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Subject: **Trustee and Non-Fiduciary Family Member Found Liable for Breach of Fiduciary Duty in Making Loan From Life Insurance Trust**

Major References: ***Paradee v. Paradee, Del. Ch. NO. CIV.A. 4988-VCL; WL 3959604 (Oct. 5, 2010)***

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SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS *WASHINGTON REPORT*.

In Paradee v. Paradee, Del. Ch. NO. CIV.A. 4988-VCL; WL 3959604 (Oct. 5, 2010), a Delaware Chancery Court found the trustee of a second-to-die life insurance trust and a non-fiduciary family member liable to the beneficiary of the trust for participating in the making of a loan from the trust to the family member without considering whether the loan was a good investment for the trust and its beneficiaries. The trustee was apparently more interested in pleasing the grantors of the trust, with whom he had a pre-existing business relationship, than in his duty of loyalty to the beneficiaries. This case provides an object lesson on how not to choose a trustee, and how the intentions of a trust's grantor may be frustrated by the wrong choice.

William Charles Paradee, Sr. ("Charles Sr."), and his first wife had two children: W. Charles Paradee, Jr. ("Charles Jr.") and Eleanor Lee Cain. W. Charles Paradee, III ("Trey"), was the son of Charles Jr. - *i.e.*, Charles Sr.'s grandson. Approximately a year after Charles Sr.'s first wife died, Charles Sr. married Eleanor Clement Paradee ("Eleanor"), who was 17 years his junior. Charles Jr. "reacted vehemently." He reportedly "resented the relatively rapid remarriage, chafed at the age differential, and bridled at Eleanor's strong personality." After Charles Jr. presented Eleanor with a post-nuptial agreement, which she refused to sign, "their relationship fractured, bitterness ensued, and they came to dislike each other intensely."

The conflict between Charles Jr. and Eleanor caused such a rift between Charles Jr. and his father, that they ultimately parted ways, with Charles Jr. receiving a relatively small portion of the operations of Paradee Oil Company (the family business) to operate as a separate company (Paradee Gas Company).

Despite the estrangement of father and son, Charles Sr. and grandson Trey remained close. On December 28, 1989, Charles Sr. created the W. Charles Paradee, Sr. Irrevocable [Life Insurance] Trust (the "Trust") for the benefit of Trey. Eugene N. Sterling ("Sterling"), a life insurance agent, was appointed initial trustee of the Trust. Sterling "generated significant business from Paradee Oil Company. He handled the company's retirement plan, brokered its health insurance plan, and sold life insurance to numerous employees. Charles Sr. and Eleanor were longtime clients." The implication was that Sterling had a great deal to lose from angering Charles Sr. and Eleanor.

The Trust was funded with contributions in the amount of $183,019 from Charles Sr. and $183,000 from Eleanor. Sterling used the funds to purchase a single-premium second-to-die insurance policy on the lives of Charles Sr. and Eleanor from Manufacturers Life Insurance Company (the "Policy"). If the Policy performed as expected, no additional premiums would be required, and the Policy eventually was expected to be self-sustaining. The undisputed intent of the Trust, according to the Court, was to provide insurance proceeds to Trey.

Trey, who was a minor when the Trust was formed, had no knowledge of the Trust or of the Policy. Under the terms of the Trust, Trey had the power to remove the existing Trustee and appoint himself as Trustee once he turned thirty. "But 1999 would come and go without Trey ever learning about the Trust's existence." Trey eventually was notified about the Trust in 2009, when he was forty years old.

Three years after creating the Trust, by letter dated July 30, 1993, the Paradees instructed Sterling to revoke it and deliver the cash value back to Charles Sr. and Eleanor. The Court found that, "[a]lthough the letter was signed by both Charles Sr. and Eleanor, . . . Eleanor was the driving force behind it." By 1991, Charles Sr. had begun to slip mentally, and the family's financial affairs were increasingly under Eleanor's control. Eleanor said that she wanted the cash value to pay an outstanding tax bill of approximately $155,000 relating to Paradee Oil. The Court, however, determined that the Paradees had more than sufficient assets at this time to pay the tax bill without looting the Trust.

Sterling consulted the attorney who drafted the Trust, Joanna Reiver, Esq. ("Reiver"), who advised Eleanor that "irrevocable" meant "irrevocable," and that the Paradees could not access the Policy's cash value by revoking the Trust. Although Eleanor was stymied in this attempt to terminate the Trust, she nevertheless made several other attempts to do so in the succeeding years.

Reiver and Eleanor then talked about whether the Trust nevertheless could loan money to the Paradees. Reiver discussed the idea with Sterling (the Trustee), who advised that there was no reason not to loan out a portion of the Policy's cash value. He concluded that a secured loan of up to $200,000 at 8% was allowable and sustainable, although "I want to point out that the interest, if unpaid, could cause the policy to lapse."

The loan that eventually was funded by means of a $150,000 loan on the Policy from Manufacturers Life Insurance Company (the "Policy Loan") to fund the Trust's loan to the Paradees (the "Trust Loan"). The Policy Loan charged compound interest at a floating rate set in the first year at 8.75%, subject to change on an annual basis.

The Trust Loan was executed on November 18, 1993 by Charles Sr. on behalf of Silver Corporation (the new name of Paradee Oil). The loan was unsecured and bore interest at a fixed, as opposed to the Policy Loan's floating rate. The Policy Loan charged 8.75% interest in the first year. The Trust Loan charged 8%. Sterling made no effort actually to collect the interest.

In February 1998, Eleanor told Sterling that the Paradees could not pay the interest on the Trust Loan. She said they wanted the Policy surrendered for its then-cash value of $155,000 and the proceeds used to make a different investment. Sterling, who was clearly conflicted about his dual roles *vis a vis* the Paradee family, consulted his attorney, who advised him that he risked personal liability if he agreed to Eleanor's latest request. The Paradees, to whom this communication was forwarded, then paid the interest on the loan.

On July 1, 1998, Charles Sr. passed away. Under the terms of the Trust Loan, the Trust had the right to recover the principal and interest due at any time after the earlier of the death of Charles Sr. or Eleanor. Sterling made no effort to collect.

On July 18, 1999, Trey turned 30, the age at which he became entitled to serve as trustee. Sterling did not notify Trey of his rights under the Trust.

On September 24, 1999, Manufacturers Life Insurance Company demutualized, and eligible policyholders, including the Trust, were entitled to receive either cash or Manulife shares. Because the Policy Loan reduced the cash value of the policy on which the share calculation was based, the Trust received fewer shares than it otherwise would have.

Following a serious confrontation with Trey, Eleanor asked Reiver to contact Sterling to find out the current face value of the Policy, whether it was paid up, and whether there was "[a]nything we can do about it." Reiver consulted with Sterling who advised him that the policy would lapse if the interest on the Trust Loan was not paid.

On April 2, 2003, Sterling died. Reiver advised Eleanor of the fact that Trey could serve as his own Trustee now that he was over 30 years old. On April 23, 2003, Eleanor nevertheless appointed herself Trustee. Also in 2003, for the first time, Silver Corporation - now owned by the W. Charles Paradee Charitable Remainder Annuity Trust, of which Eleanor was the trustee - failed to pay the interest due on the Trust Loan. No further payments were made thereafter. Unpaid interest began to be capitalized and added to the outstanding loan balance. In 2005, with a total outstanding loan balance of $185,203.94, the Policy, which originally had a death benefit in excess of $1 million, lapsed.

Reiver advised Eleanor on numerous occasions that she had a duty to notify Trey about the Trust, was obligated under the Trust to pay income to Trey, and should use Trust assets to maintain the Policy. Eleanor did none of these things. She instead discussed with Reiver and another advisor how to collapse the Policy and access its cash value.

The Court concluded that "Eleanor consciously, intentionally, and vengefully refused to take any action to protect or preserve the Policy because she did not want Trey to benefit [after her death]."

On July 7, 2005, after the Policy lapsed, Eleanor resigned and appointed her handyman, "Smith" as the Trustee. Smith was not financially sophisticated and did not understand his duties as Trustee. However, in 2007, Smith came to understand Trey's interest in the Trust and told Reiver that he wanted "to do what is right." It took Reiver another two years to notify Trey of his rights because, speculated the Court, "she knew litigation would result and was not in a hurry to set it in motion."

In August 2009, after finally receiving a letter from Reiver, Trey promptly exercised his right to become Trustee and demanded that the Trust Loan be paid. On September 30, 2009, Silver Corporation paid the Trust $340,389.04, comprising $150,000 in principal and $190,398.04 in interest.

A court of Chancery in Delaware has broad powers to order an equitable remedy for a breach of trust. Eleanor, although not technically a trustee of the Trust during most of its existence, "aided and abetted Sterling in breaching his fiduciary duties by making the Trust Loan." To prove aiding and abetting, Trey had to (and did) demonstrate: (1) the existence of a fiduciary relationship; (2) that the fiduciary breached his duty; (3) that the non-fiduciary defendant knowingly participated in the breach; and (4) damages resulting from the concerted action of the fiduciary and the non-fiduciary.

Sterling, the actual fiduciary, breached his duty of loyalty when deciding to loan money from the Trust to the Paradees. "Instead of evaluating what was in the best interests of the Trust, he evaluated whether he could please his long-time clients, the Paradees." If Sterling had considered what was best for the Trust, he would have refused the Paradees' request.

The fact that the Trust indenture specifically authorized Sterling to make loans from the Trust (albeit with adequate interest and security), "does not answer the separate question of whether he breached his fiduciary duties by doing so." Under Delaware Law, "inequitable action does not become permissible simply because it is legally possible." Sterling's consultation with legal counsel did not insulate him from liability, particularly since he did not follow it.

Since Eleanor knowingly participated in Sterling's breach, she was deemed to be equally culpable. Eleanor also breached her own duty of loyalty upon becoming Trustee when she did not inform Trey about the Trust or his rights thereunder.

The Court also found that Smith breached his obligations as Trustee by failing to notify Trey about the Trust, by not making distributions of Trust income to Trey, and by not managing the Trust corpus and instead treating it as simply another of Eleanor's accounts. "Although Smith's advisors bear primary responsibility for his failings, a limited remedy against Smith is warranted."

The Trust's Damages.

To remedy all of these breaches, the Court awarded damages to the Trust, as follows:

1. The value of the Policy's death benefit ($1,150,700), for which Eleanor alone was determined to be liable.

2. Losses relating to the incremental shares of ManuLife stock that the Trust should have received in the demutualization and stock split, for which Eleanor alone was also determined to be liable.

3. Losses attributable to the failure to sell the Manulife shares at their optimum value. ". . . Although it would be improbable (bordering on impossible) for the Trust to have sold precisely at the top of the market, the faithless fiduciary must bear that risk, not the innocent beneficiary."

From these awards, the Court deducted the value of assets currently held by the Trust that it would not hold if the Trust Loan was never made and the Policy remained in force. These included: (i) the cash currently held by the Trust as a result of dividends received over the years on the Manulife stock, (ii) the $340,389.04 paid to the Trust in September 30, 2009, and (iii) any interest the Trust has received on those amounts, all calculated as of September 30, 2010.

4. The Court also noted that, in allowing the Policy to lapse, the defendants caused the Trust to lose the favorable income tax treatment that is accorded to death benefits under § 101 of the Internal Revenue Code. Eleanor therefore was required to pay an additional amount equal to the income tax, if any, on the portion of the damages award attributed to the lost Policy Value.

Trey's Damages.

The Court ordered that Trey, individually, in his capacity as income beneficiary of the Trust, should receive the value of the dividends paid on the Manulife shares prior to October 31, 2007. A portion of this liability for Trey's lost income was ordered to be allocated between Eleanor and Smith, with the remainder allocated to Eleanor alone.

Attorney's Fees.

In an unusual departure from the "American Rule," the Court also ordered the payment by Eleanor of Trey's and the Trust's attorneys' fees. Attorney's fees are rarely awarded for breaches of fiduciary duty, but, in this case, Eleanor's pre-litigation actions were "so egregious" as to justify the award. Smith's conduct, however, did not rise to that level, and so the fee award was imposed only against Eleanor.

* * * * *

It is notable that most of the circumstances surrounding this case, not to mention the subsequent litigation, could have been avoided (i) had Trey's grandfather, Charles Sr., chosen a more truly independent trustee, such as a bank, to administer the Trust for the benefit of his grandchild, or (ii) had Sterling (the not so independent trustee) chosen to act as an independent trustee would have acted. In effect, the office of trustee (including such office in connection with a life insurance trust) is not an empty one; it carries within its parameters a serious potential liability, the existence of which can be disregarded by the trustee only at his peril.

Any AALU member who wishes to obtain a copy of ***Paradee v. Paradee*** may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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