

**NON-TAX ESTATE PLANNING CONSIDERATIONS GROUP
SOME HOT TOPICS**

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This brief presentation focuses on the following recent cases. By far the larger number deals with questions of trustees' duties and responsibilities in making investments. Other topics include a novel question of trustee responsibility in connection with a defectively drafted trust, donor control of charitable gifts, the relationship of adoption to the "new biology," the relationship between domestic partnership and same-sex marriage, and the meaning of one provision of the Uniform Principal and Income Act.

Trust investment; language allowing retention of stock of corporate trustee does not negate duty to diversify.

Wood v. U.S. Bank, N.A., 160 Ohio App.3d 831, 828 N.E.2d 1072 (Ohio App. 1 Dist. 2005)

Decedent's inter vivos trust allowed the trustee to retain property added to the trust including shares of a corporate trustee. After decedent's death the corporate trustee sold other assets to raise necessary cash increasing the concentration in its own stock to 86%. The stock declined greatly in value during the two-year period between death and the final distribution of the trust. A beneficiary of the trust, the decedent's widow, sued the trustee for failure to diversify the trust assets. The Ohio intermediate appellate court reversed a judgment for trustee and ordered a new trial.

The court held that the language allowing the corporate trustee to retain its own stock did override the common law duty of undivided loyalty but did not have any effect on the duty to diversify in Ohio's version of the Uniform Prudent Investor Act (R.C. 1339.52 et seq.), citing in support Restatement Third, Trusts, § 229, comment *d*. Overriding that duty can only be accomplished by express language.

A retrial was ordered to determine if the statutory "special circumstances" excusing a lack of diversification were present.

Trust investment; no fiduciary duty to remainder beneficiaries to produce growth greater than rate of inflation.

SunTrust Bank v. Merritt, 272 Ga. App. 485, 612 S.E.2d 818 (2005)

Testator created a testamentary trust requiring mandatory income to her son and giving the trustees, a corporate trustee and the son, discretion to invade principal for the son if "absolutely necessary" to provide essential support. (No principal invasions were ever made.)

The remainder was given to son's descendants. At son's insistence the trust was invested in tax exempt bonds. Originally funded with \$675,000 the trust was worth \$732,000 at son's death. Identical trusts created for the testator's other children were invested primarily in stocks and had more than trebled in value by the time of son's death.

The remainder beneficiaries sued the corporate trustee alleging that the trustee breached its duty by failing to invest the trust so that the value of the principal would keep pace with inflation.

The intermediate appellate court dismissed the claims of the remainder beneficiaries. First, by making the beneficiary/trustee the sole income beneficiary the language of the trust prevents the trustee from breaching any duty by maximizing the beneficiary's income. The only duty owed the remainder beneficiaries is to preserve the value of the trust. The court then held that preservation of the value of the trust did not include a duty to preserve the purchasing power of the trust by investing to keep up with inflation, its rationale consisting of repeating the statement that the trustee's only duty is to preserve the principal and the assertion that the corpus was invested consistent with the intention of providing income to the lifetime beneficiary.

Trust investment; no duty to consider estate tax consequences of investments.

Namik v. Wachovia Bank of Georgia, 612 S.E.2d 270 (2005)

In 1989 an Iraqi general, Ibrahim Ali, came to Atlanta to visit his son Issam Namik. During his visit he purchased a six-month CD from Wachovia in the amount of \$2.6 million. The bank officer with whom Ali dealt convinced him of the wisdom of creating a revocable trust. According to the bank officer Ali gave instructions to invest the proceeds of the CD on maturity in United States government debt. When the CD matured the bank officer prepared a memorandum describing Ali's instructions, but the trust officer assigned to the trust could not contact Ali and invested the entire proceeds in a money market account where they remained for the life of the trust. Ali returned to Iraq where he was imprisoned and died in 1990. In 1994 Namik informed the bank of Ali's death. Ali's estate eventually paid approximately \$1.5 million in estate tax and interest. Namik and the other beneficiaries of the estate sued the bank on several theories all of which revolved around the bank's failure to follow Ali's instructions which would have avoided estate tax liability, certain U.S. government issues being exempt from estate tax in the hands of non-resident aliens.

The Supreme Court of Georgia reversed the intermediate appellate court's reversal of the trial court's verdict for Namik and remanded.

First, the Court rejected the intermediate court's holding that the memo prepared by the bank officer was inadmissible. Because the trust agreement said nothing about Ali's investment preferences the memo was admissible to prove a separate oral agreement on matters about which a document is silent. Nor was the memo inadmissible as parol evidence of an understanding arrived at subsequent to the date of the prior writing. Whether the date of the contract was the

date of the execution of the trust agreement or the date on which the instructions were memorialized by the bank's employee "the memo cannot accurately be characterized as parol evidence of an understanding arrived at subsequent to the contract"

Second, the intermediate court erred in reversing the verdict for Namik on the grounds that the trustee has no duty to engage in estate planning for Ali. The trial court properly found liability based on the bank's failure to exercise the care a prudent person would use in the circumstances. "Although the testimony at trial was in conflict, there was sufficient evidence to support the trial court's finding that Wachovia should have been aware of the potential estate tax consequences of its investment decisions and should have invested in accordance with Ali's instructions in the [bank officer's] memo."

The Court remanded the case for consideration of the amount of damages to be awarded.

Trust investment; trustee surcharged for gross negligence in selecting investments.

In re Scheidmantel, 868 A.2d 464 (Pa. Super. 2005)

In July 1998 Stella Scheidmantel (the "Grantor") created a revocable trust with her husband as beneficiary for life, remainder to the Grantor's then living issue. The trust included an exculpation clause immunizing the trustee, a bank, from liability for all but actual fraud, gross negligence or willful misconduct. The original corpus consisted of certificates of deposit and shares in a commercial bank which in August 1999 was acquired by Sky Financial (SKFY). The trust received 16,002.15 shares of SKFY in exchange for its holdings in the target bank. The Grantor died in March 1999. SKFY then acquired the corporate trustee and became trustee of Scheidmantel trust on January 1, 2000. The life beneficiary died on December 9, 2000.

After SKFY became trustee, a new employee of the bank, Oehmler, examined the Scheidmantel trust, changed the investment objective from "safety and income" to "balanced" and changed the trust's "time horizon" from three to seven years to seven to ten years. At that time the life beneficiary's health was in decline. In September 2000 the same bank employee began to diversify the trust's investments, selling 8,000 shares of SKYF after the declaration of a stock dividend but before the ex-dividend date. Between the end of September 2000 and December 1 of that year Oehmler continued liquidating income producing assets and investing in mutual funds, lowering the trust's projected income. After the life beneficiary's death and the termination of the trust Oehmler bought shares in three additional mutual funds. Some of these shares were institutional shares that could not be held by individuals and had to be liquidated before distribution.

The trustee filed its first and final account in May 2002. Two of the remainder beneficiaries filed objections.

The Superior Court first noted the trust was created before the effective date of

Pennsylvania's adoption of the Uniform Prudent Investor Act and therefore was not under a duty to diversify and also noted that even after the effective date the statute still allowed the retention of assets forming a disproportionately large share of the portfolio so long as the retention was compatible with the exercise of reasonable care, skill and caution.

After discussing in some detail the effect of the exculpatory clause and the evidence that the trustee held itself out as possession special skills, the court concluded that no matter what level of skill the trustee should have exercised its actions constituted gross negligence.

The trustee erred by changing the investments in the trust without considering the aims of the Grantor—primarily the support of the life beneficiary—and the circumstances—the life beneficiary's rapidly declining health. The court therefore affirmed the lower court's surcharge of the trustee and remanded the case for a recalculation of damages to take into account the value of the mutual fund shares received by the remainder beneficiaries on distribution of the trust.

Fiduciary duty; trustee liable for negligently providing information leading grantor to contribute to defectively drafted trust

Hatleberg v. Norwest Bank Wisconsin, 7080 N.W.2d 15 (Wis. 2005)

After her husband's death, Phyllis Erickson was contacted by Sevig, an employee of Bank, with an offer to discuss her estate planning. Among other devices he suggested an irrevocable trust to which Mrs. Erickson could make annual gifts in the amount of the present interest exclusion. Although the bank employee offered to refer Mrs. Erickson to an attorney, she instead asked an attorney who was her neighbor to draft the trust. The trust the attorney drafted lacked a Crummey power provision and therefore gifts to the trust did not qualify for the present interest exclusion. Bank served as trustee.

Sevig noticed the defect in the trust in 1988, three years after the trust was created and after Mrs. Erickson had begun to make annual gifts. Sevig notified the drafter who responded that he believed the trust was adequate, that because the trust was irrevocable it was too late to do anything anyway, and that he believed (erroneously) that the trust was completely funded. Neither the drafter nor Sevig informed Mrs. Erickson of the defect in the trust, and Sevig continued to advise her to make annual gifts, which she did.

After Mrs. Erickson's death the problem with the trust came to light and because the \$440,000 in gifts she had made to the trust did not qualify for the present interest exclusion her estate owed an additional \$173,644 in estate taxes.

Having settled the malpractice action against the drafter, the estate went to trial on its claim against Bank and prevailed. The intermediate appellate court affirmed the verdict for the estate on the grounds that Bank had been negligent in failing to inform Mrs. Erickson of the defect in the trust, Bank as trustee having assumed a duty to review the trust document.

The Supreme Court also affirmed, but on different grounds. The Court held first that a trustee has no duty “to review a trust agreement drafted by another and draw legal conclusions as to its effectiveness.” Second, there was no liability based on undertaking to act and doing so negligently because Mrs. Erickson did not suffer physical harm (Restatement Second of Torts, § 323). Finally the Court did not reach the question of whether Bank violated a duty to inform Mrs. Erickson of the defect because liability would be upheld on grounds unrelated to Bank’s serving as trustee. By telling Mrs. Erickson to continue to make gifts to a trust it knew to be defective, Bank negligently supplied information for the guidance of another, violating a duty defined in Restatement Second of Torts, § 552 and also a duty under Wisconsin common law. Because the first representation occurred in 1988, three years after the trust was created, the Court remanded for a consideration of whether damages should be adjusted.

Charitable gifts; property given in trust loses trust character after expended for charitable purpose.

St. Mary’s Medical Center v. McCarthy, 829 N.E.2d 1068 (Ind. App. 2005)

Testator’s will devised a portion of the residue in trust for the benefit of a hospital, the corpus and income of the trust to be expended as directed by a committee of persons named in the will to create a memorial to the testator’s family. The committee expended the trust property to build a chapel on the hospital grounds which was completed in 1956. In 2003 the hospital decided to raze the chapel in order to expand its facilities.

A grandson of one of the committee members (and a first cousin three times removed of the testator) obtained an injunction preventing the hospital from destroying the chapel. The hospital appealed and the intermediate appellate court dissolved the injunction.

The court first assumed without deciding that the plaintiff had standing. It then held that the testator’s will did not create a trust that continued beyond the expenditure of the fund to create the memorial. The memorial was the property of hospital. In addition, the will did not create a condition subsequent which would return the property to the donor should the prescribed use cease.

Adopteds; exclusion of adopteds does not apply to gestational surrogacy.

In re Doe, 7 Misc.3d 352, 793 N.Y.S.2d 878 (Sur.Ct. New York County 2005)

In 1959 settlor created New York trusts for the issue of his children which expressly stated that “adoptions shall not be recognized. One of settlor’s daughters and husband became parents of fraternal twins through a surrogacy arrangement under which anonymously donated ova were fertilized with husband’s sperm and carried to term by an unrelated surrogate mother. The agreement was governed by California law and a California court subsequently issued a

judgment of paternal relationship establishing daughter and her husband as the twins' parents. The trustees petitioned for construction of the trust and the Surrogate held that settlor did not intend to extend the exclusion of "adoptions" to the assisted reproductive technique at issue and that the California paternity order was entitled to full faith and credit in New York.

Domestic partnership; New Jersey statute gives benefits of tenancy by entirety.

Hennefeld v. Township of Montclair, 22 N.J. Tax 166 (N.J. Tax 2005)

A same-sex couple residing in New Jersey entered into a marriage in Canada and a civil union in Vermont and became registered domestic partners under New Jersey law (N.J.S.A. 26:8A-2). The partners transferred their home into a tenancy by the entirety from a joint tenancy with right of survivorship subsequent to the marriage and civil union but prior to registration and claimed a 100% exemption from property tax based on the total disability of the veteran partner. The parties had been receiving a 50% exemption based on the veteran's proportionate ownership of the joint tenancy.

Held, the couple could not hold the residence in a tenancy by the entirety. Comity does not require New Jersey to recognize the Canadian marriage or the Vermont civil union, but the couple is entitled to the 100% exemption under the New Jersey domestic partnership act from the date of their registration as domestic partners.

Principal and Income; percentage test of partial liquidation applies to amount received by trust.

In re Estate of Thomas, 124 Cal.App.4th 711, 21 Cal.Rptr.3d 741 (Cal.App. 2 Dist. 2004)

California's enactment of the Uniform Principal and Income Act includes the provision that a distribution received by a trust from an entity is a partial liquidation of the entity and thus allocable to principal "if the total amount of money and property received in a distribution or series of distributions is greater than 20% of the entity's gross assets . . ." (Prob. Code § 16350(d)(1)(B))

Betty Thomas created a testamentary trust to pay the income to her husband for his life, remainder to her children by prior marriages. Two of those children are trustees. The trust's sole asset is shares of a corporation which owns the Chelsea Hotel in New York City. The corporation is an S corporation and the sole income beneficiary of the trust, which is a qualified subchapter S trust, paid income tax on all the income attributable to the trust's shares even though the corporation retained much of its earnings. In September of 2001 the corporation distributed \$7.5 million of some \$10.5 million in undistributed income. The trust received \$1.2 million of this distribution. On advice of counsel the trustees allocated the distribution to principal because the total distribution of \$7.5 million was more than 20% of the corporation's gross assets.

The income beneficiary began an action seeking to have the distribution reallocated to income. The trial court granted the income beneficiary's request and the trustees appealed.

The California Court of Appeal affirmed. The court held that the "plain meaning" of the language in the statute referring to money "received in a distribution" is the money received by the trust, not the total amount received by all recipients of the distribution. According to the court, neither the legislative history of the statute nor policy require deviation from that plain meaning.