Matter of Wellington
2015 NY Slip Op 31294(U)
June 30, 2015
Sur Ct, Nassau County
Docket Number: 117708
Judge: Edward W. McCarty III
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SURROGATE'S COURT OF THE STATE OF NEW YORK
COUNTY OF NASSAU

In the Matter of the Judicial Settlement of the Final Account of Proceedings of the WELLINGTON TRUSTS.	File No. 117708 File No. 167490 File No. 329415 File No. 329418 File No. 329419 Dec. No. 30689 Dec. No. 30690 Dec. No. 30691 Dec. No. 30692 Dec. No. 30693

On January 6, 7, 9, 10 and 13, 2014, this court conducted the first portion of a bifurcated trial, which focused on the issue of fiduciary liability in connection with five contested trust accountings filed on behalf of JPMorganChase Bank, N.A., and on behalf of Herbert Wellington, Jr., who served as co-trustee on four of the five trusts. The objectant is Sarah P. Wellington, a beneficiary of two of the five trusts.

Each party submitted a post-trial brief on August 4, 2014. The court heard post-trial oral argument on November 12, 2014, and the transcript of the oral argument was sent to the court on April 22, 2015.

BACKGROUND

The background of this proceeding, along with the applicable law, have been reviewed previously in decisions issued by this court, but will be summarized below for purposes of clarity.

The objectant, Sarah P. Wellington (Sarah), is a daughter of Thomas D. Wellington (Tom) and a granddaughter of Herbert G. Wellington, Sr. (Herbert, Sr.) and Elizabeth Wellington (Elizabeth), all three of whom are deceased. The Wellington Trusts (the Trusts),

were created pursuant to four instruments: (1) the 1961 Trust Agreement executed by Herbert, Sr. on August 15, 1961; (2) Herbert Sr.'s Last Will and Testament; (3) Elizabeth's Last Will and Testament; and (4) Tom's Last Will and Testament.

JPMorganChase Bank, N.A. and its predecessor banking corporations (each and collectively referred to as JPMorgan) served as a trustee of the Trusts for more than 50 years, often with a co-trustee. Herbert, Sr. had appointed his older son, Herbert Wellington, Jr. (Herb), as co-trustee, while Elizabeth had appointed Herbert Sr.'s and Herb's business partner, Robert Merrill (Robert), as co-trustee.

The Tom Trusts: Tom Trust #1, Tom Trust #2, and Tom Trust #3

While Tom was alive, there were three Trusts for his benefit. These were established under the 1961 Trust Agreement (Tom Trust #1), under Herbert Sr.'s Will (Tom Trust #2) and under Elizabeth's Will (Tom Trust #3). Tom died in July 2000.

The Sarah Trusts: Sarah Trust #1

Under the 1961 Trust Agreement, upon Tom's death, one-fourth of Tom Trust #1 flowed into a trust for the benefit of Sarah (Sarah Trust #1), and the balance flowed to trusts for her half-siblings. The trustees of Sarah Trust #1 were JPMorgan and Herb. The co-trustees shared equal investment authority, and neither was empowered to make unilateral investment decisions. At the same time, Article Seventh of the governing trust instrument provided that Herb could at any time, and for any reason or no reason, remove and replace the corporate trustee.

The governing instrument gave the trustees authority to acquire and retain investments they deem advisable, "whether or not such investments be of the character permissible for investments by fiduciaries and they shall be under no obligation to diversify investments."

As of September 18, 2000, the value of Tom Trust #1 was $35,518,000.00, making the 25% share of Sarah Trust #1 worth $8,879,500.00. Sarah Trust #1 was funded in March 2001

with a transfer of $3,642,902.68 from Tom Trust #1, which was invested 96% in equities and 4% in cash. In May 2001, JPMorgan transferred additional securities into the Sarah Trust #1, bringing the total value to $7,291,922.51, of which 98% was invested in equities and 2% was invested in cash. Of the equity holdings, Merck made up more than 29% of the portfolio, GE made up more than 19%, nearly 8% was in Microsoft, approximately 7% was in SBC, and approximately 6% in Intel. The portfolio yielded 1.3% income.

By December 31, 2002, the value of Sarah Trust #1 had decreased to $4,391,414.00.

Herb resigned as co-trustee of Sarah Trust #1 by decree of this court dated April 4, 2005. Herb died on August 15, 2005.

The Sarah Trusts: Sarah Trust #2

In his Will, Tom exercised powers of appointment granted to him under Herbert Sr.'s Will and under Elizabeth's Will and created four new trusts, one for each of his four children, funded with the combined assets from Tom Trust #2 and Tom Trust #3. The trust for Sarah that was created pursuant to Tom's power of appointment is known as Sarah Trust #2. JPMorgan served as sole trustee of Sarah Trust #2, following the renunciation of the other nominated co-trustees.

As of September 18, 2000, the value of Tom Trust #2 was approximately $2,866,000.00, which was invested 99% in equities and 1% in cash, and the value of Tom Trust #3 was approximately $1,858,000.00, which was invested 93% in equities, 1% in cash, and 6% in fixed income. The share of Sarah Trust #2 was thus worth $1,181,000.00.

In December 2001, the assets of Tom Trust #2 were distributed to the four trusts created for Tom's children. The value of the assets transferred from Tom Trust #2 to Sarah Trust #2 had decreased $250,000.00 since Tom's death. The assets of Tom Trust #3 were distributed to the four trusts created for Tom's children approximately one year after Tom's death. During that

year, the value of the assets transferred from Tom Trust #3 to the Sarah Trust #2 had decreased by half, or approximately $250,000.00, and were invested 11% in fixed income, 9% in cash, and 80% in equities.

JPMorgan began diversification of Sarah Trust #2 in 2003, proposing a reduction over time of stock concentrations in excess of 10%.

THE ACCOUNTS

In August 2003, JPMorgan and Herb filed petitions seeking approval of their accounts for the Tom Trusts and Sarah Trust #1. JPMorgan filed a petition seeking approval of the bank's account as trustee of Sarah Trust #2. The petitions were served on all interested parties, including, but not limited to, Sarah and her half-siblings. The accountings were updated through June 2004 after Herb's resignation as co-trustee. Subsequently, the accountings for the Sarah Trusts were updated through April 2009.

Sarah filed the only objections to the accounts.

OBJECTIONS TO THE ACCOUNT

In her objections to the accounts filed by JPMorgan for the Sarah Trusts, Sarah alleged that JPMorgan breached its fiduciary duties to her by: (1) failing to diversify the trusts' assets, which resulted in substantial trust losses; and (2) failing to make appropriate distributions to her from the income and/or principal of the trusts. Sarah seeks equitable and monetary damages in the form of restitution, retroactive distributions, return of commissions, surcharges, attorneys' fees, diversification, removal of the fiduciary and appointment of a successor trustee or co-trustee. Although Sarah objected to the conduct of both co-trustees, JPMorgan and Herb, she only sought affirmative relief from JPMorgan.

In December 2012, Sarah entered into a settlement agreement with Herb's estate in connection with her objections to the accounts. Pursuant to the settlement agreement, Herb's

estate paid $100,000.00 to Sarah in exchange for a full release. Sarah agreed to indemnify Herb's estate against any claims for contribution.

As a result of the settlement reached between Sarah and Herb's estate, JPMorgan moved for leave to supplement its pleadings to assert an affirmative defense for a credit pursuant to New York's General Obligations Law or to assert a cross–claim against the estate of Herbert G. Wellington, Jr. with respect to each of the trusts which are the subject of the objections and the settlement agreement. The motion was granted in a decision dated September 26, 2013.

Subsequently, Sarah alleged that Herb lacked capacity to serve as a co-trustee during the period of the accounts, and that JPMorgan knew or should have known this. In connection with this allegation, Sarah asserts that JPMorgan was obligated to seek advice and direction from the court or bring a proceeding to have Herb removed.

THE BIFURCATED TRIAL

The trial conducted before this court was limited to the issue of liability. If the court finds that JPMorgan is liable, the court must schedule the second portion of the bifurcated trial, to address the issue of damages. If the court determines that damages were sustained, it will then consider whether responsibility for the damages should be apportioned between JPMorgan and Herb as co-trustees, as argued by JPMorgan.

Nine witnesses testified at the trial on the issue of liability: Loren Ross (Ross), expert witness for Sarah; Jonathan Blattmachr (Blattmachr), who was counsel to Herb from 1980 until Herb's death; Charles Wellington (Charles), Herb's oldest son; Peter Wellington (Peter), Sarah's half-brother; Sarah; Brian Bandler (Bandler), who was the trust officer at JPMorgan during the accounting period of the Sarah Trusts; Timothy J. Erb (Erb), who was the JPMorgan portfolio manager on the Trusts during the accounting period of the Sarah Trusts; Jeffrey Osmun (Osmun), expert witness for JPMorgan; and Paul Napoli (Napoli), expert witness for JPMorgan.

SARAH'S POSITION

The following key points were made by, or on behalf of, Sarah, during the trial and in her counsel's post-trial brief:

1. JPMorgan believed that it was appropriate to diversify the assets held in the Sarah Trusts.

2. Despite this, when Herb refused to consent to diversification of Sarah Trust #1, JPMorgan deferred to Herb, because Herb was a long-time client and JPMorgan did not want Herb to use the power given to him under the trust instrument to remove JPMorgan as co-trustee of Sarah Trust #1 and the other trusts created under the 1961 Trust Agreement.

3. JPMorgan knew, or should have known, that Herb's mental capacity was seriously diminished by a series of strokes even before the Sarah Trusts were funded.

4. During the period of the judicial accountings, the values of the Sarah Trusts decreased dramatically.

5. JPMorgan is liable to Sarah for damages resulting from failure to diversify the assets held in the Sarah Trusts and failure to make appropriate distributions.

6. Although JPMorgan seeks to place the blame on Herb for the losses in value of Sarah Trust #1 during the accounting period, the bank cannot escape its fiduciary responsibility to Sarah, whether or not Herb was competent. However, since Sarah takes the position that Herb was not competent, and that JPMorgan knew this, JPMorgan had a responsibility to apply to the court to have Herb removed.

Sarah's Expert Testimony

Ross, the expert witness on behalf of Sarah, testified concerning JPMorgan's policies and procedures on investment and diversification. Ross referenced the June 23, 1999 letter from

Robert William of JPMorgan to Herb, in which he stated the bank's position that having 40% of the trust invested in shares of Merck "represents an uncomfortably large concentration in one security and suggest[s] a sale of at least a small portion of this stock." The witness opined that the 40% concentration in Merck stock was "extraordinary" and far beyond what was allowed by JPMorgan's own policies and procedures. Ross testified that if JPMorgan "wanted to really reduce that position or any concentration, they should have explored that much more fully with their co-trustee and pressed harder rather than a simple suggestion to reduce the concentration and diversify." The expert witness then discussed the increased risk created by such a large concentration of trust assets in one stock, which he depicted as "an outsized bet, and you can be right and maybe very lucky or you could be wrong and it could be disastrous to the trust beneficiaries . . . ." He continued by saying that "if you're in one segment of the market, say just stocks, particularly large capitalization stocks as they were at that time, you could experience the meltdown that occurred between 2000 and 2002, one which damaged this trust and the portfolio value."

The witness also discussed a letter dated November 21, 2000, sent by Brian Jandrucko (Jandrucko) of JPMorgan to Herb, in which Jandrucko referred to the fact that Tom Trust #1 and Tom Trust #2 were "almost entirely composed of US large-cap stocks, with very low cost basis. Given this concentrated exposure, the portfolio is subject to greater volatility than if the trusts were more diversified." The letter acknowledged Herb's unwillingness to diversify the trust assets and then recommended a plan to reduce the trusts' exposure to risk by diversifying among large-cap stocks, cash, fixed income, small-cap stocks and international holdings.

On August 28, 2002, JPMorgan sent a letter, addressed to both Herb and his wife, in which JPMorgan again recommended diversification of the trust assets, and again acknowledged

Herb's refusal to consent to the recommended investment strategy. As noted by Ross, JPMorgan asked Herb to sign and return a copy of the letter if he wished to continue his current strategy for the assets, which were largely made up of large-cap securities with a low cost basis. Herb signed and returned the letter to JPMorgan.

The expert witness was questioned about JPMorgan's reliance upon Herb for investment decisions, in the event that JPMorgan believed or should have believed, at some point during the management of the Trusts, that Herb was no longer competent. Ross stated that if JPMorgan as a co-trustee perceived that Herb was "flawed in judgment or incapacitated or even negligent, that co-trustee needs to take some remedial action in order to protect the interests of all the beneficiaries . . . ."

The witness testified that after Tom died, Bandler wrote a letter to Tom's four children, including Sarah, on September 19, 2000, which valued the Tom Trust #1 at $35,518,000.00, to be divided and distributed among four separate trusts for Tom's children. At that time, the Tom Trust #2 was valued at $2,866,000.00, which would also be divided into four separate trusts for Tom's children, including Sarah. Based upon these valuations, Sarah Trust #1 and Sarah Trust #2 were initially worth a combined total of $9,596,000.00.

The witness testified that the market value of principal of Sarah Trust #1 and Sarah Trust #2 in May 2001 was $7,291,922.51, invested 98% in equities and 2% in cash. The witness stated that this concentration in equities "was egregious. It was too much risk for this kind of portfolio and for this trust." He noted that the prudent investor rule requires a trustee to consider a beneficiary's individual and personal needs. In Sarah's case, this required planning for the fact that she was unmarried, without children, and needed a solid cash flow, which wasn't met by the 1.3% yield being earned by the trusts.

On cross-examination, Ross agreed that JPMorgan could not diversify the portfolio of Sarah Trust #1 without Herb's consent. Under JPMorgan's policies and procedures dated May 26, 2000, "[c]o-trustees serve with equal authority except as limited by the governing instrument. All trustees must agree before any decisions can be made or course of action followed, unless the trust instrument or governing law provides otherwise." Counsel for JPMorgan elicited further testimony from Ross that: (1) the assets in Tom Trusts #1, #2, and #3, from which the Sarah Trusts were funded, were almost entirely invested in equities, not very diversified, and concentrated in specific securities through the date of Tom's death; (2) under the prudent investor rule, grantor intent is an important factor; and (3) the terms of the 1961 Trust expressly allowed the co-trustees to retain any securities held in the account, invest in securities not of the kind specifically approved for fiduciary investment, and make investments in the sole and absolute discretion of the trustees, regardless of diversification.

The expert witness agreed that during the 44 years that the Tom Trusts were in existence, the value had increased from $2,000,000.00 to $36,000,000.00. At Tom's death, when the Sarah Trusts were funded with 25% of the Tom Trust assets, Sarah was 33 years old, with an additional 50-year life expectancy, so that the time horizon for managing her trusts needed to be long-term. The witness was also asked to testify about the fact that the assets in Sarah Trust #1 had a very low basis, so that sales prior to May 2003 would have been subject to the very high federal capital gains tax rate in place at the time.

The expert witness was asked to read from the 2000 JPMorgan manual concerning corporate policy in developing an annual capital gains budget for each account, which was to equal no more than three percent of each account's market value. Counsel for JPMorgan then questioned the witness about JPMorgan's policy regarding concentrated holdings, and the fact

that the corporation had no mandate to bring a stock that makes up over 30% of a portfolio to a holding of less than 30%.

Ross testified that JPMorgan should have been doing "the very, very best they can to discover the reasons or the rationale for intransigence on diversifying the portfolio up until a point that they believe that it's inimical to the interests of prudent administration of the trust and the beneficiary's interests. At that point it seems to me they have a legitimate ground to seek possibly legal redress or guidance."

On re-cross-examination, counsel for JPMorgan questioned Ross as to whether correspondence between Sarah and Bandler at JPMorgan in 2002 constitutes or reflects an investment plan for the Sarah Trusts; Ross opined that the correspondence is not the equivalent of an investment plan.

The Competency of the Co-Trustee

Sarah takes the position that as a result of a series of strokes, Herb lacked capacity to serve as co-trustee of Sarah Trust #1 and make investment decisions during the accounting period, and that JPMorgan knew or should have known of Herb's incapacity and should have initiated a court proceeding to seek advice and direction, or to have Herb removed.

In support of the argument that Herb was incompetent during a portion or all of the period of time covered by the Sarah Trust #1 accounting, her counsel offered the testimony of two fact witnesses, Blattmachr and Charles. No medical testimony or written evidence was proffered.

Blattmachr is an attorney who represented Herb since 1980 until his death; he testified that until 2000 Herb was a rigorous man, strong willed, opinionated and bright. Then Herb suffered a series of strokes. A major stroke reduced Herb's ability to react to things and his

mental capacity was greatly diminished. While Blattmachr believed that Herb still retained the capacity to execute a will and codicil, his physical and mental condition deteriorated significantly, and he became essentially bedridden. Blattmachr testified that if you knew Herb before the strokes, you would have seen that his faculties had significantly diminished, and that almost anyone meeting him in 2003 would have realized that Herb was impaired.

On cross-examination, Blattmachr was questioned about the codicil and health care proxy addendum he prepared and had Herb sign on May 3, 2004, at which time the witnesses signed the self-proving affidavit to the codicil concerning Herb's competency and lack of impairment to make a valid will or codicil. Counsel for JPMorgan also cross-examined Blattmachr about corporate documents prepared by his law firm in April 2002, January 2003 and December 2004. These documents, listing Herb as Chairman of the Board and President of HGW, Inc., were executed by Herb. Blattmachr agreed that he never advised his law firm associates that Herb was unable to sign the documents, and that Blattmachr personally supervised Herb's execution of the accounting petitions on August 21, 2003. Blattmachr testified that he believed that Herb had the capacity to sign the accounting petitions on that date, and further agreed that he never alerted anyone at JPMorgan or at his firm that he had any doubts as to Herb's capacity. Blattmachr confirmed that until the last time he saw Herb, he never believed that Herb was legally incompetent, though he had some physical impairments, such as difficulty writing.

On redirect examination, Blattmachr testified that he believed that in 2004, and probably well before then, following the stock market would have been too difficult for Herb. He further testified that after Herb's major stroke in January 2001, his capacity to make investment decisions was very diminished.

The court also heard testimony from Charles, Herb's oldest son. He testified that after

his father's first stroke, in the late 1990's, his father became less active. After his second major stroke, in January 2001, Charles testified that Herb was weaker and had less attention span, but was capable of making decisions about investments and equities. He also testified that in 2004, Herb was disoriented.

The court admitted the May 19, 2004 letter written by Gary Friedman (Friedman), as counsel to Charles, to Timothy Erb of JPMorgan, which was sent in response to a letter from JPMorgan seeking the written consent of Herb to a proposed sale to raise cash in Sarah Trust #1. Friedman stated, in part: "This is to advise you as your colleagues at JP Morgan and Chase Bank are aware by reason of physical and mental incapacity, Mr. Herbert G. Wellington, Jr., is not now and for some considerable period of time has not been capable of discharging the duties of a trustee."

Charles testified that in September 2004, as Herb's attorney-in-fact, he filed a petition to have Herb relieved as trustee of Sarah Trust #1. The petition stated that Herb sought permission to resign "due to his current medical condition. He has suffered several strokes over the past 16 years, the last of which in January of 2001 was severely debilitating. He is and has been incapable mentally and or physically from serving as co-trustee of the trust."

On cross-examination, Charles testified that although his father had given him a power of attorney, Charles never took over his father's bank or brokerage accounts, and that Herb signed his own complex tax returns and received account statements and paid attention to his assets until his death. Charles also testified that he was present at the signing of his father's codicil in 2004, and that he did not raise any concern about his father's ability to execute a codicil, or that his father was incapacitated, not competent, or impaired. Further, Charles testified that he never objected to his father's continued administration of the trusts created for Charles under the 1961

Trust.

Charles testified that the petition to relieve Herb as trustee was only filed after Sarah initiated a court proceeding against the trustees. As attorney-in-fact, Charles filed a second petition to relieve Herb as trustee of a different trust, and in that petition Charles only stated: "Due to his current medical condition, he is incapable mentally or physically from serving as one of the trustees of this trust."

JPMORGAN'S POSITION

JPMorgan's position, as expressed during the trial and in the post-trial brief submitted by counsel for the bank, may be summarized briefly as follows:

1. Herbert, Sr. and Herb achieved great wealth with their long-term equity growth-oriented investments (the Wellington investment philosophy), which emphasized high-quality well-capitalized American stocks. The Wellington investment philosophy, as applied to the Sarah Trusts, provided adequate diversification, even though it was not identical to JPMorgan's preferred strategy.

2. JPMorgan could not diversify the assets of Sarah Trust #1 without Herb's consent, and Herb was unwilling to deviate from the Wellington investment philosophy. At the same time, the periodic letters JPMorgan sent to Herb concerning diversification were limited to recommendations, because the investment strategies of Herb and JPMorgan were not that different.

3. Representatives of JPMorgan and Sarah spoke by telephone, met in person and corresponded concerning Sarah's needs and the investment strategies being used, including the different treatments of Sarah Trust #1 and Sarah Trust #2.

4. JPMorgan's conduct followed the standards set by Prudent Investor Act. Specifically,

the prudent investor rule allows for the power to adjust while still investing for long-term growth. Further, the prudent investor rule refers repeatedly to the terms of the governing instrument, and to grantor intent.

5. The instrument did not impose a duty on the trustees to diversify assets, and the family had its own investment philosophy. The fact that the grantor appointed Herb and gave him the power to remove the corporate trustee indicated that the grantor wanted Herb to determine the investment strategy.

6. The Sarah trusts were diversified within five years, which is in accordance with JPMorgan's internal policies, which sets five years as the investment horizon for high-cap growth investments.

7. Herb was not incompetent.

8. JPMorgan is not trying to place the blame on Herb. Instead, JPMorgan's position is that the investment strategies were reasonable and that neither trustee should be held liable, especially in light of grantor intent and the trust instruments.

9. There would have been enormous tax consequences if the trustees had quickly diversified much of the trust corpus, since 90% of the value of the assets contained in the Sarah trusts represented long-term gains.

10. Some of the decrease in the value of the Sarah trusts actually reflects distributions and administrative expenses.

JPMorgan's Expert Testimony

JPMorgan had two expert witnesses take the stand. The first was Osmun, who stated that based upon his review of the case file in connection with Sarah's allegations against JPMorgan, it is his opinion, as expressed in his written report, that JPMorgan complied with the standards of

care that it owed Sarah. He testified that JPMorgan conducted an initial review of the account and annual reviews thereafter, and created trust profiles that included investment objectives. While acknowledging that the correspondence reflected that JPMorgan would have preferred a more diversified portfolio in Sarah Trust #1, the record also reflects that JPMorgan considered a number of other factors, including the investment background of the grantor and his appointment of Herb as co-trustee, along with the requirement of co-trustee consent and Herb's ability to remove JPMorgan. The record reflects that JPMorgan considered the tax costs of diversification, Sarah's long-term life expectancy, and the language in the instrument permitting non-diversification. The witness testified that the language in Sarah Trust #1 regarding no duty to diversify, which he said " was "beyond the norm . . . beyond boiler plate . . . it would jump out at me as an indicator of the grantor's intent." Similarly, the witness testified that the trust language that authorized Herb to remove JPMorgan was not a typical trust provision when the trust was created. Based upon all of these factors, and Herb's professional background and family connection, Osmun testified that "it would be reasonable for the bank to give great weight" to Herb's input on investments. In response to questions, Osmun acknowledged that after Herb resigned, JPMorgan began diversification of the assets in the Sarah Trust #1, although not all at once, due to tax considerations. Within five years of the funding of Sarah Trust #1, it held no concentrations in excess of ten percent, which comports with JPMorgan's policies.

In connection with Sarah Trust #2, Osmun opined that JPMorgan met the requirements of diversification under the prudent investor rule. Under the terms of Sarah Trust #2, JPMorgan was able to diversify, and in less than five years from the date of funding, the Trust held no concentrations of stock that were greater than ten percent. Osmun testified that he disagreed with Ross' testimony that JPMorgan did not have an investment plan documented for the Trusts,

because the trust profile generated in connection with each trust was an investment policy statement. When questioned about the reduction in value suffered by the Sarah Trusts, the witness stated that the trustees' conduct, and not the investment performance, is controlling in determining compliance with the prudent investor rule, and that the trustees utilized the power to adjust to make distributions that satisfied Sarah's needs. On cross-examination, the witness stated that JPMorgan would have preferred to diversify the Sarah Trusts, but could not do so without Herb's consent.

The second expert witness to testify on behalf of JPMorgan was Napoli, whose expertise is in trust investments. Napoli testified that the two most important factors in asset allocation decisions for a trust are the "time frame for the life of the trust, and . . . risk and volatility, and the ability for a portfolio to accept that volatility." He quoted a scholarly study that proved that long-term investors who are patient earn higher returns in equity than in fixed income or cash, but that the trade-off is increased volatility. Based upon Sarah's life expectancy at the time the trust was created, the witness testified that the trust could be invested for the long-term, with acceptance of the increased volatility, for a likely higher return, and that looking at a three-to-five year period of trust management does not give a good picture of whether the investment style was a good one for the long run.

Napoli testified that the Wellington investment philosophy emphasized big-cap stocks and growth, which was an acceptable style of investment, though it differed from that of JPMorgan. He noted that all of the securities that were in the Sarah Trusts were listed in JPMorgan's target portfolios and recommended as buys.

Napoli also testified that although counsel for Sarah characterized the difference in value in the Sarah Trusts as losses, the value of the securities had diminished in a down draft of the

market, which is only a loss if you sell the securities. Further, some of the reduction on the value of the Sarah Trusts reflected principal distributions.

BURDEN OF PROOF

The petitioner bears the initial burden of proof in a contested accounting proceeding. Petitioner must show that all assets have been accounted for, and that a full and complete accounting has been filed (*Matter of Schnare*, 191 AD2d 859 [3d Dept 1993], *appeal denied* 82 NY2d 653 [1993]*; Matter of Hunter,* 27 Misc 3d 1205[A] [Sur Ct, Westchester County 2010]). Only then does the burden shift to the objectant, who must introduce enough evidence to show that the accounting filed by petitioner is incomplete or in some other way inaccurate (*Matter of Schnare*, 191 AD2d 859 [3d Dept 1993], *appeal denied* 82NY2d 653 [1993]). If the objectant is able to meet this burden, then the accounting party must prove, by a fair preponderance of the evidence, that the account filed is complete and accurate (*Matter of Hunter,* 27 Misc 3d 1205[A] [Sur Ct, Westchester County 2010]). After taking the account and hearing the proofs of the interested parties, the court is given discretion to then "make such order or decree as justice shall require" (SCPA 2211 [1]).

At trial, the parties stipulated that JPMorgan had met its initial burden by filing the five accountings. Thus, the burden of proof passed to objectant to prove that JPMorgan breached its fiduciary duties.

THE APPLICABLE LAW

The five accounts cover time periods dating as far back as 1962, and span different standards for trust investment, as discussed at length in this court's decision issued on September 30, 2013. The objections raised by Sarah are limited to the time period after Tom's death in 2000, at which time the applicable standard for investment was the prudent investor rule.

Under EPTL 11-2.3, a trustee is required to manage and invest trust property in accordance with the prudent investor standard. Like its predecessor, the prudent man rule, this statute is based upon a common-law rule that required a trustee "to employ such diligence and such prudence in the care and management, as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs (*Matter of Strong*, 41 Misc 3d 1231 [A] [Sur Ct, Monroe County 2013], citing *King v Talbot*, 40 NY 76, 85-86 [1869]). The statute measures a standard of conduct, rather than a trustee's performance or the outcome of a trustee's decisions. Under EPTL 11-2.3 (b) (2), "[a] trustee shall exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio, taking into account the purposes and terms and provisions of the governing instrument." A trustee is required:

> "(A) to pursue an overall investment strategy to enable the trustee to make appropriate present and future distributions to or for the benefit of the beneficiaries under the governing instrument, in accordance with risk and return objectives reasonably suited to the entire portfolio;
>
> (B) to consider, to the extent relevant to the decision or action, the size of the portfolio, the nature and estimated duration of the fiduciary relationship, the liquidity and distribution requirements of the governing instrument, general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of investment decisions or strategies and of distributions of income and principal, the role that each investment or course of action plays within the overall portfolio, the expected total return of the portfolio (including both income and appreciation of capital), and the needs of beneficiaries (to the extent reasonably known to the trustee) for present and future distributions authorized or required by the governing instrument;
>
> (C) to diversify assets unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument; and
>
> (D) within a reasonable time after the creation of the fiduciary relationship, to determine whether to retain or dispose of initial assets" (EPTL 11-2.3 [b] [3]).

Trustees with special investment skills, such as a bank or trust company, are held to even

higher standards, which "require the trustee to exercise such diligence in investing and managing assets as would customarily be exercised by prudent investors of discretion and intelligence having special investment skills" (EPTL 11-2.3 [b] [6]; see *Matter of Hyde*, 44 AD3d 1195 [3d Dept 2007], *appeal denied*, 9 NY3d 1027 [2008]).

ANALYSIS

Failure to Diversify

Sarah's primary objection is that by failing to quickly diversify the holdings in Sarah Trust #1 and Sarah Trust #2, JPMorgan failed to meet the standard set by the prudent investor rule.

The prudent investor rule places great emphasis on a trustee's duty to diversify assets, but also provides sufficient flexibility for the fiduciary to not diversify assets if the trustee determines that it is not in the best interests of the beneficiaries to diversify, or if the grantor directed a different investment strategy (*Matter of Hunter*, 27 Misc 3d 1205 [A] [Sur Ct, Westchester County 2010], citing *Matter of Dumont*, 4 Misc 3d 1003 [A], *revd on other grounds* 26 AD3d 824 [4th Dept 2006]). In reaching this determination, the trustee is obligated to consider the purpose of the governing instrument, as well as its provisions and terms. Any determination as to whether or not a trustee's conduct meets the prudent investor standard must include consideration of all of the relevant circumstances and facts (EPTL 11-2.3 (b) (1); *Matter of Hunter*, 27 Misc 3d 1205 [A], [Sur Ct, Westchester County 2010]). Further, "[a] trustee is not liable to a beneficiary to the extent that the trustee acted in substantial compliance with the prudent investor standard or in reasonable reliance on the express terms and provisions of the governing instrument" (EPTL 11-2.3 [b] [1]).

In *Matter of Knox* (98 AD3d 300 [4th Dept 2012]), the court addressed a trust created by

a grantor for his grandchildren. The trust was funded with shares of Woolworth, which the grantor had co-founded, and shares of Marine Trust Company of Western New York. The Trust Company was named as sole trustee and was given a power to invest trust funds "without regard to diversification or to limitations or restrictions of any kind" (*id*. at 305). The trust instrument further provided that the trustee was authorized to consult with counsel, and would be protected in connection with any action taken in good faith under advice of counsel.

When the trustee filed an account, covering the years 1957 through 2005, the adult income beneficiaries and the guardian ad litem for the minor remainder beneficiaries filed objections to the trustee's retention of the Woolworth stock. The court noted that under the prudent investor rule and its predecessors, "it is not sufficient that hindsight might suggest that another course would have been more beneficial; nor does a mere error of investment judgment mandate a surcharge" (*id*. at 309 [citations omitted]).

Of particular relevance to the case at bar, the court in Knox noted that "it is well established that retention of securities received from the creator of the trust may be found to be prudent even when purchase of the same securities might not" (*id.*, citing *Matter of Hahn*, 93 AD2d 583, 586 [4th Dept 1983]; *Matter of Weston*, 91 NY 502, 508 [1883]), and that the standard of care established by the prudent investor act or any predecessor in the law is considered subordinate to the terms set out in the governing trust instrument (*id*. at 310). EPTL 11-2.3 (a) provides that "[a] trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard defined by this section, except as otherwise provided by the express terms and provisions of a governing instrument . . . ."

Finally, the court in Knox noted that "[a]t times, holding an overweight concentration of a security may be in the best interests of the beneficiaries" (*Matter of Knox,* 98 AD3d 300, 316

[4th Dept 2012], citing *Matter of Hyde*, 44 AD3d 1195, 1199-1200 [3d Dept 2007]; *Matter of Kettle*, 73 AD2d 786, 786 [4th Dept 1979]).

In *Matter of Ely* (37 Misc 3d 875 [Sur Ct, Erie County 2012] *affd* 109 AD3d 1118 [4th Dept 2013]), HSBC Bank USA sought judicial settlement of its account as corporate trustee of a testamentary trust for the benefit of the grantor's son for the years 1968 through 2006. Upon the son's death, in 2004, he exercised his power of appointment over the trust funds and directed that they be paid into a new trust for the benefit of his wife, naming Genesee Valley Trust Company as trustee. Sixty percent of the trust value consisted of shares in a closely held family company. HSBC invested 70% of the remaining 40% of the trust value in just four companies: Merck, General Electric, Pfizer and Microsoft. The son's wife, as a trust beneficiary and as executor of her husband's estate, and Genesee Valley Trust Company, as trustee, filed objections to HSBC's acquisition and retention of these stocks, arguing that the assets should have been more diversified, and that the lack of diversification caused a loss to the trust.

In finding that HSBC's decision to retain the concentrated holdings in four companies complied with the prudent investor standard, the court noted that "[t]here is no blanket prohibition to retaining stocks in a concentrated manner, provided the decision to do so was made with 'reasonable care, skill and caution'" (*id*. at 882, citing EPTL 11-2.3 [b] [2]). Where a trustee acted "in reasonable reliance on the express terms and provisions of the governing instrument" or "in substantial compliance with the prudent investor standard," the trustee will not be liable to the beneficiaries (*id*.). Citing EPTL 11-2.3 (b) (3) (C), the court further noted that there is no need for a trustee to diversify trust assets if "the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument" (*id*.). Surrogate Howe quoted the decision of the

Court of Appeals in *Matter of Janes* (90 NY2d 41 [1997]) for the holding that "the prudent investor standard 'dictates against any absolute rule that a fiduciary's failure to diversify, in and of itself, constitutes imprudence'" (*id*. at 882).

The Surrogate in *Matter of Ely* found that although HSBC retained a concentration in four stocks, HSBC satisfied the applicable prudent investor standards because: (1) the stocks were on the bank's approved list; (2) the investments complied with the beneficiary's direction that the investments focus on long-term growth; (3) the bank was in compliance with its own internal policies; and (4) there was a review of the trust's investment strategy and performance no less than annually. When the four stocks fell in value as part of an overall market decline in 2001, HSBC decided that it would not be prudent to sell the stocks in a declining market, and that a sale would trigger substantial capital gains taxes. The Surrogate found that the record evidenced a well-thought-out and balanced approach to managing the trust assets, and dismissed all of the objections to HSBC's account.

In connection with the objection based upon JPMorgan's failure to diversify the holdings in the Sarah Trusts, the court finds that the bank's conduct was in compliance with the prudent investor standard during the period of the accounts filed for the Sarah Trusts. In reaching this finding, the court has considered: (1) grantor intent regarding diversification, as expressed in the 1961 Trust Agreement; (2) grantor intent regarding investment philosophy, as expressed in the appointment of Herb as co-trustee; (3) grantor intent, as expressed in the power given to Herb to remove the corporate trustee at any time and for any reason or for no reason; (4) grantor intent, as evidenced by the Wellington investment philosophy and the history of investment of these trusts; (5) the relatively short period of time covered by the accounts, as compared with the long-term investment strategy chosen for the Sarah Trusts; (6) that the disputed stocks were on the

bank's approved list; (7) that JPMorgan complied with its own policy of diversification within five years, for high-cap growth investments; and (8) there was an initial review of the trust's investment strategy and an annual review thereafter, including trust profiles setting investment objectives.

Inadequate Distributions

Sarah argues that JPMorgan failed to make distributions in amounts adequate to meet her needs. The court finds that Sarah failed to prove this. The bank repeatedly increased scheduled distributions to meet Sarah's needs, and utilized the power to adjust once it was enacted in New York (EPTL 11-2.3 [b] [5]). All of the income from Sarah Trust #1 was distributed to Sarah, and she received income and principal from Sarah Trust #2. In addition, JPMorgan made multiple large distributions at Sarah's request.

Competency of Co-Trustee

Lastly, the court will address Sarah's assertion that Herb lacked capacity while serving as co-trustee of Sarah Trust #1, and that JPMorgan knew or should have known this and was obligated to seek the court's advice and direction or petition for the removel of Herb. A party asserting mental incapacity bears the burden of proof (*Smith v Comas*, 173 AD2d 535 [2d Dept 1991] [citations omitted]). "[A] person is presumed to be competent at the time of the performance of the challenged action and the burden of proving incompetence rests with the party asserting incapacity" (*Matter of Obermeier*, 150 AD2d 863, 864 [3d Dept 1989], citing *Matter of Gebauer*, 79 Misc 2d 715, 719 [Sur Ct, Cattaraugus County 1974], *affd* 51 AD2d 643 [4th Dept 1976]; 66 NY Jur 2d, Infants and Other Persons Under Legal Disability, § 109, at 316). The person raising the challenge must "establish incompetency at the time the action took place" (*id*., citation omitted]).

Although JPMorgan's counsel elicited testimony that Herb executed a codicil to his will on May 3, 2004, only two weeks before the Friedman letter was sent to JPMorgan, "[i]t is hornbook law that less mental capacity is required to execute a will than any other legal instrument. The reasons for this lower standard stem from the concept of a will as the testator's last act, and from considerations of fairness which militate against depriving elderly or infirm testators of the right to dispose of their property . . . Additionally a will is not the product of a bilateral transaction between putative antagonists and does not require the sharpness of mind of persons involved in a business transaction" (*Matter of Goldberg*, 153 Misc 2d 560, 564-565 [Sur Ct, New York 1992], citing Radigan, Attorneys Are Alerted to Take Early Precautions To Avoid Will Contests in Sensitive Situations, NYLJ, Apr. 20, 1981, at 3, col 1; *Matter of Bossom*, 195 App Div 339, 343 [3d Dept 1921]; *Matter of Seagrist*, 1 App Div 615, 620 [1st Dept 1896], *affd* 153 NY 682 [1897].)

While neither side has proven an absolute standard of competency applicable to trustees, the standard for measuring the competency of a party to a contract has been a cognitive test, with a focus on the party's ability to understand the nature and consequences of a transaction and make a rational judgment concerning it (*Ortelere v Teachers' Retirement Bd.*, 25 NY2d 196 [1969]).

The court heard testimony that during the period of the accounting, and subsequent to his strokes, Herb executed corporate documents, the accounting petitions and complex tax returns, and that he followed his assets until his death. The critical consideration in determining whether the capacity standard has been met in cases where a person has some understanding of a particular transaction, but has a mental deficit, is whether the transaction in its result is one

which a reasonably competent person might have made" (*Matter of Goldberg*, 153 Misc 2d 560, 566-567 [Sur Ct, New York 1992] [citations omitted]).

Over the period of the Sarah Trust #1 accounting, JPMorgan periodically asked Herb to consider further diversification of the trust assets, and Herb repeatedly chose to retain the original trust assets, all of which were investments made by his father, Sarah's grandfather, Herbert, Sr. Based upon all of the factors before the court, including the history of family investments, and the grantor's appointment of Herb as a trustee of Sarah Trust #1, and the grantor's empowerment of Herb to remove the corporate co-trustee, this court is not prepared to say that a competent trustee might not have made the decision made by Herb, and agreed to by JPMorgan, to retain the original investments, with an eye on long-term growth.

Further, Sarah did not introduce any evidence that even if Herb lacked capacity, JPMorgan knew or should have known. There is nothing in the record to indicate that JPMorgan learned or could have learned this from the bank's interaction with Herb, since Herb's position on retaining investments during this period was the same as it has always been, and the same as the historic position of his father, Herbert, Sr., who was the grantor of the trusts. The two fact witnesses who testified that Herb was incapacitated while serving as co-trustee of Sarah Trust #1 never put JPMorgan or anyone else on notice until after a decision was made in 2004 to have Herb resign as co-trustee. Accordingly, this court has evaluated the conduct of JPMorgan based upon the assumption that JPMorgan reasonably assumed Herb's continued capacity.

During the 44 years that the Tom Trusts were in existence prior to Tom's death, the investment of the trust assets increased the value from approximately $2,000,000.00 to approximately $36,000,000.00. After Tom's death, when these same assets were transferred to the trusts for the benefit of Tom's children, there was a downturn in the market, but JPMorgan

testified that the time horizon to be factored into the investment strategy for the Sarah Trusts was long-term, based upon her life expectancy.

Given all of these factors, it is not surprising that in the limited period of time covered by the accounting of the Sarah Trust #1, which was expected to last almost another 50 years, that JPMorgan deferred to Herb's investment strategy.

CONCLUSION

The objections are dismissed.

Settle decree.

Dated: June 30, 2015

EDWARD W. McCARTY III
Judge of the
Surrogate's Court