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Trusts and Estates Law Section Newsletter

A publication of the Trusts and Estates Law Section of the New York State Bar Association

A Message from the Section Chair


Gary B. Freidman

Greetings. As I write this article we still have no federal estate tax and with the death of several persons on the *Forbes* 400 list, there likely will be some interesting litigation over whether the tax can be reinstated retroactively.

Notwithstanding our state legislature's continued inability to pass a budget bill, it has acted on bills of interest to our Section. For those of us whose clients have pet elephants, tortoises, alligators, chimpanzees or parrots, now these animals can be adequately provided for as the Governor has signed a bill eliminating the 21-year limit on pet trusts (Laws 2010, ch. 70). Will the rule against perpetuities fall next?

Currently awaiting signature by the Governor are bills which do the following: establish a two-year statute of limitations in seeking a default in failing to exercise a right of election (S8057); amend EPTL 7-1.17 to clarify that a lifetime trust must be executed by the person establishing such trust, who need not be the "creator" (A11316); increase the assets which constitute exempt property under EPTL 5-3.1 (A8969); provide a default rule construing language in wills with reference to the pre-January 1, 2010 Internal Revenue Code (a consequence of the temporary expiration of the federal estate tax) (A9857); and the "technical corrections" to last year's sweeping overhaul of the power of attorney provisions of the General Obligations Law (A8392).

Inside

Kudos to all of our Section members who labored long and hard for the passage of these bills.

In reviewing the "Pending Legislation" pages on our Section's website, one bill of interest can't seem to get off the ground—S4067. This bill would require the Banking Board to adopt regulations which would require banks to make a written disclosure to persons opening a joint account detailing their rights and liabilities as joint depositors. Although far from the solution, this is certainly a step toward helping to stem the numerous disputes we see concerning joint bank accounts.

We are in the process of planning this year's Fall Section Meeting in Rochester. The program will be co-chaired by Audrey Peartree and Eric Penzer. There are so many recent developments to choose from that finalizing the program is becoming difficult—suggested topics have included the recent Court of Appeals decisions involving estate planning malpractice and allocation of legal fees among beneficiaries, total return investing after the financial "melt-down of '08" and a refresher course in planning with only a $1,000,000 unified credit. The format will follow that of last year's successful program—three one-hour roundtables on Thursday and a half-day program and luncheon on Friday, allowing attendees to earn up to eight CLE credits. We hope to have our Thursday evening festivities at the Genesee Country Village & Museum, a 700-acre complex, which is the largest and most comprehensive living history museum in New York State. It has the third largest collection of historic buildings in America, consisting of 68 historic structures furnished with 15,000 artifacts, providing an authentic 19th century environment, staffed by historic interpreters in period-appropriate dress. It should be educational and fun!

And now for the solicitations. Once again, if you are interested in becoming more involved with the Section, I urge you to contact me (gfreidman@gss-law.com). Our committees do interesting and important work and there's plenty for everyone to do. Also, you should consider joining our Section's group on the LinkedIn social networking site for business professionals. We now have nearly 300 members. As membership increases, the site will be another way for you to learn of Section events and to discuss issues relating to our practices with your colleagues. The service is free. I would expect that the Section's "Jobs Board" would be of interest to many. Attorneys and firms who are looking to hire an attorney can post job listings which will be seen only by members of our Section. Attorneys who are looking for employment (either full-time or part-time) in trusts and estates can also post their resumes on the Jobs Board. This service is also free. The URL is: http://www.linkedin.com. Then search "Groups" for the NYSBA Trusts and Estates Law Section—and sign up!

Gary B. Freidman

Mark Your Calendars Now!

New York State Bar Association

ANNUAL MEETING

January 24-29, 2011

Hilton New York • New York, NY

Trusts and Estates Law Section Meeting

Wednesday, January 26, 2011

Editor's Message

And the Fall is here. I sincerely hope you all had a terrific Summer and enjoyed the excellent articles in the Summer *Newsletter*. This issue contains eight outstanding, interesting and useful articles, the first published letter to the editor, the third Best of the List Serve string and the customarily superb case reporting columns of Ilene Cooper and Professors LaPiana and Bloom. The editorial board trusts that you will find time to read the *Newsletter* cover to cover, or at the least cherry pick your way through the fine contributions in this issue.

The editorial board is soliciting for the Winter *Newsletter* excellent articles and columns, alerts on pending legislation, outlines and transcripts from continuing legal education or other presentations, letters to the editor and opinion pieces, agenda and submissions from the various committees of the Section, CLE program updates and excerpts from articles related to trusts and estates issues in other publications. As in the past, I encourage you to submit an article discussing a case, matter or issue in which you are or have been recently involved. Having your work published in the Winter *Newsletter* has an added bonus in that the issue will be available on various tables during the New York State Bar Association Annual Meeting in New York City in January 2011—that's exposure to a few thousand other attorneys in addition to being mailed to nearly 5,000 subscribers.

The editorial board invites you to voice your opinion on pending legislation or existing laws, regulations and practices, and to otherwise get involved in the section. Perhaps your ideas will be the springboard for an improvement in the way we all practice law, the laws of the state and the lives of the people in our community.

Ian W. MacLean, Editor in Chief

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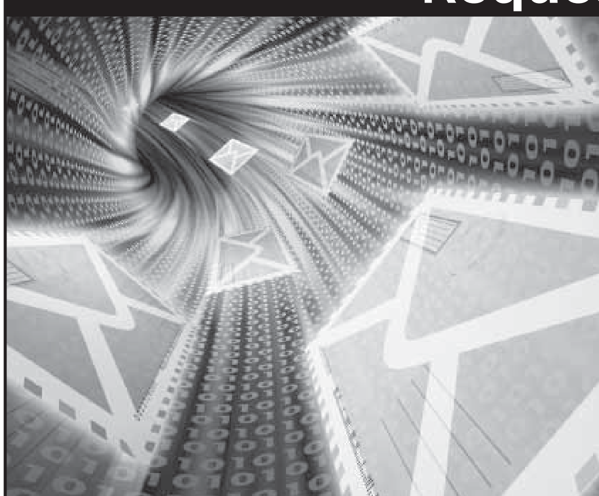

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Articles should be submitted in electronic document format (pdfs are NOT acceptable), and include biographical information.

www.nysba.org/TrustsEstatesNewsletter

Partition Proceedings in the Surrogate's Court

By Hon. C. Raymond Radigan and James Lippert

Introduction

C. Raymond Radigan

After a decedent's death it may be necessary to partition any realty in which the decedent held an interest as a tenant in common. While the estate may already be before the Surrogate's Court, the current case law holds that the Surrogate does not have jurisdiction over a partition proceeding, unless, at the very least, a party can show "extraordinary circumstances." Therefore, the partition action must be commenced in Supreme Court. Yet the partition action cannot be commenced in Supreme Court until the fiduciary of the estate seeks permission from the Surrogate's Court. Therefore, oftentimes an estate must hopscotch between two courts just to obtain the desired relief. As such, the current law regarding the Surrogate's Court's jurisdiction over partition procedures is an unnecessary procedural quagmire.

Part I of this Note will explore the expansion of the Surrogate's Court. First, it demonstrates that even before an amendment to the New York State Constitution, the trend was one of enlarging the Surrogate's Court: from one of limited, specialized jurisdiction into a court that heard all matters related to the affairs of decedents. Moreover, it explains how this movement was captured in an amendment to the New York State Constitution. Further, this Part explores the Surrogate's Court's specific expansion over partition proceedings. This includes an express statutory provision that grants the Surrogates' Courts at least some jurisdiction over partition proceedings involving an estate. Part II of this Note explores the uncertainty surrounding this statutory grant. Namely, whether a Surrogate's Court has jurisdiction over the actual partition proceeding, or whether its jurisdiction is limited to merely granting the fiduciary of the estate permission to commence, or join, a partition proceeding in Supreme Court. Part III of this Note concludes that Surrogates' Courts have jurisdiction over partition proceedings. First, it notes that there is nothing in the plain language of the statutory text that explicitly limits the Surrogate's Court to procedural jurisdiction only. Also, this Part concludes that because partition proceedings involve the affairs of decedents or the administration of their estates, the constitution grants the Surrogates' Courts jurisdiction over them. As such, even if the statutory provision was meant to limit the Surrogate's Court's jurisdiction to only procedural matters, it is invalid because the Legislature cannot remove jurisdiction that the constitution grants. Finally, this Part concludes that since the Legislature expressly preserved any jurisdiction that the Surrogate's Court had before the constitutional amendment, the Surrogates' Courts have jurisdiction over partition proceedings. For these reasons, the Surrogate's Court ought to exercise jurisdiction over all aspects of a partition proceeding.

James Lippert

I. The Expansion of the Jurisdiction of the Surrogate's Court

The Surrogate's Court's jurisdiction over partition proceedings has expanded over the course of many years. Such expansion is not a surprise given the expansion of the Surrogate's Court's jurisdiction in general. For instance, the court has transitioned from a court of limited, specialized jurisdiction into one that has jurisdiction over all matters related to decedents' affairs and the administration of their estates. Likewise, the Legislature has, to some extent, statutorily authorized the Surrogate's Court's jurisdiction over partition actions. But even before the statutory grant, the Surrogates' Courts often exercised jurisdiction over partition actions. Therefore, the natural progression of the Surrogate's Court's jurisdiction supports its jurisdiction over partition proceedings.

A. The Constitutional Expansion of the Surrogate's Court's Jurisdiction

The jurisdiction of the Surrogate's Court has been one of steady growth. At its inception, the Surrogate's Court was considered a court of limited jurisdiction, and only had jurisdiction over those actions specifically authorized by statute.[1] Despite such narrow jurisdiction, however, the courts continually expanded the Surrogate's Court's jurisdiction.[2] The courts justified this by looking to the now superseded Surrogate's Court Act ("SCA"), which stated that the Surrogates' Courts had jurisdiction "to administer justice in all matter relating to the affairs of the decedent."[3] Therefore, so long as the matter was collaterally related to the affairs of decedents, the courts generally held that the Surrogates' Courts had jurisdiction.[4]

In 1962 their jurisdiction dramatically expanded when similar language was added to the New York State Constitution.[5] Article 6, Section 12 of the New York State Constitution confers jurisdiction to the Surrogates' Courts over "all actions and proceedings relating to the affairs of decedents, probate of wills, administration of estates and actions and proceedings arising thereunder or pertaining thereto, guardianship of the property of minors, and such other action or proceedings, not within the exclusive jurisdiction of the Supreme Court, as may be provided by law." As a result, the Surrogate's Court lacks subject matter jurisdiction only when it is "abundantly clear that the matter in controversy in no way affects the affairs of a decedent or the administration of his estate."[6] As such, the constitutional amendment greatly expanded the reach of the Surrogate's Court's jurisdiction.

Although the Surrogate's Court's jurisdiction is derived from the constitution, the Legislature codified it in the Surrogate's Courts Procedure Act ("SCPA"), which replaced the SCA.[7] But the Legislature also provided that "[t]he court shall continue to exercise full and complete general jurisdiction in law and in equity to administer justice in all matters relating to estates and the affairs of decedents."[8] Therefore, this legislative grant makes clear that the constitutional amendment does not deny the court any jurisdiction it had prior to the amendment.

Thus, the Surrogate's Court has jurisdiction over all matters relating to the affairs of decedents and the administration of their estates. And this jurisdiction cannot be limited or removed by the Legislature. What's more, the Legislature preserved the jurisdiction the Surrogate's Court had prior to the constitutional amendment. In sum, the Surrogate's Court has come a long way from its narrow jurisdictional roots.

B. The Statutory Expansion of the Surrogate's Court's Jurisdiction in Partition Actions

A partition proceeding is a legal remedy available to those who own property as tenants in common.[9] Common tenancy is the most basic form of property ownership when two or more agents both own real property.[10] In such a relationship each cotenant has an "undivided right to possession of the entire asset, although not to the exclusion of the other owners."[11] But there is no right of survivorship in a common tenancy.[12] Thus, each cotenant may designate in his / her will who receives his / her interest in the event of death.[13]

Still, either before or after the death of a cotenant, it might be necessary to physically divide the interests of tenants in common. As such, a cotenant will commence a partition action.[14] Following a partition action, the tenancy is terminated and a specific portion of the entire estate vests in each former owner.[15] If physical division of the property is not feasible, then the partition forces a sale of the property and the proceeds are divided among the former owners pursuant to their vested portion of the former estate.[16]

Prior to 1975 "the Surrogate's Court had no statutory authority for the partitioning of real estate in which a decedent had an interest."[17] Nevertheless, many courts held that the Surrogate's Court had jurisdiction over partition proceedings involving an estate.[18] For instance, some courts found authorization in sections of the SCA. Section 234 of the SCA, for example, permitted a sale "for any…purpose deemed by the surrogate to be necessary." The courts interpreted this section as "merely in substitution for the far more cumbersome and expensive proceedings for partition which [were] maintainable in courts of general jurisdiction.'"[19] Therefore, prior to the constitutional amendment there was a trend towards allowing partition proceedings in Surrogate's Court.

Courts also justified expanding the Surrogate's Court's jurisdiction on policy grounds. Namely, that all matters relating to the affairs of the decedent should be centralized in the Surrogate's Court "where the court was [*sic.*] complete power to safeguard the interest of the parties."[20] The courts justified this policy on the grounds that the Surrogates' Courts specialized in the administration of the decedents' estate and, thus, were best suited to deal with matters that involved an estate.[21] What's more, the courts recognized that such centralization would keep costs down and expedite the administration of the estate.[22] Thus, if a partition action involved an estate, the Surrogates' Courts had jurisdiction over the action because they were familiar with the types of issues that might arise concerning the estate.

In 1975, however, the SCPA was amended, and the Legislature added section 1901(2)(i), which specifically deals with partition proceedings. That section provides that "the executor or administrator may bring a partition action or intervene in a pending partition action on behalf of the estate, if, upon application duly made, the surrogate approves." At the same time, the Legislature added section 901(4) to the Real Property Actions and Proceedings Law, which provides that "the executor or administrator may bring a partition action or intervene in a pending partition action on behalf of the estate if, upon application duly made, the surrogate approves." Therefore, the effect of these amendments is that "[a]n action for partition and sale of real property held in common may be maintained as a matter of right by any co-tenant or with the consent of the Surrogate by their fiduciary."[23] That said, while these amendments create statutory jurisdiction for the Surrogate's Court over partition proceedings, the extent of the jurisdiction is subject to debate.

II. Uncertainty Regarding the Surrogate's Court Substantive Jurisdiction in Partition Actions

There is a split of authority in the New York courts concerning the jurisdictional limits of the Surrogate's Court in partition proceedings. On the one hand, most courts hold that the Surrogate's Court only has procedural jurisdiction over partition proceedings in which the estate is a cotenant. That is, the court only has authority to approve a fiduciary's interjection into an existing partition, or to commence a partition action.[24] On the other hand, some courts hold that in limited circumstances the Surrogate's Court has jurisdiction to preside over a partition action. Still, even these courts refrain from holding that the Surrogate's Court has jurisdiction over any and all partitions that relate to the affairs of the decedent or to the administration of the decedent's estate.[25]

A. Most Courts Hold That the Surrogate's Court Only Has Procedural Jurisdiction Over Partition Proceedings

Those courts holding that the Surrogate's Court does not have substantive jurisdiction, under any circumstances, over a partition action involving a decedent base this conclusion on the statutory text of section 1901(2)(i) and the understanding of the suit as between living persons.[26] These courts believe that section 1901(2)(i) is merely procedural, a way of providing notice to those with an interest in the estate that a partition action is forthcoming.[27] Such notice is important because the beneficiaries might want to buy the property themselves and without notice the real estate might be partitioned before they have an opportunity to buy it.[28] Therefore, the Legislature must have included section 1901(2)(i) to ensure that any person interested in the estate has the opportunity to purchase the real estate, or take other action regarding the property, before the partition proceeding is complete.[29] Therefore, section 1901(2)(i) merely "adds a step to the partition process where an estate is involved."[30]

B. Some Courts Acknowledge That the Surrogate's Court Has Limited Substantive Jurisdiction in Partition Proceedings

Some courts hold that section 1901(2)(i) confers jurisdiction upon the Surrogate's Court to preside over partition proceedings if justified by extraordinary circumstances.[31] Moreover, at least one court also requires that the estate hold a majority interest in the common tenancy.[32] Such a conclusion is premised, in part, on the *In Re Piccone* decision and the constant trend towards expanding the jurisdiction of the Surrogate's Court.[33] After all, the Surrogate's Court has jurisdiction over any affairs related to decedents or the administration of their estates.[34] Also, these courts note that a surrogate is authorized to sell the decedent's interest in real property under section 1902.[35] Since similar issues are raised in partition actions, such actions are not outside the Surrogate's Court expertise.[36] Moreover, "[i]t is judicially wise and economically beneficial if litigation involving the decedent's property and funds [is] disposed of in Surrogate's Court."[37] That said, no court has gone so far as to find unlimited substantive jurisdiction in partition proceedings. Thus, unless a party can show extraordinary circumstances—and perhaps a majority interest—even the courts that recognize substantive jurisdiction under section 1901(2)(i) will not allow the proceeding in Surrogate's Court.

For instance, in *In Re Lewis* the surrogate noted that the Surrogate's Court could have substantive jurisdiction "if this was a case…involving realty in which the decedent had a majority interest as a tenant in common, and the expeditious adjudication of a partition action was essential to the proper administration of an estate."[38] Yet it did not exercise jurisdiction because no such "special circumstances" were implicated in that case.[39]

Therefore, while no court has fully recognized the Surrogate's Court's jurisdiction over partition proceedings, some courts hold that in "special circumstances" the Surrogate's Court can preside over a partition action. That is, if the party shows that the decedent had a majority interest as a tenant in common and a need for an expeditious partition proceeding, then the Surrogate's Court has jurisdiction.

III. The Surrogate's Court Has Substantive Jurisdiction over Partition Actions

The courts should hold that Surrogates' Courts have full jurisdiction over partition proceedings when an estate is involved, regardless of whether any extraordinary circumstances exist. This conclusion is justified for three reasons. First, the plain meaning of the statute does not inevitably lead to the conclusion that the jurisdiction of the Surrogate's Court is merely procedural. Since the Surrogate's Court has jurisdiction over the rest of the decedent's estate, forcing the fiduciary to commence an action in Supreme Court only unnecessarily fragments the administration of the estate. Second, the partitioning of property in which the estate has an interest relates to the affairs of decedents and the administration of their estates. Therefore, even if the Legislature sought to limit the Surrogate's Court's jurisdiction to merely granting approval, it would be invalid because the Surrogate's Court derives its jurisdiction from the constitution. Third, prior to the constitutional amendment there was a trend towards allowing Surrogates' Courts to preside over partition actions. Since the constitutional amendment did not remove any jurisdiction the Surrogates' Courts had prior to the amendment, the Surrogates' Courts have jurisdiction to preside over partition proceedings.

While it is true that section 1902(2)(i) merely speaks of "granting approval," at the same time it does not explicitly prohibit substantive jurisdiction. There is no reason why the Surrogate's Court could not grant approval for a fiduciary to bring a partition, and then preside over the actual proceeding. To hold otherwise is to create an unnecessary delay in the administration of the estate. Although some courts argue that this section was added in order to provide notice to beneficiaries of the estate, the Supreme Court has concurrent jurisdiction over the affairs of decedents.[40] As such, the procedures in the service rules under the Civil Practice Law and Rules would put the beneficiaries on sufficient notice. Therefore, if the Surrogate's Court only has jurisdiction in order to provide notice to beneficiaries, the section does nothing more than add an unnecessary bifurcation to the proceeding, which, in turn, does nothing more than fragment cases while increasing costs and delaying the administration of the estate. Given the desire to prevent fragmentation of cases,[41] the Legislature must have intended to grant the Surrogate's Court authority to preside over partition proceedings where an estate is involved.

But it is ultimately irrelevant whether section 1901(2)(i) grants the Surrogate's Court jurisdiction over partition proceedings where a party is a fiduciary for an estate, because such proceedings relate to the affairs of decedents and administration of their estates. Since the constitution provides that the Surrogate's Court has jurisdiction over such matters, the Legislature cannot withhold jurisdiction. After all, it is hard to imagine a partition proceeding brought by the fiduciary for an estate, and on behalf of the estate, where it is "abundantly clear that the matter in controversy *in no way* affects the affairs of a decedent or the administration of his estate."[42] For instance, a sale will change the nature of the gift passing through intestacy or under the will. Likewise, whether the property is partitioned or not could affect the value of the gift.[43] For example, if real property was sold immediately before the housing bubble burst, then the size of the estate is much larger than if the property was not partitioned.

Also, the Surrogate's Court should have jurisdiction over partition proceedings because, prior to the amendment of the constitution, the case law supported jurisdiction in the Surrogate's Court. Since the constitutional amendment did not remove any jurisdiction that already existed, the courts should still have jurisdiction. For example, section 234 of the SCA permitted a sale "for any…purpose deemed by the surrogate to be necessary." Thus, section 234 was "'merely in substitution for the far more cumbersome and expensive proceedings for partition which [was] maintainable in courts of general jurisdiction.'"[44] Therefore, just as the Surrogate's Court had jurisdiction over what amounted to a partition before the constitutional amendment, so too should the Surrogate's Court have jurisdiction over partition proceedings today.

Likewise, the case law prior to the constitutional amendment was in a trend of expansion: away from a more limited jurisdiction towards a more general jurisdiction. Because the constitutional amendment did not remove any jurisdiction granted prior to the amendment, the court should continue this trend—especially in light of the constitutional amendment. But denying the Surrogate's Court jurisdiction would be reversing course from these earlier cases. In light of the costs and delay that would result from fragmentation of the proceedings, it is not an advisable course of action. Therefore, the courts should hold that the Surrogate's Court has jurisdiction over partition proceedings where the estate is a party.[45]

Conclusion

The Surrogates' Courts should have jurisdiction over partition proceedings where a decedent's estate is involved. But, according to most courts, the Surrogates' Courts only have jurisdiction over a limited, procedural aspect of a partition proceeding, while those courts recognizing jurisdiction unnecessarily limit it to "extraordinary circumstances." Yet the plain language of the specific statutory grants does not mandate such a narrow reading. And even if it did, it is irrelevant because the Legislature cannot remove from the Surrogate's Court's jurisdiction what the court is granted in the constitution. And the constitution grants the Surrogate's Court jurisdiction over all matters relating to the affairs of decedents and the administration of their estates. Moreover, such narrow jurisdiction is not consistent with the Surrogate's Court's ever-expanding jurisdiction. Since the constitutional amendment did not remove jurisdiction that the Surrogates' Courts exercised prior to the amendment, then the Surrogates' Courts still have jurisdiction over partition proceedings involving the affairs of decedents or the administration of their estates.

Endnotes

1. *See* C. Raymond Radigan, *Jurisdiction after Piccione*, N.Y. St. B.J., Apr. 1984, at 12; Margaret Valentine Turano & C. Raymond Radigan, New York Estate Administration § 1.02 (2007).
2. *See In Re Piccione*, 57 N.Y.2d 278, 287, 442 N.E.2d 1180, 1183, 456 N.Y.S.2d 669, 672 (1982); Turano & Radigan, *supra* note 1, at § 1.02.
3. N.Y. Surr. Ct. Act § 40. This provision was construed as a general grant of jurisdiction, in addition to those enumerated elsewhere. *See Raymond v. Davis*, 248 N.Y. 67, 74, 161 N.E. 421, 423 (1928) (opining that unnecessary fragmentation of cases only resulted in great costs and delayed finality: "To remit the claimant to another forum after all these advances and

retreats, these reconnaissances and skirmishes, would be a postponement of justice equivalent to a denial. If anything is due him, he should get it in the forum whose aid he has invoked.").

4. *See In Re Wedland's Estate*, 35 N.Y.S.2d 622, 625 (Sur. Ct. Orange County 1942).

5. *See* Turano & Radigan, *supra* note 1, at § 1.02.

6. *In Re Piccione*, 57 N.Y.2d 278, 288, 442 N.E.2d 1180, 1184, 456 N.Y.S.2d 669, 674 (1982); *but see In Re Dicosimo*, 180 Misc.2d 89, 91–92, 687 N.Y.S.2d 592, 594 (Sur. Ct. Bronx County 1999) ("[E]ven though a matter may tangentially relate to the affairs of the decedent, it will not automatically fall within the jurisdiction of the surrogate's court if entertaining the proceeding would unduly hinder the court in carrying out its primary area of specialization.").

7. *See* N.Y. Surr. Ct. Pro. Act § 201(3) (McKinney 2009); *see also* Turano & Radigan, *supra* note 1, at § 1.02; 1-2 Warren's Heaton on Surrogate's Court Practice § 2.02[2] (2007).

8. N.Y. Surr. Ct. Pro. Act § 201(3) (McKinney 2009); *see id.* § 201(1) ("The court…shall continue to be vested with all jurisdiction conferred upon it by the Constitution of the State of New York….") (emphasis added).

9. *See* 3-27 Warren's Weed New York Real Property § 27.18[1] (4th ed. 1999); Manel Baucells & Steven A. Lippman, *Justice Delayed Is Justice Denied: A Cooperative Game Theoretic Analysis of Hold-Up in Co-Ownership*, 22 Cardozo L. Rev. 1191, 1195 (2001).

10. *See* 3-27 Warren's Weed New York Real Property § 27.18[1] (4th ed. 1999); Baucells, *supra* note 9, at 1193.

11. Baucells, *supra* note 9, at 1194; *see* 3-27 Warren's Weed New York Real Property § 27.18[1] (4th ed. 1999).

12. 3-27 Warren's Weed New York Real Property § 27.02[2] (4th ed. 1999).

13. *See id.*

14. 1-3 Warren's Weed New York Real Property § 3.01[1][c] (4th ed. 1999).

15. *See* 3-27 Warren's Weed New York Real Property § 27.18[1] (4th ed. 1999); Baucells, *supra* note 9, at 1195.

16. *See* 3-27 Warren's Weed New York Real Property § 27.18[1] (4th ed. 1999); Baucells, *supra* note 9, at 1195.

17. 5-68 Warren's Heaton on Surrogate's Court Practice § 68.04[7] (2007).

18. *See generally Wade v. Bigham*, 178 Misc. 305, 34 N.Y.S.2d 22 (Sup. Ct. Queens County 1942); *In Re Wendland's* Estate, 35 N.Y.S.2d 622 (Sur. Ct. Orange County 1942); *In Re Klein's Will*, 188 Misc. 34, 66 N.Y.S.2d 450 (Sur. Ct. Broome County 1946); *McGirr v. Keesler*, 273 A.D. 778, 75 N.Y.S.2d 24 (2d Dep't 1947); *La Barbera v. Argentieri*, 191 N.Y.S.2d 812 (Sup. Ct. Kings County 1959).

19. *Wade*, 178 Misc. at 307, 34 N.Y.S.2d at 24 (quoting 2 Bradford Butler, New York Surrogate Law and Practice § 1536); *Wedland's Estate*, 35 N.Y.S.2d at 624.

20. *La Barbera v. Argentieri*, 191 N.Y.S.2d 812, 813 (Sup. Ct. Kings County 1959); *see McGirr v. Keesler*, 273 A.D. 778, 778, 75 N.Y.S.2d 24, 24 (2d Dep't 1947); *Wedland's Estate*, 35 N.Y.S.2d at 625.

21. *La Barbera*, 191 N.Y.S.2d at 813, *McGirr*, 273 A.D. at 778, 75 N.Y.S.2d at 24; *Wedland's Estate*, 35 N.Y.S.2d at 625.

22. *See Wade*, 178 Misc. at 308, 34 N.Y.S.2d at 24 (quoting 2 bradford butler, new york surrogate law and practice § 1536); *Wedland's Estate*, 35 N.Y.S.2d at 625.

23. *In Re Crowell*, N.Y.L.J., May 5, 1989, at 27, col. 6 (Sur. Ct. Nassau County) (Surrogate Radigan); *see* 5-68 Warren's heaton on surrogate's Court Practice § 68.04[7] (2007); 3-27 Warren's Weed New York Real Property § 27.18[5] (4th ed. 1999).

24. *See In Re Birnbaum*, 131 Misc.2d 925, 928, 502 N.Y.S.2d 390, 392 (Sur. Ct. Monroe County 1986) (Surrogate Ciaccio); *In Re Rupolo*, N.Y.L.J., Jan. 6, 2005, at 27, col. 2 (Sur. Ct. Suffolk County) (Surrogate Czygier); *In Re Rigels*, N.Y.L.J., Jan. 6, 2005, at 27, col. 3 (Sur. Ct. Suffolk County) (Surrogate Czygier); *In Re Martin*, Jun. 21, 1996, at 26, col. 5 (Sur. Ct. New York County); *In Re* Harbach, April 12, 2001, at 25, col. 4 (Sur. Ct. Suffolk County) (Surrogate Weber); *In Re Foerster*, June 11, 1991, at 30, col. 3 (Sur. Ct. Suffolk County) (Surrogate Signorelli); *In Re Brillon*, N.Y.L.J., July 15, 1992, at 23, col. 3 (Sur. Ct. Bronx County) (Surrogate Holzman) (stating that a partition is an action between living persons and, thus, the Surrogate's Court does not have jurisdiction). Interestingly, it is Surrogate Holzman who, in a few years, would head the movement towards allowing substantive jurisdiction in limited situations.

25. *See In Re Lewis*, N.Y.L.J., Dec. 30, 2008, at 38, col. 3 (Sur. Ct. Bronx County) (Surrogate Holzman) (holding that a Surrogate's Court only has substantive jurisdiction when there are "special circumstances"); *In Re Dickson*, N.Y.L.J., Jan. 10, 1995, at 28, col. 2 (Sur. Ct. Bronx County) (same). Moreover, while some court cases do not squarely address substantive jurisdiction, some will take a more active, and perhaps substantive, involvement in the partition. *See, e.g.*, *In Re Roarty*, N.Y.L.J., Dec. 23, 1998, at 29, col. 1 (Sur. Ct. Nassau County) (Surrogate Radigan).

26. *See Birnbaum*, 131 Misc.2d at 928, 502 N.Y.S.2d at 392 (holding that the Surrogate is "limited to 'granting approval' which can not [*sic*] be interpreted to include factfinding and determination of substantive issues that may be involved."); *In Re Rigels*, N.Y.L.J., Jan. 6, 2005, at 27, col. 3 (finding that SPCA 1901(2)(i) and RPAPL 901(4) "provide the court with the limited procedural role of assuring that all the estate's beneficiaries or distributees, as the case may be, receive notice of such an application without conferring jurisdiction on this court to determine the merits of whether partition is authorized."); *In Re Rupolo*, N.Y.L.J., Jan. 6, 2005, at 27, col. 2 (holding that a partition is a dispute between the living); *In Re Brillon*, N.Y.L.J., July 15, 1992, at 23, col. 3 (holding that a partition action involves a dispute between living parties). *See In Re Martin*, N.Y.L.J., Jun. 21, 1996, at 26, col. 5 ("[I]t would require 'an extraordinary exercise of judicial discretion' for the [S]urrogate's [C]ourt to become involved in the merits of a partition action.") (quoting *In Re Dickson*, N.Y.L.J., Jan. 10, 1995, at 28, col. 2)). But some courts, rather than relying on an either/or approach, deny substantive jurisdiction because the dispute is between living persons and because the conferring statute is merely procedural. *See id.*

27. *See Birnbaum*, 131 Misc.2d at 927, 502 N.Y.S.2d at 392.

28. *See id.* at 927, 502 N.Y.S.2d at 392.

29. *See id.* at 927, 502 N.Y.S.2d at 392.

30. *See id.* at 927, 502 N.Y.S.2d at 392.

31. *See In Re Lewis*, N.Y.L.J., Dec. 30, 2008, at 38, col. 3 (Sur. Ct. Bronx County); *Zeglen v. Zeglen*, 150 A.D.2d 924, 925, 541 N.Y.S.2d 267, 268 (3rd Dep't 1989); *see also In Re Dickson*, N.Y.L.J., Jan. 10, 1995, col. 2.

32. *See In Re Lewis*, N.Y.L.J., Dec. 30, 2008, at 38, col. 3.

33. *See id.*

34. *See id.*

35. *See id.*

36. *See id.*

37. *Zeglen v. Zeglen*, 150 A.D.2d 924, 925, 541 N.Y.S.2d 267, 268 (3rd Dep't 1989).

38. *Id.*

39. *Id.*

40. *See* N.Y. Const. art VI, sec. 12; *Zeglen*, 150 A.D.2d at 925, 541 N.Y.S.2d at 268; 1-2 Warren's heaton on surrogate's Court

Practice § 2.02[1][a] (2007); Turano & Radigan, *supra* note 1, at § 1.05.

41. *See generally Raymond v. Davis*, 248 N.Y. 67, 74, 161 N.E. 421, 423 (1928) ("To remit the claimant to another forum after all these advances and retreats, these reconnaissances and skirmishes, would be a postponement of justice equivalent to a denial. If anything is due him, he should get it in the forum whose aid he has invoked."); *In Re Zalaznick*, 84 Misc.2d 715, 719, 375 N.Y.S.2d 522, 526 (Sur. Ct. Bronx County 1975) ("The proper administration of justice mandates the pursuit of procedures which will allow the most expeditious and economic litigation of issues possible. To achieve this…fragmentation…must be zealously avoided…."); *In Re Duell*, N.Y.L.J., Oct. 13, 2000, at 27, col. 3 (Sur. Ct. N.Y. County) (advising the Supreme Court to transfer the matter to the Surrogate's Court to prevent fragmentation).

42. *See Piccione*, 57 N.Y.S.2d at 288, 442 N.E.2d at 1184, 456 N.Y.S.2d at 674 (emphasis added); *but see In Re Dicosimo*, 180 Misc.2d 89, 91–92, 687 N.Y.S.2d 592, 594 (Sur. Ct. Bronx County 1999) ("[E]ven though a matter may tangentially relate to the affairs of the decedent, it will not automatically fall within the jurisdiction of the surrogate's court if entertaining the proceeding would unduly hinder the court in carrying out its primary area of specialization.").

43. An exception, however, would be where the property was specifically devised to a beneficiary. In such an instance, the property passes immediately upon death to the beneficiary. *See In Re Pesa*, N.Y.L.J., July 7, 2003, at 27 (Sur. Ct. Nassau County). As such, the estate never holds the property.

44. *Wade v. Bigham*, 178 Misc. 305, 307, 34 N.Y.S.2d 22, 24 (Sup. Ct. Queens County 1942) (quoting 2 Bradford Butler, New York Surrogate Law and Practice § 1536); *In Re Wendland's Estate*, 35 N.Y.S.2d 624 (Sur. Ct. Orange County 1942).

45. But not where the property is specifically devised. *See In Re Pesa*, N.Y.L.J., July 7, 2003, at 27 (Sur. Ct. Nassau County).

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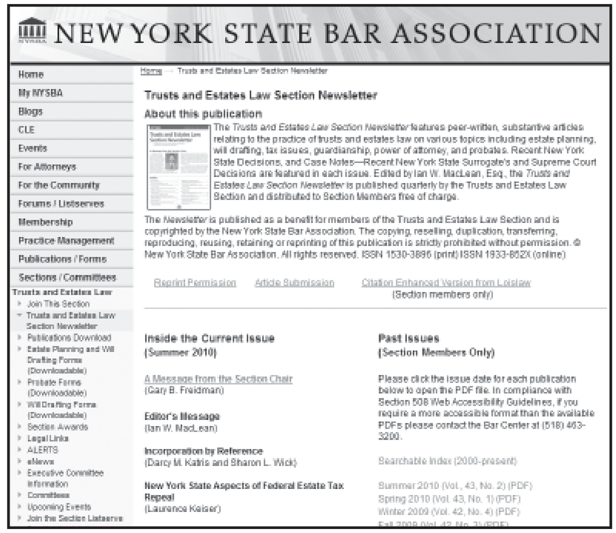

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Bequests to Will Witnesses—A Trap for the Unwary?

By Lee A. Snow

Most trusts and estates practitioners are aware of the numerous problems that may arise when persons who have no experience drafting Wills attempt to prepare or in fact prepare their own Wills. A case decided last year illustrates some of the less recognized dangers that may be created as a result of a do-it-yourself Will execution.

In *Estate of Cynthia R. Wu*,[1] the New York County Surrogate's Court held that the estate tax apportionment clause in the decedent's Will was ineffective to absolve the decedent's brother from paying a portion of the estate taxes where the brother, who was the beneficiary of two life insurance policies on the decedent's life but not a beneficiary under the Will, was one of the two attesting witnesses to the Will. By strictly applying the New York statute that voids dispositions made to attesting witnesses, the Court followed the letter of the law, but, in this particular case, by doing so, the Court may also have defeated or diminished the testatrix's intention to benefit her brother.

EPTL § 3-3.2[2]

The statute in question, New York Estates, Powers and Trusts Law § 3-3.2(a), provides that a beneficial disposition or appointment of property made to an attesting witness under a Will is void if such witness's testimony is necessary to prove the Will. The statute offers two leniencies to this rule, however. EPTL § 3-3.2(a)(2) provides that a beneficial disposition to an attesting witness will not be void where the Will can be proved without the testimony of such witness, for example, where there are at least two other attesting witnesses who have received no beneficial disposition or appointment under the Will. EPTL § 3-3.2(a)(3) provides further that if an attesting witness is also a distributee of the decedent, then even if such witness's testimony is necessary to prove the Will, such witness will be entitled to receive the lesser of her intestate share or the value of the disposition made to her under the Will. If the void disposition to the distributee / witness becomes part of the residuary estate, the witness receives her share from the residuary estate. If the void disposition passes in intestacy (which could occur, for example, if the witness were the sole residuary beneficiary), then the witness receives her share ratably from the distributees who succeed to such interest.[3]

EPTL § 3-3.2 is derived from the predecessor statute, Decedent Estate Law § 27,[4] which provided the same general rule as EPTL § 3-3.2 and the same two leniencies described immediately above, albeit with a slightly different focus and in more antiquated language.

A Few Background Cases

The courts have held that where beneficial dispositions were made in a Will to all of the Will's attesting witnesses, the Will could still be admitted to probate, but the dispositions to the witness beneficiaries would be void.[5] In *Estate of Fracht*,[6] the decedent's nephew, an attorney who was obviously unfamiliar with estate law, prepared the decedent's Will. 50% of the residuary estate was left to the decedent's wife, the other 50% to the nephew, and the decedent's sister was a contingent beneficiary of the residuary estate. The wife, nephew and sister acted as witnesses. The court held that the wife, who was one of the decedent's distributees, could receive an amount equal to the lesser of her intestate share or the testamentary disposition made to her. The court also ruled that the entire 50% residuary interest left to the nephew and the contingent residuary bequest left to the decedent's sister (neither of whom were distributees) were void. Therefore, the voided portion of the wife's inheritance and the nephew's entire beneficial interest both passed to the contingent residuary beneficiaries of the Will (other than the sister).

In *In re Hens' Will*,[7] an older case decided under the DEL, the Surrogate's Court of Nassau County held that a residuary disposition under the Will to two beneficiaries would be effective even though the beneficiaries were witnesses to a Codicil to the Will. In this case, the two residuary beneficiaries under the Will were not witnesses to the Will, but were necessary witnesses to a Codicil to the Will that reduced the amount of a cash legacy made under the Will and thereby increased the value of the residuary estate. The court held that the original disposition of the residuary estate to these two witness beneficiaries was effective (because they were not witnesses to the Will) but the increase in the residuary estate made by the Codicil was void with respect to the witness beneficiaries. Because there was no alternative disposition of such amount, such amount passed in intestacy.

In *In re King's Estate*,[8] the court held that the determination of whether the attesting witness receives a beneficial disposition under the Will is made at the time of execution and attestation and that the disinterest of the witness must exist at the time of execution.

In this case, the Will left the entire residuary estate to the attorney-draftsman. There were three witnesses to the Will: the attorney-draftsman, the decedent's cousin (who received a $500 legacy) and a third person who had no interest in the Will. Before the Will was admitted to probate, the decedent's cousin signed a deposition stating that he was aware that by virtue of his testifying in favor of the Will's being admitted to probate, he would forfeit his $500 legacy. The attorney-draftsman argued that, as a result of the cousin's forfeiture, there were two disinterested witnesses, the attorney-draftsman was therefore not a necessary witness and thus he could receive his residuary legacy. The Court rejected this argument, holding that the disinterest of the witnesses must exist at the time of execution, not at the time of probate; the Court concluded that the attorney-draftsman must forfeit his residuary legacy.

With respect to the not infrequent practice of having a nominated executor act as one of a Will's witnesses, the courts have long held that the nomination of an attesting witness as an executor is not deemed a beneficial disposition to such witness. The courts' rationale for reaching this conclusion is that any payments made to the executor are compensation for services to be rendered rather than a beneficial disposition.[9]

The *Wu* Case

The *Wu* case is about extending the application of EPTL § 3-3.2(a)(1) to the tax apportionment clause of a Will. In *Wu*, the decedent, Cynthia Wu, executed a Will providing that all estate taxes payable by reason of her death with respect to property passing both under the Will and outside the Will were to be paid out of her estate without apportionment. Wu's brother, who was the beneficiary of two insurance policies on her life valued at approximately $3.3 million, was one of two attesting witnesses to the Will. Therefore, his testimony was necessary for its probate.[10]

In *Wu*, a case of apparent first impression, the New York County Surrogate's Court was presented with the question whether the tax apportionment clause of the Will was effective to absolve the brother from his share of estate taxes in light of EPTL § 3-3.2(a)(1). The Court couched its decision as hinged on whether the Will's estate tax non-apportionment clause was tantamount to a beneficial disposition to the witness brother.

The Court began its analysis by noting that the policy underlying EPTL § 3-3.2 and its predecessor DEL § 27 is to impose safeguards against fraud and undue influence by preventing a witness to a Will from benefiting under the Will if probate is dependent upon the witness's testimony. The brother argued that in this case there was no fraud or undue influence because, when he acted as a witness to the Will, he was unaware of his designation as beneficiary of the decedent's life insurance policies. The Court stated that even if the brother's assertion were true, his knowledge of the life insurance policy beneficiary designation was irrelevant. The Court held that "the application of EPTL 3-3.2(a)(1) to a non-distributee is absolute." While, the Court explicitly recognized that its strict application of the statute may lead to an unduly harsh result in certain circumstances, it opined that applying the statute rigidly was necessary due to the language of the statute and the public policy that it carries out.

Conclusion

The arguably unsettling significance of the holding in *Wu* is that the brother, who was not mentioned in the Will and, according to his testimony, was unaware that he was named as a beneficiary of a non-probate but estate-taxable asset, nevertheless was deemed to receive a beneficial disposition under the Will because of the Will's estate tax non-apportionment clause.

The *Wu* case clearly illustrates the dangers of having a do-it-yourself Will execution ceremony. Where the decedent may gather her family members and friends as witnesses, she is not likely to recognize that such an informal execution ceremony could defeat her intentions to benefit the same family members or friends under her Will. Even attorneys who are not knowledgeable in trusts and estates law may be unaware of the statute or its pitfalls. Furthermore, attorneys who do not concentrate in trust and estate practice and who are aware of the statute may not have the experience to know that only reviewing the terms of the Will to determine who may or may not serve as witnesses is not always sufficient. In order to ensure that the decedent's wishes are carried out, it often necessary and always advisable to gather complete information about the decedent's non-probate assets.

In light of the above, experienced trusts and estates law practitioners should continue to provide and adhere to the time-tested practice that Wills should be executed most often in an attorney's office, with attorneys or employees of the attorney acting as quasi-professional witnesses. Following such a procedure should in most cases ensure that the Will execution formalities are complied with and, equally importantly, ensure that the witnesses to the Will are truly disinterested. Because of the Court's decision in the *Wu* case, doing so is more important than ever before.

Endnotes

1. 24 Misc.3d 688, 877 N.Y.S.2d 886 (Surr. Ct., N.Y. Co. 2009) (hereinafter "Wu" or the "Wu case").
2. N.Y. Estates Powers and Trusts Law (EPTL) § 3-3.2 provides as follows:

    Competence of attesting witness who is beneficiary; application to nuncupative will

(a) An attesting witness to a will to whom a beneficial disposition or appointment of property is made is a competent witness and compellable to testify respecting the execution of such will as if no such disposition or appointment had been made, subject to the following:

(1) Any such disposition or appointment made to an attesting witness is void unless there are, at the time of execution and attestation, at least two other attesting witnesses to the will who receive no beneficial disposition or appointment thereunder.

(2) Subject to subparagraph (1), any such disposition or appointment to an attesting witness is effective unless the will cannot be proved without the testimony of such witness, in which case the disposition or appointment is void.

(3) Any attesting witness whose disposition is void hereunder, who would be a distributee if the will were not established, is entitled to receive so much of his intestate share as does not exceed the value of the disposition made to him in the will, such share to be recovered as follows:

(A) In case the void disposition becomes part of the residuary disposition, from the residuary disposition only.

(B) In case the void disposition passes in intestacy, ratably from the distributees who succeed to such interest. For this purpose, the void disposition shall be distributed under 4-1.1 as though the attesting witness were not a distributee.

(b) The provisions of this section apply to witnesses to a nuncupative will authorized by 3-2.2.

3. *Id.* at § 3-3.2(a)(3)(A)&(B).

4. N.Y. Decedent Estate Law (DEL) § 27 provided as follows:

Devise or bequest to subscribing witness

If any person shall be a subscribing witness to the execution of any will, wherein any beneficial devise, legacy, interest or appointment of any real or personal estate shall be made to such witness, and such will cannot be proved without the testimony of such witness, the said devise, legacy, interest or appointment shall be void, so far only as concerns such witness, or any claiming under him; and such person shall be a competent witness, and compellable to testify respecting the execution of the said will, in like manner as if no such devise or bequest had been made.

Except as hereinafter provided in this section no subscribing witness to a will shall be entitled to receive any beneficial devise, legacy, interest or appointment of any real or personal estate thereunder unless there are two other subscribing witnesses to the will who are not beneficiaries thereunder.

But if such witness would have been entitled to any share of the testator's estate, in case the will was not established, then so much of the share that would have descended, or have been distributed to such witness, shall be saved to him, as will not exceed the value of the devise or bequest made to him in the will, and he shall recover the same of the devisees or legatees named in the will, in proportion to, and out of, the parts devised and bequeathed to them.

5. *Estate of Fracht*, 94 Misc.2d 664, 405 N.Y.S.2d 222 (Surr. Ct. Bx. Co. 1978).

6. *Id.*

7. *In re Hens' Will*, 39 Misc.2d 78, 239 N.Y.S.2d 1007 (Surr. Ct. Nassau Co. 1963).

8. *In re King's Estate*, 68 Misc.2d 716, 328 N.Y.S.2d 216 (Surr. Ct. N.Y. Co. 1972).

9. *Fracht*, *supra*; *see Pruyn v. Brinkerhoff*, 7 Abb.Pr.N.S. 400 (Sup. Ct. 3rd Dist. 1867).

10. *Wu*, *supra*; *see* N.Y. Surrogate's Court Procedure Act (SCPA) § 1404 (1).

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The Transfer for Value Tax Trap

By Robert J. Adler

An important exception exists to the general rule of Internal Revenue Code § 101[1] that life insurance proceeds are excluded from gross income of the recipient. This exception is known as the "transfer for value rule" and it works like this: After the initial issuance of a policy, if it is subsequently transferred for "valuable consideration," the income tax exclusion under IRC § 101(a) is lost, and the beneficiary must include in gross income the proceeds received, to the extent that they exceed both the consideration paid by the transferee of the policy and any subsequent premium payments or other costs of maintaining the policy subsequent to the transfer.[2]

The exempting of life insurance proceeds from income taxation is based upon a rationale that insurance functions as an alleviation of economic hardship flowing from the insured's death. When a policy is "purchased" by one party from another the situation begins to look more like an investment or business type transaction, in which the eventual receipt of the proceeds on death of the insured is a bargained-for benefit, having no strong policy rationale for exclusion from income of the recipient. Thus, the economic hardship rationale may well be inapplicable in cases where an insurance policy has been transferred for valuable consideration.

Example

John purchases a $750,000 life insurance policy on his own life, naming his brother Tom as the beneficiary. Subsequently, John transfers the ownership of the policy to Tom for $5,000. This is a transfer for value under IRC § 101(a)(2). During the succeeding four years Tom pays annual premiums of $2,000 per year. Thereafter, John dies and Tom receives the $750,000 death benefit under the policy. Because of the transfer for value rule, Tom realizes ordinary income in the amount of $737,000 (the $750,000 proceeds, less the $13,000 which he paid to acquire and maintain the policy).

The Transfer for Value Rule

The transfer for value rule can become a tax trap for unwary advisors and their clients.

Neither Cash Consideration nor Formal Transfer of Policy Ownership Are Necessary for Triggering of the Rule

The transfer for value rule can come into play under a variety of circumstances in which a party acquires an interest in the proceeds for some form of valuable consideration. There need not necessarily be a formal transfer or assignment of ownership of the policy.[3] For example, the naming of a beneficiary in exchange for any kind of valuable consideration could constitute a transfer for value. The granting by separate agreement of a right to receive all or part of the death benefit would constitute a transfer for value, as long as there is consideration given for such right.[4] Whether or not the policy has a cash value at the time of the transfer for consideration has no bearing on the applicability of the transfer for value rule. A transfer for value can occur even though no purchase price per se is paid for the interest in the policy, as long as the transferor receives some type of valuable consideration.

Pledge of Policy as Collateral

If an insurance policy is pledged as collateral to secure a loan or other obligation, this is not deemed a transfer for valuable consideration, and will not generally trigger the transfer for value rule. Thus, if the insured dies owing a debt secured by pledge of his insurance policy, and the pledgee receives all or a portion of the insurance proceeds in satisfaction or reduction of the debt, such proceeds will not be gross income to the recipient.[5]

Common Situations Involving the Transfer for Value Tax Trap

Transfer of Policy Subject to Policy Loan

If ownership of a life insurance policy is transferred at a time when the policy is subject to a policy loan, even if no other consideration is received for the transfer, it will be deemed a transfer for value. Under the IRS's rationale, in such a situation the transferor realizes consideration in the form of relief from the debt represented by the policy loan.[6] The transferor-taxpayer is considered to benefit from discharge of debt upon disposition of an asset securing the debt (the life insurance policy), even when the debt is "non-recourse," as is the case with an insurance policy loan.[7]

Split-Dollar Plans

If a split-dollar plan is established utilizing an existing policy, or if a policy subject to a split-dollar plan is rolled out to a designee of the employee/insured, there is a potential transfer for value problem.

Buy-Sell Agreements

Since buy-sell agreements are commonly funded with life insurance, and it is sometimes determined to be advantageous to make changes in the ownership of the policies involved, care must be taken to avoid the transfer for value trap in connection with any such transfers.

Purchases and Sales of Businesses

If a business that owns one or more life insurance policies (e.g., key man policies) sells its assets, or its assets are transferred in liquidation, it is likely that the policies will be deemed to have been transferred for value, and if retained by the acquiring party until the death of the insured, the death benefit (in excess of the consideration paid for the policy's acquisition and subsequent maintenance) will likely be treated as ordinary income.

Business Contractual Arrangements Requiring Life Insurance

In business arrangements in which the services of a particular individual are of critical importance, it is sometimes required that life insurance be maintained on that individual. Thus, for example, if the insured party acquires and maintains the policy, but is contractually required to name one or more parties as beneficiary(s), the transfer for value rule will come into play, and the death benefit will be taxable to such beneficiary as ordinary income. (This would not be the case, however, if the policy is acquired, and the premiums paid, by the beneficiary.)

Transfer for value problems can be avoided in all of the above situations, and many others, if there is a clear understanding of the statutory exceptions to the transfer for value rule, discussed immediately below.

Statutory Exceptions to the Transfer for Value Rule

IRC § 101(a)(2), which sets forth the transfer for value rule, contains two important exceptions.

Transferor's Basis Exception—IRC § 101(a)(2)(A)

The so-called "transferor's basis exception" provides that the transfer for value rule does not apply where the transferee's basis in the policy is determined in whole or in part by reference to its basis in the hands of the transferor. This exception is of greatest importance in the context of policy transfers that constitute, at least in part, gifts.

Transfers That Are Part Sale and Part Gift

When property is transferred by gift, the property takes a "carryover" basis in the hands of the transferee; i.e., the transferor's basis is carried over and becomes the basis of the property in the hands of the transferee. While this exception would eliminate all pure gifts of insurance policies from the application of the transfer for value rule, a pure gift transfer (for no consideration whatsoever) would not be subject to the rule, even absent the exception, since the rule itself only applies when the transfer involves at least some consideration. On the other hand, the exception is important in situations where a transfer has a gift element, but the transferor receives at least something in connection with the transfer. This is referred to as a part-gift, part-sale transfer. Because the transferor's basis exception to the transfer for value rule operates when the transferee's basis is determined in whole or in part by reference to the transferor's basis, the exception will apply in a part-gift, part-sale situation, since the gift portion of the transfer will involve a carryover basis.

Example

Bill is the owner of a $500,000 insurance policy on his life. His basis in the policy is $10,000; the cash value of the policy is $12,000. Bill transfers ownership of the policy to his son, Sheldon, for an agreed consideration of $2,500. Bill has made a part-gift, part-sale of the policy, the gift being the excess of the policy's fair market value (measured by the cash value) over the amount paid. Under the carryover basis rule applicable when there is a gift involved, Sheldon's basis in the policy would be $10,000, Bill's basis at the time of the transfer, even though Sheldon paid only $2,500 for the policy. Even though there was a transfer of the policy for valuable consideration, the transfer for value rule would not apply, because of the applicability of the transferor's basis exception (i.e., Sheldon's basis is determined in whole or in part by reference to Bill's basis).

It should be noted that in a part-gift, part-sale situation where the amount of consideration received by the transferor exceeds the transferor's basis (even though it is less than the market value of the policy), the carryover basis rule is not applicable, and the transferee's basis is the amount of consideration furnished (i.e., the amount paid).[8] In such a situation the transfer for value rule exception would not operate, and the rule would apply. In the example above, if Sheldon had paid $11,000 for the policy, that would be his basis, and the transfer for value rule would apply (i.e., Sheldon's basis would not be determined in whole or in part by reference to Bill's basis but instead by reference to his cost of acquiring the policy).

Policy Transfers in Tax-Free Reorganizations

Under a number of circumstances involving the transfer of property to a corporation in connection with its formation or reorganization (e.g., in a merger transaction), the transfer will not be considered a taxable transaction. In such circumstances, the property will take a carryover basis in the hands of the transferee. Thus, if a life insurance policy is transferred to a corporation in such a tax-free transaction, its basis in the hands of the transferee will be determined by reference to the basis in the hands of the transferor, and, thus, the transfer for value rule will not be applicable.

Policy Transfers Between Spouses or Incident to Divorce

Generally, the transfer for value rule does not apply to the transfer of life insurance policies between spouses as long as the transfer occurred after July 18, 1984, and both spouses elect to have the nonrecognition rules of Code § 1041 apply.[9] The transferee's basis in the policy is equal to the transferor's adjusted basis immediately before the transfer,[10] regardless of whether or not any consideration was paid, and thus, the transfer falls within the "transferor's basis exception" to the transfer for value rule.

The transfer for value rule will also not apply in the case of life insurance policies transferred between spouses (or former spouses) pursuant to a divorce decree, as long as the divorce decree is entered into after July 18, 1984, and the election is made to have the IRC § 1041 nonrecognition rules apply.

Transfer for Value Taint Cannot Be Removed by Subsequent Transfer That Would Otherwise Qualify for the Transferor's Basis Exception

If a policy has been the subject of a transfer for value transaction, and neither of the exceptions to the transfer for value rule is applicable, the death benefit will be subject to taxation as ordinary income. With limited exceptions (discussed below), once this "taint" attaches to a transferred policy it cannot be eliminated by a subsequent transfer to another party, even if the subsequent transfer is totally gratuitous and involves no valuable consideration. Just as the basis in the hands of the transferor will carry over to the transferee, so will the "taint" in effect carry over.[11]

Example

Able acquires a $600,000 policy on his own life. After having paid premiums totaling $3,000, he sells the policy to Baker for $3,500, a transfer for value. Baker then makes premium payments totaling $4,000 more, and transfers the policy for no consideration, as a gift to his daughter, Casey. Thereafter, Casey makes premium payments totaling $8,000. Able then dies, and Casey receives the death benefit of $600,000. Because of the prior transfer for value from Able to Baker, the death benefit is not exempt from taxation, even though no consideration was involved in the transfer by which Casey obtained the policy. Casey may, however, exclude from income the amount which Baker could have excluded ($3,500 purchase price, plus $4,000 in premium payments), plus the $8,000 which Casey paid in premiums, or a total exclusion of $15,500. Accordingly, Casey realizes ordinary income of $584,500.

Transfers of Business Life Insurance Under the Proper Party Exception—§ 101(a)(2)(B)

This exception to the transfer for value rule operates when the transferee is either the insured party or any of the following affiliates of the insured:

- a partner of the insured;
- a partnership in which the insured is a partner; or
- a corporation in which the insured is either an officer or stockholder.

As long as the transferee is one of these so-called "proper parties," it does not matter whether or not the transfer involved any consideration flowing to the transferor. Moreover, if the final transferee of a policy is one of these proper parties, any transfer for value taint which may have attached to the policy as a result of any prior transfer for value will be eliminated and the death benefit will be receivable tax free.[12]

Transfers to Grantor Trusts

Although not specifically dealt with in the proper party statutory exceptions in § 101(a)(2), some types of transfers for consideration can, under certain circumstances, avoid the transfer for value rule, when there is effectively no change in the beneficial ownership of the policy for income tax purposes.

Example

IRS Revenue Ruling 2007-13 reaches a favorable conclusion on the tax consequences of a transfer of a life insurance policy insuring the trust grantor's life, from one grantor trust to another, and from a non-grantor trust to a grantor trust. In both situations, the ruling concludes that the transfer for value rule does not apply. IRS Revenue Ruling 2007-13 affirms the similar results obtained on IRS Private Letter Rulings 200636086, 200606027, 200518061, 200514002, and 200514001.

Example

In *Swanson v. Comm'r*,[13] the Tax Court held that where a grantor retained extensive powers to deal with the trust property, including the right to interpret or amend the trust instruments, he should be treated as the owner of the property. The only limitation on his power was the provision that he could not become the owner of the property. However, he could add or change beneficiaries, alter trust provisions and otherwise acquire complete control over the property. According to the court, there was no transfer for value to the extent of the grantor-insured's ownership of the trust corpus, in this case 91 percent. The remaining 9 percent of the insurance proceeds was subject to income tax under the transfer for value rule.

Endnotes

1. 26 U.S.C. § 101 (references to the Internal Revenue Code are to 26 U.S.C. § 1, et sec., 1986, as amended (hereinafter IRC)).
2. *Id.* at § 101(a)(2).
3. Treas. Reg. § 1.101-1(b).
4. *See* Treas. Reg. § 1.101-1(b)(4).
5. *Id.*
6. *See* Internal Revenue Service Rev. Rul. 69-187, 1969-1 C.B. 45.
7. See Treas. Reg. § 1.1001-2(a)(4)(i).
8. *See id.* at § 1.1015-4(a)(1).
9. IRC §§ 101(a)(2) and 1041.
10. *Id.* at § 1041(b)(2).
11. *See* Treas. Regs. §§ 1.101(b)(2) and 1.101-1(b)(3)(iii) (providing that in the case of a transfer involving a carryover basis, the amount of death benefit that can be excluded from income by the transferee may not exceed the amount that could have been excluded by the transferor if there had been no transfer (plus consideration and other amounts paid by the transferee)).
12. *See id.* at § 1.101-1(b)(3)(ii).
13. 33 T.C.M. 296 (1974).

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Court of Appeals Rules There Is Privity Between the Estate Planner and the Client's Personal Estate Representative: But No Privity to Beneficiaries of the Estate

By Gary E. Bashian

The traditional protection from legal malpractice claims afforded Estate practitioners by the doctrine of Privity has been relaxed by a recent New York Court of Appeals decision.

In the *Estate of Saul Schneider v. Finmann*,[1] a unanimous Court of Appeals has ruled that a personal Estate representative "stands in the shoes of the decedent," and therefore has "the capacity to maintain a malpractice claim on the Estate's behalf."[2]

As many know, New York was one of the few remaining States that continued the precept that there was no Privity between a client's Estate and an attorney. Without this relationship of Privity, a personal Estate representative did not have the necessary standing to bring a malpractice suit against a negligent Estate planner. Now, such an action no longer requires strict attorney-client Privity as the Court has ruled that "Privity, or a relationship sufficiently approaching Privity, exists between the personal representative of an Estate and the Estate planning attorney,"[3] thus imposing a duty upon the Estate planner towards the personal representative of an Estate as would exist between an attorney and live client.

This newly imposed duty between the attorney and the Estate's personal representative establishes the threshold element necessary to bring a negligence action which was formerly denied to the personal Estate representative. Where it is found that this duty has been breached by an attorney, causation of damages is proved, and based on the actual damages that result to the Estate, the client's Estate now has a claim for malpractice in its quiver of arrows that should send quivers of concern to all Estate planning attorneys who have acted casually because of their belief that they would be protected by the old law. Although most attorneys will explain in detail orally the Estate, gift and income tax options and issues, there will now be lawsuits against attorneys who know the laws and tax consequences, explained all of the laws and tax consequences, but did not put it in writing. Even better, a writing acknowledged by the signature of the client.

The *Schneider case*[4] presented a situation that, until now, left a negligent Estate planning attorney immune from recourse by the former client's Estate. Mr. Schneider was represented by Mr. Finmann and his firm from early 2000 to his passing in late 2006. Plaintiff, the duly appointed personal representative of his Estate, alleged that based on the advice of his counsel, the decedent purchased a $1 million life insurance policy and over the next several years he transferred the policy in, and out, of a number of limited liability partnerships of which he was the principal owner, and then subsequently transferred the policy back to himself in his own individual name. Upon Mr. Schneider's death, this series of transactions resulted in the proceeds of the life insurance policy to be included as part of his gross taxable Estate. At the trial level, the Nassau County Supreme Court predictably granted Defendant's summary judgment motion for plaintiff's failure to state a cause of action pursuant to CPLR § 3211(a)(7), which was later affirmed by the Appellate Division Second Department on the same grounds.

The Appellate Division Second Department invoked the "well established rule in New York" expressed in *Spivey v. Pulley*[5] "with respect to attorney malpractice that absent fraud, collusion, malicious acts, or other special circumstances, an attorney is not liable to third parties, not in Privity, for harm caused by professional negligence,"[6] and did not allow the Estate to bring an action under Estates Powers and Trusts Law (EPTL) 11-3.2(b). As noted by the Appellate Division Second Department, New York Courts have strictly applied Privity in the past, and disallowed negligence claims against an Estate planner in its absence.

Upon being heard by the New York Court of Appeals, though, *Schneider* was not summarily dismissed for failure to state a cause of action. Indeed, New York's highest Court, relying heavily on the reasoning articulated in the Texas Supreme Court case *Belt v. Oppenheimer*,[7] determined that the personal representative of the Estate could pursue the malpractice cause of action against the allegedly negligent Estate planner. However, Estate beneficiaries and other third parties are still bared from bringing malpractice actions against Estate planners for negligent planning.

Belt v. Oppenheimer[8] involved a similar suit in Texas by the personal representatives an Estate who brought an action against the attorney planners for negligently incurring “over $1.5 million in tax liability that could have been avoided by competent Estate planning.”[9] The *Belt* court reasoned that although damages did not occur to the Estate until after the death of the client, the negligent act occurred while the decedent was alive. If the decedent had discovered this prior to death, he could have brought suit against the Estate planner to recover fees, and for costs to restructure the Estate in order to ameliorate the negligence. Therefore, if the injury occurs during the client’s lifetime, a claim of malpractice survives the client’s death and is justiciable by the personal Estate representative. Logically, the Estate is standing in the same shoes as the dead client, and is essentially the alter ego of the dead client.

Schneider seems to have adopted the Texas Supreme Court’s reasoning, indicating that “the personal representative of an Estate should not be prevented from raising a negligent Estate planning against the attorney who caused harm to the Estate. The attorney planner surely knows that minimizing the tax burden of the Estate is one of the central tasks entrusted to the professional.”[10]

Though the *Schneider* decision is far from revolutionary, and the rather narrow ruling endeavors to balance the interests of both Estate representatives and their legal counsel within the framework of the EPTL 11-3.2(b) which allows the personal representative of an Estate to maintain an action for “injury to person or property” after the testator’s death, the real question is what will be the scope of liability and the dollar amount of damages that a negligent planner may be exposed to for their malpractice.

While the New York Court of Appeals has specifically stated that this new application of the Privity requirement ensures that Estate planning attorneys will not be subject to “undesirable results, uncertainty, and limitless liability,”[11] it remains probable that if the reasoning of the *Belt* Court, cited above, were pushed to its logical extreme, it would result exactly in the “undesirable results, uncertainty, and limitless liability” that both New York’s and Texas’ highest Courts were specifically trying to avoid.

For example, if the personal Estate representative truly does “stand in the shoes of the decedent,”[12] then arguably he or she would be able to bring any variety of negligence claims on behalf of the Estate that are not prohibited by statute or common law. *Schneider* indicates that the basis of a malpractice action would flow from the failure to fulfill “one of the central tasks entrusted to the professional.” What constitutes the essential duty of the Estate planner that, if breached, would be ruled negligence, and what method the Court will use to calculate damages, remain open issues to be determined by the Courts based on the unique and particular facts of each case.

There will, therefore, undoubtedly be many new actions throughout the Courts as personal Estate representatives bring suit where they suspect they have a cause of action due to negligent planning. Clearly, only time, and the inevitable litigation that the *Schneider* case will produce, can answer these questions.

Estate planners in New York must take great care when addressing their clients’ needs as this application of Privity will have significant repercussions throughout their practices. It would behoove all attorneys to make sure their file contains enough memos and correspondence, confirmed by the client in writing, explaining the details and implications of the Estate plan as it is structured. This will be especially important where the client makes a decision to do something that will clearly, or may, result in additional taxes or other damages that that client’s Estate could pursue post-death.

Endnotes

1. 210 NY Slip Op. 05281.
2. *Id.* (citing *Belt v. Oppenheimer* 192 SW 3d 780, 787 (Tex 2006)).
3. *Id.*
4. *Id.*
5. 138 A.D.2d 563, 564 (2d Dep’t 1988).
6. *Schneider v. Finmann*, 60 A.D.3d 892, 893 (2d Dep’t 2009).
7. 192 S.W.3d 780 (Texas 2006).
8. *Id.*
9. *Id.* at 782.
10. 210 NY Slip Op. 05281.
11. *Id.*
12. *Id.* (citing *Belt v. Oppenheimer*, 192 S.W.3d 780, 787 (Texas 2006)).

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What Clients Should Know Before You Set Up Their Private Foundation

By Jasmine M. Hanif

Many times a client comes in insisting that he or she wants to set up a private foundation without first understanding the sometimes less than intuitive rules imposed on the administration of such entities. For some, a private foundation makes perfect sense. For others, the amount of money the client intends to use to fund the foundation and his or her goals in creating one are simply not sufficient to outweigh the administrative burdens of using a foundation, leaving such goals better accomplished through other means, such as perhaps a donor-advised fund or simply a direct gift to charity. While practitioners regularly discuss with clients the pros and cons of creating a foundation in various jurisdictions and whether to use a corporate entity or a trust, there are a number of additional administrative issues that we, as their advisors, should be educating such clients on from the outset. In this way clients may better understand the magnitude of the task they are undertaking and the limitations and burdens of using a private foundation to achieve their charitable goals.

This article is intended to summarize those administrative rules and regulations affecting your typical "plain-vanilla" family foundation. It assumes that the foundation is set up as a corporation in New York, it will not be soliciting contributions from the public and that it has registered with the New York Attorney General's Office pursuant to Section 8-1.4 of the New York Estates, Powers and Trusts Law.[1]

Financial Statements and Annual Filing Requirements

A private foundation is required to file annual federal and state tax information returns. Clients should make sure that the Foundation's accountants are aware of this filing requirement and are able to prepare the forms.

1. Form 990-PF

The Internal Revenue Service requires a private foundation to file a Form 990-PF regardless of the amount of its annual gross receipts.[2] This annual return asks for a variety of information, including the private foundation's gross income, expenses, assets, liabilities, net worth, contributions, and the names and addresses of trustees and private foundation managers. The Form 990-PF must be filed on or before the 15th day of the fifth calendar month following the close of the private foundation's fiscal year.[3] At the same time, a copy of the Form 990-PF must also be filed with the Attorney General of the State of New York.[4]

A private foundation is allowed an automatic three-month extension of time to file the Form 990-PF with the IRS by filing an "Application for Extension of Time to File an Exempt Organization Return (Form 8868)" in a timely manner.[5] A copy of this extension form should be submitted with the copy of the Form 990-PF when it is submitted to the Attorney General.[6]

2. Form CHAR500

All registered private foundations, even those meeting certain annual report exemption requirements, must file with the Charities Bureau of the Attorney General of the State of New York every year on Form CHAR500.[7] Form CHAR500 is due six months following the end of a foundation's annual accounting period and, unless the foundation is exempt, must be accompanied by a copy of the foundation's Form 990-PF and a filing fee.[8] If a foundation has (1) total gross receipts not exceeding $25,000 for the reporting period and (2) total assets not exceeding $25,000 at any time during the reporting period it will be exempt from the more detailed reporting requirements applicable to this period and will only be required to file CHAR500 in order to claim the annual report exemption.[9] A request for a three month extension of time to file may be made by email.[10] Additional extensions may be granted upon written request.

Public Disclosure Requirements

Section 301.6104(d)-1 of the income tax regulations requires that a foundation make available for public inspection the foundation's annual information return (Form 990-PF) for the three most recent years, along with the foundation's application for tax exemption (Form 1023) and any letters or documents issued by the IRS with respect to such application (which necessarily includes the determination letter from the IRS approving the foundation's application for tax exemption). These documents must be made available for public inspection without charge at the foundation's principal office during regular business hours. If a foundation does not maintain a permanent office or has no office hours, the foundation may mail, within 2 weeks of receiving a request for inspection, such documents to the requestor in lieu of allowing an inspection. A foundation must comply with requests from the public for copies of such documents, and is permitted to charge only reasonable fees for reproduction and postage. Copies must be provided immediately to anyone who requests the documents in person and within 30 days if the request is made in writing. A foundation will not be required to comply with requests for copies of such documents if the private foundation has made the requested documents "widely available" (for example, by posting them on the internet through the private foundation's own web site or on a database of exempt organization documents maintained by another organization),[11] or if the IRS determines that the foundation is the subject of a harassment campaign.[12] However, it must still allow public inspection by office visitation.

The penalties for failure to comply with these requirements are severe.[13] The penalty for failure to disclose documents, either for public inspection or upon request, will be imposed on the persons who fail to meet the requirements. For example, for failures to disclose either the private foundation's annual information return(s) or its application(s) for tax exemption, the person failing to meet the requirements will have to pay $20 *per day* as long as such failure continues. The maximum penalty for failing to disclose any one annual information return may not exceed $10,000. There is no such ceiling on the penalty for failing to disclose the private foundation's application for tax exemption. Finally, an individual's willful failure to comply with these rules may result in an additional penalty of $5,000.[14]

In addition, Section 406 of the Not-for-Profit Corporation Law of New York State requires that a foundation publish notice of the availability for inspection of the foundation's annual information return in a newspaper designated by the clerk of the county in which the principal office of the foundation is located. Such publication is required to be made no later than the due date for filing the foundation's annual return. The notice must state that the annual return of the foundation is available for inspection during regular business hours by any citizen who requests it within 180 days after the date of such notice and must state the address and telephone number of the foundation's principal office and the name of its principal manager. The New York law requiring publication is somewhat inconsistent with the IRS rule regarding inspection as it imposes a 180-day time limit and does not provide an alternative for those foundations which do not maintain a principal office. Nevertheless, publication must be made as prescribed under New York law.

Corporate Governance

As a corporation, a foundation should observe corporate formalities and maintain proper books and records, including contemporaneous records of the meetings of the Board of Directors. An annual meeting of the Board of Directors is generally required for the purpose of electing directors and officers, receiving the annual reports of the Board and officers, and for the transaction of any other business. Meetings need not be frequent so long as the directors are able to communicate their goals through written and oral communication with the foundation managers.

In addition to the annual meeting, good corporate governance should include the development and adoption of sound governance policies. While the typical family foundation may have little immediate need for such policies, by adopting formal policies at the outset, the foundation will have put in place procedures that will help avoid the possibility that those in positions of authority over the foundation may receive an inappropriate benefit which could ultimately result in the imposition of excise taxes against the foundation and its managers and in the revocation of the foundation's tax-exempt status. Governance policies may include policies regarding conflicts of interest, record retention, compensation, expense reimbursement, gift acceptance and whistleblowers.

Foundation Excise Taxes

A private foundation is a nonprofit, tax-exempt organization established to maintain or aid scientific, educational, charitable, religious, or other philanthropic activities, and which is usually controlled and supported by a single source, such as a family or a company, rather than the general public. With the exception of a tax on investment income and unrelated business income,[15] a foundation is exempt from state and federal income taxation, and contributions to a foundation are deductible by the donor for income tax purposes. Unlike a public charity, however, a foundation permits a donor to maintain a high degree of control over the foundation's funds.

As a result of perceived abuses involving private foundations, Congress enacted complex, technical rules to govern private foundations. These rules regulate a foundation's investments, distributions, expenditures, and certain other transactions. If these rules are violated, the foundation can be subject to onerous penalties, including termination of the foundation's nonprofit status. The following discussion provides an overview of these rules, which should be explained to a client before proceeding with the creation of a foundation. These rules are enforced through the collection or potential imposition of excise taxes, some of which are imposed on the foundation and some of which are imposed on individuals because of their relationship with the foundation. In general, the excise tax on net investment income described in paragraph (a) below applies to all private foundations that earn net investment income and cannot be avoided. The remaining excise taxes discussed below in paragraphs (b) through (f) are in the nature of penalties designed either to encourage or prohibit certain types of activities or transactions by the foundation or its managers.

a. Code Section 4940: Net Investment Income[16]

Under Section 4940 of the Internal Revenue Code (the "Code"), a private foundation will be subject to a tax of two percent (one percent under certain circumstances) of its net investment income for each tax year. The net investment income includes interest, dividends, rents, royalties and certain net capital gains which result from selling assets that produce such kinds of investment income. Expenses attributable to the production of investment income are deductible against investment income. Capital losses offset capital gains but excess capital losses may not be used to offset other types of investment income or be carried over to future tax years.

If a foundation's tax liability is expected to be $500 or more, the foundation is required to make quarterly estimated payments of the excise tax on its net investment income as well as on any unrelated business income. Quarterly estimated payments are due on the 15th day of the 5th, 6th, 9th, and 12th months of the foundation's fiscal year.[17]

b. Code Section 4942: Minimum Distribution Requirement[18]

To avoid the excise tax imposed by Section 4942 of the Code, a private foundation must spend a minimum amount of its funds annually to accomplish its charitable purposes directly or to make grants to organizations that will directly use the funds to accomplish charitable purposes. These annual obligations are known as "qualifying distributions." Qualifying distributions encompass grants to public charities, any amounts paid to accomplish the charitable purposes described in the Code, and any amounts paid to acquire any asset used (or held for use) directly in carrying out such purposes. A qualifying distribution also includes reasonable administrative expenses that are necessary to achieve a foundation's charitable purposes.

The minimum amount of a qualifying distribution for any given year is generally equal to the private foundation's "minimum investment return" less certain taxes and any excess qualifying distributions in earlier years (which may be carried forward for five years). The minimum investment return is deemed to be 5% of the aggregate fair market value of all of the assets of a private foundation other than those used in carrying out the foundation's exempt purposes. For the purpose of calculating fair market value, commonly accepted methods of valuation are used, such as market quotations to value public securities.

A private foundation may set aside funds for a specific project for as long as five years if it can be shown to be a better way to accomplish the project than making immediate payments. Such "set-asides" are treated as qualifying distributions, and must be pre-approved in writing by the IRS. The IRS has traditionally been reluctant to approve set-aside requests. Recognizing this, Congress created a second type of set-aside which may be used by a private foundation only in its early years. This alternate type of set-aside may generally be made under the following conditions:

1. The set-aside amount must be paid for the specific project within five years;
2. The set-aside must be for a project that will not be completed before the end of the year of the set-aside;
3. During its first four years of operations, the private foundation must distribute at least the sum of (a) 20% of its minimum qualifying distribution for its first year, (b) 40% of its minimum qualifying distribution for its second year, (c) 60% of its minimum qualifying distribution for its third year, and (d) 80% of its minimum qualifying distribution for its fourth year (although no portion of such amount need be distributed in any one taxable year of the four-year period); and
4. During each year after its fourth year, a private foundation must distribute 100% of its minimum qualifying distribution.

The rules regarding set-asides are highly technical. A client intending to set aside funds each year for specific future projects should consult with counsel regarding compliance with the set-aside rules.

Section 4942 imposes a substantial tax on the "undistributed income" of a private foundation. Undistributed income is the amount by which a private foundation's minimum investment return for the taxable year exceeds its qualifying distributions. The initial tax imposed on a private foundation for failure to distribute income is 30% of the undistributed income. An additional tax, equal to 100% of the undistributed income, is imposed if the failure to distribute is not corrected. The consequences of this tax are particularly severe, since the tax is in addition to, and not in lieu of, making the income distribution.

c. Code Section 4941: Self-Dealing[19]

Section 4941 of the Code prevents a private foundation from entering into most business transactions with any “disqualified person.” Disqualified persons include (1) substantial contributors to the private foundation (a person is a substantial contributor if he or she contributes more than $5,000, if such amount is more than 2% of the *total* contributions received by the private foundation up through the close of the tax year in which the contribution was received; once a person is a substantial contributor, his or her status as such can be terminated only in limited circumstances); (2) owners of more than 20% of the voting power of a corporation, the profits interest of a partnership or the beneficial interest of a trust or unincorporated enterprise, any of which is a substantial contributor to the foundation; (3) private foundation managers (any officer or trustee of the private foundation); (4) certain members of the family of any substantial contributor, 20% owner, or private foundation manager; (5) corporations of which a substantial contributor, 20% owner, or private foundation manager owns at least 35%; and (6) certain government officials.[20] “Family” for this purpose includes a spouse, ancestors, children, grandchildren, great grandchildren, and their spouses.[21]

The Code restricts “self-dealing” between a private foundation and a disqualified person by imposing an excise tax on such transactions. Section 4941(d)(1) of the Code defines self-dealing as: (1) any transaction involving the sale, exchange or lease of property between a foundation and a disqualified person; (2) the lending of money or other extension of credit between a foundation and a disqualified person (including transfer of property subject to a mortgage or lien from a disqualified person to a private foundation if the private foundation assumes, or takes title subject to, the mortgage or lien); (3) the furnishing of goods, services, or facilities between a foundation and a disqualified person; (4) the payment of compensation or payment of reimbursement or expenses by a private foundation to a disqualified person; (5) the transfer to, or for the benefit of, or use by, a disqualified person of the income or assets of a private foundation; and (6) the agreement by a private foundation to make any payment of money or other property to a government official.

An example of self-dealing is where a private foundation’s assets are used to discharge the enforceable pledge of a disqualified person. But the self-dealing prohibition is quite broad and technical and acts of self-dealing are not always so obvious. Common sense or business judgment alone cannot be applied to evaluate whether a proposed act will constitute self-dealing.[22] For example, a seemingly innocuous example of self-dealing is where a foundation leases property from a disqualified person at a below-market rate. Even though the transaction is favorable to the foundation, it still constitutes self-dealing. However, a private foundation may lease space from a disqualified person if such lease is made at no charge to the foundation.[23] Yet another example of self-dealing is where a foundation purchases tickets to a fundraising event which is attended by a disqualified person.[24] Even if the disqualified person reimburses the foundation for the cost of his meal at such event self-dealing has occurred. A better practice would be for the foundation to make a direct grant to the organization hosting the event.

There are a number of exceptions to the self-dealing rules. For example, the Code provides that none of the following will be considered acts of self-dealing: (1) the furnishing by a disqualified person to a private foundation of services, supplies, or facilities that are used exclusively for charitable purposes without charge; (2) certain loans to a private foundation from a disqualified person if the loan is without interest, and if the loan proceeds are used exclusively for charitable purposes; (3) the furnishing of goods, services, or facilities by a private foundation to a disqualified person if they are furnished on a basis that is no more favorable than that made available to the general public, and if the goods, services, or facilities so furnished are functionally related to the private foundation’s performance of its charitable purposes; (4) the payment of compensation to disqualified persons for their personal services, if the services are reasonable and necessary to the private foundation’s charitable purposes, and if the compensation is not excessive; and (5) certain transactions between a private foundation and a corporation that is a disqualified person, which occur pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization.[25]

Once again, these rules are technical and absolute. For example, “without charge” does not mean at a reduced charge. If a disqualified person provides office space to be used for charitable purposes at no charge to the private foundation, no self-dealing has occurred. If a disqualified person charges below-market rent to the private foundation, an act of self-dealing has occurred. The compensation exception applies only to personal services and does not exempt other transactions.

The tax on self-dealing is 10% for the disqualified person of the amount involved in each act of self-dealing each year and 5% (maximum $10,000 per act of self-dealing) for a private foundation manager of the amount involved. If the self-dealing act is not corrected (that is, if the private foundation is not placed in a financial position no worse than that in which it would have been if the disqualified person had dealt with the private foundation under the highest fiduciary standards), an additional tax of 200% is imposed on the self-dealer and a tax of 50% is imposed on a private foundation manager (maximum $10,000 per act of self-dealing). Under limited circumstances, the IRS may, in its discretion, abate this tax, as well as the other taxes described below.

d. Code Section 4943(c): Excess Business Holdings[26]

In general, a private foundation may hold up to 20% of the voting stock of a corporation, reduced by the percentage of voting stock owned by disqualified persons (as defined above with respect to self-dealing). If the private foundation and all disqualified persons together do not own more than 20 percent of the voting stock, the private foundation may also hold nonvoting stock. In the case of a partnership or joint venture, "profits interest" is substituted for "voting stock" and "capital interest" is substituted for "nonvoting stock." (Although not specifically addressed in the Code, other entity forms such as limited liability companies which are classified as partnerships for tax purposes are generally treated as partnerships for purposes of determining excess business holdings.) Holdings in sole proprietorships are not permitted. A private foundation that violates this rule incurs an initial excise tax equal to 5% of the value of its excess business holdings, followed by a tax equal to 200% of such excess if the violation is not cured.

The 20% rule works as follows: assume that A Corp. has outstanding 100 shares of voting stock. The private foundation possesses 20 shares of A Corp. voting stock, representing 20% of the voting power in A Corp. Assume that a disqualified person owns 9% of A Corp. voting stock. The permitted holdings of the private foundation in A Corp. are 11%. The foundation would be required to dispose of 9% of the voting stock of A Corp.

In addition to the 20% rule, special 35% and 2% rules apply. If effective control of the corporation rests in persons who are not disqualified persons with respect to the private foundation, the private foundation and all disqualified persons may hold together up to 35% of the voting stock. There is also a minimal interest rule under which a private foundation (together with all other related private foundations) may own up to 2% of the voting stock and up to 2% of all outstanding shares of all classes of stock in a corporation, regardless of the percentage of stock owned by disqualified persons.

There is also a special rule regarding gifts and bequests that allows a private foundation five years from the date it receives stock to dispose of its excess business holdings. If business interests are transferred to a private foundation pursuant to the terms of a will or a trust, the five-year period will begin to run on the date the stock is distributed from the estate or trust to the private foundation. An additional five years for disposition may be permitted if a gift or bequest involves diverse, large, or complex business holdings.

A business that derives at least 95% of its income from passive sources (dividends, interest, annuities, royalties, rents, and gain from the sale of real property excluded from unrelated business income) will not be subject to the excess business holdings provision. Thus, stock in a passive holding company will not constitute excess business holdings even if the company is controlled by the private foundation. Instead, the private foundation will be treated as owning its proportionate share of any interests in business enterprises owned by the holding company, and the private foundation's proportionate share of such interests will be limited by the excess business holdings provision.

If a private foundation does not dispose of its excess business holdings, an initial tax is imposed equal to 10% of the value of the excess business holdings during the taxable year. If the situation remains uncorrected, there is a second tax equal to 200% of the excess business holdings.

e. Code Section 4944: Jeopardy Investments[27]

The foundation's managers may not invest its assets in a manner that would jeopardize the carrying out of its exempt purpose. A "prudent investor" standard applies and requires an analysis of ordinary business care and prudence in determining whether the foundation has made investments that may jeopardize its exempt purpose. Investing in, for example, federally insured certificates of deposit, AAA-rated bonds, and blue-chip stocks, will ordinarily satisfy the prudent trustee standard. In contrast, trading in commodity futures, trading in securities on margin, buying puts or calls or selling short, purchasing warrants or investing working interests in oil and gas wells—activities which could result in immediate and substantial portfolio losses—will be subject to "close scrutiny" and may be found to constitute a jeopardizing investment. No investment is specifically designated as a jeopardizing investment; however, because of recent market events it is expected that more scrutiny will be made of the risk and diversity of investment portfolios.

The initial tax imposed on a private foundation for its speculative investment is 10% of the amount invested. A 10% tax is also imposed directly on a private foundation manager who knowingly participates in the speculative investment (maximum $10,000 per speculative investment). If the jeopardizing investment is not corrected, a second tax of 25% may be imposed on the private foundation and of 5% on a foundation manager (maximum $20,000 per speculative investment).

f. Code Section 4945: Taxable Expenditures[28]

Section 4945 of the Code penalizes "taxable expenditures" by a private foundation, which are defined generally as amounts paid or incurred by the private foundation (1) to influence legislation or any public election; (2) to achieve a purpose other than a charitable purpose; or (3) to make grants to (a) individuals (unless such grants are made pursuant to a program approved in advance by the IRS) or (b) tax-exempt organizations that are not public charities (*i.e.*, other private foundations) or foreign charities without exercising extensive supervisory control of the grant ("expenditure responsibility") to ensure its proper use. A private foundation is considered to be exercising expenditure responsibility as long as it exerts all reasonable efforts and establishes adequate procedures to (1) see that the grant is spent solely for the purpose for which it is made, (2) obtain full and complete reports from the grantee on how the funds are spent, and (3) make full and detailed reports with respect to such expenditures to the IRS. In addition, before making the grant, an inquiry should be made to ensure that the grantee will use the grant for proper purposes.

The IRS has assumed a very strict position on expenditure responsibility. The rules governing taxable expenditures are technical and complex. Because of their complexity, many private foundations prefer to restrict their grants to public charities in order to avoid these rules. If the client anticipates using his foundation to make grants to foreign charities or to other tax-exempt organization that are also private foundations rather than public charities, the requirements of Code Section 4945 should be reviewed in detail.

Improper expenditures cause an initial tax to be imposed on the private foundation of 20% of the amount of the taxable expenditure, and if the expenditure is not corrected, a second tax of 100% of the amount of the taxable expenditure may be imposed. Such improper expenditures also cause an initial tax to be imposed on a private foundation manager of 5% of the amount of the taxable expenditure (maximum $10,000 per taxable expenditure) and an additional tax of 50% of the amount of the taxable expenditure if the expenditure is not corrected (maximum $20,000 per taxable expenditure).

Conclusion

At the end of the day, the decision to create a private foundation rests ultimately with the client. But it is the attorney's job to make sure the client is presented with all of the ramifications of doing so first. This article is by no means an exhaustive discussion of the issues affecting private foundations. However, it should provide a good start for discussion with your clients. If, after considering all of the administrative and tax issues discussed above, the client still wants to create a private foundation, such a decision will truly be an informed one.

Endnotes

1. Additional registration and reporting requirements (including requirements for audited financial statements) and alternate filing deadlines are imposed on organizations which make public solicitations. Such organizations are beyond the scope of this article.
2. I.R.C. § 6033(b) & (c); Treas. Reg. § 1.6033-2(a)(2).
3. Treas. Reg. § 1.6033-2(e).
4. I.R.C. § 6033(c); Treas. Reg. § 1.6033-3(c).
5. Treas. Reg. § 1.6081-9.
6. 13 N.Y.C.R.R. 91.5(f).
7. 13 N.Y.C.R.R. 91.5(b) & (c).
8. 13 N.Y.C.R.R. 91.5(c).
9. 13 N.Y.C.R.R. 91.5(e).
10. 13 N.Y.C.R.R. 91.5(f).
11. Treas. Reg. § 301.6104(d)-2.
12. Treas. Reg. § 301.6104(d)-3.
13. I.R.C. § 6652(c)(1)(C) & (D).
14. I.R.C. § 6685.
15. The Section 4940 excise tax on investment income is discussed below; however, the tax on unrelated business income has been omitted from this article because of its limited applicability to private foundation in general and more specifically to the type of "plain-vanilla" private foundations contemplated as within the scope of this article.
16. See also Treas. Reg. § 53.4940-1.
17. See Instructions to form 990-PF.
18. *See also* Treas. Reg. §§ 53.4942(a)-1, *et seq.*
19. *See also* Treas. Reg. §§ 53.4941(a)-1, 53.4941(b)-1, 53.4941(c)-1, 53.4941(d)-1 *et seq.* and 53.4941(e)-1.
20. I.R.C. § 4946(a).
21. I.R.C. § 4946(d).
22. *See* Rev. Rul. 77-379, 1977-2 C.B. 387.
23. Treas. Reg. § 53.4941(d)-2(b)(2).
24. IRS Priv. Ltr. Rul. 9021066.
25. I.R.C. § 4941(b)(2).
26. *See also* Treas. Reg. §§ 53.4943-1, *et seq.*
27. *See also* Treas. Reg. §§ 53.4944-1 and 53.4944-2.
28. *See also* Treas. Reg. §§ 53.4945-1, 53.4945-2, 53.4945-3, 53.4945-4, 53.4945-5 and 53.4945-6.

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Pierre, Part Deux

By Laurence Keiser

In the Spring 2010 issue of this *Newsletter* I reported on the case of *Pierre v. Commissioner*.[1] In *Pierre*, the Tax Court awarded a victory to the taxpayer, holding that gifts of interests in a former single member limited liability company were not gifts of the underlying assets. (The entity was not a disregarded entity for gift tax purposes.)

Apparently the Internal Revenue Service was not finished with Mrs. Pierre. Because of the further issues, the second case, recently decided,[2] is also noteworthy.

Let's review the facts. Mrs. Pierre received a $10 million cash gift from a wealthy friend in 2000. On July 13, 2000, on advice of tax counsel, she created the single member LLC. On July 24, 2000 she created trusts for her son and granddaughter. On September 15, 2000, she funded the trust with $4,250,000 of cash and securities. Based on an appraisal which took into account a 10% discount for lack of control and a 30% discount for lack of marketability, Mrs. Pierre's advisors determined that she could give a 9.5% interest in the LLC to each of the trusts without triggering gift taxes. So that was done on September 27, 2000. On that same date, she also sold each of the trusts a 40.5% interest in the LLC in exchange for a secured promissory note.

The IRS argued in this case that the step transaction doctrine should be applied to integrate the gift portion and the sale portion. Based on this application, IRS argued that Mrs. Pierre transferred 50% interests, not minority interests, and the discounts should be much lower and therefore Mrs. Pierre made taxable gifts.

It is noteworthy that IRS did not attempt to apply the step transaction doctrine to the creation of the LLC and the subsequent transfers of the LLC interests as it sought to do in some earlier cases. As noted here, Mrs. Pierre transferred the property to the LLC on September 15, 2000. She transferred the LLC interests on September 27, 2000, twelve days later.

Although she had non-tax reasons for making the transfers, Mrs. Pierre did not list any non-tax reasons for splitting the gift transfers from the sale transfers. IRS argued that Mrs. Pierre divided the transfer at issue into four transfers only to avoid the gift tax. The Tax Court agreed: "It is appropriate to use the step transaction doctrine where the *only* reason that a single transaction was done as two or separate transactions was to avoid gift tax."[3]

All the transactions happened on the same day. Indeed they happened at the same time. Mrs. Pierre intended to give her entire interest away without paying gift tax. It was not noted whether there were two separate assignments. Furthermore, taxpayer's accountant recorded the transfers as two gifts of 50% interests. (The accountant also testified that some records no longer existed.) The Court also noted that although interest had been paid, no principal payments had been made on the notes, despite the passage of eight years. The Court concluded that the transactions were planned as a single transaction and the multiple steps were used solely for tax purposes.

Although the IRS won on the step transaction issue, it was less successful on its argument that taxpayer's appraisals were significantly overstated because the appraisal ought to have been made of a 50% interest and not a 9.5% interest and a 40% interest. The IRS did not present an expert report, but argued that the discounts for lack of control and lack of marketability had to be reduced. In contrast, taxpayer presented a further appraisal at trial proposing a 10% discount for lack of control and a 35% discount for lack of marketability. (Despite this, petitioner on brief only argued for a discount of 30%.)

Petitioner's expert acknowledged that if he were valuing a 50% interest, the discount for lack of control would be reduced from 10% to 8%. The Court so held. However, the expert stuck with the 30% discount for lack of marketability. The Court accepted the 30% discount for lack of marketability in the absence of other testimony.

There continues to be significant disagreement among appraisers regarding discounts for a 50% interest. As we know, 50% is not a minority interest, but neither does it represent control. At least one Court case found a 44% discount where timberland was involved. However IRS has always asserted that there should only be a discount for the cost of partition. In the very recent case *Ludwick v. Commissioner*,[4] the taxpayer took a 30% discount for a 50% tenant-in-common interest. IRS argued for an 11% discount. The Tax Court held that a 17% discount was appropriate.

Stepping back, Mrs. Pierre engaged in a fairly common planning scenario technique. The taxpayer creates a partnership (or LLC), then gives away enough to stay within the $1 million gift tax exclusion, and sells the rest for a note. This has the effect of freezing the estate value. The interest in the property (with its appreciation potential) has become a promissory note (which increases by the interest rate).

Advocates of the "sale to an intentionally defective grantor trust" transaction usually suggest that a gift first be made to fund the trust. The gift gives the trust substance and the ability to make payments on the note, even in the absence of income from the property purchased. But the transactions should not happen simultaneously. Planners must recognize this. The Tax Court might have rejected the application of the step transaction doctrine if the steps were even six days apart, as it held in *Holman v. Commissioner*.[5]

Endnotes

1. 133 T.C. 24 (2009).
2. T.C. Memo 2010-106.
3. T.C. Memo 2010-106 (citing *Shepherd*, 115 T.C. 376 (2000), *aff'd*, 283 F. 3d 1258 (11th Cir. 2002) and *Senda*, T.C. Memo 2004-160, *aff'd*, 433 F.3d 1044 (8th Cir. 2006).
4. T.C. Memo 2010-104.
5. 130 T.C. 170 (2008).

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NYSBA

Staying Competitive with a Directed Trust Statute: The Proposed Bill for New York

By Natalia Murphy

With its rich case law and well-developed statutory framework, New York is certainly a mature jurisdiction when it comes to trust administration, but it can hardly be called "trust-friendly." Increasingly, clients in New York are looking beyond the Empire State to meet their trust needs, particularly clients that prefer a trust model granting authority to a settlor or advisor to direct a trustee as to one or more aspects of trust administration. Presently, there is no statute in New York authorizing so-called "directed trusts," but there is a growing consensus among practitioners and industry lawyers that New York ought to enact one if it is to remain a competitive trust jurisdiction. A 2005 Appleseed study reinforces this sentiment, finding that while trust business continued to grow nationwide, New York's trust business is in decline.[1] Unsurprisingly, almost every major New York trust company has opened a Delaware trust office to meet its New York clients' demand for directed trusts, representing a real loss for the New York economy.

Directed trusts are commonly utilized in several situations. One typical scenario involves a settlor funding a trust with an interest in a closely held business, while continuing to manage the business or involving family members in management as part of succession planning. Another typical scenario involves a settlor wishing to maintain a concentrated stock position to fund the trust, contrary to a trustee's normal practice to diversify trust investments to limit exposure under the Prudent Investor Act. A third typical scenario involves a settlor appointing a trusted advisor, already used for management of personal assets, for investment of assets transferred to a trust. In each instance, the settlor or appointed advisor is responsible for decisions concerning the business or investments funding the trust, while the trustee handles all other trust administration functions. Another common thread is that the trustee expects to avoid liability for losses resulting from trust investments over which it has no control, whereas the settlor expects reduced trustee fees because the trustee does not handle a major function of trusteeship, namely, investment of trust assets.

This article will examine current law in New York touching upon directed trusts and note its shortcomings and I review the Restatement, UTC and Delaware approaches to directed trusts. A key focus of this article is how each of these approaches fares with respect to the balance of trustee and settlor expectations concerning liability and fees. Finally, this article sets forth the proposed bill for directed trusts in New York, which many in the T&E community hope will soon be taken up by the Legislature.

Current Law in New York Relating to Directed Trusts

New York is one of only seventeen states that is without a statute authorizing directed trusts. There is, however, some judicial support in New York for directed trusts. The 1989 Nassau County Surrogate's court decision in *In re Rubin* is a key decision providing support for directed trusts.[2] *In re Rubin* was a construction proceeding where the executors disputed the validity of a will clause granting advisors power to direct the executors.[3] The court acknowledged the long-standing principle that a testator has the right to "limit, qualify, or condition the authority granted to his fiduciary."[4] The court further acknowledged that a testator may appoint in a governing instrument an individual whose advice the named fiduciaries must follow, specifically mentioning the scenario "where the testator divides the fiduciary functions between a primary fiduciary and an advisor on investments."[5] *In re Rockefeller*[6] and *In re Winston*[7] are subsequent cases also upholding the right of testators / settlors to grant advisors power to direct executors and trustees as to administration under a will or trust. Importantly, however, none of these cases concerns investment issues arising in a directed trust context. None addresses the crucial issue of trustee liability for losses resulting from improper investments or the settlor's expectation to incur reduced trustee fees under a directed trust. While providing some judicial support for directed trusts, these cases are not a substitute for the certainty and uniformity that would be afforded by a statute, particularly one that addresses the issues of responsibility for trust investments, potential liability and trustee fees.

Although lacking a directed trust statute, New York does have EPTL 11-2.3(c), which allows trustee investment responsibility to be delegated to another, but only at the trustee level. In other words, EPTL 11-2.3(c) is not applicable in the directed trust context where the settlor—not the trustee—appoints a directing advisor to handle trust investments, thereby relieving the trustee of responsibility for investment decisions. Moreover, under EPTL 11-2.3(c), the delegor trustee retains significant oversight responsibility for the actions of the delegee and, consequently, lacks incentive to lower its fees in light of its potential liability. Another shortcoming is that although the statute requires a delegee to submit to the jurisdiction of New York courts, and thus be joined as a party to a court proceeding, that requirement may be trumped by an arbitration clause in a delegation agreement, which many financial institutions routinely use. *In re Blumenkrantz* is a case where the trustee had delegated its investment function to a delegee pursuant to an agreement containing an arbitration clause, and a trust beneficiary later challenged the prudence of the trustee's investments in an accounting proceeding.[8] The Nassau County Surrogate's court held that the delegee was not subject to an accounting proceeding and that the issue of delegee's liability must be arbitrated between the trustee and the delegee or between the beneficiary and the delegee.[9] Thus, to the extent it is considered a substitute for a directed trust statute, EPTL 11-2.3(c) is inadequate.

The Restatement, the UTC and the Delaware Approaches

Restatement (Second) of Trusts § 185 is a directed trust provision, but one of limited appeal. It has been enacted only in Iowa.[10] Section § 185 reads:

> If under the terms of the trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of such power, unless the attempted exercise of the power violates the terms of the trust or is in violation of a fiduciary duty to which such person is subject in the exercise of the power.

By its terms, the Restatement imposes a duty on a trustee to act in accordance with the directions of an advisor appointed under the trust. However, it is inadequate in the trust investment context because it fails to limit a directed trustee's liability for investment decisions made by an appointed advisor. Under this approach, a directed trustee owes a duty to a settlor to oversee the actions of a directing advisor, the same as it would for the actions of a co-trustee. The directed trustee must carefully scrutinize the appointed advisor's actions to determine whether the advisor is violating its fiduciary duty or acting in contravention of the terms of the trust. It must make a reasonable inquiry and investigation prior to acting on any direction and determine if it should act in the absence of direction. In short, the Restatement approach invites a court proceeding whenever the trustee and the advisor disagree or the advisor fails to take action deemed necessary by the trustee.

UTC § 808(b) is similar to Restatement (Second) of Trusts § 185, but appears to afford more protection to the directed trustee in terms of potential liability for the investment decisions of a directing advisor. UTC § 808(b), enacted in seventeen states and the District of Columbia,[11] reads:

> If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.

Compared to the Restatement, the "manifestly contrary" and "serious breach" language relaxes the trustee's oversight responsibility for the investment decisions of a directing advisor. Notwithstanding, a trustee directed as to trust investments must still investigate the directing advisor's investment strategy to determine if there is a breach of fiduciary duty. Further, just as with the Restatement approach, a directed trustee lacks an incentive to lower its fees because it still must evaluate a directing advisor's investment decisions to avoid potential liability for those decisions.

Delaware is representative of the fifteen states that have enacted statutes that clearly define the roles of the directed trustee and the directing advisor.[12] The Delaware directed trust statute relieves the directed trustee from any obligation to oversee the actions of the advisor, be it investment reviews or recommendations, if the advisor is solely authorized under the trust to direct the acquisition, disposition or retention of trust investments.[13] The statute expressly provides that a directed fiduciary is not liable for any loss resulting, directly or indirectly, from the investment decisions of a directing advisor, except in cases where there is willful misconduct by the trustee.[14] Its application in an investment context was tested in *Duemler v. Wilmington Trust Company* in the Delaware Chancery court.[15] In *Duemler*, one of the trust investments, in an overall portfolio of highly risky assets, declined dramatically when the investment advisor failed to act.[16] The court held that the investment advisor breached its fiduciary duty because it failed to take the necessary and appropriate action to protect the investment, but did not find any breach of fiduciary duty by the trustee.[17] The court recognized that an investment advisor alone must have responsibility for investment decisions, without the oversight of a trustee, if directed trust provisions are to have operative effect.[18]

Proposed Directed Trust for New York

The NYSBA is lobbying the Legislature to enact a directed trust statute providing for a clear division of trust investment responsibilities and liability as between a directing investment advisor and a directed trustee. The NYSBA proposes the following directed trust statute and is currently seeking a sponsor in the New York Legislature:

EPTL Section 11-2.2A. Directed Trusts

(a) As used in this section:

(1) The term "investment advisor" means one or more fiduciaries whose appointment is provided by the terms of the trust instrument and who has authority to direct investment decisions.

(2) The term "administrative trustee" means one or more trustees whose appointment is provided by the terms of the trust instrument and whose sole responsibility with respect to the investment of trust funds is to follow the written directions of the investment advisor. The administrative trustee shall possess all powers and duties granted to a trustee other than the powers and duties to direct the investment decisions.

(3) The term "investment decision" means retention, purchase, sale, exchange, tender or other transaction affecting the ownership of trust property.

(4) The term "trust" means any express trust of property, created by a will, deed or other instrument, whereby there is imposed upon any fiduciary the duty to administer property for the benefit of a named or otherwise described income or principal beneficiary or beneficiaries, or both. A trust shall not include trusts for the benefit of creditors, resulting or constructive trusts, business trusts where certificates of beneficial interests are issued to any beneficiary, investment trusts, voting trusts, security instruments such as deeds of trust and mortgages, trusts created by the judgment or decree of a court, liquidation or reorganization trusts, trusts for the sole purpose of paying dividends, interest, interest coupons, salaries, wages, pensions or profits, instruments wherein persons are mere nominees for others, or trusts created in deposits in any banking institution or savings and loan institution.

(b) Except as otherwise provided by the express terms and provisions of a trust instrument within the limitations set forth by section 11-1.7 of this chapter:

(1) The investment advisor is solely responsible for investing the trust funds by directing the administrative trustee in writing as to the investment decisions of the trust funds held by the administrative trustee.

(2) The administrative trustee shall comply with the written directions of the investment advisor and if the administrative trustee acts in accordance with such directions, the administrative trustee shall not be liable for any loss resulting from any action taken pursuant to such directions or not taken by reason of inaction of the investment advisor.

(3) The investment advisor is a fiduciary to the extent of the powers, duties and discretions granted to the investment advisor under the terms of the trust instrument and under this section, and the investment advisor is liable for any loss that results from breach of said fiduciary duty.

(4) The administrative trustee shall have no duty to review the actions of the investment advisor while the investment advisor is acting.

(5) Notwithstanding any provision in this section to the contrary, if at any time there is a vacancy in the office of investment advisor and no designated successor investment advisor is able and willing to act, then, upon written notice to the administrative trustee, all powers and duties conferred on the investment advisor under the terms of the trust instrument and under this section shall vest in the administrative trustee.

(c) By accepting the appointment to serve as investment advisor or administrative trustee, the investment advisor and the administrative trustee submit to the jurisdiction of the courts of this state even if the investment advisory agreement or other related agreements provide otherwise, and the investment advisor and the administrative trustee may be made a party to any action or proceeding relating to decisions, actions or inactions of the investment advisor or the administrative trustee.

(d) The investment advisor shall be entitled to such compensation as may be reasonable, and the court, upon application of a person interested in the trust, may review the reasonableness of such compensation.

(e) The administrative trustee shall be entitled to either commissions in accordance with section 2312 of the Surrogate's Court Procedure Act or one-half of the commissions provided under section 2309 of the Surrogate's Court Procedure Act, whichever section of the Surrogate's Court Procedure Act is applicable.

(f) This section shall apply to all trusts which came into existence after _______________, 201__ and which incorporate this section by reference.

The proposed statute makes clear that the directed or administrative trustee must comply with the directions of the investment advisor.[19] Importantly, unlike some jurisdictions that do not deem an investment advisor to be a fiduciary, the proposed statute expressly deems the investment advisor to be a fiduciary. It clearly imposes liability on the investment advisor for any losses resulting from a breach of its fiduciary duty, while relieving the directed trustee of any potential liability for such losses. It also addresses the settlor's expectations for reduced fees, providing that an individual trustee receive one-half of the statutory trustee's commissions, while entitling a corporate trustee to reasonable compensation, taking into account its lack of investment responsibility. By way of comparison, Delaware trust companies charge on average 75 basis points less when they are not responsible for trust investment decisions. Lastly, the proposed directed trust statute overcomes the shortcomings of EPTL 11-2.3 (c) with respect to arbitration clauses in investment agreements. The proposed statute expressly overrides arbitration clauses in such agreements and subjects investment advisors and administrative trustees to the jurisdiction of the New York courts. This provision should trump the operation of an arbitration clause because the investment advisors and administrative trustees all contractually agree to administer the trust pursuant to the terms of the governing trust instrument.

Conclusion

New York clients are a sophisticated lot and many demand the option to control trust investments for the next generation. By enacting a comprehensive directed trust statute, New York can meet this legitimate demand, stay competitive with rival jurisdictions and bolster the State economy.

Endnotes

1. Appleseed, A., In re Trusts: Preserving Jobs and Taxes in New York's Personal Trust Business, A Report to the Lower Manhattan Development Corporation, February 2005.
2. *In re Rubin*, 143 Misc.2d 303, 540 N.Y.S.2d 944 (Sur. Ct., Nassau Co. 1989), *aff'd*, 172 A.D.2d 841, 570 N.Y.S.2d 996 (2nd Dep't, 1991).
3. *Id.*
4. *Id.* at 304, 945.
5. *Id.* at 305-306, 946.
6. *In re Rockefeller*, N.Y.L.J., 8/24/99, p. 28, col. 2 (Sur. Ct., N.Y. Co.).
7. *In re Winston*, N.Y.L.J., 12/24/90, p. 33, col. 3 (Sur. Ct., Westchester Co.).
8. *In re Blumenkrantz*, 14 Misc.3d 462, 824 N.Y.S.2d 884 (Sur. Ct., Nassau Co. 2006).
9. *Id.* at 467, 889.
10. Iowa Code § 633A.4207(2).
11. Alabama: Code of Ala. § 19-3B-808(b); Arkansas: A.C.N. § 28-73-808(b); District of Columbia: D.C. Code § 19-1308.08(b); Florida: Fla. Stat. § 736.0808(2); Kansas: K.S.A. § 58a-808(b); Maine: 18-B M.R.S. § 808(2); Michigan: MCLS § 700.7809 (4); Missouri: § 456.8-808(2) R.S. Mo.; Nebraska: Neb. Rev. Stat. Ann. § 30-3873(b); New Mexico: N.M. Stat. Ann. § 46A-8-808(B); North Carolina: N.C. Gen. Stat. § 36C-8-808(b); North Dakota: N.D. Cent. Code § 59-16-08(2); Oregon: ORS § 130.685(2); Pennsylvania: 20 Pa. C.S. § 7778(b); South Carolina: S.C. Code Ann. § 62-7-808(b); Texas: Tex. Prop. Code § 114.003(b); Vermont: 14A V.S.A. § 808(b); Virginia: Va. Code Ann. § 55-548.08(B).
12. Delaware: Del. Code Ann. tit. 12, § 3313. *See also* Arizona: Ariz. Rev. Stat. § 14-10808; Colorado: CRS § 15-1-307; Georgia: O.C.G.A. § 53-12-194(c); Idaho: Idaho Code § 15-7-501(2); Indiana: Ind. Code Ann. § 30-4-3-9(a); Kentucky: KRS § 286.3-275; Nevada: NRS § 163.5549; New Hampshire: N.H. Rev. Stat. Ann. §§ 564-B:8-808(b), 564-B:12-1206-1207; Ohio: Ohio Rev. Code Ann. §§ 5808.08(B), 5815.25(B); Oklahoma: 60 Okl. St. § 175.19; South Dakota: S.D. Codified Laws §§ 55-1B-1-3; Tennessee: Tenn. Code Ann. §§ 35-15-808, 35-3-122-123; Utah: Utah Code Ann. § 75-7-906(4); Wyoming: Wyo. Stat. Ann. §§ 4-10-808(b), 4-10-715, 4-10-717-718.
13. 12 Del. C. § 3313(b).
14. *Id.*
15. *Duemler v. Wilmington Trust Co.*, 2004 Del. Ch. LEXIS 206 (Del. Ch. Nov. 24, 2004).
16. *Id.*
17. *Id.*
18. *Id.*
19. The proposed statute is a default statute and contemplates that the settlor will define the scope of the directing advisor's authority and divide functions between the directing advisor and the directed trustee.

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Is It Possible for Fiduciaries to Rely on Modern Portfolio Theory to Diversify Today?

By Bruce L. Resnik

Introduction

For over 100 years, fiduciaries have been working with the New York state legislature to be able to diversify their portfolios and invest in different kinds of securities. Not until 1950 was it permissible for fiduciaries to invest in equities. But by 1994, the pendulum had swung so far that the Prudent Investor Act imposed a duty on fiduciaries to diversify investments. That law gave little guidance on what proper diversification was. Since then, fiduciaries have embraced Modern Portfolio Theory ("MPT") because it seemed to establish a "scientific" basis for diversification. However, MPT did not seem to prevent significant portfolio losses in the current credit crisis. Unfortunately, the investment environment of 2010 seems to present even more challenges to diversification—cash investments do not seem to pay a return that will keep up with inflation, bonds may be subject to capital losses from increasing interest rates and issuer defaults and the growth in equities seems to have stalled in the last 10 years. In light of all this, how should a fiduciary properly diversify investments?

Discussion

In *King v. Talbot*,[1] the New York Court of Appeals adopted a form of the Prudent Man Rule which was eventually codified into the "legal list doctrine." The statute listed the types of investments that were permissible for fiduciaries and included bank accounts, U.S government bonds and high grade corporate bonds. Common stocks were not on the list, probably because they were deemed too speculative for fiduciaries.

However, after World War II, bond investors began to incur substantial capital losses as the general level of interest rates rose and the country experienced historically high inflation rates. Fiduciaries appealed to state legislators to allow up to 35% of a trust portfolio to be invested in what were called "non-legals," like common stocks, and this was approved in 1950. By 1965, in the face of continuing and mounting bond losses, this percentage was increased to 50%. By 1970, after more years of high inflation and the historic stock market gains in the "go-go" years of the late 1960s, the "legal list doctrine" was repealed in its entirety and replaced by the Prudent Man Rule.[2]

Perhaps the biggest problem with the Prudent Man Rule, speaking strictly from an investor's perspective, was that the performance of each investment made by a fiduciary was judged in isolation. To our eyes today, that seems patently unfair as we tend to see things more on a portfolio basis. On the whole, if a portfolio as a whole has made substantial returns over time, why penalize a fiduciary for those investments that performed poorly? That was finally remedied in 1994 when New York adopted the Prudent Investor Act, which became effective on January 1, 1995. The Act provides that a fiduciary has a duty to invest and manage property in accordance with the prudent investor standard, which is essentially a standard of conduct, not of outcome or performance.[3]

Most importantly, that Act required that fiduciaries look at their investment portfolios as a whole. The way it did this was by imposing a general duty on fiduciaries to diversify investments.[4] Commentators at the time pointed out that the Prudent Man Rule was "hopelessly out of step with modern investment theory."[5] What commentators were probably referring to was a theory dubbed Modern Portfolio Theory (MPT).

Where did this "modern" theory come from? It originated in the 1950s in a series of papers by Dr. Harry Markowitz of the University of Chicago. This new theory, which drew heavily on Dr. Markowitz's remarkable knowledge of mathematics, attempted to quantify the concept of investment risk. Theoretically, investment risk, which was defined as the volatility of an asset's returns in the past, could be quantified and then reduced and diversified away within a portfolio by carefully combining investments with different historical performance characteristics. This offered what looked like a "scientific" basis to obtain attractive returns while controlling risk by dividing all assets into classes and then by investing in certain asset classes, whose historical returns did not "correlate," that is, did not produce similar returns over time. This was a groundbreaking theory because understanding, defining and quantifying investment risk was, and still is, one of the most difficult concepts for investors and fiduciaries to understand and to manage.

While, the original papers describing MPT were highly quantitative, the theory was soon simplified and popularized both for individuals and fiduciaries by asset managers, private banks and brokerage houses.

In order to demonstrate the "scientific" nature of this theory, fiduciaries were deluged with MPT concepts like the Efficient Market Theory, efficient frontiers and the Capital Asset Pricing Model, as well as MPT statistics like standard deviations, beta coefficients, Sharpe ratios, correlation coefficients, expected returns, etc. which sought to "scientifically" justify the efficacy of this approach. Indeed, a whole generation of investment analysts has now been trained in this approach, and it is nearly ubiquitous at this time.

Through the 1990s and especially the early years of this century, the MPT approach became highly institutionalized and formularized. Every conceivable desired rate of return became identified with a portfolio allocated among equity and fixed income asset classes. Equities were generally perceived to be more volatile and hence "riskier" than fixed income investments, but they were also believed to provide higher returns over long periods of time (often referred to as the "5.00% risk premium for equities"). In short, if an investor or fiduciary desired a portfolio with a very high rate of return, all they had to do was dial up the percentage of equities in their investment portfolio.

Unfortunately, fiduciaries who thought their portfolios were safely diversified incurred substantial losses when the current credit crisis hit. Losses in equities were historically large, and there were also losses in some fixed income securities, as well as in hedge funds and other alternative investments.

Complicating things today is that the current investment environment seems to offer only more investment challenges for fiduciaries—cash investments do not pay a return that seems sufficient to keep up with inflation, bonds may be subject to capital losses both from rising interest rates and increasing issuer defaults, and the growth in equities seems to have stalled in the last 10 years.

Was Reliance on MPT Wrong?

Since it first appeared, MPT has been the subject of academic as well as "real world" criticism.

First, the most successful individual investors, like Warren Buffet and George Soros, did not seem to use the MPT approach, but, instead, seemed to concentrate on either taking big bets on the expected performance of a narrow asset class in the future, such as currency, or on buying operating companies with valuable consumer franchises and holding them for very long periods of time. Unfortunately, neither of these strategies is readily accessible to fiduciaries and, even if they were, only a few professional investors have really been successful achieving these extraordinary returns over time.

Second, asset classes, the building blocks of the portfolios developed by asset managers, private banks and brokerage houses, quickly proliferated and became splintered. For example, equities were soon categorized by the size of the market capitalization of the company issuing securities (large cap, mid-cap, small-cap), and by the arbitrary classification of an equity as either a "value stock" or a "growth stock," or by the location of the corporate headquarters (international or U.S.). Confusingly, one asset manager's small cap stocks were often larger than another's; and one manager's "value stocks" were occasionally another manager's "growth stocks," and so forth.

Third, and most difficult to understand, however, was that some asset classes were held out to be "non-correlating," like alternative investments including hedge funds, private equity funds, managed future portfolios, etc. In other words, their history of returns did not closely match that of other asset classes, such as equities. Hence, according to MPT, making investments in those areas could reduce the "risk" of a portfolio. This certainly seemed to be contradictory from a common sense point of view, especially considering the short operating history of many of such investments (a history which is highly skewed by survivor bias), the high level of leverage often employed by many of these new investment vehicles to increase their returns, their frequent reliance on only one expert or investment "guru," their high fees, the opaqueness or absence of their financial disclosures and the lack of investment liquidity, which were often associated with many of these investments.

Fourth, some MPT assumptions always seemed somewhat suspect. For example, the theory assumed that every asset's investment returns were "normally" distributed (i.e., would resemble a bell curve), that the correlations between asset classes are fixed and unchangeable over time, that all investors have access to the same information at the same time, that all securities can be divided into parcels of any size, and most of all, that there is a perfect trade-off between risk and return. That is, if you invest in "riskier" asset classes, you will be rewarded with higher returns over time. And almost no consideration was given to the effect of taxes on investments and their historical returns.

Finally, it always seemed a little counter-intuitive to invest in an asset class for its future performance by looking solely at its historical returns. In retrospect, that seemed a little like driving a car by looking in the rear view mirror!

In spite of all these qualms, the MPT approach to diversification seemed to be successful, particularly in the period from 2002 to 2007. However, it seemed to fail decisively in the current credit crisis that followed. All asset classes seemed to become correlated—they all went down at the same time!

Was MPT Incorrect?

It is important to realize that MPT is just a theory with some very important limitations. MPT's definition of investment risk solely as the volatility of an investment's past returns is probably just too narrow for the real world. There are many more risks out there. Just one example of such risks would be "price risk." Even after locating a desirable asset class to invest in, the first question to ask should be when to invest to get the investment at the best price. History shows that attractive asset classes are soon bid up in price to where attractive returns are difficult to achieve. If an investor pays too much for assets, their returns will tend to be adversely affected.

MPT was also interpreted as a reason to be neither a tactical nor strategic investor. The theory encouraged investors and fiduciaries to focus only on the historical track record of asset classes, which can be greatly skewed depending on the time period selected. It also did not seem to encourage focusing on which asset classes will show the most potential for appreciation in the future.

And think about this. In light of present market conditions, is it reasonable to assume that adding equities to a portfolio will increase the portfolio's return in any reasonable time horizon (although it will probably increase the portfolio's volatility)? The "reliable" 5.00% risk premium for investing in equities may or may not be reliable any more. As of December 31, 2009, the Standard & Poor's Index of 500 Stocks was where it was in April of 1998—over 11 years ago. Yet a first class postage stamp in 1998 cost 32 cents, and today it costs 44 cents! It is far more likely that the annual percentage growth in equities will track the percentage growth in the economy as a whole, which is likely to be less than recent historical percentages in light of the seriousness of the present economic crisis.

With the limitations of MPT exposed at this time, what strategies can fiduciaries use to diversify now and in the future?

Unfortunately, there is no easy answer to this question and no new theory for fiduciaries to rely on today to diversify in accordance with the law. But what should fiduciaries consider?

Fiduciaries are likely to be increasingly presented with portfolios that initially are drawn using MPT techniques, but which provide for "dynamic" changes of the asset allocation by an overall (or "overlay") portfolio manager. This will permit the manager more flexibility to take advantage of tactical changes in the capital markets. In addition, these portfolios will also likely include more "strategic" areas of investing to capture future returns, whether they are new industries or overseas capital markets.

To an MPT purist, this might be considered "market timing," but, even if it were, there are obvious intuitive advantages in making investments with a view to both tactical and strategic considerations.

But before embracing portfolios like this, fiduciaries should ask questions, particularly when an investment advisor points out a new area that looks attractive for investment. One such question is whether that investment class is "overpriced" or "underpriced" in the current market. It is advisable to avoid buying overpriced assets, regardless of their future prospects.

Fiduciaries should also think twice before investing in alternative investments with heavy fees and withdrawal restrictions. History has yet to prove that most of these investments are going to be successful in the long run. And for trusts as well as individuals, liquidity can be extremely important and should not be easily given up because real life can often make cash demands at the most inappropriate times.

Finally, fiduciaries should ask, if after the long hard road to get to the point where they can invest in equities, do they really need to invest in equities? Consider that the "5.00% risk premium" for equities might be an artifact of the last 50 years, and if the economy grows much slower in the future than it has in the past equities are likely to generate a much lower rate of return. At the extreme, there are some studies, especially those by Robert D. Arnott, that are easily accessible on the internet, that show that investments in bonds have even performed better over long periods of time than investments in equities.

Conclusion

Dr. Markowitz's theory will be with us for a long time and rightfully so. But like most theories, it was only a theory, and its limitations may have been glossed over by the asset managers, private banks and large brokerage companies who put together the asset classes that fit so neatly into their recommended portfolios. It should not be relied upon as the sole strategy for diversifying any portfolio today.

Unfortunately, now that fiduciaries have a duty to diversify, there appears to be no easy or scientific way to do so. To diversify today, fiduciaries will have to fall back on caution, skepticism of the equity markets and plain common sense. To paraphrase Warren Buffet, what is important today is not the return on investment, but rather the return of one's investment. We are living through difficult economic times. Fiduciaries should be cautious and more careful than ever. There are no easy formulas for diversification. Investing was never easy in the past and will probably never be easy in the future.

Endnotes

1. 40 NY 76 (1869).
2. Estates, Powers and Trusts Law (EPTL) § 11-2.2(a)(1).
3. *Id.* at § 11-2.3.
4. *Id.* at § 11-2.3(b)(3)(C).
5. McKinney's Consolidated Laws of New York Annotated, Practice Commentaries to EPTL § 11-2.3, p. 317.

Bruce Resnik is an experienced financial professional with Summit Equities, Inc., member FINRA/SIPC, who concentrates on advising individuals and families on how to cope with their financial problems and realize their financial goals. He is a graduate of both Columbia's School of Law and School of Business and practiced law in New York City as well as having served as Chief Financial officer of both public and private companies. He was awarded the Personal Financial Specialist designation by the American Institute of Certified Public Accountants in 2008. Less than 5,000 CPA's in the U.S. have earned this credential which qualifies them to provide sophisticated financial and estate planning advice.

Mr. Resnik is a member of the New York State Bar Association, the New York City Bar Association, the American Institute of Certified Public Accountants, the New York State Society of Certified Public Accountants (where he serves on the Estate Planning Committee as well as the Personal Financial Planning Committee) and The Estate Planning Council of New York. Further background is available at www.bruceresnik.com.

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An Old Case

Subject: [trusts-estates] use of insurance benefits dictated by will

Date: Tue, 27 Jul 2010 11:16:10 -0400

To: Trusts and Estates Law Section<trusts-estates@lists.nysba.org>

Dear List Members;

I have met with a client who brought in 23 year old copies of a voluntary administration petition and a filed will. At the time the Petition for Vol. Admin was filed she was a minor, being a daughter of the decedent.....The will made many specific bequests in addition to a bequest in trust for her benefit. In the second paragraph, before the specific bequests of cash and property, it made a direction that the amount of insurance proceeds under a specific policy of which decedent's "god-sister" was named beneficiary, was to be used by her to pay all bequests which followed and admin expenses....

Of course, the voluntary admin petition listed only personal property, under the amount requiring probate.... and no further papers were ever filed with the court. The attorney who filed it, drafted the will, was co-executor and co-trustee, and has since died.....

Any thoughts on whether the provisions of the will can be imposed on the individual who got the proceeds of the policy as the named beneficiary?

Thank you in advance for any suggestions...

David G. Ross, Esq.
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Subject: Re: [trusts-estates] use of insurance benefits dictated by will

Sent: Wednesday, July 28, 2010 11:41 AM

To: Trusts and Estates Law Section

I recall seeing a case about an old estate where the beneficiary was allowed to sue because she did not know about her possible inheritance. In effect, they applied a discovery toll to the statute of limitations. Wish I could recall the case, but if it is enough $ you are talking about, would be worth it to find it.

Lori J. Perlman
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Subject: RE: [trusts-estates] use of insurance benefits dictated by will Old case on fraud

Sent: Wednesday, July 28, 2010 1:55 PM

To: Trusts and Estates Law Section

Lori,

The "old case" you may have been thinking of could be [Elizabeth Fowler] *Azoy v. Fowler*, 57 A.D.2d 541, 393 N.Y.S.2d 173, 1977 an Appellate Division, Second Department case which I handled for the plaintiff Mrs. Azoy; she was a financial columnist for the *New York Times* who discovered deed conveyances of property which she believed to be estate assets of the estate of her father who was deceased for a great number of years. The executor allegedly had deeded off the parcels outside the estate but this was not subsequently proven at trial. The passage of time makes proof in any such case extremely difficult and juries can be quite skeptical.

In *Azoy v. Fowler*, *supra*, the Appellate Division applied a **two year from discovery regimen** to determine that the proceeding was not barred by the statute of limitations. This approach as set forth in Azoy has been applied a number of times in other cases. But the allegations of the plaintiff were subsequently rejected by the jury on the case in chief when we tried the matter in the then "new" Goshen Courthouse, Orange County, NY.

I guess this makes me an "old guy."

Jim Riley

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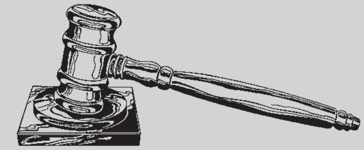
Recent New York State Decisions

By Ira M. Bloom and William P. LaPiana



Ira M. Bloom

ELECTIVE SHARE

Equitable Considerations Disqualify Surviving Spouse from Taking Elective Share

EPTL 5-1.2(a) disqualifies a surviving spouse from taking the elective share in the deceased spouse's estate if a final decree of divorce, annulment, or declaration of nullity was in effect at decedent's death or if the marriage was void as incestuous or bigamous, or was prohibited under Domestic Relations Law § 8. Marriages entered into through fraud or in which one of the parties lacked capacity to contract a valid marriage are voidable, not void, and under the literal words of the statute the survivor of such a marriage is not barred from taking the elective share even if the marriage is annulled after the defrauded or incapacitated party's death.

In an extensive opinion thoroughly discussing both the law of void and voidable marriages and the equitable power of the court to prevent a person from profiting by his or her wrongdoing, the Second Department has affirmed the trial court and held that the survivor of a marriage annulled after the death of the other spouse on the grounds that the decedent lacked capacity to contract a valid marriage cannot claim the elective share in the decedent's estate where the survivor procured the marriage through wrongdoing. *Campbell v. Thomas*, 73 A.D.3d 103, 897 N.Y.S.2d 460 (2d Dep't 2010) (*See also In re Berk*, 71 A.D.3d 883. 897 N.Y.S.2d 475 (2d Dep't 2010), reversing summary judgment in favor of surviving spouse's claim to the elective share and remanding to Surrogate's Court for a determination whether survivor is disqualified under the principles enunciated in *Campbell*).

MALPRACTICE

Personal Representative May Maintain Malpractice Action Against Attorney for Negligent Estate Planning

Attorney negligently caused avoidable estate taxes. Decedent's personal representative sued the attorney for malpractice but the Appellate Division dismissed the case because there was no privity between attorney and the personal representative. The Court of Appeals unanimously reversed on the narrow grounds that "privity or a relationship sufficiently approaching privity, exists between the personal representative of an estate and the estate planning attorney." Significantly, the Court of Appeals reaffirmed the requirement of strict privity for all others: "Strict privity remains a bar against beneficiaries' and other third-party individuals' estate planning malpractice claims absent fraud or other circumstances. Relaxing privity to permit third-parties to commence professional negligence actions against estate planning attorneys would produce undesirable results—uncertainty and limitless liability." *In re Schneider v. Finmann*, 2010 NY Slip Op. 05281 (decided June 17, 2010).

William P. LaPiana

MARRIAGE

New York Has Subject Matter Jurisdiction over Dissolution of Vermont Civil Union

One party to a Vermont civil union sought to dissolve the relationship in Supreme Court, which dismissed the proceeding because the court lacked subject matter jurisdiction. The Appellate Division reversed, holding that because New York public policy protects same-sex couples "in a myriad of ways," the doctrine of comity allows the Supreme Court to exercise subject matter jurisdiction over a proceeding to dissolve a civil union involving a same-sex couple. The opinion includes a full discussion of the public policy established by both statutory and case law. The court noted, however, that there is a distinction between having subject matter jurisdiction and the granting of relief. The court specifically states that the conclusion that subject matter jurisdiction exists does not determine in any way the question of what relief, if any, is available on the merits. *Dickerson v. Thompson*, 73 A.D.3d 52, 897 N.Y.S.2d 298 (3d Dep't 2010).

Marriage of New York Residents Performed in New Jersey Is Valid Under New York Law Even if Not Valid Where Celebrated

Decedent and petitioner had participated in a formal marriage ceremony in accordance with Islamic law. The ceremony was performed in New Jersey at the home of petitioner's brother. The location was dictated by Islamic law which requires a marriage be celebrated at the residence of the bride's eldest male relative. The couple did not, however, obtain a marriage license. Immediately after the marriage the couple returned to the husband's residence in Brooklyn where they resided until the husband's death four years later.

Because New Jersey law requires the issuance of a license, the couple's marriage was not valid under New Jersey law. New York, however, recognizes a marriage as valid even though the couple has not obtained a marriage license so long as the marriage was solemnized, that is, so long as the couple declares in the presence of a clergyman or magistrate and the witnesses that they take each other as man and wife. (DRL § 25)

A child of the decedent by his prior marriage was granted letters of administration and eventually the surviving spouse filed a petition to compel an accounting. The administrator moved to dismiss on the grounds that the marriage was invalid under New Jersey law.

The Surrogate denied the motion to dismiss and the Appellate Division affirmed. Although the legality of a marriage is usually governed by the law of the place where it is celebrated, Restatement (Second) of Conflict of Laws § 283 states that the validity of a marriage is determined by the law of the state that has the most significant relationship to the marriage. Under that rule the validity of the marriage is governed by New York law under which it is indeed valid. *In re Farraj*, 72 A.D.3d 1082, 900 N.Y.S.2d 340 (2d Dep't 2010).

NO CONTEST CLAUSES

Safe Harbor of EPTL 3-3.5 May Not Be Exclusive After All

In *In re Singer*, 13 N.Y.3d 447, 920 N.E.2d 943, 892 N.Y.S.2d 836 (2009) (reported in the previous issue) the Court of Appeals stated that a no-contest clause in a will was not violated where the beneficiary never filed objections to probate, even though the beneficiary's attorney examined the drafter of decedent's previous wills who is not one of the persons whose examination cannot violate a no-contest clause under EPTL 3-3.5(b)(3)(D).

Applying *Singer*, the Appellate Division, First Department has affirmed Surrogate Glen's order construing a will and finding that a proposed proceeding to revoke the letters testamentary and letters of trusteeship of two non-family fiduciaries would violate the will's no contest clause which disinherits any beneficiary who brings a proceeding to "void, nullify or set aside all or any part" of the will. In its decision, the court stated that the statement in *Singer* on the scope of the EPTL 3-3.5(b)(3)(D) safe harbor was "dictum" and that there are no public policy exceptions to the enforcement of a no contest clause. *Hallman v. Bosswick*, 72 A.D.3d 616, 899 N.Y.S.2d 233 (1st Dep't 2010).

STATUTES OF LIMITATION

Infancy of Distributees of Decedent Does Not Toll Period Applicable to Personal Injury Claim by Decedent's Administrator

Infant decedent died as a result of injuries intentionally inflicted by mother's boyfriend. Mother pleaded guilty to criminally negligent homicide; her boyfriend was convicted of second degree murder. The decedent's distributees are her infant sisters. Her mother is disqualified by reason of the felony conviction and her father by reason of abandonment. The infant distributees' attorney applied for and received letters of administration in the decedent's estate one year and 11 months after her death. The administrator then brought wrongful death and personal injury proceedings against several defendants including the county department of social services.

The Supreme Court dismissed the personal injury action and the Appellate Division affirmed. After granting leave to appeal a divided Court of Appeals affirmed, agreeing with the lower courts that the personal injury action was barred by the one-year-plus-90 days statute of limitations for a personal injury action against a municipality (General Municipal Law § 50-i(1)). In an opinion by Judge Graffeo, the Court refused to extend beyond wrongful death proceedings the application of CPLR 208 which tolls any statute of limitations of less than three years when "a person entitled to commence an action" is a minor. (*Hernandez v. New York City Health & Hosps. Corp.*, 78 N.Y.2d 687, 585 N.E.2d 822, 578 N.Y.S.2d 510 (1991)). The court reasoned that the two proceedings are fundamentally different. The wrongful death proceeding belongs to the decedent's distributees and therefore minor distributees should have the benefit of tolling. The personal injury action, however, is a claim of the decedent assumed by the estate and the proceeds from a successful action would be first applied to the debts and expenses of the estate. The two actions are fundamentally different.

Three judges dissented in an opinion written by Judge Ciparick. *Heslin v. County of Greene*, 14 N.Y.3d 67, 923 N.E.2d 1111, 896 N.Y.S.2d 723 (2010).

TRUSTS

Refusal to Exercise Discretion to Distribute Not Made in Good Faith

Husband and wife created irrevocable trusts with the husband's two siblings as co-trustees. At husband's death the trust property is to be distributed to wife unless the co-trustees determine that wife is unable to handle her own affairs because of illness or mental or physical disability. Husband died and the co-trustees refused to distribute the trust property to wife, having determined that she indeed was incapable of handling her own affairs.

The Surrogate determined that the decision was not an abuse of discretion but nonetheless ordered distribution of the trust corpus (with an adjustment for property wife did not transfer to her own trust) to wife.

The Appellate Division affirmed, holding that the co-trustees had not made their determination in good faith. The co-trustees had no contact with wife, did not investigate her capabilities, did not raise concerns related to her management of her own funds, nor did they "revisit the issue in subsequent years." *In re Harmon*, 73 A.D.3d 1059, 900 N.Y.S.2d 761 (2d Dep't 2010).

Court Cannot Order Trustee to Make Distribution in Absence of Finding of Abuse of Discretion

In a child support proceeding Supreme Court found that father was obligated to continue to pay certain amounts towards son's tuition and ordered the corporate co-trustee of a discretionary trust for father's benefit to distribute $10,000 per month to father. The Appellate Division affirmed but modified by deleting the order to the trustee. In the absence of any evidence of abuse of discretion or exercise of bad faith by the trustee the court has no authority to override the trustee's exercise of discretion. *Haynes v. Haynes*, 72 A.D.3d 535, 900 N.Y.S.2d 22 (1st Dep't 2010).

Ira Mark Bloom is Justice David Josiah Brewer Distinguished Professor of Law, Albany Law School. William P. LaPiana is Rita and Joseph Solomon Professor of Wills, Trusts and Estates, New York Law School.

Professors Bloom and LaPiana are the current authors of Bloom and Klipstein, DRAFTING NEW YORK WILLS (Matthew Bender) (Bloom as principal author; LaPiana as contributing author).

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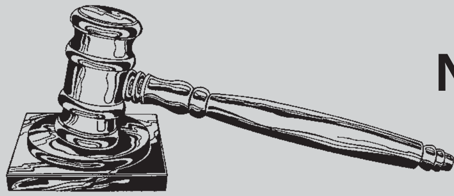

Case Notes— New York State Surrogate's and Supreme Court Decisions

By Ilene Sherwyn Cooper

Construction

The issue before the court in *In re Saviano* was whether a beneficiary under the decedent's Will was devised a life estate or merely a right to occupy the decedent's former residence. The court opined that a life estate conveys exclusive ownership of the land during the lifetime of the life tenant, subject to certain limitations or duties. By comparison, a right of occupancy is a lesser interest in realty, conveying to the recipient a "personal privilege" in the property without the benefits of a life estate.

In reviewing the terms of the Will, the court noted that the beneficiary was devised "the right, during his lifetime, to reside in" the subject premises. The provisions of the Will were otherwise silent as to the nature of the bequest. Nevertheless, the court found it significant that the decedent did not use the words "life estate," nor the descriptive words "use and occupancy" in making the subject bequest, phrases which are traditionally used to denote a life tenancy, although not dispositive. Further, there was no language in the instrument defining the duties or limitations imposed upon the beneficiary.

Accordingly, in view of the foregoing, the court held that the beneficiary's interest in the subject property consisted solely of a right of occupancy.

In re Saviano, N.Y.L.J., June 4, 2010, p. 42, col. 1 (Sur. Ct., Suffolk Co.) (Surr. Czygier).

Deed

In *In re Marie F.*, the petitioner requested that she be appointed the guardian of the person and property of her mother, and that the court declare the invalidity of two deeds to property located in Staten Island executed by the AIP in favor of her son. The application was opposed by the AIP's son, who requested that he be appointed guardian, and that the deeds be upheld. Prior to the appointment of a guardian, the AIP passed away. Nevertheless, the court held that the issues pertaining to the deeds remained subject to its jurisdiction.

The court noted that pursuant to MHL § 81.29(d) it had the authority to revoke a conveyance made by a person determined to be incapacitated at the time of the conveyance. To this extent, the court opined that a person suffering from a mental infirmity is not presumed to be wholly incompetent for all purposes. Rather, it must be established that, because of the affliction, the person was incompetent at the time of the transaction in issue. Moreover, a person is presumed competent to execute a deed, and a person asserting incapacity bears the burden of proving incapacity by clear and convincing evidence.

The record revealed that the AIP had resided in the downstairs apartment of a two-family dwelling since her marriage. Her son resided with his family in the upstairs apartment for 30 years. In May, 2007, the AIP executed a deed transferring her ownership interest in the premises to her and her son equally. Thereafter, in the presence of counsel, who was the draftsman of the deeds, as well as counsel's father, his secretary, and the AIP's son, the AIP executed a second deed to the premises transferring full ownership thereof to her son. Notably, counsel's father was a friend of the AIP's son for many years.

According to the AIP's daughter, several months prior to the execution of the first deed the AIP needed assistance tending to her personal needs, and beginning in 2005, had continuing difficulty remembering names of relatives. Her granddaughter, who was a dentist, and who had some formal training in Alzheimer's Disease, testified that her grandmother began to progressively deteriorate beginning in 2006 and throughout 2007, such that she was unable to answer basic questions correctly.

On the other hand, the AIP's son and counsel testified that the AIP understood the nature of the deeds in issue and the import of what she was signing. Her son stated that while at counsel's office, his mother reminisced with counsel's father. Further, the son testified that at no time during his daily interaction with his mother did she exhibit any signs of mental incapacity.

With respect to the issue of the AIP's capacity, the court credited the testimony of the AIP's daughter and particularly her granddaughter over that of her son, counsel and other lay witnesses. The court found that the testimony of counsel that the AIP understood the initial deed was belied by the fact that while she had asked that her home be transferred out of her name entirely, the deed in issue transferred the property into her name and her son's name equally. The court also found the son's testimony was full of inconsistencies. Further, the court resolved the sharp conflict between the conclusions of experts called by the parties in petitioner's favor, with the result that the AIP did not have the requisite mental capacity to execute the deeds in issue.

Additionally, the court found that the deeds were the product of undue influence by the AIP's son. Of particular note was the fact that the conveyances excluded the AIP's daughter, in contravention to her previously expressed testamentary plan to divide her assets equally between her two children, and that there was no evidentiary explanation as to why she changed this plan other than the self-serving declaration of the AIP's son that it was her desire to do so. Of further note was the fact that the subject deeds were executed at a time when the AIP was in a weakened condition, when the AIP's daughter was out of state, and that they were prepared and overseen by an attorney selected by the son, and whose father was the son's long-time childhood friend.

Accordingly, the deeds were declared null and void.

In re Marie F., N.Y.L.J., May 10, 2010, p. 20, col. 3 (Sup. Ct., Richmond Co.) (Giacobbe, J.).

Disqualification of Counsel

In a contested probate proceeding, the objectant moved to disqualify petitioner's counsel from representing the estate. The record revealed that the decedent died survived by his spouse, who was the petitioner and primary beneficiary under the propounded instrument, and a son from a prior marriage, who was the recipient of a $25,000 bequest. Objections to probate were filed by the decedent's son.

In support of his motion to disqualify petitioner's counsel, objectant maintained that counsel would be called as a witness in the Will contest; that he had a unique knowledge as to decedent's mental capacity and the possible exertion of undue influence at the time he executed the propounded Will, and that as one of the two attesting witnesses to the instrument, he could offer key testimony as to due execution. The petitioner opposed the application claiming that it was premature, that nothing had been shown by the objectant to substantiate that his testimony was necessary, and that the advocate-witness rule did not preclude him from representing petitioner in connection with the administration of the estate.

The court opined that the provisions of Rule 3.7 prohibit, *inter alia*, an attorney from acting as an advocate before a tribunal in a matter in which the lawyer is likely to be a witness on a significant issue of fact. The burden of proof on the issue of disqualification is on the party requesting it, who must demonstrate that the expected testimony of the attorney is necessary and prejudicial to the attorney's client. Because disqualification impacts upon a party's right to counsel of his or her own choosing, disqualification should not be applied mechanically.

Within the foregoing context, the court acknowledged that it had consistently adhered to the majority view that allowed the attorney draftsman in a contested probate proceeding to serve as counsel for the petitioner up until the time of trial. Finding that the language of the new advocate witness Rule was substantially the same as the provisions of the prior disciplinary rule on the subject, the court concluded that established case law authorizing this pre-trial representation continued to be applicable.

Accordingly, the court denied the motion to the extent that it allowed the attorney draftsman of the propounded Will to represent the petitioner up to the point of trial, and otherwise granted the relief requested.

In re Popkin, N.Y.L.J., June 4, 2010, p. 42, col. 6 (Sur. Ct., Suffolk Co.) (Surr. Czygier).

Disqualification of Counsel

In a contested discovery proceeding, the respondent moved for summary judgment dismissing the petition and/or an order disqualifying petitioner's attorney. The court denied the motion to dismiss the petition, as well as the application to disqualify petitioner's counsel.

With respect to the issue of disqualification, the respondent alleged that petitioner's attorney represented respondent in the past, and that his current representation of petitioner was a conflict of interest. Moreover, respondent maintained that petitioner's counsel was a material fact witness, inasmuch as he allegedly advised her with respect to many of the issues before the court in the discovery proceeding. Respondent's allegations were refuted by petitioner's counsel who claimed that he made it clear to respondent that he never represented her, and that he could not provide her with legal advice. Petitioner further maintained that the matters in dispute in the pending litigation were not the subject of any conversation between his attorney and respondent.

The court opined that a party seeking disqualification must make a clear showing that removal is warranted. Because disqualification deprives a party of the right to counsel of his/her own choosing, and could simply be utilized as a strategic device to advantage one party over another during the course of litigation, careful scrutiny is required to insure that the circumstances require such a result.

Based on the foregoing, the court held that respondent had failed to satisfy her burden of showing that petitioner's counsel should be disqualified based on a conflict of interest under Rule 1.9 of the Rules of Professional Conduct. Generalized allegations such as those proffered by respondent did not suffice. Further, the court noted that at the present stage of the proceeding, where no pre-trial order had been entered, and pre-trial discovery was incomplete, it was unclear whether petitioner's counsel would be called as a witness. Therefore, the court concluded that disqualification on the basis of the advocate-witness rule was premature, and denied the application.

In re Conrad, N.Y.L.J., May 24, 2010, p. 37, col. 4 (Sur. Ct., Suffolk Co.) (Surr. Czygier).

Guardianship—Article 17-A

In *In re Yvette A.*, the court was confronted with a contested guardianship proceeding, in which the petitioner sought his appointment as guardian for his daughter pursuant to Article 17-A of the SCPA. The application was opposed by all parties, including the guardian ad litem, who recommended that the matter be referred to the Supreme Court for commencement of an Article 81 guardianship proceeding in order for the special needs of the AIP to be accommodated. Despite the opposition, the court granted the petition and appointed the petitioner Article 17-A guardian of the person and property of his daughter, subject to certain restrictions.

In reaching this result, the court noted that although Article 17-A does not specifically provide for the tailoring of the guardian's powers or for reporting requirements similar to Article 81, the statute implicitly authorizes the court to impose such terms and restrictions on a guardianship in order to best satisfy the interests of the IP. Further, the court noted that the provisions of Article 17-A empower the court to modify an existing order appointing a guardian in order to adapt it to new circumstances regarding the IP. In view thereof, the court concluded that it had the power to tailor an order of guardianship at the outset to suit the needs of the IP.

In re Yvette A., N.Y.L.J., Apr. 2, 2010, p. 26, col. 1 (Sur. Ct., N.Y. Co.) (Surr. Webber).

In Terrorem Clause

In a probate proceeding and a proceeding by the nominated executor for the recovery of property pursuant to SCPA § 2103, respondents moved the court for a stay of the probate proceeding pending the outcome of the discovery proceeding, a construction of the *in terrorem* clause in the decedent's Will, and an order granting them the right to depose the attorney-draftsman of a prior instrument and the nominated successor executor prior to filing objections.

The court denied the application for construction, holding that the court has no authority to construe a Will prior to its probate.

With respect to the requested examinations, the court opined that while *in terrorem* clauses are valid and enforceable, they are not favored by the courts and will be strictly construed. To this extent, the court noted that the subject clause, if found valid, was broad enough to impact the decedent's children and grandchildren, thus making a decision by a child to object potentially detrimental to that child's heirs. This was especially so in light of the fact that 40% of the decedent's residuary estate passed to her grandchildren, and that the value of that interest stood to be enhanced by nearly $20 million if the discovery proceeding proved successful.

Based on the recent decision by the Court of Appeals in *In re Singer*, 11 NY3d 716 (2009), the court recognized that the provisions of EPTL § 3-3.5 no longer establish the parameters of who may be deposed without triggering an *in terrorem* clause. Rather, a deposition of any person with information of "potential value or relevance" may proceed, subject to the determination by the court on a case-by-case basis as to whether such examination resulted in a forfeiture, or was "in keeping with the testator's intent." Accordingly, the court granted the application to depose the nominated successor executor and attorney-draftsman of the decedent's prior Will, but cautioned the respondents that they did so at their peril.

Further, the court denied the application to stay the probate proceeding, and instead directed that objections to the propounded Will, if any, be filed within 30 days of its determination of the SCPA § 2103 proceeding.

In re Baugher, N.Y.L.J., July 2, 2010, p. 25, col. 1 (Sur. Ct., Nassau Co.) (Surr. Riordan).

Jurisdiction

The preliminary executor of the estate instituted a discovery proceeding against four respondents. The proceeding was discontinued against two, without prejudice. The remaining two respondents were an individual resident of Switzerland, and a Swiss company. The petitioner moved for judgment against these respondents on the basis of their default.

Although the petition requested a turnover of assets, it failed to define the assets in issue or the sum of money allegedly owed to the estate. Hence, the court opined that the petition would have been better crafted as an order to attend, requesting an inquiry or examination of the respondents. The court noted under such circumstances, process issues in the form of the order to attend, rather than citation. Such an order is more akin to a subpoena, and thus may only issue to persons found in the state. As such, the court found that the subpoena issued to the respondent in Switzerland was of no effect. Similarly, the court found that invocation of the court's long arm jurisdiction was to no avail.

Accordingly, the court held that an open commission was available to the petitioner, upon proper application, and dismissed the petition.

In re Arman, N.Y.L.J., July 6, 2010, p. 28, col. 1 (Sur. Ct., N.Y. Co.) (Surr. Glen).

Limited Letters

In a contested discovery proceeding by one co-executor against the other, the petitioner moved for summary judgment on the issue of the appointment of a third fiduciary for the limited purpose of resolving disputes between the co-executors with respect to the sale of real property.

The said realty was the principal asset of the decedent's estate. The executors agreed that the property had to be sold, and actively marketed the premises through several real estate brokers since 2004, successively lowering the asking price, though to no avail. In order to cover the cash deficit of the estate, and more particularly the costs of maintaining the property, the fiduciaries, who were also the sole beneficiaries of the estate, entered into an interim agreement to cover the charges from their own funds.

Thereafter, cooperation between the co-fiduciaries broke down, and they were unable to agree on a broker to list the property, the price at which it was to be offered, or payment of the carrying costs. The court found the deadlock between the co-executors to be detrimental to the estate, most particularly to the sale of the real property. While it noted that it had the authority to require a fiduciary to comply with such directions as it may make whenever fiduciaries disagree with respect to any issue affecting the estate (SCPA § 2102(6)), it concluded that the sale of the subject property would require active decision-making that a single order could not necessarily address. Under such circumstances, the court held that the appointment of a third fiduciary was appropriate to break any deadlock through the rule of the majority.

Accordingly, the application of the petitioner was granted.

In re Cushing, N.Y.L.J., July 7, 2010, p. 34, col. 2 (Sur. Ct., N.Y. Co.) (Surr. Webber).

Limited Letters

Prior to conducting examinations pursuant to SCPA § 1404, the decedent's distributees moved to compel the proponent to execute HIPAA-compliant medical authorizations. The court granted the application. Although the court had previously granted preliminary letters testamentary to the petitioner, letters never issued inasmuch as she failed to post a bond. Accordingly, the court issued limited letters of temporary administration to the petitioner, for the purpose of her executing the medical authorizations within the time provided for in the court's order.

In re Riccardi, N.Y.L.J., June 28, 2010, p.26, col. 5 (Sur. Ct., Bronx Co.) (Surr. Holzman).

Recusal

In a hotly contested accounting proceeding, the executors moved to have the court recuse itself and for a change of venue, alleging a lack of impartiality because of an alleged relationship between counsel for one of the parties and the court. The application was opposed by the objectants.

The court opined that in the absence of statutory grounds, the decision on a recusal motion is discretionary and within the personal conscience of the court. Pursuant to the provisions of Section 14 of the Judiciary Law, the grounds for recusal include consanguinity, prior representation and a matter in which the court is interested. The court found none of these grounds applicable. Nonetheless, in light of the hostility between the litigants, the court held that it did not want counsel to be concerned over its long-standing social relationship with a group that included counsel for the objectants. Accordingly, in the exercise of discretion, the court recused itself, and the matter was referred to the Chief Administrative Judge for the assignment of a judge to whom the matter should be transferred.

In re Rella, N.Y.L.J., July 7, 2010, p. 34, col. 5 (Sur. Ct., Bronx Co.) (Surr. Holzman).

Removal of Fiduciary

In a contested proceeding to remove the trustee, a hearing was held to determine whether the trustee's right to serve should be suspended pending the final resolution of the matter.

In support of the application to suspend the fiduciary, the petitioner alleged, *inter alia,* that the trustee: (1) was negligent in failing to market a parcel of realty located on Long Island, which was the principal asset of the trust; (2) engaged in self-dealing by utilizing trust funds to pay for his personal expenses; (3) the trustee failed to maintain the books and records of the trust; and (3) violated order of the court. In opposition to the application, the fiduciary maintained, amongst other things, that he did not misuse trust funds, and took all steps necessary to liquidate the subject realty. At the hearing, the sole witness was the trustee.

Based upon the proof and testimony adduced at the hearing, the court held that suspension was warranted. In particular, the court noted that the trustee could not describe the terms of the trust for which he was charged, or the manner in which he managed assets of the trust, other than the parcel of realty. Further, the court found it significant that while the trust had an interest in a parcel of realty located in France, that property had never been marketed. Further, the court found that the trustee did not timely supply information concerning the assets of the trust and or trust funds that were expended. In sum, the court concluded that the trustee's testimony indicated a lack of awareness of his duties as a fiduciary, which threatened the proper administration of the trust.

Accordingly, the trustee was suspended, upon qualification of an agreed upon successor.

In re Mack, Decided June 29, 2010, File No. 310 P 2008/A (Sur. Ct., Suffolk Co.) (Surr. Czygier).

Res Judicata

In contested accounting proceedings, the beneficiaries of the intervivos trusts in issue moved for partial summary judgment against the trustee alleging that in 1927, when the trusts were created, the trustee breached its fiduciary duty of loyalty by making investments in companies in which it had substantial interests. The trustee cross-moved to dismiss the supplemental objections raising this issue.

The record revealed that the subject trusts were two of seven trusts created by the settler in 1927 for the benefit of her children. In 1953, when the settler died, the trustee accounted with respect to all of the trusts. Thereafter, in 1974, second intermediate accountings were filed with respect to some of the trusts. Decrees settling the accounts in 1953 and in 1974 were entered. In 2001, petitions were filed for a compulsory accounting with respect to two of the trusts, of which the movants were beneficiaries. These accountings were filed, together with petitions for their judicial settlement. In 2005, the movants sought to vacate the court's orders of 1953 and 1974 settling the trustee's accountings, claiming that the trustee had engaged in constructive fraud against them, and that the court had failed to obtain personal jurisdiction over them. These motions were denied, and the Appellate Division affirmed. Prior to the Appellate Division's decision, the movants filed supplemental objections to the trustee's accountings, alleging that the trustee breached its duty of loyalty by investing in trust assets in which it had a substantial interest.

In support of its motion, the movants maintained, *inter alia*, that the prior orders settling the trustee's account did not preclude the court from considering the self-interested investments of the fiduciary, inasmuch as the investments, while listed in the account, did not reveal the trustee's interest in the assets. Hence, the beneficiaries claimed they were not foreclosed, despite the court's orders settling the accounts, from now seeking to set them aside and requesting damages. The trustee argued that the arguments pertaining to the investments were, or could have been, raised on the prior motions to vacate the orders settling the accountings, and in any event, the supplemental objections were precluded by the "law of the case" doctrine.

In denying the motion for summary relief, and granting the trustee's cross-motion, the court relied on the doctrine of res judicata, which holds an accounting decree to be conclusive not only as to issues which were actively presented and determined, but also as to those issues which could have been raised regarding all matters set forth in the accounting. Although the court recognized that the rule does not apply where the facts have not been sufficiently disclosed in the account to put the parties on notice that there has been self-dealing, in the case *sub judice*, the court found that the account listed the investments in issue, and correspondence between the trustee and the settler sufficiently apprised the beneficiaries of the self-dealing with respect to the trust investments. At the very least, this correspondence, stated the court, was sufficient disclosure made to put the beneficiaries on notice, and imposed upon them a duty of inquiry even prior to the entry of the 1953 decree. Having failed to raise such inquiry regarding the investments, or to object at that time, the court held the beneficiaries were barred from raising any issue with respect to the investments.

In re Sanchez, N.Y.L.J., April 5, 2010, p. 18, col. 1 (Sup. Ct., N.Y. Co.) (Edmead, J.).

Ilene S. Cooper, Farrell Fritz, P.C., Uniondale, New York

Editor's Note: In the Summer 2010 Issue of this* Newsletter, *the citation to an important Article 17-A case was omitted from case summary. Ms. Cooper's summary and the citation are set forth below. –Ed.

Guardianship Under Article 17-A

Before the court was an application for the petitioners' appointment as guardians of their 22-year-old son. Incident to the relief requested, the petitioners sought the power to sell their son's artwork and make charitable contributions with the proceeds on their son's behalf.

In feeling compelled by the confines of the statute to deny the additional relief requested by the petitioners, the court expressed frustration and dissatisfaction with the restrictive provisions of SCPA Article 17-A, most certainly as compared to the provisions of Article 81 of the Mental Hygiene Law. Indeed, the court noted that "Article 17-A is a blunt instrument which allows for none of the 'tailoring' that characterizes our adult guardianship statute, MHL Article 81." In particular, the court found it pertinent that Article 81 specifically authorizes the court to allow the guardian of the property to make gifts from the funds of the incapacitated person.

As a consequence, the petitioners withdrew their petition in favor of commencing a proceeding under Article 81.

In re John H., N.Y.L.J., Mar. 15, 2010, p. 19, col. 1 (Sur. Ct., N.Y. Co.) (Surr. Glen).

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August 5, 2010

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Re: "Death Bed" "Quickie" Marriages Held to be Void Ab Initio by Appellate Division, NYSBA Trusts and Estates Law Section Newsletter, Summer 2010, Vol. 43, No.2

Dear Mr. MacLean:

I am writing to you with respect to the above referenced article which was published in the most recent section newsletter. I am an attorney with Novick & Associates, P.C., and I was involved in a case which was the subject of the article authored by Gary E. Bashian, Esq. and Michael Candela. Specifically, my firm represented the decedent's daughter in the Matter of Richard Kaminester.

I would like to address a flaw in the characterization by the authors of a party to the proceeding. Briefly, the proceeding at issue concerned the validity of a right of election filed by the decedent's live-in girlfriend who had secretly married the decedent during a pending Article 81 guardianship proceeding. After the decedent's death, the judge in the Article 81 proceeding annulled the marriage and other transactions based upon lack of capacity. The issue then became whether the marriage was void *ab initio* or whether the right of election became fixed and unalterable upon the decedent's death. As the article correctly indicates, the marriage was held to be void *ab inito* and the live-in girlfriend was denied the right of election.

However, there was a second component to the proceeding which was not addressed by the authors. The authors incorrectly refer to the live-in girlfriend as a "caretaker" despite the fact that the word "caretaker" does not appear in the court's decision.[1] In fact, it was our client's

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[1] While I understand the authors' need to focus the recitation of facts in the Kaminester case to flow with the theme of the article, the characterization of Foldes as a "girlfriend" is a critical component to the court's equitable estoppel holding due to the misrepresentation to the Article 81 court.

position that the live-in girlfriend neglected the decedent and that the mischaracterization implies a close and caring relationship which was non-existent. The characterization of the live-in girlfriend as a "caretaker" is critical to the court's decision because the court held that she was equitably estopped from claiming that she was the surviving spouse based upon her misrepresentation to the Article 81 court that she was merely a "girlfriend" and not the spouse after the secret marriage ceremony took place. Matter of Kaminester, 26 Misc.3d 227, 236 (2009) ("Even in the absence of the First Department's decision in this case, this court would invalidate Foldes' exercise of a spousal right of election, under the doctrine of estoppel."). The word "girlfriend", which was a fraudulent misrepresentaiton, was essential to the court's holding. The court specifically held that "it became incumbent upon Foldes' counsel to disclose the existence of Foldes' one-month marriage to decedent" and that "[t]o permit Foldes now to assert a spousal right of election, a position inconsistent with her 'misleading and deceptive' silence, would be inequitable." Id. at 236-37.

I am unaware of the newsletter's policy regarding corrections and amendments, but I feel that this characterization should be addressed and corrected.

Very truly yours,

Albert V. Messina Jr.

cc: Kimberly Kaminester
David Kaminester

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