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**OUTLINE OF STATE LAW ISSUES REGARDING
CHALLENGES TO DISPOSITION OF OWNERSHIP INTERESTS IN
FAMILY BUSINESS ENTITIES**

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I. Introduction

Family business entities present a host of legal issues, whether the “business” involves tree farming (Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003)) or the management of an elderly individual’s assets (Strangi v. Commissioner, 417 F.3d 468 (5th Cir. 2005)). A recent line of Tax Court decisions (and related appeals) reveals a heightened level of IRS scrutiny of transactions involving the creation of family business entities. In an era when such entities (and the potential tax advantages associated with them) are coming under attack, we may encounter an increasing tension among family members as to the ownership and control of the underlying assets, since in many instances, as in Strangi, the business entity controls much of the family wealth.

This article will explore the various legal issues that might be invoked if a family member seeks to dispute the disposition of interests in a family business entity. This article cites primarily to New Jersey law, but those citations are intended to illustrate the concepts that have been adopted in many jurisdictions, even if the substantive law varies.

In many instances, a family business dispute might involve a small operating business entity that has grown substantially beyond that which was anticipated at the time of creation. In other instances, however, the dispute may involve facts such as those presented in Strangi, where the elderly decedent (or his son-in-law agent) transferred virtually all of his assets to a business entity based

on (at least according to the IRS) his desire to reduce the value of the assets for transfer tax purposes.

The management, operations and disposition of interests in such an entity may be the subject of a dispute involving state corporation, limited liability company and partnership law issues. See, e.g., Strassenburgh v. Straubmuller, 146 N.J. 527 (1996) (applying New Jersey Business Corporation Act dissenting shareholder provisions and other legal doctrines in context of a dispute among family shareholders in a 110 year-old family owned business that had evolved from a one-man glass works to a multinational corporation).

It is also possible that one or more disappointed parties might invoke other legal doctrines to invalidate the creation of the entity. See, e.g., Pascale v. Pascale, 113 N.J. 20 (1988) (business owner who transferred his interests in a family business to his son asserted claim to recover those assets, asserting that the transfer was the product of son's undue influence). Similarly, disputes may arise involving the manner in which an estate is administered where the decedent owned interests in closely held business entities.

While much ink has been devoted to the problems that have been encountered in recent years in defending the valuation of family business entities for transfer tax purposes, it is important to remember that a disappointed family member might invoke other legal doctrines to challenge the very creation of the entity. One need only briefly consider the facts of cases such as Strangi to

recognize that a disappointed family member often can identify several causes of action based on theories such as undue influence, lack of capacity, improvident transfer of assets or a breach of fiduciary duty. In Strangi, for example, the elderly decedent's son-in-law became aware that decedent's stepchildren might challenge the disposition of decedent's assets. The son-in-law then orchestrated the transfer of virtually all of the decedent's assets to a prepackaged family partnership entity. All of this was done at a time when the decedent suffered from multiple medical issues; he died shortly after the transfers occurred. While Strangi focused on transfer tax issues associated with those events (such as whether decedent retained an interest in the assets he allegedly transferred), the same facts might have been cited by other family members (such as the stepchildren) to support a challenge to the transaction.

Lawyers who are involved in creation of such entities often act as "family counsel," representing various family members when such planning is implemented. That form of joint representation may involve ethical issues requiring conflict waivers and the like. See e.g., ACTEC Commentaries on the Model Rules of Professional Conduct, Comment on MRPC 1.7 (3rd Ed. 1999). In any event, if one or more family members becomes dissatisfied with a family business transaction, they may later seek to set aside the arrangement, in which event (as demonstrated in Pascale) the role of the drafting lawyer may come under

scrutiny (and his testimony and actions may be important factor in determining whether the transaction should be invalidated).

II. Capacity Issues (Testamentary vs. Contractual); Freedom of Disposition

In a dispute involving the disposition of assets by will, a court may be called upon to determine whether the testator possessed the required testamentary capacity. A person is free to dispose of his property as he deems appropriate, whether by will, deed, gift or trust. See Alper v. Alper, 2 N.J. 105, 114-115 (1949); Casternovia v. Casternovia, 82 N.J. Super 251, 257 (App. Div. 1964) (“It is well settled in this State that every citizen of full age and sound mind has that right to make such disposition of property by will or by deed as he or she in the exercise of individual judgment may deem fit.”).

Each state has its own standard for testamentary capacity. See In re Will of Landsman, 319 N.J. Super. 252, 267 (App. Div. 1999), certif. denied, 162 N.J. 127 (1999) (“Testamentary capacity exists where the testator can comprehend the property he is about to dispose of, the natural objects of his bounty, the meaning of the business in which he is engaged, the relation of those factors to the others, and the distribution that is made by the will.”); Gellert v. Livingston, 5 N.J. 65 (1950) . It often said that the level of capacity required to make a will is lower than that required in other transactions, such as a contract. See, e.g., In re Halton’s Estate, 111 N.J. Eq. 143, 148 (N.J. Prerog 1932) (testator “may not have

sufficient strength of memory and vigor of intellect, to make, and to digest all parts of a contract, and yet he may be competent to direct the distribution of his property by will"); accord In re Coddington's Will, 281 A.D. 143, 146 (N.Y. A.D. 3rd Dept. 1952). Thus, when the matter involves an elderly and infirm person, it is possible that a dispute involving the creation of a business entity by that person could focus on the capacity to make a contract, as opposed to the capacity to make a will, with the result being that even if a disposition by will might have been declared valid, the contractual arrangements might be invalidated because of the higher capacity standard.

These disputes often involve disgruntled family members, such as those with whom the testator did not enjoy a relationship. Most American jurisdictions permit the disinheritance of one or all family members. "[A] will cannot be set aside merely because it is 'unequal or unjust.' If capacity, formal execution, and volition appear, the will of the most impious man must stand, unless there is something, not in the motives which led to the disposition, but in the actual disposition, against good morals or against public policy." In re Blake's Will, 21 N.J. 50, 57 (1956); Matter of Will of Liebl, 260 N.J. Super. 519 (App. Div. 1992).

The disposition of family business interests may be subject to other limitations, however, such as the rights of a spouse. Ordinarily, a person may dispose of his property as he desires, subject to certain limited exceptions, such as

an elective share law. N.J.S.A. 3B:8-1 et. seq. A person can not entirely exclude his surviving spouse, except to the extent permitted by the elective share law or community property law (where applicable).

III. Undue Influence

Any disposition (will, trust or gift) may be invalidated if it is the product of, or tainted by, “undue influence.” Gellert, 5 N.J. at 71; In re Blake’s Will, 21 N.J. at 55, 56; In re Dodge, 50 N.J. 192 (1967); Haynes v. First National State Bank, 87 N.J. 163, 176 (1981); Pascale, 113 N.J. at 20.

“Undue Influence” is defined by case law. One New Jersey Court said, in broadest terms:

"Undue influence" has been defined as “mental, moral or physical exertion” which has destroyed the "free agency of the testator" by preventing the testator "from following the dictates of his own mind and will and by accepting instead the domination and influence of another.” [Haynes, 87 N.J. at 176 (quoting In re Neuman, 133 N.J. Eq. 532, 534 (E. & A. 1943)).]

“[T]o constitute undue influence, there must be a disruption of the freedom of will and of judgment of the testator.” Pascale, 113 N.J. at 30 (quoting In re Hale’s Will, 21 N.J. 284, 288 (1956)). Courts have observed that not all influence constitutes undue influence. Spouses, children, relatives, friends, business associates and others influence the disposition of property on a daily basis. Those who are considering the disposition of property often consult with

the potential recipients of the property as well as other advisors. In Gellert, the New Jersey Supreme Court said:

Not all influence is “undue” influence. Persuasion or suggestions or the possession of influence and the opportunity to exert it, will not suffice. It must be such as to destroy the testator’s free agency and to constrain him to what he would not otherwise have done in the disposition of his worldly assets. The coercion or domination exercised to influence the testator may be moral, physical, or mental, or all three, but the coercion exerted upon the testator’s mind must be of a degree sufficient to turn the testator from disposing of his property according to his own desires by the substitution of the will of another which he is unable to resist or overcome. Each case of this nature must be governed by the particular facts and circumstances attending the execution of the will and the conduct of the parties who participated in order to determine if the coercion exerted was “undue.” [Gellert, 5 N.J. at 73 (citations omitted)].

As a general rule, unless a presumption of undue influence arises, the person asserting an undue influence claim bears the burden of proving undue influence. “The burden of proving undue influence is upon the person asserting it and it must be clearly established.” Gellert, 5 N.J. at 71; see Haynes; Pascale. In most cases, the person exerting undue influence does so in a subtle or secretive manner, often over an extended time period, such that it would be very difficult to prove the actual exertion of influence. “As undue influence is usually covert, it seldom can be established by direct testimony and the contestant to make out his prima facie case usually must resort to a presumption or to circumstantial testimony.” 5 N.J. Practice (Clapp, Wills & Administration) § 62 (Rev. 3rd ed. 1982).

Given the difficult proof issues, some jurisdictions impose mechanisms (presumptions or inferences) that require the party alleged to have committed the influence to prove that he did not exert such influence. Many cases address this issue in the testamentary context (such as Haynes, Gellert, and In re Hopper, 9 N.J. 280 (1952)). Other cases involve inter vivos dispositions (Dodge and Pascale). Pascale involves a family business transaction.

Since it may be easier to establish a presumption of undue influence in the context of an inter vivos transaction, it may be useful to review first the standard for challenging testamentary disposition. In Haynes, for example, the Supreme Court described the presumption of undue influence in a will contest:

[T]he burden of proving undue influence lies upon the contestant unless the will benefits one who stood in a confidential relationship to the testatrix and there are additional circumstances of a suspicious character present which require explanation. In such case the law raises a presumption of undue influence and the burden of proof is shifted to the proponent.

* * *

The first element necessary to raise a presumption of undue influence, a "confidential relationship" between testator and a beneficiary, arises "where trust is reposed by reason of the testator's weakness or dependence or where the parties occupied relations in which reliance is naturally inspired or in fact exists...."

* * *

The second element necessary to create the presumption of undue influence is the presence of suspicious circumstances which, in combination with such a confidential relationship, will shift the burden of proof to the proponent. Such circumstances need be no more than "slight."

* * *

In this jurisdiction, once a presumption of undue influence has been established the burden of proof shifts to the proponent of the will, who must, under normal circumstances, overcome that presumption by a preponderance of the evidence. [Haynes, 87 N.J. at 176-178.]

By comparison, in cases such as Dodge and Pascale, the Supreme Court summarized the requirements for challenging an inter vivos transaction. The Pascale court said:

In respect of an inter vivos gift, a presumption of undue influence arises when the contestant proves that the donee dominated the will of the donor or when a confidential relationship exists between donor and donee. [Pascale, 113 N.J. at 30.]

The Dodge court further stated:

[W]henver it appears that the relations between the parties to an inter vivos gift are of such character that in reasonable probability they do not deal with each other on terms of equality because one has given friendship and justifiably reposes confidence in the other, that on the donee's side superior knowledge exists as to the nature of the transaction proposed by him, as well as the detriment to be suffered by the donor if he engages in it, and the donee fails to see to it that the donor thoroughly understands its nature and consequences, equity should regard it as voidable at the instance of the

donor or his representatives. [Dodge, 50 N.J. at 228.]

The Pascale court noted that with respect to a will, the contestant must prove both a confidential relationship and suspicious circumstances to establish a presumption, while only the former element is required to establish the presumption in the inter vivos context. Thus, it may be easier to attack an inter vivos transfer (such as a gift of interests in a family business entity) as opposed to a testamentary disposition.

Many cases turn on whether undue influence has been exerted by one who occupies a confidential relationship with the testator or grantor. See e.g., Pascale, Haynes, and Dodge. To understand the types of relationships that the courts have deemed "confidential relationships," it may be helpful to focus on the reason for imposing a presumption in that context:

[T]he purpose [of the confidential relationship presumption] is not so much to afford protection to the donor against the consequences of undue influence exercised over him by the donee, as it is to afford him protection against the consequences of voluntary action on his part, induced by the existence of the relationship between them, the effect of which upon his own interests he may only partially understand or appreciate. [Dodge, 50 N.J. at 228.]

In evaluating whether a "confidential relationship" exists, courts have examined many factors, including the family, social or business relationship

between the testator or grantor and the party who allegedly exerted undue influence. As the Pascale court observed:

The nature of a confidential relationship is difficult to define, but encompasses all relationships "whether legal, natural or conventional in their origin, in which confidence naturally inspired, or, in fact, reasonably exists." *** [A] confidential relationship "includes not only all cases of technical, legal, fiduciary relationship, such as guardian and ward, principal and agent, trustee and *cestui que* trust, but also all cases where trust and confidence actually exist. It comprehends *** all cases where 'the relations between the [contracting] parties appear to be of such a character as to render it certain that they do not deal on terms of equality, but that either on the one side from superior knowledge of the matter derived from a fiduciary relation, or from over-mastering influence; or on the other from weakness, dependence or trust justifiably reposed, unfair advantage is rendered probable.'"

Among the most natural of confidential relationships is that of parent and child. [Pascale, 113 N.J. at 34 (citations omitted).]

A number of cases define the burden of proof the proponent of a will must meet once the burden has been shifted as a result of a presumption of undue influence. In Haynes, the Supreme Court described this burden as follows:

In the case of a presumption of undue influence, apparently because the presumption is fortified by policy, the proponent must, according to the language of the cases, prove, to the satisfaction of the trier of fact, that there was no undue influence. In connection with this presumption, unlike other presumptions, the courts do not speak as to the

burden of going forward with the evidence. However, we conclude, the moment this presumption is erected, both the burden of proof...and the burden of going forward with proof, shift to the proponent and are identical and coincident. To meet each of these assignments, the proponent must establish by the same quantum of proof that is, by a preponderance of the proof that there is not undue influence. [Haynes, 87 N.J. at 178 (quoting In re Week's Estate).]

The Haynes court recognized that certain situations might call for "a stronger presumption of undue influence and a commensurately heavier burden of proof to rebut the presumption." 87 N.J. at 178. For example, the Haynes court required the proponent of a will to rebut the presumption by clear and convincing evidence where the will had been drawn by an attorney who also acted as the attorney for a primary beneficiary of the will. This is an important distinction that may be relevant in family business transactions, where the family attorney is often called upon to represent several family members.

A presumption of undue influence may be rebutted in a case involving an inter vivos transaction, as the Pascale court observed:

When the presumption of undue influence arises from an inter vivos gift, the donee has the burden of showing by clear and convincing evidence not only that "no deception was practiced therein, no undue influence used, and that all was fair, open and voluntary, but that it was well understood." If the donor is dependent on and makes an "improvident gift" to the donee that strips the donor of all or virtually all his assets, a presumption arises that the donor did not understand the consequences of his

act. In this context, the donee must show that the donor "had the benefit of competent and disinterested counsel." A similar rule applies when a physically or mentally weakened donor, without receiving any advice, makes a gift to a donee on whom the donor depends. If that gift leaves the donor without adequate means of support, the presumption of undue influence is conclusive. When the donor is not dependent on the donee, however, "independent advice is not a prerequisite to the validity of an improvident gift even though the relationship between the parties is one of trust and confidence." [*Pascale*, 113 N.J. at 31 (citations omitted).]

It is important to note that the quoted language also describes what has been called an "improvident transfer," where the donor strips himself of all of his assets, essentially leaving himself (at least on paper) without a means of support. In that context, the New Jersey courts have indicated that the presumption of undue influence may be "conclusive." See *Seylaz v. Bennett*, 5 N.J. 168 (1950). That type of analysis would be relevant in matters involving facts such as those in *Strangi* (or similar 2036 cases), because there it was alleged that the decedent had transferred virtually all of his assets to a business entity. As a matter of state law, such a transfer, leaving the decedent with few or no assets, might be subject to challenge as an improvident transfer.

Other jurisdictions have concluded that an undue influence claim involving a trust or similar *inter vivos* disposition should be evaluated under the same standards that apply in the will context. See, e.g. *Hagen v. Hickenbottom*,

41 Cal. App. 4th 168, 182, 48 Cal. Rptr. 197, 205 (Ct. App. 1995) (undue influence principles relating to a will "are manifestly as applicable to an estate plan formalized by simultaneously executed inter vivos trust and pour-over will as to a will alone."); Crump v. Moss, 517 So.2d 609, 612 (Ala. 1987) ("Proving undue influence in the procurement and execution of a trust requires essentially the same evidence as is required to invalidate a will."); Sun Bank/Miami N.A. v. Hogarth, 536 So.2d 263, 268 (Fla. App. 1988) (in determining whether probate court had jurisdiction over an inter vivos trust, court held that the probate court did have jurisdiction where the will and trust agreement "must be read together to give effect to [the] testamentary plan."). Other courts evaluating trust undue influence claims have merely recited undue influence standards without addressing whether the same standards would apply in the will context. See Matter of McKittrick Trust, 865 P.2d 1099 (Mont. 1993); Creek v. Union Nat. Bank, 266 S.W.2d 737 (Mo. 1954); see Scott on Trusts, § 333 (rescission of trusts); Bogert, Trusts and Trustees, § 44 (Rev. 2nd Ed. 1984). It seems clear that undue influence principles can be invoked in most jurisdictions to support a claim to recover assets transferred by a decedent to a family business entity.

IV. Breach of Fiduciary Duty Issues

In some instances, a family business transaction is implemented by a person having a fiduciary relationship to the donor/transferor. For example, if the son-in-law in Strangi employed a power of attorney to establish the business

entities, his actions would be evaluated by a breach of fiduciary duty standard. Similar concerns may be implicated where a fiduciary of an estate or trust controls the right to operate or manage family business assets.

A fiduciary must “exercise that degree of care, prudence, circumspection and foresight that an ordinary prudent person would employ in like matters of his own.” In re Accounting of Koretzky, 8 N.J. 506, 524 (1951). Additionally, “[t]he most fundamental duty owed by the trustee to the beneficiaries of a trust is the duty of loyalty and he is not permitted to place himself in a position where it would be for his own benefit to violate that duty.” Koretzky, 8 N.J. at 528.

Many of these principles have been summarized in the following edict: “Many forms of conduct permissible in a workday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of the courts of equity when petitioned to under-mine the rule of undivided loyalty by the disintegrating erosion of particular exceptions.” In re Estate of Carter (Bankers Trust Co. v. Bacot), 6 N.J. 426, 437 (1951).

An agent acting under a power of attorney, of course, owes such fiduciary duties to his principal, such that the agent’s actions may be voided if they are

contrary to the interests of the principal. That means the principal (or those acting on his behalf, such as those who have interests in his estate, can challenge transactions made by the agent (such as the creation of a family business entities that results in the transfer of assets to family members), since such a transaction might not be “solely” for the principal’s benefit. D’Amato v. D’Amato, 305 N.J. Super. 109, 115 (App. Div. 1997). As a result, a court may impose upon the agent the affirmative burden of proving that a disputed transaction was solely for the principal’s benefit. Id. That type of dispute would probably focus on whether the agent’s actions were consistent with the principal’s directions (in the power of attorney or perhaps as communicated to the agent). Lewis v. Travelers Ins. Co., Inc. 51 N.J. 244, 251 (1968). Ultimately, however, the agent’s actions would be judged by the fiduciary duty standards summarized above. Campagna v. U.S., 474 F. Supp. 573, 585 (D.N.J. 1979).

Thus, if the creation of a family business entity is implemented by one having a fiduciary relationship to the principal, and the fiduciary will benefit from the transaction (by receiving ownership interests, compensation or other benefits), the fiduciary’s actions are subject to judicial scrutiny.

V. Time Requirements for Challenging a Disposition

Probate rules typically identify the mechanism and time requirements for challenging a will (see, e.g., Rule 4:85 of the Rules Governing the Courts of the State of New Jersey), but those rules often do not establish specific time periods

for challenging family business transactions. Inasmuch as probate proceedings involve primarily equitable claims, the doctrine of laches probably would determine whether a challenge is untimely. The laches time period might be measured by reference to an analogous statute of limitations, but laches can bar a claim even though the analogous statute of limitation has not run. See Lavin v. Hackensack, 90 N.J. 145, 151-153, 1982). In other instances, the fiduciary of an estate may be called upon to recover assets that were transferred or a beneficiary may claim (in an accounting proceeding) that the fiduciary should have recovered such assets; each of these options may be considered, depending on the facts available. It is possible that the fiduciary's would be required to pursue claims to recover assets transferred on an inter vivos basis, if the fiduciary believed grounds for a challenge might exist.

IV. The Role of the Drafting Attorney

In many undue influence cases, the drafting attorney may become the central witness. In some cases, her actions may determine who has the burden of proof in the proceeding. In New Jersey, for example (as set forth in Haynes and Pascale), if the donor's attorney also has been counsel to the donee, that likely will result in the imposition of a presumption of undue influence that must be rebutted by a heightened (i.e., clear and convincing) burden of proof. Those cases developed those presumptions by analysis of the applicable rules of ethics,

concluding that where the same attorney represents the donor and donee, the donor does not have the benefit of disinterested counsel.

The Pascale court, however, sustained the disputed transaction, recognizing that even though the attorney represented parties with conflicting interests, the donor was in fact able to exercise independent judgment and was not subject to undue influence. The Pascale court (like the Haynes court) noted its concern as to the conflicts of interest, such that the rulings (or any analogous rulings in the relevant jurisdiction) should be considered by attorneys who are called upon to represent multiple family members in such a transaction. See e.g., ACTEC Commentaries on the Model Rules of Professional Conduct, Comment on MRPC 1.7 (3rd Ed. 1999). Ultimately, the role of waivers and related documents may turn on analysis of state ethics rules, such that it is important to resolve such representational issues when proceeding with this type of transaction. Nonetheless, cases such as Pascale may be worthwhile reading for those handling transactions in the family business context.