial petition was that George had been an investment genius, but upon his death, the remaining trustees mismanaged the portfolios resulting in loss to the trusts. The initial petition thus asserted:

> 2.Although Mellon was nominally the portfolio manager of the A.B.M. (i.e. "Alexander Trust") Trust, George had selected and recommended most of the trust's investments over a period of several years. He had performed that function superbly, and the trusts' assets had grown from less than $1 million to more than $15 million during his trusteeship. George received monthly distributions of approximately $43,000, equal to 4% of the trust's asset value, from the A.B.M. Trust.
>
> 4.Many of the A.B.M. Trust's investments were inappropriate <u>after</u> George's death in light of the changed beneficiaries of the trust, those beneficiaries changed economic circumstances, and the profound changes in the economy and markets.
>
> 5. Since George's death, John and Mellon have violated their duties as trustees in several respects, including but not limited to the following:
>
> c.Neglecting the management of the A.B.M. Trust's portfolio, with the result that its value has plummeted, declining at a rate that far exceeds the decline in the securities markets generally.
>
> d.Maintaining A.B.M. Trust investment positions that became totally inappropriate after George's death.
>
> 5/1/09 Petition re Alexander Trust, ¶¶ 2, 4, 5 (emphasis added).

With the Amended Petition, George once again is characterized as playing a dominant role in selecting the trust's portfolio but that performance is no longer described as "superb;" instead, it comes across as "risky" decisions that were imprudent even while George was alive:

> 44. George played a major role in selecting investments for the GM and ABM Trusts and managing the portfolios. He was a brilliant investor, but his approach to investing was aggressive and sometimes risky, and required the constant and nimble employment of his extraordinary investment talents.

47. <u>Investments and portfolio decisions made while George was alive</u>, when he was the GM and the ABM Trusts' sole beneficiary, <u>were imprudent</u> and cried out for changes after George's death in view of

a. the loss of George's other income to Carol and George's minor children;

48. <u>At the time of George's death,</u> the GM and ABM Trusts' <u>assets were not deployed in accordance with modern portfolio theory</u> in that

a. the two trusts were invested virtually entirely in equities, with no significant component of fixed income.

b. the portfolios consisted of too few different stocks.

c. the portfolios were concentrated in too few industries, and

d. the portfolios were heavily concentrated in highly volatile industries and securities.

70. <u>When George was alive</u>, and the sole income beneficiary of the GM and ABM Trusts, <u>he had favored a strongly growth-oriented and risky investment regime in which the portfolio was concentrated in a small number of equity investments in a narrow sector of the market,</u> with no fixed income component. John was generally in agreement with this approach.

71. Mellon considered George's approach too risky and, by way of compromise, recommended that the GM and ABM Trusts adopt what Mellon calls an "Aggressive Growth" investment objective, pursuant to which 10-30% of the portfolio would be invested in fixed income instruments, and the balance in a larger number of equities spread across all market sectors. But George and John rejected this approach.

72. Regardless of whether the Aggressive Growth investment objective would have been suitable or unsuitable during George's lifetime, and regardless of whether it was suitable or unsuitable for Lisa as an income beneficiary, the Aggressive Growth approach recommended by Mellon was plainly too risky for Wilhelmina and Alexander as income beneficiaries in view of the various facts enumerated elsewhere in this Petition, including the children's and Carol's circumstances, the state of the economy and securities markets in 2008 and the fact that equities are generally more volatile than fixed income investments.

3/21/11 Amended Petition, ¶¶ 44, 47, 48, 70, 71, 72 (emphasis added).

With these allegations, petitioners have thereby further extended their net of liability for any surcharge to ensnare their father's estate. Ironically, one of the trustees' purposes in filing an account was to obtain discharge for George's estate. As Laffend wrote in a July 30, 2008 memo to DiMedio, since "this family cannot agree that today is Wednesday! We are filing the accounts to 1. Clear up George's estate liability…." Ex. T-39 <u>See also</u> Petition for Adjudication for George Trust, ¶ 13 (asking the court to "discharge the deceased trustees).

3.Petitioners Claim for Damages Failed to Establish that the Trusts Suffered a Legally Recognizable Loss

a.Under Controlling Pennsylvania Precedent, a Trustee's Liability for Surcharge is Based on the Long Term Performance of the Trust and Not on an Arbitrary Short Term as Selected by Petitioners

Before a surcharge can be imposed on a trustee, a court must find "(1) that the trustees breached a fiduciary duty and (2) that the trustee's breach caused a loss to a trust." Estate of Warden, 2 A.3d at 573 (citations omitted). In the instant case, Petitioners seek to impose liability on John and Mellon based on the unrealized losses suffered by the George and Alexander Trusts in the wake of the economic crisis in September 2008. Initially, they premised their damages calculations on the arbitrary one year period of April 2008 to April 2009. See Ex. P-189 at 4 & 15.. In the course of the hearings, however, Petitioners' presented testimony by their expert Chapin as well as a report that extended his damage calculations beyond April 2009 to the date when the trusts were split October 31, 2010. See Ex. P-250. That extension of the time frame relied on the same methodology.

Pennsylvania courts, however, have rejected similar attempts to cherry-pick a narrow time-span as the basis of a surcharge. Instead, they have focused on the long term performance of a trust to determine the appropriateness of a surcharge. In the Estate of Pew, for instance, the Superior Court rejected the argument that trustees should be surcharged based on losses suffered by the trust due to the decline in market value of certain stocks during a the short time period (1989-1991) covered by the supplement to a Third Account. Instead, the Pew court concluded that the trustees' liability for surcharge should be based on their long-term performance. It looked back 60 years to 1932 the date of the trust's inception, emphasizing that the value of principal "was still more than five times greater than its value on the date of its establishment by the settlor." Estate of Pew, 440 Pa.Super. at 241-42, 655 A.2d at 544. More recently, the focus of the Pew court on the long term performance of a trust fund in a surcharge claim was reaffirmed by the Estate of Warden, 2 A.3d 565 (Pa. Super. 2010). The Warden court refused to impose a surcharge on trustees because there had been long term growth in the assets; it noted that the trust assets had increased from $1.5 million at the trust's inception in 1951 to $189 million by the beginning of the litigation before it. Although three accounts had been filed for the trust, the court did not confine its definition of long-term growth to a particular accounting period; instead, it calculated the growth of the assets from the inception of the trust. See generally, McCullough Trust, 21 Fid. Rep. 2d 135,138, 143 (Allegheny Cty. O.C. 2001 (No surcharge imposed on trustee where the trust over the long term coinciding with the accounting period suffered no loss); Pew and Sheronas Trusts, 17 Fid. Rep. 2d 368, 372 (Mont. Cty. O.C. 1997)(whether the trusts suffered a loss "is measured by the long term performance of the Oryx investment, not by its short term performance" as "calculated by a comparison of the value of the investment when it first came under Glenmede's control and management in 1964 with its value as reflected in the second accounts" in July 1993).

The "no loss, no surcharge" rule, where loss is measured from an ancient inception date of the trust, arbitrarily insulates trustees from surcharge actions and, warrants thoughtful reexamination. This case, however, does not provide the factual basis for doing so. The trustees in the instant case do not seek to have the performance of the Alexander Trust and George Trust measured from the date of their inception. Instead, they focus more narrowly on the growth of the trust assets from the date of the last, most recent accounting.[191] Focusing on an accounting period to determine whether a trust portfolio has been prudently administered makes sense since this approach provides both flexibility and certainty. This is because the PEF Code, 20 Pa.C.S. §3501.1, gives broad discretion to the fiduciary, the parties in interest-and the court—to request an accounting. Mellon presented expert testimony and an expert report by Eugene Maloney to establish the gains realized by both the Alexander Trust and George Trust. Ex. T-112. The guardian ad litem likewise presented a final report that over the relevant accounting periods neither trust had suffered a loss:

> The most recent prior audit to the current audit of the **George Trust** was in 1984. The principal balance awarded by the Adjudication of Catania, P.J. dated September 18, 1984 and the schedule of distribution thereon consisted of cash and securities valued at $2,035,314. The Account was stated for the period through June 4, 2009, a supplement was filed updating the Account through December 31, 2009, and a second supplement was filed updating the Account through October 31, 2010. At the end of the second supplemental accounting period, the market value of the principal balance on hand was $17,534,423, consisting of cash, securities and mutual funds. The cumulative net gain on conversions was $23,583,462 over the 25 year accounting period. Over that period of time, principal disbursements totaled $9,665,550.

[191] 6/13/11 John McFadden Brief at 37-38 (the "evidence demonstrates that trusts have enjoyed significant growth over the accounting periods" judged from the beginning accounting date of 1985 for the George Trust and the beginning accounting date of 2006for the Alexander Trust"); 6/13/11 Mellon Brief at 36 ("the accounts and supplemental accounts of record with the Court reflect more than $26 million in realized gains during the accounting period"),

> The **Alexander McFadden Trust** has its situs in Philadelphia. It was last accounted for in 2005 when an account was filed…. The principal balance awarded to George's trust by the Adjudication of Herron, J. dated 12/2/05, and per the bring down statement attached to the Account was $9,973,421, consisting of cash, securities and mutual funds. A supplement was filed updating the Account through December 31, 2009, and a second supplement was filed updating the Account through October 31, 2010. At the end of the second supplemental accounting period, the market value of the principal on hand was $10,315,865, consisting of cash, securities and mutual funds. <u>The cumulative net gain on conversions was $1,564,955 over the 4 ½ year accounting period.</u> Over that period of time, principal disbursements and distributions totaled $2,527,889.
>
> 7/8/11 Guardian ad litem Report at 14-15; 6/3/09 Alexander Account at 4.

B. Petitioners' Proposed Calculations for Surcharge Are Arbitrary, Imprecise and Unrelated to the Terms of the Trust or the Relevant Circumstances of the Beneficiaries

Another reason why the petitioners' surcharge claim is denied is their failure to present a reasonable basis for computing damages. This is critical: "[s]ince damages generally will not be presumed, they cannot be recovered unless the evidence provides a sufficient basis for estimating them with reasonable certainty, and they should not be estimated on the basis of mere conjecture or speculation." <u>Killey Trust,</u> 29 Fid. Rep. 437, 444 (Phila. O.C. 1979).

Initially, Petitioners sought damages in the total amount of $12,764,314 based on the expert report of Thomas Chapin. This was based on his calculation of a $5,427,052 "shortfall" for the Alexander trust and a $7,337,262 "shortfall" for the George Trust when compared to the "pro-forma" portfolio ending value on April 30, 2009. Petitioners subsequently presented testimony and a chart that carried the "shortfalls" to the later date of October 31, 2010, concluding at that point the two trusts had a combined "shortfall" of $12,346,374 when compared to the projected performance of Chapin's "pro forma" portfolio. <u>See</u> Ex. P-250. In the amended petition petitioners filed in March 2011 and in their subsequent post-trial brief, petitioners sought damages based on 75% of the amounts calculated in Chapin's initial report. In other words, they sought 75% of the George Trust's injury of $7,337,262 "attributable to the Trustees' mismanagement of the portfolio" and 75% of the Alexander Trust's injury of $5,427,02 for a total of $9,573,235.50. <u>See</u> 3/21/11 Amended Petition, ¶ 126(b); 4/26/11 Petitioners' Brief at 78.

The underlying presumptions for these calculations were problematic and speculative. First, as the trustees observe, Chapin referenced "shortfalls" rather than "losses," suggesting the ephemeral nature of the shifting balances in the portfolio as a basis for damage calculations.

Second, his calculations were premised on a starting portfolio amount as of April 30, 2008 of $41,590,000, which would have had to be reallocated to conform to the "balanced" pro forma allocation within days of George's death. Ex. P-189 at 7. In testimony, however, Chapin conceded that he had not factored the capital gains taxes that would have accompanied the necessary sales into his calculations. If those taxes had been considered, his starting amount would have been less.[192]

Chapin's presumption that the radical reallocation could have been accomplished by April 2008 was unrealistic. Moreover, the decision to focus initially solely on the one year period of April 2008 to April 2009 appears arbitrarily oriented towards maximizing "damages." With the benefit of hindsight, it is now clear that this period spanned the worst months following the Lehman Brothers bankruptcy on September 15, 2008. In fact, petitioner's expert Chapin unabashedly acknowledged that his focus on the one year period between April 2008 and April 2009 straddled a period of extreme economic distress:

> Stock prices held steady from mid-July through the end of August 2008. Oil prices, however, began to sell off sharply, declining from their $145/ barrel high to $115(-21%). **Worldwide equity and credit markets then contracted severely starting in September 2008 in the face of a liquidity crisis which resulted in a rash of major corporate bankruptcies (e.g. AIG, Lehman Brothers) hastily arranged mergers (e.g., Wachovia, Merrill Lynch), and massive government intervention in the financial markets. A pervasive sense of crisis persisted through much of the fall and early winter. Led downward by Financial sector stocks (-71%), the overall U.S. stock market returned -45.7% from April 30, 2008 through the end of February 2009.** Segments of the U.S. bond market also performed poorly, though the relative strength of U.S. Treasury bond prices resulted in positive (+ 1.9%) returns on bonds as an asset class across this 10-month period. With the Federal Reserve aggressively lowering interest rates to foster marketplace liquidity, yields in cash reserves fell well below 1%. Ex. P-189 at 13 (emphasis added).

Significantly, as Chapin noted, the nadir of this economic crisis was reached in March 2009:

> **Prices in the U.S. stock market bottomed on March 9, 2009 and proceeded to stage a rally that continued for much of the subsequent 13 months…. But with this uptrend only just starting to get underway, at April 30, 2009 overall stock market values remained appreciably lower than they were twelve months later.** Ex. P-189 at 13 (emphasis added).

[192] 11/2/10 p.m. N.T. at 90-91 (Chapin).

Chapin's initial expert report on the performance of the trusts, however, stopped in April 2009 and did not consider the effect of the rally. In testimony, Chapin acknowledged that earlier drafts of his report had chosen different end dates: one draft had gone to December 2009,while another went as far as March 31, 2010.[193]He offered various reasons for limiting his report to the one year of severe economic distress: that was when the trustees began to diversify or when the petitioners began their litigation.[194] Neither explanation is convincing; neither diminishes the arbitrary nature of his analysis, seemingly designed to maximize damages based on unrealized loss. There is, moreover, an unintended consequence to this rationale that his initial report stopped in April 2009 because that is when the trustees began to diversify: by extension, this would concede that from that date onward (i.e. April 2009) there is no need to focus on the trustees' conduct,

Another arbitrary aspect of Chapin's damages analysis is his focus on an 8 year time frame when calculating the allocation for his pro-forma "best" portfolio. As his report explained, to devise the "best" portfolio, Chapin used the AllocationADVISOR product's "Monte Carlo Simulator" program to "run 100,000 simulated McFadden Trust portfolio outcomes across an 8 year investment horizon for each combination of assets." Ex. P-189 at 8. In testimony, he explained that he selected this 8 year investment horizon because that coincided with the number of years remaining until Alexander—only one of the three beneficiaries—reached majority.[195] No attempt was made to link the time-frame of his analysis to the terms of the trusts or to an accounting period. In fact, Chapin conceded that he did not know when the George trust terminates—but no attempt was made by the petitioners to raise that as an issue for review.[196] In fact, none of the parties raised the issue of the George Trust's termination date or presented the factual evidence necessary for its resolution. Consequently, it "is axiomatic that a court should not decide a case on the basis of issues not raised by the parties." Scharlach, 809 A.2d at 382.

There is a more serious problem with the selection of an 8 year period of analysis. As Chapin admitted where calculations are premised on a typical rate of return of stocks over a 7 to 10 year period of time there are years when you might be up 30% one year and then down 10% the next. To focus on just one year, this suggests, could lead to arbitrary results. More to the

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193 11/3/10 a.m. N.T. at 16.
194 11/2/10 p.m. N.T. at 43 (Chapin).
195 11/2/10 a.m. N.T. at 102 (Chapin); 11/2/10 p.m. at 94-95 (Chapin).
196 11/2/10 p.m. N.T. at 70 (Chapin).

point, Chapin testified that the outcomes in 2008 and 2009—the period he isolates for his damages calculation—were "very extreme outcomes in anyone's experience" with negative returns of 35% to 40%.[197]

Perhaps the most arbitrary aspect of Chapin's model was the assumption—or imperative—that the trustees should and could have reallocated the trust assets to conform to his pro forma hypothetical model by April 30, 2008 which was only days after George's death. For the reasons previously outlined, the record established that the complex tasks the trustees encountered in the aftermath of George's death and the careful process they followed in addressing them could not have been completed in the matter of days envisioned by Chapin's model. To begin the calculation of damages from the date of April 2008—as set forth in his report and testimony--would be unconscionable. In reaching this conclusion, however, the difficulties facing the petitioners in selecting a fair and reasonable time frame must be acknowledged.

*C. **Petitioners' Misinterpret <u>Estate of Stetson</u> in Their Effort to Surcharge the Trustees***

In their initial case, the petitioners presented the expert report and testimony of Chapin to lay out their surcharge theory and a calculation of damages by comparing the performance of the trust to the performance of Chapin's hypothetical "best" pro forma 60% (fixed income)/40% (equities) portfolio allocation. In so doing, they attempted to quantify the loss to the trusts caused by the trustees' alleged mismanagement. Not until the weakness of that analysis was exposed did Petitioners suggest an alternative theory of damages. Under the <u>Estate of Stetson,</u> 463 Pa. 64, 345 A.2d 679 (1975), they argue, "misconduct by the trustee and a related loss—are all that the Petitioner must show." The petitioners then assert "the word 'related' is significant, as it demonstrates that Petitioners need not show that a 'resulting' or 'consequent' or 'proximately caused' loss has occurred." They claim that they have met this burden by showing that the "catastrophic" losses by the trust were "related to and the result of" the breaches detailed above," which included favoring Lisa's interests, failing to appoint a third trustee, failing to split the trusts, failing to rebalance the trust, providing inadequate distributions, disclosing

[197] 11/2/10 a.m. N.T. at 100-102 (Chapin)(describing the yearly fluctuations "up to 30% one year, and down 10% another year" in a long term analysis); 11/2/10 p.m. N.T. at 9 (Chapin)(describing the extreme losses occurring in 2008 and 2009).

confidential information and engaging in "pointless litigation" over the options.[198] According to the petitioners, the burden then shifted to the trustees "to prove, as a matter of defense, that the loss would have occurred in the absence of a breach of duty." [199]

While the petitioners acknowledge that they "never set out to prove that the entire diminuition of the portfolios—the $19,500,000 loss experienced between April 2008 and April 2009—should be surcharged against the trustees," they now claim that the trustees should be surcharged for this entire "loss" which they define as "the difference between the market value of the portfolios as of the (sic.) George McFadden's death and the end date chosen by the Court" which is "either May 1, 2009(when the petitions were brought) or November 1, 2010 (when the trusts were divided and the independent trustee was appointed)" This would result in a surcharge of either $19,424,873 or $13,605,296.00."[200] Under this alternative theory, the petitioners assert that it is not their "job to quantify that or any measure of damages;" instead the burden fell on the trustees to show "how much of the diminuition was the product of market conditions and how much could be attributed to their action and inaction."[201]

This alternative argument is unconvincing. This is borne out in their Amended Petition where they seek damages that are framed in terms of the calculations of Chapin's expert report rather than the total losses of the trusts.[202] Likewise, their post-trial brief seeks a surcharge predicated on the Chapin calculations. See 4/26/11 Petitioners' Post-Trial Brief at 78, ¶ c.

More significantly, Petitioners misinterpret the burdens of proof set forth in Stetson by suggesting that it eliminated the requirement that the party seeking a surcharge has the burden of showing that a breach of fiduciary duty resulted in or caused the alleged losses. The facts and procedural posture of the Stetson court's analysis demonstrates this. In Stetson, the beneficiaries of a trust objected to the terms of a settlement by their trustee, Fidelity Bank, when it agreed to settle a secured obligation of the trust for less than the full amount. In 1928, Fidelity loaned $41,728 attributable to the Stetson trust to Hahnemann Hospital and received as security a mortgage on the hospital's property. Although the loan was due for repayment in 1931, the

198 4/26/11 Petitioners' Brief at 64-66. Petitioners lump all these breaches together in their Stetson argument under the headings "The Trustees' Fiduciary Breaches Damaged the Trusts, and They Should be Surcharged" and "The Trustees Committed Breaches and the Trusts Suffered Harm." Id. at 64.

199 4/26/11 Petitioners' Brief at 65 (quoting Estate of Stetson, 463 Pa. at 84, 345 A.2d at 690)(emphasis added).

200 4/26/11 Petitioners' Brief at 66-67.

201 4/26/11 Petitioners' Brief at 66.

202 3/21/11 Amended Petition, Proposed Decree, ¶ 3. Petitioners seek 75% of the George Trust's "injury of $7,337,262" which was the amount specified by Chapin as the George Trust's shortfall for the period between April 2008 to April 2009. See Ex. P-189 at 4.

hospital remained in default for 30 years. The trustee then accepted $30,252 as repayment for the trust, resulting in a loss of $11,500. The beneficiaries sought to surcharge the trustee for that amount on the theory that the loan had been secured by real estate worth $5,550,000. The trustee contended that the real property was so specialized that after demolition its value would have been less than the debt. Estate of Stetson, 463 Pa. at 82, 345 A.2d at 689.

The Stetson court began its analysis of these claims by emphasizing the general rule "that a trustee who breaches a fiduciary duty will not be surcharged for a loss sustained by the trust if there is no causal connection between the breach of duty and loss." Stetson, 463 Pa. at 84, 345 A.2d at 690. It then set forth the affirmative defense available to the trustee if breach of duty and loss is established: "If the trustee commits a breach of trust and if a loss is incurred, the trustee may not be chargeable with the amount of loss if it would have occurred in the absence of a breach of trust."[203] In reviewing the record of the trial court, however, the Pennsylvania Supreme Court concluded that the trial court had made two errors: first, it failed to consider whether the trustee had, in fact, breached its duty. Second, it placed the affirmative defense on the beneficiaries rather than the trustee. The Pennsylvania Supreme Court therefore remanded the case so that the trial court could make the following determinations:

> On remand, the court must determine whether appellants (i.e. the beneficiaries) have proved that Fidelity acted imprudently or carelessly in accepting Hahnemann (the hospital's) settlement proposal. If the court concludes that they have, it must further determine whether Fidelity has proved that the loss to the trust would have occurred in the absence of a breach of the duty.
> Estate of Stetson, 463 Pa. at 85, 345 A.2d at 691.

Significantly, the existence—and amount—of loss or damages was not at issue in Stetson; the loss was clearly $11,500. What needed to be established was whether the trustee had breached its duty by accepting a settlement agreement for an amount less than that loss. If the beneficiaries met their burden of proof, the trustee still had available an affirmative defense on which they had the burden of proof.[204]

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[203] Stetson, 463 Pa. at 83-84, 345 A.2d at 690. Alternatively, the court explained that "when a beneficiary has succeeded in proving that the trustee has committed a breach of duty and that a related loss has occurred, we believe that the burden of persuasion ought to shift to the trustee to prove, as a matter of defense, that the loss would have occurred in the absence of a breach of duty. Id., 463 Pa. at 84, 345 a.2d at 690(emphasis added).

[204] The shifting burdens of proof set forth in Stetson were clearly explained in Estate of Lychos, 323 Pa. Super. at, 85, 470 A.2d at 142 as follows: "Once a beneficiary has succeeded in proving that the trustee committed a breach of duty and that a related loss occurred, the burden shifts to the trustee to show that the loss would have occurred in the absence of the breach of that duty."

There is no merit to the petitioners' argument that under Stetson, they only have to show "misconduct by the trustee and related loss;" which means that they are not required to "show that a 'resulting' or 'consequent' or 'proximately caused' loss occurred;" and that is not their "job to quantify that or any measure of damages."[205] In making these arguments, Petitioners ignore the clear language of Stetson that it "is generally the rule that a trustee who breaches a fiduciary duty will not be surcharged for a loss sustained by the trust **if there is no causal connection between the breach of duty and loss."** Estate of Stetson, 463 Pa. at 83-84, 345 A.2d at 690 (emphasis added).

This requirement for a surcharge that the breach of duty causes the claimed loss is rooted in Pennsylvania precedent. In the early case of Harton's Estate, 331 Pa. 507, 520, 1 A.2d 292, 298 (1938), for instance, the Pennsylvania Supreme Court carefully distinguished among alleged breaches of fiduciary duty to emphasize the necessity of showing that an alleged breach was the cause of the claimed losses before a surcharge can be imposed on a trustee for investment losses. In Mendenhall Trust, 484 Pa. 77, 82 fn.3, 398 A.2d 951,954 fn 3 (1979), the Pennsylvania Supreme Court clearly stated: "A trustee cannot be surcharged for a breach of his duty unless the breach caused a loss." This causal relationship between the alleged breach and claimed loss has been consistently embraced by Pennsylvania surcharge cases.. See, e.g., In re McCune, 705 A.2d 861, 865 (Pa. Super. 1997)("A trustee cannot be surcharged for a breach of his duty unless the breach caused a loss"); Estate of Pew, 440 Pa. Super. at 240, 655 A.2d at 544 (1994)("A trustee cannot be surcharged for a breach of duty unless the breach caused a loss to the trust"); Estate of Lychos, 323 Pa. Super. at 85, 470 A.2d at 141("It is well established in this Commonwealth that a fiduciary who has negligently caused a loss to an estate may properly be surcharged the amount of that loss')(emphasis added); In re Scheidmantel, 868 A.2d at 493 ("The purpose of a surcharge is to compensate beneficiaries for the loss caused by the fiduciary's want of the appropriate level of care").

Petitioners claim for a surcharge based on their misinterpretation of Stetson must therefore be rejected.

D. The Trustees' Failure to Appoint a Third Trustees Is Not Relevant to the Assessment of Surcharge Damages Due to Its Tenuous and Speculative Relation to the Claimed Loss But

[205] 4/26/11 Petitioners' Brief at 65-66.

It Constitutes a Breach of Duty as to the Administration of the Trust That Warrants Removal of John and Mellon as Trustees

Petitioners claim that the failure of the trustees to appoint a successor trustee to replace George is relevant to their claim for economic damages because, inter alia, the "appointment would have broken the deadlock between Mellon and John, and (as the Court has held) the Court should presume that the third trustee would have acted prudently."[206] It is undeniable that both Trust documents required one corporate and two individual trustees at all times. The purpose for more than one trustee arguably is to assure discussion and debate over investment decisions rather than according a sole trustee unilateral control or avoiding a tie vote and a deadlock in the case of an even number of trustees. The record established that after George's death, McGrath, on behalf of the corporate trustee, decided to launch a vigorous dialogue with John to encourage diversification. John, based on his years of experience as a successful trustee, resisted a radical transformation of the trust portfolio, but was willing to consider some reorientations. To characterize this as a deadlock is not supported by the record; instead, it was a dialogue between highly skilled, experienced trustees based on contemporaneous facts as contemplated by the parameters of the trust document.

The petitioners' model for the imposition of damage is highly unrealistic in setting an April 2008 deadline for radically transforming the trust portfolio and then calculating damages for failure to do so. In the span of 8 days, a third trustee would have had to be appointed; he or she would have to agree to the Chapin model for reallocation of the trust; and he or she would have had to persuade both John and Mellon to adopt a radically different 60% fixed income/40% equity allocation for the portfolio. In their scorched earth theory that only one portfolio was in the best interests of the beneficiaries and their rejection even of the Mellon aggressive growth target as too risky, the petitioners have set up an unrealistic theory for imposing liability on the trustees premised on their failure to appoint a third trustee post haste.

For these reasons, petitioners have failed to show that the trustees' failure to appoint a third trustee—even if it was a breach of fiduciary duty—was a cause of the claimed economic losses. This is fatal to their argument. An attempt to surcharge a trustee for a breach that did not result in loss to the trust estate was rejected by the Pennsylvania Supreme Court in Harton's Estate, 331 Pa. 507, 1 A.2d 292 (1938). In that case a corporate trustee as was the custom at the

[206] 6/27/11 Petitioners' Reply Brief at 5 (citing 20 Pa. C.S. §7203).

time purchased assets in real estate mortgages in its own name but for the benefit of various trusts it was administering. Rather than addressing the legality of such purchases, the court focused instead on whether this alleged breach was relevant to the alleged loss so that it could be the basis of a surcharge on the trustee. The Harton court emphatically rejected the theory that a "technical" breach could be the basis of a surcharge where it was not directly related to the alleged loss:

> This question, however, we deem it unnecessary to adjudicate on the record before us, in the absence of any showing that the alleged breaches of trust on the part of the accountant were in any degree responsible for the losses, if any, which resulted….In the ALI Restatement of Trusts, sections 204 and 205, it is pointed out that the trustee is liable only for losses resulting from a breach of trust. Here it cannot be asserted that the investments made in the name of the trustee, without public designation of their fiduciary character, were the cause of the losses alleged to have occurred….It would be unconscionable to impose a surcharge on the present accountant on the sole ground of the technical breach of trust asserted, without proof of other violation of duty more clearly responsible for the loss which, events may ultimately show, has occurred.
> Harton's Estate, 331 Pa. at 520-21, 1 A.2d at 298.

For the reasons set forth below, the failure to appoint a third trustee **is a** reason for the removal of John and Mellon as co-trustees. It cannot serve as the basis for the calculation of damages to surcharge them because such a link is both tenuous and speculative.

B. John McFadden and Mellon Are Removed as Co-Trustees Due to the "Substantial Change In Circumstances" Under 20 Pa. C.S. § 7766(b)(4) Resulting From the Split of the Trusts and Due to Their Failure to Appoint a Successor Trustee as Required by the Trust Documents, and the Breakdown in the Distributions to the Minor Beneficiaries in 2010

The Pennsylvania Uniform Trust Act enacted on July 7, 2006 sets forth guidelines for when a court may remove a trustee. These guidelines apply to both McFadden Trusts. See 20 Pa.C.S. § 7701, Editor's Notes ("the addition of 20 Pa.C.S. Ch. 77 shall apply to all trusts created before, on or after the effective date of the paragraph except for 20 Pa.C.S. §7752). While the provisions relating to removal of a trustee appear straightforward, they unfortunately have been subject to scant review by courts. Under Section 7766(b), a court may remove a trustee "if it finds that removal of the trustee best serves the interests of the beneficiaries of the trust and is not inconsistent with a material purpose of the trust, a suitable cotrustee or successor trust is available and:

(1) the trustee has committed a serious breach of trust;
(2) lack of cooperation among cotrustees substantially impairs the administration of the trust;
(3) the trustee has not effectively administered the trust because of the trustee's unfitness unwillingness or persistent failures; or
(4) there has been a substantial change of circumstances. A corporate reorganization of an institutional trustee, including a plan of merger or consolidation, is not itself a substantial change of circumstances.
20 Pa.C.S. § 7766(b).

The Uniform Law Comments to Section 7766 note that "subsection (b)(4) lists a substantial change of circumstances as a possible basis for removal of a trustee" such as a "substantial change in the character of the service or location of the trustee." The note cautions that before "removing a trustee on account of changed circumstances, the court must also conclude that removal is not inconsistent with a material purpose of the trust, that it will best serve the interests of the beneficiaries and that a suitable co-trustee or successor trustee is available." 20 Pa.C.S. § 7766, Uniform Law Comments. In addition, the Uniform Law Comments state that subsection (b)(4) "contains a specific but more limited application of Section 411 [20 Pa.C.S. §§7740.1] which "allows the beneficiaries by unanimous agreement to compel modification of a trust if the court concludes that the particular modification is not inconsistent with a material purpose of the trust." More to the point, this would allow "the qualified beneficiaries to request removal of the trustee if the designation of the trustee was not a material purpose of the trust." Id.

By decree dated November 10, 2010, this court ordered that the George and Alexander McFadden Trusts for the benefit of George McFadden should both be divided as of November 1, 2010 into three separate trusts for the benefit of each individual beneficiary: Lisa McFadden, Wilhelmina McFadden and Alexander McFadden. John and Mellon were to remain as co-trustees "pending further order of the Court." Winfield Jones was appointed Trustee for the trust for Wilhelmina McFadden and Trustee for the trust for Alexander McFadden. This split of the trusts constitutes a "substantial change in circumstances" that eliminates the strained relations among the three beneficiaries that plagued the administration of the trusts. It allows each trust to be more responsive to the differing interests of Lisa, Alexander and Wilhelmina. The guardian of Wilhelmina and Alexander, Winfield Jones, throughout the various pleadings has vigorously requested the removal of John and Mellon as trustees. He has, for instance, emphasized his wards' interest in having a portfolio with fixed income—and John McFadden has repeatedly expressed his disbelief in such an investment strategy. Removal of John and Mellon will therefore best serve the interests of the new beneficiaries and be consistent with the trusts' purpose of providing income to those beneficiaries. See 20 Pa.C.S. §7766, Uniform Law Comments ("Subsection (b)(4) of this section (§7766) similarly allows the qualified beneficiaries to request removal of the trustee if the designation of the trustee was not a material purpose of the trust").

Before John and Mellon can be removed, however, the court must determine that suitable successor trustees are available. Although the petitioners propose Carol McFadden as a successor trustee, her appointment would not be appropriate for various reasons. First, in refusing to honor the Affordable options, she has taken a position directly adverse to the trusts in the past when her children were beneficiaries. Secondly, based on the record in this case as a parent her personal financial interests are adverse to those of her children where she would be called upon to decide the proper distributions for their "maintenance, education and support." See, e.g., Sutliff v. Sutliff, 515 Pa. 393, 398, 405-06, 528 A.2d 1318, 1320, 1323-24 (1987)(noting the inherent conflict of interests where a parent is custodian of his child's UGMA Account and has legal obligation to support his children and analogizes those duties to those of a trustee). Finally, in her testimony, she displayed a worrisome lack of familiarity with financial matters generally, and with her family's financial matters in particular.[207] The Petitioners shall therefore file a petition proposing an individual and corporate trustee to succeed John and Mellon. Upon consideration of these nominations, John and Mellon will be removed to be replaced by the new trustees if deemed qualified.

[207] See, e.g., 2/9/11 p.m. N.T. at 60 (CM):

> Q: You loaned money to the estate (i.e. George's Estate of which she serves as executrix) in order for the estate to pay taxes, is that correct?
>
> A: I am not sure on that.
>
> Q: You don't know if you are a creditor or not of the estate?
>
> A: They were—no, I don't think I am. But they were joint income tax for 2008, so it would have been my liability, as I understood it, as well as George's.
>
> Q: Have you lent any money to the estate in the payment of any estate obligation?
>
> A: I don't think I am a creditor of the estate.

During their November 2008 meeting, Laffend recalls that Carol stated that because "the estate does not have enough money to pay the taxes so she is going to sell her apartment, lend the money to the estate for the taxes because they do not want to sell the Affordable Furniture or Crescent Drilling companies to raise the cash." Ex. T-70.

Section 7766 also provides that a court may replace a trustee where he or she has committed " a serious breach of trust." 20 Pa.C.S. §7766(b)(1). According to the Uniform Law Comments, while a serious breach "may consist of a single act that causes significant harm or involves flagrant misconduct," it can also "consist of a series of smaller breaches, none of which individually justify removal when considered alone , but which do so when considered together." In this case, John and Mellon have committed such a series of smaller—but nevertheless serious-- breaches which justify their removal: they failed to provide for the appointment of a substitute trustee despite the clear language in both trusts requiring "three trustees at all times" and they disclosed confidential information exacerbating the strains within the family to the detriment of all the beneficiaries that eventually led to a breakdown in the distribution of income to Wilhelmina and Alexander in 2010 despite the clear purpose of the trusts to provide income for their support.

1. John Breached the Duty to Appoint a Third Trustee Set Forth in the George Trust and Both Co-Trustees Breached their Duty to Seek a Timely Appointment of a Successor Trustee for the Alexander Trust

The duties of a trustee are, in the first instance, set forth in the trust document. Where those duties are explicit and unambiguous, the settlor's intent is controlling and must be honored. Estate of Niessen, 489 Pa. 135, 139, 413 A.2d 1050, 1052 (1980). The authority to appoint a successor trustee, can "only arise from 'clear, unequivocal and unambiguous terms' and those terms must be "strictly construed." Frank Trust, 400 Pa. 614, 620, 162 A.2d 680, 684 (1960). The wills creating the George and Alexander trusts unambiguously require that "there shall be at all times a corporate trustee and two individual Trustees." The wills differ, however, in clarity as to how a successor trustee is to be selected. Under George McFadden's 1930 will, when an individual trustee dies, "the remaining individual Trustees may and shall appoint a successor to such trustee." He further provided that a successor trustee would be paid only 1% on the income and no commission based on principal. 1/6/1930 George McFadden Will, Article Third. The March 10, 1942 Alexander McFadden will, in contrast, made no provision for how a successor trustee should be appointed.

Despite this clear requirement for three trustees at all times, no successor trustee was appointed for George until November 10, 2010 when this court appointed Winfield Jones successor trustee while simultaneously ordering that the trusts be split into three trusts for the benefit of Wilhelmina, Alexander and Lisa. Prior to this, the trustees had been well aware of their obligation to appoint a third trustee but had failed to do so. Days after George's death, Laffend had raised the obvious need to replace George and name a third trustee. She noted in an April 29, 2008 memorandum that both Lisa and Carol would like to be named successor trustees but suggested instead that a more neutral candidate such as John Suria be considered. Ex. P-7. She later confessed, however, that she did not consider this an urgent issue and concluded that it would be best to raise it in the context of an accounting. John told Laffend that there was no rush to appoint a new trustee and it could wait until next summer.[208] He agreed that the issue of the third trustee should be raised in the context of an accounting so that the new trustee could serve without threat of liability for the antecedent actions of the prior trustees.[209]

The accounts were not filed, however, until after Carol McFadden, on behalf of her two children, had filed a petition seeking one. Laffend testified that the accounts had been ready for filing in November 2008, but she then offered numerous unconvincing reasons for why the accounts were not filed until the petitioners forced the issue by filing their petitions.[210]

Mellon and John offer several legal arguments in their defense which ultimately are unpersuasive on a practical level. They correctly argue, for instance, that under applicable law, the requirement that there be three trustees "at all times," merely means that the vacancy must be filled. If the phrase "at all times" had not been included, then the trustee position could be left vacant. While this legal argument is supported by Stolzenbach's Estate, 346 Pa. 74, 79-80, 29 A.2d 6, 9 (1942) and 20 Pa.C. S. § 7764(b), it misses the point. The position still had to be filled and neither John nor Mellon did so.

Mellon next argues that while the settlor's intent is paramount, it must be given a reasonable construction. This, too, is correct as far as it goes. Given the complex family dynamics with all of its strains, it would be unreasonable to expect that John or Mellon could have been able to appoint a successor trustee within days of George's death as the petitioners assert—and which is critical to their surcharge theory requiring reallocation of the portfolio with the pressure exerted by a third trustee by April 30, 2008. Nonetheless, the total failure of the

208 11/4/10 p.m. N.T. at 44; Ex. T-70; 1/5/11 p.m. N.T. at 46-47 (JL).
209 2/10/11 p.m. N.T. at 34-35 (JM).
210 11/9/10 a.m. N.T. at 70-77 2/9/11 a.m. N.T. at 7-8, 12 (Laffend).

trustees to appoint a successor cannot be reasonably explained.[211] John attempts to justify the failure to appoint a successor by the difficult circumstances facing the co-trustees: the risk of successor liability; the strained family relations; and the limited remuneration available for an individual trustee under the trust document. He testified that he had asked Carol's attorney, Vaughn Williams, for recommendations from Carol's family.[212] Laffend had suggested David Hamilton or Winfield Jones after attending George's funeral. Barbara Lawrence in December 2009 sent a copy of David Hamilton's resume to Mellon. Ex. T-80. But none of these candidates were selected by John or Mellon.

The critical fact that none of the parties acknowledge is that under the trust documents the choice of a successor trustee was fully discretionary. They were free to appoint whomever they believed would have been best qualified so long as this discretion was exercised in good faith. Brown's Appeal, 345 Pa. 373, 379, 29 A2d 52,55 (1942)("While a court cannot control the discretion conferred upon a trustee it may compel him to exercise it in good faith and within the bounds of a reasonable judgment"). John's selection in June 2009 (Ex. T-97) of George Melas as successor trustee for the George Trust was sanctioned by the trust document even if Carol— who was not a beneficiary of the trust-- disagreed with that selection. Mellon's concern with finding a successor trustee that would have been acceptable to the warring factions within the McFadden family perhaps best explains the failure to appoint a successor trustee.[213] It is ironic, however, that the very tensions that made it difficult to find a "consensus" successor trustee also made it imperative for the co-trustees to make such a choice to protect themselves from the claim that they had breached a clear duty imposed by the trust documents. Admittedly, none of the cases cited by the petitioners removed a trustee for failure to appoint a successor trustee. Rather, they concluded that if a successor trustee was required under a trust agreement or will and the trustees fail to act, a court may appoint a successor trustee.[214] Arguably, the issue of the

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[211] John's citation of numerous cases for the proposition that "at all times" means within a "reasonable time" begs the issue. See 6/14/11 JM Brief at 48-49 Moreover, many of the cases cited are a stretch factually. See, e.g., Drumbar v. Jeddo-Highland Coal Co., 155 Pa. Super. 57, 37 A.2d 25 (1944(focusing on time period for asserting a hernia workers' comp claim); Havens v. Strayer, 326 Pa. 563, 193 A. 13 (1937)(noting that contract requiring temporary bridge to be open at all times should be interpreted reasonably and did not excuse keeping it open despite a known danger that caused fatal accident).

[212] 2/10/11 a.m. N.T. at 72(JM); 6/14/11 JM Brief at 47 & 49.

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[213] See, e.g., 11/4/10 p.m. N.T. at 89-90 (JL)(Laffend testified that she opposed the appointment of Melas as co-trustee in internal discussions with John).

[214] 4/26/11 Petitioners' Brief at 27. Petitioners cite two cases for the proposition that "when George passed away, the law required that a replacement be appointed by both Trusts." Id. Neither case cited, however, supports that

successor trustee's breach of the duty to name a successor trustee was not raised in the cases petitioners cite, where it has been raised in this case. Based on the clear language of the trust documents, and the facts of record, Mellon and John failed to fulfill the settlor's intent.

Both Mellon and John seek to excuse their failures to appoint a successor trustee by citing the benefits of presenting this issue in the context of an accounting. They are undeniably correct that such an approach is normally valid. The trustees, however, were not faced with normal circumstances. Very shortly after George's death, they realized the extreme tensions that existed within the McFadden family. Under such circumstances, it would have been prudent to seek appointment of the third trustee. Nonetheless, in this case, the process of raising the third trustee issue in an accounting was unnecessarily stalled and delayed. Numerous excuses were proffered for this delay—such as the need to do income accumulation accounts for the children. These excuses are ultimately unconvincing, however, especially since the accounts were not filed until after a petition had been filed to compel an accounting. In light of the strains within the family, a more expeditious approach should have been taken to find a replacement for George as trustee. As the Pennsylvania Supreme Court has observed:

> A successor trustee is usually appointed by the Orphans' Court upon the application of a party in interest after notice to all parties in interest and the court usually selects the successor trustee from the nominees submitted by the parties in interest unless the nominee is not fit to serve.
> Frank Trust, 400 Pa. 614, 624, 162 A.2d 680, 686 (1960).

2. **The Trustees Properly Exercised Their Discretion Under the Trust Documents in Making Distributions to the Income Beneficiaries Until 2010 When They Ceased Direct Distributions for Willa and Alex through their Mother after Requiring Carol for the First Time to Submit Her Personal Income Tax Return**

The petitioners argue that the trustees breached their fiduciary duty by failing to make distributions as the settlors intended. Up until 2010, however, the trustees exercised the discretion accorded to them prudently despite the intransigent demands by Carol's attorney. They abused their discretion, however, when they cut off the direct $30,000 monthly distributions to the beneficiaries' mother because she failed to turn over her personal income tax

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proposition nor removed a trustee for failure to appoint a successor. See, e.g., Obici Trust, 390 Pa. 180, 134 A.2d 900 (1957)(where trustees cannot agree on who to name as a successor trustee, a court may appoint a successor trustee but no trustees were removed); Corn Exchange National Bank and Trust Co., 112 Pa. Super. 32, 37, 170 A. 713, 715 (1934)(court appointed successor trustees despite a vacancy of more than a decade but mortgage payment made in intervening period to the executor of a deceased trustee's estate did not discharge the debt).

information which they formally requested for the first time in January 2010. Ex. T-104. In so doing, they frustrated a fundamental purpose of the trusts to provide for the support and maintenance of the minors even if sums were still distributed to the minors' income accumulation accounts.

a. The Wills of George and Alexander McFadden and the UPIA Gave the Trustees Discretion in Deciding on the Level of Distributions to the Minor Beneficiaries

The starting point of any analysis of the trustees' distributions to the beneficiaries must be the terms of the wills. The wills of George and Alexander McFadden provided for distribution of income to adult beneficiaries in the proportion of two parts to a male beneficiary and one part to a female beneficiary. They also contained special provisions for the distribution of income to a minor. Both wills stated that income was to be applied for a minor's support, maintenance, and education. More specifically, George McFadden's will provides that "during the minority of each child, or the issue thereof, my Trustees shall apply the income as they shall deem proper for the support, maintenance and education of such child or the issue thereof." Ex. P-1, 1/6/1930 George McFadden Will, ARTICLE FOURTH.

The Will of Alexander McFadden provides:

> Any income payable hereunder unto any beneficiary who may be a minor shall be used and applied by my Trustees in and about his or her maintenance, education and support, directly, without the intervention of a guardian. Similarly, any portion of my estate falling in distribution unto any distributee who may be a minor shall be held in Trust by my Trustees and income therefrom, and in the discretion of my Trustees any portion of the principal thereof, during minority, used and applied in and about his or her maintenance, education, and support, directly, without the intervention of a guardian.
> 3/10/1942 Alexander McFadden Will, Article FOURTH.

The wills, therefore, distinguish between adults and minors to accord the trustees discretion in determining distributions to minor beneficiaries for their maintenance, education, and support. Under longstanding Pennsylvania precedent, "where discretion is conferred upon the trustee with respect to the exercise of a power, the court will not interfere with him in his exercise or failure to exercise the power so long as he is not guilty of abuse of discretion." Koppel Trust, 14 Pa. D. & C. 3d 585, 590 (O.C. Mont. Cty. 1980) (Tredinnick, J.)(citations omitted). Despite this deference to discretionary powers of a trustee, those powers nonetheless are subject to "the supervisory powers of the courts." In re Swinsons Estate, 167 Pa.Super. 293, 74 A.2d 485, 487 (1950). Section 7780.4 of the Pennsylvania Uniform Trust Act dealing with "discretionary powers" requires that a "trustee shall exercise a discretionary power in good faith and in accordance with the provisions and purposes of the trust and the interests of the beneficiaries, notwithstanding the breadth of discretion granted to a trustee in the trust instrument, including the use of such terms as 'absolute,' 'sole,' or 'uncontrolled.'" 20 Pa. C.S. §7780.4.

In the present case, the issue of income distributions was complicated by the past history of distributions of income to George. Prior to George's death, the trustees had moved to a UPIA or total return distribution which included both traditional income and growth. The trustees' power to adjust under the UPIA, as set forth in 20 Pa.C.S. § 8104, provides that "a trustee may adjust between principal and income by allocating an amount of income to principal or an amount of principal to income to the extent the trustees consider appropriate." According to the trustees, the UPIA gave them the power to adjust or define as income 2, 3 or 4 per cent of the market value of the trust based on an average of 3 years. In exercising this discretion, Mellon focused on the facts of a particular portfolio. It also put in place certain guidelines; for instance, it would not consider a UPIA distribution unless the portfolio was sufficiently oriented towards growth with at least 60% equity investment. 1/5/11 p.m. N.T. (JL); 1/4/11 a.m. N.T. at 20-21, 54-56 (MM). In making UPIA distributions, the trustees were required to consider various factors. One factor, for instance, was "[t]o the extent reasonably known to the trustee, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument." 20 Pa.C.S. § 8104 (b)(8). A critical issue, therefore, is whether the trustees exercised their discretion in good faith in accordance with the purposes of the trust and the interests of the beneficiaries. 20 P.C.S. §7780.4.

b. The Trustees Properly Exercised Their Discretion in Requesting a Budget to Determine the Income Needs of the Minor Beneficiaries

George's death signaled more than a change in beneficiaries. As the sole income beneficiary, George received the total distributions from the trusts which he was free to use as he chose. In fact, he used those sums, inter alia, to support an extended family and all of its expenses.[215] Upon his death, however, the trustees were charged with making discretionary distributions to his minor children for their maintenance, support and education. Moreover, the distributions now had to be divided among three beneficiaries with 25 % to Lisa, 25% to Willa

[215] Ex. P-58A (9/8/08 letter from Lawrence).

and 50% to Alex. As Laffend explained, the trustees sought to adhere to the intent of the documents: if trust funds were used to support a family and not just the minor as provided by the documents, would the minor come back in future years to ask why so much had been expended when he was only 10 years old. 1/5/11 p.m. N.T. at 72-73 (JL). Carol through her attorneys took the position that the basic level of distributions should match those that had been given to George. Mellon essentially agreed that George's level of distributions should be maintained. John advocated distribution of a lesser 2 percent distribution to the keep down the sums in the income accumulation accounts that would be available to them at 18 "at least until we know them better." Ex. T-51. Significantly, the Petitioners' own expert, Thomas Chapin, shared the assumption that the children's income needs would be less than George who had been the head of a household.[216]

To exercise their discretion, the trustees requested Carol to prepare a budget, which was required by Mellon's Trust Administration Committee (TAC). This budget served a dual role in the exercise of the trustees' discretion: (1) it helped them decide whether to continue making UPIA distributions or switch to traditional income distributions, and (2) it helped them determine the proper amount to distribute to "support" and "maintain" the minors.[217] The request for a budget was thus an appropriate—in fact necessary—exercise of the trustees' discretion. Indeed, the petitioners' guardian, Winfield Jones, when subsequently asked, concurred on the prudence of seeking such a budget.[218]

The request for a budget—which was not produced until the end of May 2008—did not delay the trustees from taking other actions to assure distribution to the beneficiaries. When notified that the family was in financial distress, the trustees made an emergency distribution of $10,000; this sum represented the amount of traditional net income the trust would have generated without recourse to a UPIA distribution. Although Carol's attorney denigrated the $10,000 as an insult, it was viewed by the trustees as an emergency, temporary way to get money quickly to the family without analyzing UPIA distributions or a budget. Laffend also submitted a preliminary recommendation for distributions prior to receiving the budget in order to get the review process going. In a memorandum to TAC, Laffend recommended that the trusts continue paying out to the 3 new beneficiaries the 4% UPIA distribution that had been paid to George,

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216 See, e.g., 11/2/10 p.m. N.T. at 87-88 (Chapin).
217 1/5/11/a.m. N.T. at 89-91 (JL); 1/5/11 p.m. N.T. at 17-18 (JL); 11/9/10 a.m. N.T. at 67-68 (JL); Ex. P-15.
218 1/6/11 p.m. N.T. at 67 (WJ).

with 25% going to each of the female beneficiaries and 50% to the male beneficiary as mandated under both wills. Ex. T-13 TAC approved this recommendation, deviating from its normal practice of requiring a budget, because of the tragic, transitory circumstances of the family with the understanding that the distributions would be paid into income accumulation accounts for the minors. 2/7/11 p.m. N.T. at 21-25 (Rowe).

Once the initial budget was received from Carol, Laffend sent it to McGrath to consider, inter alia, whether to continue making distributions in accordance with the UPIA. Based on McGrath's calculations, the trustees decided to continue making UPIA distributions because allocating the portfolio to meet the income needs would not provide necessary long-term growth for the portfolio. They also created income accumulation accounts to receive the distributions for the minors and Carol established UTMA accounts for them with JP Morgan to receive the direct distributions from the income accumulation accounts. Ex. T-13; Ex. T-35. In the meanwhile, the trustees worked on obtaining payment on George's insurance policies, which Carol eagerly awaited according to her attorney. Ex. T-12. By early June 2008, Carol received $422,000 from those policies.[219]

Carol did not give her initial budget to the trustees until late May 2008. This preliminary budget was sketchy and did not account for such expenses as medical insurance. Significantly, the budget did attempt to distinguish between the needs of the children and the needs of the household as a whole: it set forth, for example, "two thirds of the total household expenses, representing the share allocable to the children." Ex. P-15 (5/29/08 e-mail from Lawrence). After Laffend filled in some of the missing items, the preliminary budget came to $1.2 million annually. Ex. P-18. John was concerned that the budget seemed to intermingle expenses for the entire family; he sent a copy of it to Lisa for "research," though subsequently apologizing for doing so as this represented a breach of confidentiality. 2/10/11 a.m. N.T. at 83 (JM). He was also critical of the proposed budget because it "seems to assume that the trusts will finance a lifestyle that was unsustainable even while George was alive." He noted that George had borrowed large sums to support his standard of living and had been able to generate large consulting fee income. Ex. T-98

[219] 1/5/11 a.m. N.T. at 87-88 (JL).

When TAC reviewed Carol's preliminary budget, it reaffirmed its commitment to a 4% UPIA distribution. In contrast, John continued to advocate a lower distribution of 2%.[220] Mellon agreed to go along with this 2% distribution as a starting point. Ex. P-15 (5/30/08 e-mail from Laffend); Ex. T-27. And, in fact, within months, the trustees decided to raise the UPIA distributions for 2009 to 3.7%. 4/26/11 Petitioners' Brief at 50; Ex. P-114. Based on their initial compromise, by mid-June 2008 the trustees agreed to distribute $30,000 a month to the beneficiaries. To avoid "micromanaging," the trustees distributed to Carol a $240,000 lump sum to cover the expenses from May to December 2008. The $30,000 paid directly to Carol each month was intended to cover expenses such as food, clothing and entertainment. From mid-2008 to the end of 2009, Willa received distributions of $463,328.17 from the trusts while Alex received distributions of $546,759 from the trusts for that same period.[221]

With each distribution and insurance payment, Carol's attorney complained that the distributions provided by the trustees were inadequate when compared to the sums that George had taken from the trusts. She also bristled at the requests for budgets. By letter dated June 11, 2008, Lawrence told the trustees that these "trusts currently are the sole source of support for Alexander and Willa McFadden." Ex. T-23. Again in early September 2008, Lawrence complained that the distributions to the children were inadequate when compared to the "excess" of $1,000,000 that George had received from the trusts. Focusing on the initial payment of $10,000 to the family, Lawrence asserted that "[c]onditioning further payment beyond that meager sum on a budget was, I suppose, a textbook response to a distribution request. Asking for it from the children's mother, whose husband had just died in a plane crash and was overwhelmed by newly pressing needs was, in our view grossly insensitive." Ex. T-42 "Since these trusts," Lawrence once again asserted, "represent the children's sole source of support" and as a consequence "the family is in desperate need of additional funds." Ex. T-42 In addition to this letter, Lawrence presented a revised budget (hereinafter "September 2008 budget") that did not attempt a breakdown of household expenses to distinguish the 2 children's expenses from those of the family as a whole. Instead, Lawrence asserted:

> The household expenses shown on the budget are the full cost to the family of these expenses. The expenses have not been prorated for the family members as the trusts are the only means available to maintain the children's standard of living. Ex. T-42, n.1.

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220 2/10/11 a.m. N.T. at 81-82 (JM).

221 Ex. C-1 & Ex. C-2; 11/9/10 a.m. N.T. at 83-85 (JL); 2/10/11 a.m. N.T at 85-86 (JM); 1/5/11 p.m. N.T. at 34 (JL)..

This revised McFadden family budget totaled $2,177,212.34. Ex. T-42.

This $2 million dollar September 2008 budget caused confusion and raised grave concerns among the trustees. McGrath sent an e-mail on September 12, 2008 to Lawrence asking her to "please clarify whether you are suggesting that the trusts—in support of the minor children—should be solely responsible for the entire $2mm?" Ex. T-43. Relations were further strained when the trustees learned that Carol through her attorney was refusing to honor the Affordable options. Shortly after the trustees received the revised budget, Carol's attorney Vaughn Williams on September 24, 2008 rejected the trustees' request to exercise the Affordable Options on behalf of "Affordable Holdings, Inc, " whose director was the mother of two of the trust beneficiaries, Carol McFadden. Exs. T-92 & T-174. John Suria of Mellon suggested that "[p]erhaps it's time that the children have a guardian of their estate" because their mother was "conflicted." Ex. T-51. After discussing the situation with Suria, John Meigs raised several questions about the budget with Lawrence:

> In the meantime, to the budget that was submitted, in addition to issues regarding the budget itself, we'll need to have answers to the following questions:
> 1. Are there other trusts of which the children are beneficiaries? If so, how much money are they receiving from those sources?
> 2. What support is their mother providing?
> 3. What support is available to them from their father's estate?
> 4. Are there any other assets available to them? Ex. T-61

John Suria later reported that Lawrence had been surprised by these questions because "her understanding of Pennsylvania law was that unless the will required it other resources need not be considered" to which he responded that "the trustees require some basis for the exercise of their discretion." He also noted that the proffered budget "gave the trustees concerns that the budget provided a plan for the children's support of their mother." Ex. T-64 Mellon appropriately responded to its concerns by calling the Skadden attorneys to request a revised budget in which the expenses of the children were distinguished from those of the family as a whole. As Laffend reiterated when subsequently reflecting on that phone call, the September 2008 budget was troubling and problematic:

> The trustees have difficulty in dealing with this budget because the income is to be distributed to or for the benefit of the minor child for support, maintenance and education (per the documents) but it is difficult to differentiate within the context of the budget which items would be for the support maintenance and education of the child versus the

> support and maintenance of the entire household, which would be beyond the scope of the language in the document. We do not want to make value judgments for the mother as to how she should be spending the money to support her children, but at the same time we have a responsibility to the children and the settlors of the documents to follow their directive with respect to the purposes of income being distributed to minor children.
> Ex. T-54 (10/2/08 e-mail from Laffend to Rowe and Stein).

Little more than a month later, Lawrence presented another revised budget to the trustees which did segregate the children's expenses from those of the family as a whole. While the total family budget for 2009 was projected at $2,142,737.62, the amount allocated to Willa was $527,312.10, while Alex was allocated $525,516.44. Ex. P-92A. Some of the trustees' questions about the resources available to the family generally were answered when Laffend traveled to New York to meet with Carol on November 11, 2008. During that meeting, Carol told Laffend that she had an income of $50,000 monthly from Crescent but after she paid a minimum monthly mortgage of $23,000, there was little left over for every day expenses. Ex. T-70.

c. Despite Disagreement Between the Trustees, They Properly Exercised Their Discretion to Make an Emergency Distribution of $100,000 to the Minors' Accounts in November 2008

Meanwhile, Lawrence made a request for an emergency distribution of $100,000 with no explanation of the nature of the emergency. Ex. T-56 John opposed giving this amount without further details; in an e-mail, he asked Laffend: "Can we get details of the emergency? Perhaps then we can come to an agreement." Ex. T-63. In fact, John had enlisted David Hamilton, a family friend, in an effort to compromise all of the issues between Carol and Lisa and gain more information about the options. Exs. T-58; T-59. He even went so far as to suggest that no action on the emergency distribution be taken until such a compromise was attained. Ex. T-59. This linkage of distribution issues with such other issues as exercising the options would have been an abuse of discretion. Mellon, however, rejected linking distributions to other issues. "As a show of good faith," therefore, Mellon decided to make the emergency distribution in early November 2008. Ex. T-62. John vehemently disagreed. In response, he reminded—and threatened-- Mellon that the last time an authorized distribution had occurred there was "a complete loss to the trust for which Mellon should have been surcharged." Ex. T-66. Despite this vigorous debate among the trustees, the critical, practical result was that the emergency distribution was made. There was no abuse of discretion.

d. The Trustees' Distribution Decisions for 2009 Were a Prudent Exercise of Discretion

For 2009, the trustees raised the level of UPIA distributions to 3.7%. 4/26/11 Petitioners' Brief at 50. This underscores a flexibility and willingness to explore different alternatives. In so doing, they sent an e-mail to Carol McFadden to explain their process. The 3.7% UPIA distribution for 2009 was based on a 3 year average market value for both trusts (i.e. for 2008, 2007, 2006). They would therefore send ¼ of that amount outright to Lisa because she is an adult. The remaining amount, divided ¼ for Willa and ½ for Alex, would be deposited into the children's income accumulation account. From those accounts, the trustees would allocate $30,000 a month to the children's personal accounts for a total of $360,000 per year. Ex. P-114.

The Petitioners broadly argue, however, that "the trustees have breached their fiduciary duty by failing to pay Wilhelmina and Alexander their full share of the income wrongly asserting that the Alexander Trust grants them discretion to determine the amount of distributions or to withhold them on the theory that the mother has the primary obligation of support and must provide proof of need." 4/26/11 Petitioner's Brief at 49. In support, they cite <u>Estate of Krebs,</u> 483 A.2d 919, 921 (Pa. Super. 1984)(where there is no clear intent by the settlor for the accumulation of income, excess income should be distributed to the beneficiary). But <u>Krebs</u>, pre-dated the UPIA that gave the trustees discretion to distribute sums greater than traditional income. As a practical matter, Laffend explained in a letter to Carol, if the trustees had distributed just traditional net income, the total amount that would have been available for distribution would have been considerably lower or just $161,000. Under that scenario Willa would have received just $28,250 as net income for the entire year. Ex. P-114 Instead of the smaller amount of net income, under the trustees' proposal the children would receive for 2009 "$360,000 per year plus books and tuition etc. instead of $84,750 with no books or tuition." As Laffend explained, the "budget supported your need for as much as $360,000 otherwise we might have felt that remitting the net income was appropriate for these children instead of using UPIA." Ex. P-114. By using UPIA distributions, the trustees were able to distribute considerable sums for the children's support and maintenance. For the period May 28, 2008 through December 2009, the trustees distributed a total of $463,328 to Willa and $ 546,751 to

Alexander. Throughout 2009, the trustees made distributions of $229,556 for the benefit of Willa and $317,982 for the benefit of Alex from both trusts. Ex. C-1 & C-2.

e. The Trustees Abused Their Discretion When They Cut Off the Monthly $30,000 Distributions to the Beneficiaries UTMA Accounts Because Carol Refused to Supply Them with Her Personal Income Tax Return, Thereby Violating A Fundamental Purpose of the Trust to Provide Support and Maintenance for the Minors

In planning for the distributions to the minors for 2010, the trustees asked Carol to supply them with income tax returns for Willa and Alex. Ex. T-103. A few months later in January 2010, Laffend sent a letter to Carol asking her to supply the trustees with her personal 1040 tax returns because "as the mother of minor children, your ability to support the children is relevant to the decision to make discretionary distributions to the trust." Ex. T-104. John testified at the hearing that he did not recall requesting Carol's personal tax returns, but this statement lacks credibility in light of John's repeated efforts to gain information about the children's resources and the legal furor this request created.[222] Carol refused to comply with this request for a variety of reasons: the long history of the trustees' disclosing her family's personal financial information to third parties; the request for her personal tax return inevitably raised personal privacy concerns; and, the litigation by Lisa posed a particular threat to the financial well being of George's estate.

The distributions to her were discontinued, although the income was deposited in the income accumulation accounts for each child. From the George Trust, the co-trustees deposited $240,463 into Alex's income accumulation account for the period between February and October 2010 and they deposited $120,232 into Wilhelmina's income accumulation account for that same period. [223] From the Alexander Trust, the trustees deposited $140,953 into Alexander's income accumulation account for the period between February 2010 and October 2010 and they deposited $70,477 into Wilhelmina's income accumulation account for that same period.[224] Ex. T-104 & T-105.

[222] 11/16/10 a.m. N.T. at 50 (JM). Counsel for John, Mellon and Carol exchanged correspondence about this request. See, e.g., Ex. T-104; Ex. T-105.
[223] Re Alexander: George McFadden Trust, Second Supplemental Account for period 1/1/10 to 10/31/10 at 26; Alexander's Income Accumulation Account at 11. Re Wilhelmina: George McFadden Trust, Second Supplemental Account for period 1/1/10 to 10/31/10 at 26; Wilhelmina's Income Accumulation Account at 8.
[224] Re Alexander: Alexander McFadden Trust, Second Supplemental Account for the period 1/1/10 to 10/31/10 at 25; Alexander McFadden Income Accumulation Account at 13, Re Wilhelmina: Alexander McFadden Trust,

Mellon's request that Carol supply them with a copy of her personal income tax return, and the decision to cut off all distributions to her to use for the benefit of her children raises the legal issue of the extent to which a parent's financial resources should be considered in making distributions from a trust providing for the minor's maintenance, support and education. The trustees argue, inter alia, that the trust documents did not supplant Carol's obligation to support her children, and cite Pennsylvania precedent recognizing a parent's legal obligation to support his or her child financially. See, e. g. Sutliff v. Sutliff, 515 Pa. 393, 528 A.2d 1318, 1322 (1987); Flory v. Flory, 364 Pa. Super. 6, 527 A.2d 155 (1987) Those cases, however, involve different factual situations and look at the issue of parental support from a different perspective than the settlor of a trust. In Sutliff v. Sutliff, the Pennsylvania Supreme Court clearly stated that "parents have a duty to support their minor children even if it causes them some hardships." Sutliff, 515 Pa. at 402, 528 A.2d at 1322. In calculating child support, therefore, a parent's "obligation to support minor children is independent of the minor's assets" and a child's Uniform Gift to Minors Act bank account (UGMA) funds "may not be used to fulfill the parent's support obligation where the parent has sufficient means to discharge it himself." Id., 515 Pa. at 398, 528 A.2d at 1320. Accord Flory v. Flory, 364 Pa. Super. 67, 527 A.2d 155 (1987)(income from a child's guardianship account established in settlement of the minor's tort claim cannot be used to satisfy a parent's support obligation unless the parent is unable to so provide). Significantly, the parental obligation for financial support recognized in Sutliff was not inflexible since a parent's ability to pay was factored in. While recognizing a parent's legal obligation for support, courts balance a parent's capacity to support a child with the obligation to do so. In determining a parent's capacity to support his or her child, a court may consider a parent's income, stock holdings and investments as well as the full nature and extent of the parent's property. Flory v. Flory, 364 Pa. Super. at 72, 527 A.2d at 157.

The perspective of a parent's obligation to support his or child differs, however, from the perspective of a settlor who intends to provide for a minor beneficiary's support, maintenance, and education. Arguably, the settlor's intent would be thwarted if a parent's financial responsibility to support his children were given primary emphasis. In fact, the Sutcliff court in focusing on a parent's support obligation in the context of a support hearing suggested that

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Second Supplemental Account for the period 1/1/10 to 10/31/10 at 25-26;, Wilhelmina Income Accumulation Account at 10.

"funds placed in trust for the benefit of a child or for support or education may also be considered when calculating support in certain circumstances." Sutliff v. Sutliff, 515 Pa. at 403, 528 A.2d at 1322. In other words, a degree of a parent's support obligations could be offset by the extent support and maintenance was provided by a trust. The Sutliff court's discussion of trusts, however, is arguably dicta and should not be stretched too far. But after analogizing the custodian of a minor's account to a trustee, the Sutliff court concluded a parent's unrestrained access to a child's custodial bank account to relieve the parent's support obligations could not be approved unless the parent established his lack of resources to support his child.

Pennsylvania courts focusing more explicitly on the interrelationship of a trust for the support of a beneficiary and other potential resources available for his support have taken two courses. A minority view is that where a settlor gives a trustee discretion to invade principal to provide for the support and maintenance of a beneficiary, the trustee may refuse to invade principal based on the beneficiary's other resources. Estate of Tashjian, 375 Pa. Super. 221, 544 A.2d 67 (1988). In Tashjian, the Superior court emphasized that it was taking a position contrary to the majority of cases in Pennsylvania which "have concluded that by establishing a testamentary trust, the testator intended to relieve the beneficiary of the need to pay for living expenses out of her own funds." In contrast, the Tashjian court concluded that this general rule should not "be rigidly or mechanically applied" and on the facts presented refused to permit a trustee to invade trust principal to meet a widow's documented needs where she refused to disclose her resources. Id., 375 Pa. Super. at 226, 544 A.2d at 70. Although Tashjian and other cases cast the issue in terms of invading principal to provide for the support of a trust beneficiary, such precedent is relevant to this case involving discretionary distributions under UPIA which likewise involve invasion of principal to enhance income. Another case that allowed recourse to an additional source of income to the trust distribution is Koppel Trust, 14 Pa. D. & C. 3d 585 (Mont. Cty. O.C. 1980). In Koppel a father who had paid for his child's education sought to recover those expenditures from the trust he and his wife had created for their children's support, maintenance and education at a trustee's sole discretion. The father's request for reimbursement was denied for various reasons: the court deferred to a trustee's proper exercise of discretion; the father had a legal obligation to support his child; and the father had an ample income. Under these circumstances, the trustee properly declined to reimburse the father so that the income could accumulate for the children's future benefit. See also Seidel Trust, 17

Fid. Rep. 2d 109 (Berks Cty. O.C. 1996)(where deceased father's will provided for care, maintenance and education of daughter and stated that this was not to discharge a mother's support obligation, the unemployed mother should have to pay for private school by getting a job).

The contrary line of Pennsylvania cases conclude that where a trust provides for the support, maintenance and education of a beneficiary, the trust should be the primary source for funding such needs. In so concluding, however, the beneficiary's requests for support from the trust is not given carte blanche. Typically, the cases require documentation to support particular demands. In the early case Richey's Estate, 251 Pa. 324, 96 A. 74 (1916), the Pennsylvania Supreme Court concluded that where a husband's will gave his wife, as executrix, the right to income from sale of real estate as well as the right to as much of the principal as was necessary for her maintenance and support, there was a presumption she would draw first from this bequest rather than from a separate estate she had inherited from her father. In Brown's Appeal, 345 Pa. 373, 29 A.2d 52 (1942), where a trust provided that $5000 should go to the children's maintenance and remaining income should go to "travel or education," the court concluded that the trustees erred in refusing to make such payments based on the mother's ability to pay for them. In reaching this conclusion, the court focused on the settlor's intent that his former wife "maintain a home which would measure up to her social and financial position and also see to it that the children….would receive the education and other advantages 'consistent with their station in life.'" Id., 345 Pa. at 379, 29 A.2d at 55. The mother, however, was nonetheless required to document her expenditures so that the trustees could assess their reasonableness. The court therefore provided that certain claimed expenses for travel and vacation should be submitted to the trustees "for the proper exercise of their judgment." Id., 343 Pa. at 380, 29 A.2d at 55.

Similarly, in Swinsons Estate, 74 A.2d 485, 488 (Pa. Super. 1950), after analyzing an issue of funeral expenses, the Pennsylvania Superior court carefully focused on the assets available to conclude that where a will provided for income and as much principal as was necessary for the care and maintenance of decedent's aunt, the trustees abused their discretion in making income distributions of $75 rather than $81.29 because they took into consideration other assets (i.e. rental income) the beneficiary received under the will. See also Sahlin Esate,13 Fid. Rep. 2d 224 (Chest. Cty. O.C. 1993)(where husband's will provided that principal could be invaded for care and maintenance of his wife, trustees properly exercised their discretion to pay for her medical expenses documented by physician's letter even though wife had a separate estate or resources).

Applying these principles to the present dispute, it is clear that the trustees had the discretion under both wills to determine the appropriate distribution of income for the support, maintenance, and education of Willa and Alexander. In so doing, they properly sought from the children's mother a budget to determine the children's' needs. This was not an easy process given the family's tragic circumstances due to George's sudden death and his wife's unfamiliarity with the family finances. The first budget presented to the trustees at the end of May 2008 was sketchy, with blanks for such items as medical expenses and Willa's board. In addition, certain items listed such as clubs and dog expenses conceivably might not be attributable to the children's needs. The budget did, however, seek to break down costs for such items as mortgages and transportation into two-thirds of total costs, while 25% of the Southampton house rent was allocated to the children. See Ex. P-15. Given the deficiencies of this preliminary budget, John's explanation that he showed it to Lisa as "research" mitigates what otherwise would be a breach of Carol's confidentiality. Instead of being malicious, it is poor judgment. The disagreement between Mellon and John as to whether the distribution should be 4% or 2% likewise was a reasonable discretionary exercise in good faith. Mellon's decision to yield to John's proposed 2% UPIA distribution as a first step until the children's' needs could be determined through experience was reasonable.

The relationship between the trustees and Carol was strained in large measure due to the adversarial stance of her lawyers, the litigation by Lisa Melas and the Affordable options dispute. Not only did her attorney complain by letter as to the inadequacy of the initial $10,000 distribution or the $422,000 insurance payment, but in two letters she misinformed the trustees that the trust was the sole source of support for the children. In September 2008, after complaining that the trustees had required a budget from Carol, her attorney presented a budget for $2 million dollars that seemed to suggest that the trust should pay for the expenses of the entire family with no prorating as to what percentage of those expenses should be attributable to the two children. Neither Will spoke in such broad terms as would have provided for the support and maintenance of beneficiaries other than the 2 minor McFadden heirs. To suggest otherwise naturally raised the suspicions and concerns of the trustees as to whether there was a conflict of interest between the mother and her children.

The trustees' uncertainty apparently was assuaged both by the November 2008 meeting between Laffend and Carol where Carol clarified her financial situation as well as by the revised budget presented in October 2008 that distinguished between the needs of the children and those of the family at large. In 2009, the trustees decided to make UPIA distributions of 3.7% and they distributed to Carol $30,000 a month for the care and maintenance of her children. The reasonableness of such a distribution was inadvertently attested to by the analysis of the petitioner's own expert, Thomas Chapin, who used those distributions as the starting point for his damages analysis and testified that he assumed the children would receive less in distribution than their father because he had been the sole source of support for his family. When asked why Chapin did not base his calculations on the $1.38 million that George had received in distributions from the trusts during his lifetime rather than on the sums distributed by the trustees to the minors in 2009, Chapin testified:

> A: Yes, but I would say you're making one assumption about the income distribution that which I would disagree.
> Q:What assumption is that?
> A: That is that the payout should continue to be at the level that George McFadden was receiving while he was alive, those sums were supporting not only his two minor children, but himself and his spouse, whereas my understanding of the trust provisions were that as income beneficiaries, payments were to be made to them for their general support, education and maintenance, and not that it was also providing for his surviving spouse.
> 11/2/10 p.m. N.T. at 87-89 (Chapin).

This unsteady equilibrium was destroyed, however, in January 2010 when the trustees by letter requested Carol for the first time to produce her personal income tax returns. The failure of the trustees to distribute any funds to Carol for the direct support of the children when she refused to do so represented a total breakdown in one of the fundamental purposes of the trust: to provide income for the children's support and maintenance. This is not to conclude that such a request for the personal income tax returns of a beneficiary's parent would be an abuse of discretion under different factual scenarios. Rather, on the facts of this case with the extremely strained familial relations, cutting off the $30,000 monthly distributions to Carol after more than a year and half of distributions represented a total rupture in the trust relationship.

The analysis of the court in Brainard v. The Merchants and Mfrs. Nat'l Bank, 37 Pa. D & C 2d 325 (Mercer Cty. O.C.1965) is instructive. The trustees in Brainard were similarly charged by a decedent's will to use their discretion to apply income for the maintenance, education and benefit of his children. Although it contributed to pay for the children's education, it made no payments whatsoever to provide for the children's maintenance arguing that under the will it had the discretion not to do so. In concluding that the trustee abused its discretion by not distributing anything at all for the children's support and maintenance, the Brainard court emphasized that while "a court cannot control the discretion conferred upon a trustee," it may "compel him to exercise it in good faith and within the bounds of a reasonable judgment…." Id. at 330. While it is true that the trustees in this case made distributions to the income accumulation accounts of Willa and Alex, their failure to make any sums available to their mother for the children's care and maintenance fell outside the bounds of reasonable judgment. Their actions thwarted a central intent of the testators to provide for a minor beneficiary's support and is a basis for their removal.

3. The Trustees Breached Their Duty in Failing to Raise the Termination Date of the George Trust as a Question for Adjudication

Throughout these proceedings, the question of when the George Trust terminates has been lurking but not addressed by the trustees. When specifically asked about this termination date, Mellon representatives Jane Laffend and Michael McGrath acknowledged that there was some confusion as to when the George trust ends. See, e.g., 1/4/11 a.m. N.T. at 27 (MM)(noting that for one trust there "was some uncertainty but time horizon was at least 5 years"); 11/9/10 p.m. N.T. at 31(JL). A special account opinion dated June 20, 2008 and approved by Jane Laffend, Judith Stein and Rita Bolognese of the Legal Affairs Department noted that "[s]ince the Will refers only to children and issue of grandchildren, there is an ambiguity as to disposition as well as time of termination of the Trust. In order to clear up the ambiguity, disposition at George's death is subject to further proceedings." Ex. T-32. In a Proposal to TAC submitted on July 1, 2008, Laffend observed: "The trust talks about paying income to children and issue of deceased children and indicates a termination 21 years after the death of the children, and issue of children, who were alive on 1/15/31. This would indicate a termination date of 2012 since the last child died in 1991 and there were no deceased children in 1931 Trust counsel would like to have this termination date clarified." Ex. T-35. In a memo to Michael DiMedio dated July 30, 2008, Laffend stated that accounts would be filed to “get some sort of confirmation as to when the large trust may actually terminate (4 years or a lot longer).” Ex. T-39.

The initial account for the George Trust was filed with the Delaware County Orphans’ Court. The petition for adjudication raised the following as questions requiring adjudication:

> The court will be asked to authorize the division of the trust, discharge the deceased trustees and approve the selection of a successor trustee, the will requiring “that there shall be at all times a corporate Trustee and two individual Trustees.”
>
> In addition, a Petition for Citations (1) to compel an accounting, (2) to divide the trust, (3) to remove trustees and other relief and (4) to appoint new trustees, has been filed by Carol McFadden on behalf of her minor children, Alexander McFadden and Wilhelmina McFadden. Petitioners will ask that the Petitions for Citations be dismissed.
>
> Finally, the corporate Trustee has exercised its power to adjust under Section 8104 of the Pennsylvania Uniform Principal and Income Act, 20 Pa.C.S. §8105, requiring the distribution of principal from time to time.
> Petition for Adjudication, George Trust, ¶13.

Inexplicably, the issue of the termination of the George Trust was not raised in this initial petition despite the possibility that it might end as soon as 2012. Resolution of this issue requires careful consideration of law and fact: the language of George’s Will in the context of his family’s genealogy. It was a serious omission not the raise the issue with the first petition.

4. Petitioners’ Claim that the Trustees Breached Their Duty of Impartiality by Favoring the Interests of Lisa and her Children Over Those of Willa and Alex Is Not Supported by the Record

Petitioners assert that the trustees breached the duty of impartiality by favoring the interests of Lisa and her children over the interest of Willa and Alexander. The Pennsylvania Uniform Trust Act imposes a duty of impartiality on a trustee:

> If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing and distributing the trust property, giving due regard to the beneficiaries’ respective interests in light of the purposes of the trust.. The duty to act impartially does not mean that the trustee must treat the beneficiaries equally. Rather, the trustee must treat the beneficiaries equitably in light of the purposes of the trust.
> 20 Pa.C.S. §7773

According to the petitioners, the Trustees breached their duty of impartiality in numerous ways: they failed to split the trusts; they engaged in expensive litigation to exercise the

Affordable options to the benefit of Lisa; and they disclosed Carol's confidential information to Lisa who was suing her father's estate of which Carol was executor.[225]

The petitioners argue more specifically that the investment objectives of Lisa for long term growth differed from those of Willa and Alex. The simple solution to remedy these conflicts, they assert, would have been to split the trusts.[226] Yet splitting the trust immediately after George's death was not as simple as petitioners suggest because of the intractable issues raised by Carol's refusal to allow the George Trust to exercise the Affordable options. As trustees, Mellon and John owed a duty to all three beneficiaries: Alex, Willa as well as Lisa. Lisa considered the Affordable options a valuable asset of the George trust as did Mellon and John. Ex. T-89. Affordable, whose director was Carol McFadden, refused to honor those options. Ex. T-174; Ex. T-92 Lisa, therefore opposed splitting the trusts because otherwise her share of the trust would have to pay for the costs incurred in any litigation to force the exercise of those options. She forcefully expressed her desire that the options be exercised and that the trusts not be split until that was accomplished. See, e.g., Ex. T- 82.

The issue of splitting the trusts therefore put the trustees in the position of choosing among the interests of the trust beneficiaries. What made this more complicated was that they agreed with Lisa that it was in the best interests of all the beneficiaries to pursue the Affordable options. In blunt terms, John expressed his belief that Skadden's advice to Carol that the options were unenforceable created an inherent conflict of interest since they purported to represent the children while seeking to decrease their assets. Ex. T-174; Ex. T-53. Mellon, likewise, thought Carol's refusal to honor the options harmed the interests of all the trust beneficiaries including Willa and Alex. Laffend communicated this view to Carol while seeking more information about the options:

> I don't think the Crescent/Affordable discussion was quite as you stated it. We really would like to know what the options are worth—after all this is an excellent way to get these assets to your children without any estate or inheritance tax being paid on them so if they **do** belong to the trust, then it is a great estate planning tool. Let's not be too hasty in getting them off the books. Remember, these options are ONLY in your kids accounts, not John's or Mary's so by having them there George may had succeeded in getting these assets to his kids tax free which is what he wanted to do all along—we can discuss this later but it is a good thing to have them where they are, not a bad thing! (for your kids that is)

225 Petitioners' 4/26/11 Brief at 58-60.
226 Petitioners' 4/26/11 Brief at 58.

Ex. T-79 (emphasis in original).

To resolve this impasse, Mellon decided to raise the issue of splitting the trust within the context of an accounting. Early on in the summer of 2008, however, they thought the trusts should be split. See e.g, Ex. T-40 (7/29/08 e-mail from Suria). By March 2009 when John supported splitting the trusts, petitioners accuse him of favoring Lisa since he e-mailed her that "the point of splitting the trusts is to allow different levels of distribution" with more for Lisa. Ex. P-132. In the context of Lisa's unbending opposition to splitting the trusts, however, this e-mail was aimed at getting some kind of compromise on this dispute. In sum, the trustees' decisions regarding splitting the trust and the options were not the result of partiality towards Lisa but reflected their effort to advance the interests of all three beneficiaries—and of the trust—in the options. Although Carol refused to honor the options to preserve Affordable for Alex, the trustees properly focused on the interests of the trust as a whole and sought to preserve an asset.

The petitioners' complaint that the trustees improperly revealed Carol's confidential family financial information to Lisa McFadden and other third parties is more problematic. John subsequently apologized for sending a copy of Carol's budget to Lisa, who was suing her father's estate, and explained that he did so as part of his research as trustee since Lisa might have been familiar with some of items on the budget.[227] The documents of record suggest that John had a close relationship with his niece with whom he communicated frequently and freely about the family disputes. Mellon undoubtedly was aware to some extent of this communication. When Barbara Lawrence on June 26, 2008 asked Laffend to pay Carol's legal fees incurred "in connection with her efforts on behalf of her children," Laffend forwarded the e-mail to John, who then forwarded it to Lisa, who advised: "This is Carol's bill and thus payable by Carol and not the Trusts."[228] In early June 2008, Lisa e-mailed John a few comments about her father's estate and Carol's involvement with it, which John forwarded on to Laffend. Ex. P-25.

Unfortunately, John's disclosure of confidential information continued even after this issue was raised during the hearings and Mellon was aware of this. In two e-mails dated December 8, 2020, John discussed the Affordable litigation with his co-trustee for the Lisa and Alex trusts, Winfield Jones, and then copied his wife, Lisa Melas and George Melas. Ex. P-241.

[227] 2/10/11 a.m. N.T. at 83 (JM); Ex. P-57A.
[228] Ex. P-38.

Winfield Jones reported this continuing breach to Mellon's managing counsel, who testified that she had previously warned John to cease such communications: "I had told John McFadden—to my best recollection, I believed that I told Mr. Jones that I had previously spoken and had a conversation with John McFadden to heighten his awareness of those issues. In fact, I had such a conversation." 3/15/11 p.m. N.T. at 38 (JS). She then testified that she did not recall again warning John after the December 8, 2010 e-mails. 3/15/11 p.m. N.T. at 44 (JS). Her contradictory, evasive testimony that she warned John is simply not credible. John testified that no one at Mellon ever warned him. 2/14/11 p.m. N.T. at 52 (JM). His testimony on this point is credible. Throughout the hearing, there was convincing evidence that Mellon was overwhelmed by the force of John's character and its economic self-interest in managing over $100 million in McFadden trust funds. Mellon personnel should have warned John to cease breaching the confidentiality as to the split trusts for the benefit of Willa and Alexander, especially when those breaches occurred during the hearing itself. Mellon's failure to do so is another reason warranting its removal.

The closeness of John's communications with his niece contrast starkly to the lack of communication with Carol. In November 2008, when Carol repeatedly suggested that John attend a meeting with her and Laffend, he did not come. Ex. P-98; P-96. Yet Carol—in contrast to Lisa--was not a beneficiary of the trusts. In fact, under Pennsylvania law she would not have been qualified to serve as the sole guardian of her children under 20 Pa.C.S. §5112(3). She waited until May 2010 to file a petition seeking to substitute Winfield Jones as the legal representative of Wilhelmina, while withdrawing Alexander as a "party petitioner."[229] Moreover, Carol elected within days of George's death to communicate with the trustees through her lawyers. See, e.g. Ex. T-9 (4/28/08 e-mail from Vaughn Williams). As Laffend testified, it was Mellon's policy to communicate with a client's attorney if that was their preference. The record reveals numerous communication between the trustees and Carol's lawyers.

The estrangement between Carol and John nonetheless affected the administration of the trusts. It can be traced back to the March 2008 meeting that Carol attended when the trustees refused to approve George's loan request and George in response told John he would seek his removal as trustee. It can be traced back to the terrible night of George's death when Carol,

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[229] 5/12/10 Petition to Amend Pleadings. Winfield Jones was appointed guardian of the property of Wilhelmina by decree dated May 4, 2010 of the Surrogate Court of New York County. Id., ¶ 8. By decree dated June 15, 2010, this court granted the petition to amend the pleadings.

believing that John had purposefully delayed in telling her about her husband's death, hung up on him during a phone conversation and never spoke with him thereafter. It can be traced to Carol's refusal to permit the George trust to exercise the Affordable options, resulting in Mississippi litigation. It can be traced to Lisa's lawsuit against her father's estate that Carol, as executrix, was forced to defend. As Tolstoy observed in his much quoted opening to Anna Karenina: "Happy families are all alike; every unhappy family is unhappy in its own way." These painful familial conflicts are not for a court to judge, though they must be acknowledged as a factor thwarting the administration of the trusts.

While John did not reach out to Carol, there is no evidence that his actions were adverse to the interests of Willa and Alex. In pursuing the Affordable Options litigation, he believed he was protecting their economic interests as beneficiaries of the trust claiming those options. In divulging the financial information, he sought to obtain information necessary for determining an appropriate level of distributions. The record also reveals that John sought to resolve the disputes between Lisa and Carol through the efforts of David Hamilton, which he believed required disclosure of certain financial information. Ex. T-59; Ex. T-58. The litigation between Lisa and Carol was expensive; in fact, John had told Laffend that it threatened to eat up George's estate. 11/10/10 a.m. N.T. at 61-62 (JM). Reaching a settlement of these disputes would have been mutually beneficial. In seeking this resolution, John was not acting in his own self-interest in contrast to cases cited by the petitioners. In Holmes Trust, 392 Pa. 17, 139 A.2d 548 (1958), for instance, the corpus of a trust was a family company, the beneficiary was the settlor's daughter, and the trustee was the beneficiary's husband After the trustee and beneficiary divorced, the husband/trustee went to work for a company that competed directly with the settlor's company. On these facts, the court found a conflict of interest. No such personal conflict exists for John. Similarly, in another case cited by petitioners, Vitow v. Robinson, 823 A.2d 973 (Pa. Super. 2003), a trustee put her own self interest above those of a beneficiary where she preconditioned approval of a trust transaction on the granting of a severance package for her husband. Again, there is no evidence whatsoever that John was motivated by advancing his own self interests in his actions as trustee.

C. Petitioner's Claim for Punitive Damages Against John McFadden is Denied Based on the Record

On February 16, 2011 after numerous days of hearings, Petitioners filed a petition to amend their Petition to assert, inter alia, a claim for punitive damages against John. John vigorously opposed this petition arguing that the claim for punitive damages is "contrary to law" in an Orphans' Court surcharge action as well as prejudicial to him at such a late point in the proceedings. Upon consideration of the relevant precedent and arguments, this court concluded that as a matter of law, petitioners should be permitted to amend their petition to assert a claim for punitive damages against John. Based on the factual record, however, petitioners ultimately failed to establish their punitive damages claim.

Pennsylvania Courts Have Recognized Claims of Punitive Damages in Orphans' Court and Equity Actions While Section 7781 of the Uniform Trust Act Adopts a Flexible Approach to Remedies for Breach of Trust

John vigorously argued that as a matter of law punitive damages are not recognized in an Orphans' Court surcharge action. To support his argument, John cited an Allegheny County court case, Freedman Estate, 1 Fid. Rep. 2d 60 (Allegheny Cty. O.C. 1980) and two Third Circuit federal cases that sought to predict how the Pennsylvania Supreme Court would rule on this issue: Packard v. Provident Nat'l Bank, 994 F.2d 1039 (3d. Cir. 1993) and In re Corestates Fee Litigation. v. Corestates Bank, 39 F.3d 61 (3d Cir. 1994).[230]

The two federal cases are "sweep cases," where beneficiaries of trusts managed by a bank objected to the fees charged when their uninvested cash was temporarily swept into investments. In both diversity cases, the plaintiffs' claim for compensatory damages would not have satisfied the requisite amount in controversy requirement; hence, the plaintiffs claimed that punitive damages would have been available to satisfy the jurisdictional amount for subject matter jurisdiction. Both Packard and Corestates recognized that the availability of punitive damages in an action against a trustee was a uniquely state issue. Since that issue had not been addressed by the Pennsylvania Supreme Court, they turned to the rulings of lower state courts. The Packard court, relying on Freedman Estate, 1 Fid. Rep. 2d 60 (Allegheny Cty. O.C. 1980) concluded that punitive damages would not be available in a surcharge action against a trustee under

[230] 3/8/11 JM Answer, Memorandum at 4-6.

Pennsylvania law. The Corestates court followed Packard, acknowledging, however, that Packard had failed to consider two other lower court cases that dealt with this issue: Lemke Trust, 18 Pa.D. & C. 4th 417 (Dauphin Cty. O.C. 1993) and Korman Corp. v. Franklin Town Corp., 34 Pa.D & C 3d 495 (Phila. 1984). This court, however, is not bound by federal precedent; Pennsylvania precedent instead applies..

A Pennsylvania case that opposed awards of punitive damages in surcharge actions is Freedman Estate, 1 Fid. Rep. 2d 60 (Allegheny Cty. O.C. 1980). In explaining this conclusion, the Freedman court initially observed that an Orphans' Court "has been called a court of equity." Somewhat quixotically, the court stated that while "proceeding by equitable principles, it is not necessarily governed by the practice of equity." Id. at 67. After emphasizing an Orphans' Court's link to equity, the Freedman court concluded that punitive damages were not available in a surcharge action:

> The purpose of a surcharge is to reimburse beneficiaries for losses due to mismanagement and not as a punitive, disciplinary measure and thus punitive damages by way of surcharge is improper: Killey Trust, 29 Fid. Rep. 437, 439. This is particularly true when objectors make no specific objection but are protesting the entire investment policy of the trustee for the period in question and attempting to substitute an investment formula of their own their own which is highly uncertain and speculative.
> Id. at 68.

Pennsylvania cases decided after Freedman, however, took a contrary position. In 1993, a Dauphin County Common Pleas Court in Lemke Trust, 18 Pa. D. & C. 4th 417 ((Dauphin Cty. 1993) concluded that there was "no good reason" why a claim for punitive damages could not be "appropriate against a fiduciary in a proper case in an Orphans' Court proceeding than in any other." In so concluding, the Lemke court was dismissive of the analysis in Freedman Estate that seemed to hinge on the equitable nature of Orphans' Court proceedings. Instead, it relied on the analysis of Judge Takiff in Korman v. Franklin Town Corp., 34 Pa. D. & C. 3d 495, 520 (1984) that "the historical underpinnings no longer exist to justify a rule against awarding punitive damages in equity." More recently, the Chester County Orphans' court concluded that punitive damages were appropriately awarded where the executor of an estate and his brother secreted away cash that the decedent had left in her home. Krepps Estate, 17 Fid. Rep. 2d 359 (Chester Cty. O.C. 1997).

The Uniform Trust Act likewise embraces a more flexible approach to remedies for breach of trust. Section 7781, for instance, gives the court authority to provide "any appropriate relief" including several specific examples such as filing an account or removing a trustee. See 20 Pa.C.S. §7781(b)(4) & (7). The Comments to Section 7781 suggest that state courts might adopt differing approaches to the availability of punitive damages for breach of trust:

> Traditionally, remedies for breach of trust at law were limited to suits to enforce unconditional obligations to pay money or deliver chattels. See Restatement (Second) of Trusts §198 (1959). Otherwise, remedies for breach of trust were exclusively equitable, and as such, punitive damages were not available and findings of fact were made by the judge and not a jury. See Restatement (Second) of Trusts §197 (1959). The Uniform Trust Code does not preclude the possibility that a particular enacting jurisdiction might not follow these norms.
> 20 Pa. C.S. § 7781, Uniform Law Comments (emphasis added).

With Lemke and Krepps, Pennsylvania courts have been receptive to imposition of punitive damages in surcharge actions against a fiduciary. Based on this precedent, this court ruled by decree dated March 16, 2011, that the petitioners could amend their petition to set forth a claim for punitive damages against John McFadden.

Punitive damages may be awarded "only if the conduct was malicious, wanton, reckless, willful, or oppressive." Rizzo v. Haines, 520 Pa. 484, 507, 555 A.2d 58, 69 (1989). Such damages are "penal in nature" and "its purpose is to punish a tortfeasor for outrageous conduct and to deter him or others like him from similar conduct." Hutchison v. Luddy, 582 Pa. 114, 121-22, 870 A.2d 766 (2005). Courts have cautioned that the "state of mind of the actor is vital. The act, or failure to act, must be intentional, reckless or malicious." Feld v. Merriam, 506 Pa. 383, 396, 485 A.2d 742, 748 (1984).

Petitioners' amended petition filed on March 21, 2011 does not set forth a separate claim with specific facts as a basis for punitive damages against John although petitioners explicitly seek such damages in paragraph 126 (f). In their post-trial brief, petitioners use a very broad brush to support their claim for punitive damages based on the allegation of failure to appoint a third trustee, authorize money the children needed and safeguarding the trusts. 4/26/11 Petitioners' Brief at 76. These issues have already been discussed at length; based on the record presented, petitioners failed to present any evidence that John's actions in these regards were "malicious, wanton or reckless." The testimony of McGrath and John were highly credible that John did not link investment decisions to other issues. The failure to appoint a third trustee was in large part a result of the conflicts within the family which the trustees tried to negotiate without success. John credibly testified that he had asked Carol's attorney for candidates from her family. The wills imposed no limitation on John's choice. The distributions to the children were necessarily based on budgetary information supplied by Carol which was not always straightforward or clear. Her attorney twice misrepresented that the trusts were the children's sole source of support and she presented them with a budget in September 2008 that appeared to demand that the trust support and maintain not only Willa and Alex but their mother's entire family as well. In any event, considerable sums were distributed to the children until 2010 when Carol failed to supply a copy of her income tax and it is not clear whether she provided a budget. The money not directly distributed to the children was nonetheless distributed to their income accumulation account, and then to the children's guardian, Winfield Jones. There was no allegation of self-dealing of any sort.

Petitioners' additional reasons for seeking punitive damages underscore the weakness of their claims. They assert, for instance, that:

> Once he realized that he was incapable of acting in their (i.e. Willa and Alex) best interests, he had a duty to step aside. Instead, John deliberately used his position to deprive them of funds, forcing their mother to sell their homes, and adding great stress to their lives and their mother's. He recklessly refused to diversify the portfolio and make other decisions so that he could compel Carol to "capitulate" to his demands. He knowingly used his confidential position to provide information to Lisa, who threatens to deprive Wilhelmina and Alexander of their interest in George's estate. He deliberately appointed George Melas, a person he knew to be hostile to their mother, in a further effort to subjugate them to Lisa's interests. 4/26/11 Petitioners' Brief at 76 (citations omitted).

The predominant theme in this argument—and indeed throughout the litigation—has been the conflict between Carol and Lisa McFadden Melas. The trustees—and in particular John—did not create these conflicts. There is persuasive evidence, in fact, that John sought repeatedly to resolve the conflicts between Lisa and Carol, but in so doing, ensnared himself in the middle of it. <u>See, e.g.,</u> Ex. T-58. One reason for his dissemination of information about the budget supplied by Carol was his effort to equip David Hamilton as an emissary to help settle the claims between Carol and Lisa. His exchange of budgetary information with Lisa and Bill Muller, though misguided, was intended to get more information about the needs of the children since Muller, in particular, had familiarity with the family's past financial affairs based on his service as George's assistant.

The trustees faced the daunting, unenviable task of trying to administer a trust for the benefit of all three beneficiaries despite the intense conflicts between Lisa and Carol. Admittedly, splitting the trusts would have alleviated the conflicts except for the nagging issue of the Affordable Options. From the date of George's death, this options issue would render splitting the trust problematic. Lisa and the trustees believed that the options were an asset of the trust and a benefit to all beneficiaries including Willa and Alexander. Carol, in contrast, not only refused to honor the options but refused to provide information to the trustees about them. Although petitioners fault the trustees for not considering their particular economic interests before launching the Affordable litigation, it is unclear based on the lack of information as to the solvency of George's estate whether even their interests are best served by the refusal to exercise the options. The children's' guardian, Winfield Jones, admitted his lack of information about the status of George's estate, but conceded that if it was in fact insolvent he would urge the exercise of the options immediately. 3/14/11 p.m. N.T. at 54-60 (WJ).

Finally, it is not true that John forced Willa and Alex's mother to sell their home. In her testimony, Carol acknowledged that she had been faced with staggering bills upon George's death, and that it had therefore been necessary to cut back expenses. Indeed, she emphasizes that "John McFadden testified to the fact that Carol had done a 'remarkable job' in getting control of the family expenses and scaling down the lifestyle with which George had left his family." 4/26/11 Petitioners' Brief at 7. In emphasizing this testimony, petitioners in effect acknowledge that such cut backs were mandated by the circumstances created by George. It is thus unpersuasive to blame John for Carol's need to sell the homes.

For all of these reasons, there is no basis to award punitive damages against John McFadden.

Conclusion

According to the Second Supplemental Account that was filed for the George Trust and extended to October 31, 2010, the balance of principal before distribution was $16,140,252.94 and the balance of income before distributions was $535,205.57 for a total of $16,675,458.51. The Second Supplemental Account for the Alexander Trust, which extended to October 31, 2010 states a balance of principal before distributions of $ 9,261,858.40 and a balance of income before distributions of $332,652.28 for a total of $ $9,594,510.68. The accounts, however, cannot be approved as stated because of the still pending issues of attorney fees, costs and management fees. As the parties stipulated the issue as to all attorney fees (and not just those related to the present litigation) were deferred until this phase (i.e. surcharge and removal) of the litigation has been completed. 11/2/10 a.m. N.T. at 11 (Mannion). For this reason, a hearing is scheduled as set forth in a contemporaneously issued decree for December 15, 2011 in courtroom 416 at 9:30 a.m. to consider all claims for legal fees, costs and management fees.

BY THE COURT:

Date:________

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John W. Herron, J.

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