RENDERED: OCTOBER 31, 2014; 10:00 A.M.
NOT TO BE PUBLISHED

Commonwealth of Kentucky

Court of Appeals

NO. 2012-CA-002142-MR

CHARLES G. MIDDLETON; AND
LAWRENCE JONES MIDDLETON — APPELLANTS

v. — APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE SUSAN SCHULTZ GIBSON, JUDGE
ACTION NO. 07-CI-010053

PNC BANK, NA, IN ITS INDIVIDUAL
CAPACITY FOR ITS ACTION, AS
TRUSTEE UNDER THE TRUST OF
LAWRENCE JONES, SR.; AND
PARTHENON, LLC — APPELLEES

<u>OPINION</u>
<u>AFFIRMING</u>

** ** ** ** **

BEFORE: MAZE, MOORE, AND VANMETER, JUDGES.

MAZE, JUDGE: Charles G. Middleton and Lawrence Jones Middleton (collectively "the Middletons") appeal from a summary judgment order by the Jefferson Circuit Court which dismissed their claims against PNC Bank, NA, as

trustee under the trust of Lawrence Jones, Sr., and Parthenon, LLC (collectively, PNC). The Middletons argue that the trial court applied the wrong standard of proof to determine whether the alleged breaches of fiduciary duty by PNC caused an injury to the trust. We agree with the trial court that the Middletons failed to present sufficient evidence showing with reasonable certainty that the trust suffered an actual injury as a result of PNC's alleged breaches of fiduciary and statutory duties. Therefore, the trial court properly concluded that the Middletons would not be entitled to recover damages from PNC. Hence, we affirm.

For purposes of this appeal, the essential facts of this matter are not in dispute. On December 28, 1933, Lawrence Jones, Sr., created an *inter vivos* trust for the benefit of his three daughters and their descendants. (Hereinafter, "the Daughters' Trust" or "the Trust"). He established a similar trust for the benefit of his son, Lawrence Jones, Jr., and his descendants. Those trusts became irrevocable in 1935 and became testamentary trusts in 1941 under Jones's will. The Middletons are descendents of Lawrence Jones, Jr., who predeceased his father.

The Daughters' Trust designated Fidelity and Columbia Trust Company, PNC's predecessor, as trustee. Fidelity, and its successor, Citizens Fidelity Bank and Trust Company, were also responsible for management of the Trust. Over the decades, many issues involving the administration of the Trust have been raised and have been the subject of agreements and private resolutions among the beneficiaries. In 1980, Citizens Fidelity entered into an agreement with

the income beneficiaries of the Trust. Among other things, the Agreement contained the following provision:

> Citizens, as trustee shall have the ultimate responsibility for the investment of assets in the various trust estates. However, it will be guided by the recommendations made by J.B.B. Hilliard W.L. Lyons, Inc., presently employed by various Jones beneficiaries as their money manager. Citizens will not be required to recommend specific changes or actions regarding investments to such beneficiary or beneficiaries and will cooperate with recommendations made by the money manager selected by the beneficiaries or beneficiaries of various trusts. Citizens, nevertheless, will have the ultimate responsibility of determining that the investment changes recommended meet the requirements of legal trust investments; but, again, Citizens will cooperate fully with the money manager employed by any beneficiaries if such money manager's recommendations meet the legal requirements for trust investments.

Hilliard Lyons continued to manage the assets of the Trust until July 2001. Lawrence Middleton worked for Hilliard Lyons during the time that it managed the assets, and the account statements identified him as the "financial consultant" on the Trust. In 2001, the income beneficiaries of the Trust requested that PNC transfer the investment management of the Trust from Hilliard Lyons to Parthenon LLC. Parthenon was formed in 1999 by four former Hilliard Lyons employees, all of whom had a long-standing history with the Trust while at Hilliard Lyons. Following this transfer of investment management, Parthenon provided investment advisory services to PNC, which remained both trustee and custodian for the Trust's assets. Lawrence Middleton remained with Hilliard Lyons and did not continue as a consultant to the Trust.

There were other ongoing issues involving the administration of the Trust. In 1996, those issues were raised and addressed in an arbitration proceeding and order. The order settled a number of long-standing issues, most notably regarding the continued validity of the Trust under the Rule Against Perpetuities and whether the descendants of the Son's Trust could be considered as remainder beneficiaries under the Daughters' Trust. The arbitration order also required the trustee to institute a declaratory judgment action to confirm the agreement and award.

Pursuant to this latter provision, PNC instituted a declaratory judgment action in 2004 to determine, among other things, whether the descendants of Lawrence Jones, Jr. are included in the class of remainder beneficiaries under the Daughters' Trust. The Middletons, as potential remainder beneficiaries, were named parties to that action. After several years of litigation and mediation, the beneficiaries under the various trusts entered into a Settlement Agreement and Release which stipulated that the Middletons were deemed to be remaindermen under the Daughters' Trust. As part of that settlement, the Middletons agreed to accept a series of distributions in exchange for giving up their rights as potential remainder beneficiaries in the Daughters' Trust upon its termination.[1]

In addition, the Middletons reserved their right as potential remainder beneficiaries under the Trust to maintain individual claims against PNC. In

[1] This Court recently addressed several unrelated matters involving this same Trust in *Maclean v. Middleton*, 419 S.W.3d 755 (Ky. App. 2014).

October of 2007, the Middletons brought this action against PNC in its individual capacity as trustee. In their initial complaint and subsequent amended complaints, the Middletons asserted claims against PNC for breach of fiduciary duties arising from its improper delegation of investment management and failure to properly supervise investments. The Middletons also asserted that PNC's conduct while managing the Trust amounted to other violations of Kentucky law, PNC's internal policies, and the requirements of the Trust itself. The Middletons contend that PNC's actions caused losses to the Trust's investment portfolio during the period from July 2001 through October 2007.

Shortly after filing this action, the Middletons filed a motion for summary judgment on their claims. The trial court initially denied the summary judgment motion to allow completion of discovery. Following substantial discovery, the Middleton's renewed their motion for summary judgment, and PNC filed its own motion also seeking summary judgment.

The trial court entered an opinion and order on December 4, 2012, denying the Middletons' motion and granting PNC's motion. As an initial matter, the trial court found that the Middletons were estopped from challenging either the 1980 Agreement or the transfers of trust management to either Hilliard Lyons or Parthenon because Lawrence Middleton actively participated in the management of the Trust for Hilliard Lyons. Turning to the other claims, the court next concluded that there were genuine issues of material fact whether PNC's actions amounted to a breach of its fiduciary duties under the Trust and the 1980 Agreement.

However, the trial court determined that the Middletons could not prevail on these claims because they had failed to demonstrate any injury. Thus, the trial court concluded that, even if PNC had breached its duties to the Trust beneficiaries and remaindermen, the Middletons had failed to show that the Trust had suffered a loss which would entitle them to recover from PNC. The Middletons now appeal from this order.

"The proper function of summary judgment is to terminate litigation when, as a matter of law, it appears that it would be impossible for the respondent to produce evidence at the trial warranting a judgment in his favor." *Steelvest, Inc. v. Scansteel Service Center, Inc.*, 807 S.W.2d 476, 480 (Ky. 1991). Therefore, in reviewing the court's decision *de novo*, we will find summary judgment appropriate only "if the pleadings, depositions, answers to interrogatories, stipulations, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Kentucky Rules of Civil Procedure (CR) 56.03. In essence, for summary judgment to be proper, the movant must show that the adverse party cannot prevail under any circumstances. *Paintsville Hosp. Co. v. Rose*, 683 S.W.2d 255, 256 (Ky. 1985).

As noted above, the trial court found that there were genuine issues of material fact whether PNC's actions amounted to a breach of its fiduciary and other duties as Trustee.[2] The court granted summary judgment after finding that

[2] At oral argument, the Middletons requested that this Court find as a matter of law that PNC had breached its fiduciary duties as Trustee. Given the significant factual disputes underlying that

the Middletons failed to show any injury caused by PNC's action. The Middletons primarily argue that the trial court applied the wrong standard in making this determination.

The Middletons contend that the Trustee's actions should be evaluated in light of the recently-enacted Uniform Trust Code. KRS 386B.1-010 *et seq.* They focus on KRS 386B.11-040 (1)(a), which provides that Code "applies to all trusts created before, on, or after July 15, 2014," and subsection (1)(c), which provides that the Code applies to "judicial proceedings concerning trusts commenced before July 15, 2014…" However, this provision is qualified by subsection (1)(e), which specifies that "[a]n act done before July 15, 2014, is not affected by this chapter." Although these sections seem contradictory, we find that they can be reconciled in context. While the procedural provisions of the Uniform Trust Code apply to all trusts, the Code does not retroactively impose new standards for trustees' acts prior to the statute's effective date. Since all of the conduct at issue involved the Trustee's acts between 2001 and 2007, we conclude that any substantive provisions of the Code do not apply.

The Middletons primarily argue that the trial court failed to properly apply the standards set out in KRS 286.3-277 (the Uniform Prudent Investor Act) for a bank or trust company acting as fiduciary:

> (1) Notwithstanding the provisions of any other law, a bank empowered to act as a fiduciary or trust company, when investing, reinvesting, purchasing, acquiring,

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legal determination, such a finding would be beyond the scope of this Court's review on appeal.

exchanging, selling, and managing property held in a fiduciary capacity, shall act as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the fiduciary account.

(2) The standard described in subsection (1) of this section requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the account portfolio and as part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the account.

(3) In making and implementing investment decisions, the bank or trust company has a duty to diversify the investments of the account unless, under the circumstances, it is prudent not to do so.

(4) In addition, the bank or trust company shall:

(a) Conform to fundamental fiduciary duties of loyalty and impartiality;

(b) Act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents; and

(c) Incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the account.

(5) The duties of the bank or trust company under this section are subject to the rule that in investing the funds of the account, the bank or trust company:

(a) Has a duty to the beneficiaries of the account to conform to any applicable statutory provisions governing investment by fiduciaries; and

(b) Has the power expressly or impliedly granted by the terms of the account or applicable instrument and has a duty to the beneficiaries of the account to conform to the terms of the account directing or restricting investments by the bank or trust company.

The Middletons note that the trial court required them to present evidence showing that individual investments were improperly retained and lost value as a result of PNC's alleged negligence. They point to subsection (2), which

stipulates that a trustee's exercise of reasonable care cannot be judged only with respect to individual investments. Rather, they note that the proper standard under the Act requires the court to look to the soundness of the overall investment strategy and the performance of the entire portfolio.

Along similar lines, the Middletons point to § 205 of the *Restatement (Second) of Trusts* (1959), which provides that a trustee who commits a breach of the trust is chargable: (a) any loss or depreciation in value of the trust estate resulting from the breach of trust; or (b) any profit made by him through the breach of trust; or (c) any profit which would have accrued to the trust estate if there had been no breach of trust. The Middletons contend that subsection (c) is the most appropriate remedy, as it would place them in the position in which they would have been if PNC had performed its duties. *See also Wiggins v. PNC Bank, Kentucky, Inc.*, 988 S.W.2d 498, 502 (Ky. App. 1999).

As examples for applying this standard, the Middletons cite to *Dardaganis v. Grace Capital Inc.*, 889 F.2d 1237 (2nd Cir. 1989), and *Donovan v. Bierwirth*, 754 F.2d 1049 (2d Cir.1985). In both cases, the Second Circuit, applying the standard set out in § 205 of the Restatement, held that the "appropriate remedy in cases of breach of fiduciary duty is the restoration of the trust beneficiaries to the position they would have occupied but for the breach of trust." *Dardaganis*, 889 F.2d at 1243-44, *citing Donovan*, 754 F.2d at 1056. The court went on to hold that, where the alleged breach of fiduciary duty arises from a pattern of investment rather than from investment in a particular stock, it is

inappropriate to consider whether the trust lost money as a result of any specific investment decisions. Rather, the court "should presume that, but for the breach, the funds would have been invested in the most profitable of the alternatives and that the errant fiduciary bears the burden of proving that the fund would have earned less than this amount." *Id.* at 1244, *citing Donovan*, 754 F.2d at 1056.

We agree with the Middletons that the Prudent Investor Act requires the court to look to the overall soundness of the investment strategy rather than only the soundness of individual investment decisions. However, it is well-established that damages must always be proven with reasonable certainty. *Curry v. Bennett*, 301 S.W.3d 502, 506 (Ky. App. 2009), *citing Pauline's Chicken Villa, Inc. v. KFC Corp.*, 701 S.W.2d 399, 401–02 (Ky. 1985). Contingent, uncertain and speculative damages generally may not be recovered. *Id., citing Spencer v. Woods*, 282 S.W.2d 851, 852 (Ky. 1955). "But where it is reasonably certain that damage has resulted, mere uncertainty as to the amount does not preclude one's right of recovery or prevent a jury decision awarding damages." *Id*. In other words, "Kentucky law does not require [a plaintiff] to provide exact calculations of its damage—an estimation may suffice if it proves damages with 'reasonable certainty.'" *Gibson v. Kentucky Farm Bureau Mut. Ins. Co.*, 328 S.W.3d 195, 205 (Ky. App. 2010). *See also Boland–Maloney Lumber Co., Inc. v. Burnett*, 302 S.W.3d 680 (Ky. App. 2009).

The difficulty in this case arises in determining the sufficiency of the Middleton's proof of actual injury to the Trust. During the period from 2001 to

2007, the Trust principal grew from $68 million to $77 million. The Trust also generated income of nearly $12 million and paid disbursements totaling nearly $17 million. Over this same period, the earnings on the Trust investments outperformed the Standard & Poor's (S&P) 500, a stock-market index commonly used to measure the performance of investments. Since the value of the Trust grew significantly under Parthenon's management, the trial court concluded that that the Middletons had failed to show that the Trust had suffered an injury as a result of the alleged breaches of duty by PNC.

While the Middletons concede that the Trust appreciated in value between 2001 and 2007, they assert that a more prudent investment model would have generated far greater profit. Their expert on damages, Bruce McCrea, did not criticize any particular investment made by either Hilliard Lyons or Parthenon. Rather, he took the position that a reasonably prudent investor would have diversified the holdings in the portfolio more than Parthenon, and that a properly diversified portfolio would have appreciated more than the Trust actually did during this period.

In December 2011, McCrea provided his analysis of four different investment models which had been provided to him by the Middletons: the Vanguard Model; two PNC models; and the Northern Trust model. McCrea was of the opinion that any of the four models could have been applied to the Trust. However, it was his opinion that the Northern Trust model would have been the

most diversified, would have enhanced the annual returns and would have earned $17,271,977 more than was earned under Parthenon's investment strategy.

The trial court rejected McCrea's testimony for several reasons. Most notably, the trial court found that McCrea's preference for the Northern Trust model was improperly based upon hindsight from 2011, rather than what a prudent investor would have done from 2001 forward. The trial court concluded that such hindsight is not the appropriate test to determine the prudence of an investment strategy.

We agree. In the current case, unlike in *Dardaganis*, there is no allegation that the investment strategy violated the terms of an agreement. Similarly, unlike in *Donovan* and *Wiggins*, the Middletons do not contend that that PNC, as trustee, had a conflict of interest. Rather, the Middletons argue only that PNC failed to properly supervise Parthenon's management of the Trust and breached its general duties of prudential investment of the Trust assets.

In the absence of any allegations of specific misconduct by the Trustee, it is not appropriate to presume that the funds would have been invested in the most profitable of the alternatives. While financial advisors generally recommend a diversity of investment, the propriety of any particular diversification strategy is largely a matter of circumstances. *Security Trust Co. v. Appleton*, 303 Ky. 328, 197 S.W.2d 70, 73 (1946). A fiduciary cannot be an insurer of optimal performance. *Id.* at 77. The Prudent Investor Act essentially codifies this standard. KRS 286.3-277(3). Moreover, the propriety of a trustee's investment

strategy must be judged as it appeared at the time it was made and not when viewed in hindsight. *People's State Bank & Trust Co. v. Wade*, 269 Ky. 89, 106 S.W.2d 74, 76 (1937). *See also Estate of Pew*, 655 A.2d 521, 523-24 (Pa. Super. 1994).

For summary judgment purposes, we must assume that a reasonably prudent investor would have diversified the investment portfolio more than was done under Parthenon's management of the Trust.[3] Nevertheless, the Middletons do not point to any evidence of record to show that a reasonably prudent investor acting during the period at issue would have chosen the Northern Trust Model over the other available alternatives. McCrea himself admitted that any of the four hypothetical investment models would have been reasonable.

PNC also notes that the Trust's asset allocation remained the same under Parthenon as it was when it was managed by Hilliard Lyons. McCrea's investment model was based upon a complete and immediate transfer of the portfolio into the Northern Trust investments. PNC argues that such a radical change of investment strategy would not have been financially prudent. On the

[3] In his deposition, McCrea was asked to review the equity holdings of the Trust's portfolio in 2001, when Parthenon took over management, and in 2007, at the end of the damage period claimed by the Middletons. In 2001, the Trust portfolio held 13 equities. Deposition of Bruce McCrea, 1/25/2012, p. 93. While McCrea considered this to be insufficiently diversified, he did not blame Parthenon for inheriting a "bad portfolio." *Id.* at p. 161. In 2007, McCrea noted that Trust portfolio held 24 equities. *Id.* at 102. This number was "minimally" within the range which McCrea considered to sufficiently diversified. *Id.* at 102-03. Based on McCrea's own testimony, we question whether the Middletons presented sufficient evidence to show that the Trustee breached its duty to diversify the Trust investments.

other hand, a more gradual shift to the Northern Trust investment model would not have produced as much profit as McCrea predicted.

In addition, PNC points out that McCrea's hypothetical investment models are based only on the greatest return and not on the specific earnings and income objectives of the Trust beneficiaries. KRS 286.3-277 incorporates these objectives into the standard of care for prudential management of a trust. Finally, PNC asserts that McRea failed to take into account how capital gains taxes would have affected the returns if Parthenon had chosen to employ the Northern Trust model. When such tax liabilities are considered, PNC contends that the potential lost profits are illusory.

The Middletons respond that these variables relate only to determining the amount of lost profits rather than the fact of an actual injury to the Trust. We agree that there are disputed issues of fact concerning these variables. But even viewing these disputed issues in the light most favorable to the Middletons, their proof of an injury to the Trust does not rise beyond the level of speculation based upon hindsight. As noted by the trial court:

> While arguably the Trust would have performed better under another investment model, there is absolutely no information in the record that PNC knew or should have known as of 2001 to 2007 of particular models which would have performed better than the investment strategy used by Parthenon, and which it should have recommended to Parthenon or to the income beneficiaries. To arbitrarily choose a higher-performing model now, some eleven years after Parthenon became investment advisor, and award damages under that model, strikes this Court as the type of hindsight found

> impermissible by appellate courts. Under these circumstances, even if PNC breached its duties to the Plaintiffs, this Court cannot conclude that Plaintiffs have suffered a loss that entitles them to recover from PNC.

Although the trial court focused on whether individual investments were improperly retained, its reasoning is equally applicable to judge whether the Trust suffered an injury as a result of the overall investment strategy employed by PNC and Parthenon. We agree with the trial court that the potential lost profits claimed by the Middletons are speculative and lack any reasonable certainty to support a finding of an actual injury to the Trust. Therefore, the trial court properly granted summary judgment on this claim.

The Middletons also contend that that the trial court overlooked other damages which they suffered. While a trustee in breach of the trust may be liable for losses caused by his breach, a court may also deny a trustee in breach all compensation or allow him a reduced compensation or allow him full compensation. *Restatement (Second) of Trusts*, §243. As noted above, the trial court found factual issues concerning the extent duties which PNC owed under the Trust and the 1980 Agreement, and whether PNC complied with these duties. If these factual issues are resolved in their favor and PNC is found to be in breach of its fiduciary and statutory duties, the Middletons argue that they would be entitled to recover some or all of the Trustee fees paid to PNC and Parthenon during the time when PNC was in breach. Given these factual issues, the Middletons contend that summary judgment was not appropriate on this issue.

We note that that Middletons do not directly raise this issue in their primary brief. The Appellants' brief suggests that a surcharge against the trustee may be an appropriate remedy, but that brief does not address the nature of the remedy or why the trial court erred in rejecting the claim for such damages. These matters are only discussed at the end of their reply brief. The reply brief is not a device for raising new issues which are essential to the success of the appeal. *Catron v. Citizens Union Bank*, 229 S.W.3d 54, 59 (Ky. App. 2006), *citing Milby v. Mears*, 580 S.W.2d 724, 728 (Ky. App. 1979). Under the circumstances, we question whether the matter is properly presented for review.

Even if the issue is properly before this Court, we find no error. A surcharge of trustee fees is an equitable penalty imposed when a trustee fails to exercise the requisite standard of care and the trust suffers thereby. *In re Scheidmantel*, 868 A.2d 464, 493 (Pa. Super. 2005). *See also Gabriel v. Alaska Elec. Pension Fund*, 755 F.3d 647, 658 (9th Cir. 2014). A trustee cannot be surcharged for a breach of the relevant duty of care unless the breach caused an actual loss to the trust. *Scheidmantel,* 868 A.2d at 493*, citing Estate of Pew*, 655 A.2d at 543. *See also Cigna Corp. v. Amara*, 131 S.Ct. 1866, 1881 (2011), *citing* 4 *Scott and Ascher on Trusts* § 24.9, p. 1693 (5th ed. 2007). In the absence of an actual injury to the trust, we agree with the trial court that the Middletons are not entitled to a surcharge of trustee fees. Consequently, the trial court properly granted summary judgment on this issue as well.

Finally, although the issue is not raised on appeal, we question whether the Middletons have standing to assert these claims. In general, in order to support an action, a party must have a real, direct, present and substantial right in the subject matter of the controversy. *Williams v. Phelps*, 961 S.W.2d 40, 41 (Ky. App. 1998), and *Winn v. First Bank of Irvington*, 581 S.W.2d 21, 23 (Ky. App. 1978). As noted above, the Middletons waived any right to receive additional distributions from the Trust as remainder beneficiaries in exchange for a lump-sum payment in the settlement of the prior litigation. Although they reserved their right to assert claims against PNC as Trustee, any damages would only be recoverable by the Trust.

In a summary judgment order entered on August 29, 2009, the trial court acknowledged that the Middletons have no interest in the recovery of any damages as present beneficiaries of the Trust. However, the court suggested that the Middletons may be able to prove that their settlement payment was directly related to the overall value of the Trust, and that the settlement amount would have been greater but for the alleged breach of fiduciary duty by PNC. The court also held that the Middletons have standing to assert a claim for surcharge against the Trustee for actions up to the time they entered into the settlement.

Since the trial court ultimately concluded that the Middletons failed to show any injury to the Trust, the court implicitly determined that the standing question was moot. While we can appreciate the reasons for this approach, we are not convinced that the Middletons have shown any cognizable interest in the

outcome of these claims. There is no indication in the record that the amount of the 2007 settlement was based upon the total value of the Trust.[4] Furthermore, any surcharge against the Trustee would have accrued to the benefit of the Trust, and only indirectly to the income and remainder beneficiaries. Under the circumstances, we believe that, most likely, the Middletons lacked standing to assert these claims.

Accordingly, the summary judgment granted by the Jefferson Circuit Court is affirmed.

ALL CONCUR.

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ORAL ARGUMENT FOR APPELLANTS:

Charles G. Middleton

ORAL ARGUMENT FOR APPELLEES:

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[4] To the contrary, Charles Middleton admitted in a deposition that the settlement amount was not based directly on the value of the Trust, but was an agreed number intended as a compromise of the Middleton's potential future interests as remainder beneficiaries. Deposition of Charles G. Middleton, 9/22/2011, pp 320-26.