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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

Message from the Chair

Greetings:

Betsy Hartnett

Throughout the summer and fall of 2011, our Section remained active. As usual, planning for timely, informative and entertaining Section meetings was a major focus. Our Fall meeting in Buffalo, New York was a great success. In a departure from our usual format, we joined with the Elder Law Section in an expanded 10-credit hour presentation entitled *Baby Boomer Planning—A Joint Perspective.* Co-Chairs Victoria L. D'Angelo and Laurie L. Menzies enlisted a stellar roster of speakers and round table presenters from both Sections on a variety of topics crossing both disciplines. We are grateful to Hon. Barbara Howe for her interest in our Section and her willingness to be our keynote luncheon speaker.

Our reception and dinner was at the Albright-Knox Art Gallery (the first gallery I visited as a child to see modern art), a national treasure with renowned works by such greats as Picasso, Miro, de Kooning and Gorky.

As you read this, we will have also completed our Annual Meeting at the New York Hilton. Our CLE Program Chair, Mary Anne Cody, enlisted three speakers to provide an in-depth analysis of marital issues encountered in our practice. Michael Stutman, a member of the NYSBA Family Law Section, spoke on antenuptial issues, including implications of the Marriage Equality Act and important changes in the Domestic Relations Law that substantially affect how we draft antenuptial agreements, engagement letters and the statement of client's rights and responsibilities for marital proceedings. Professor Ken Joyce of Buffalo Law School addressed the spousal right of election, and James D. Spratt, an ACTEC Fellow from Atlanta, Georgia, spoke on tax issues incident to divorce and the unwinding of wealth transfer strategies.

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NYSBA

If these meetings didn't convince you that we produce some of the highest level of CLE, then you surely will be convinced by the talent and topics for our Spring meeting in Washington, D.C. Ilene Cooper, our incoming Chair, along with meeting Co-Chairs John Morken and Joe La Ferlita, are developing a CLE program focused on stipulations of settlement. The May 3–6, 2012 meeting will be held at the beautiful Willard Hotel, within walking distance of the White House and many historic government buildings. We will have a private tour of the White House (sold out). In addition, tickets to the Holocaust Museum and the Kennedy Center will be available. The Friday evening premier dinner will be at the National Museum of Natural History, with entertainment by the satirical comedy group, the Capitol Steps. Saturday's dinner will be a catered affair on the rooftop terrace of the historic Hay-Adams Hotel overlooking the White House. A jazz quartet will provide the background music. Can you find any reason not to come to Washington in May? I hope to see many of you there.

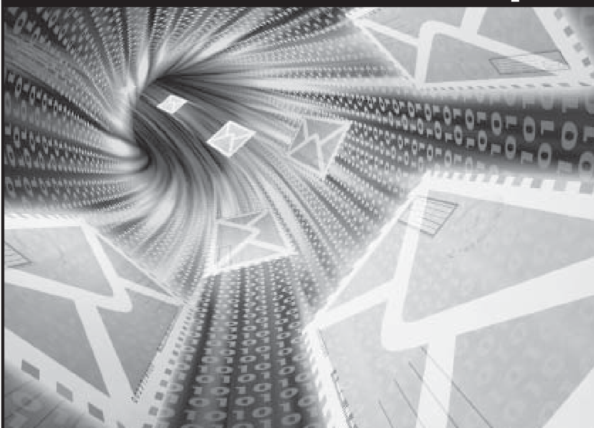
Our Section is again providing two fellowships for second-year law students enrolled in a law school in New York to work in Surrogate Courts in the summer of 2012. We are very fortunate that Hon. Peter Kelly, Surrogate of Queens County, and Hon. Ava Raphael, Surrogate of Onondaga County, have agreed to provide the opportunity to the fellowship recipients to work in their courts. These fellowships are administered through the Bar Foundation. Each recipient receives a stipend of $5,000 and is invited to our Fall meeting. The 2012 fellowship guidelines were distributed to 15 New York law schools for dissemination to their students. We are very proud to provide funding for these exceptional fellowships. We hope that this will lead to increased interest in trusts and estates law and in membership in our Section.

Our committees remain very active. I am so appreciative of the willingness of Section Chairs to address current issues that affect our clients and our practices. I would like to mention just a few recent committee initiatives. Ilene Cooper and Darcy Katris are co-chairing an ad hoc committee on the impact of the new Marriage Equality Act on the SCPA and EPTL. The Estate and Trust Administration Committee chaired by Natalia Murphy is addressing Surrogate Anderson's decision in *Lawrence v. Miller* regarding the legal fees of the Graubard Miller firm and gifts to the firm's individual partners. In her opinion the judge disallowed the gifts and recommended legislation akin to SCPA 2307-a to address these gifts. The Estate and Trust Administration Committee worked on the original SCPA 2307-a legislation and is best suited to work on any proposed legislation involving client gifts to attorneys. Lori Perlman, the new Chair of the Committee on Practice and Ethics, has charged her Committee with addressing the unique ethical considerations of virtual law practices and the practice of providing unbundled legal services. If you have an interest in any of these topics, please contact the Committee Chairs. Their contact information is in this *Newsletter*.

Lastly, my very best wishes to all for health and prosperity in the New Year.

Elizabeth A. Hartnett

Request for Articles



If you have written an article you would like considered for publication, or have an idea for one, please contact the *Trusts and Estates Law Section Newsletter* Editor:

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

www.nysba.org/TrustsEstatesNewsletter

Editor's Message

In this issue of the *Newsletter*, we explore a variety of topics related to trusts. Carlyn McCaffrey continues her comprehensive review of the various tools available to fix irrevocable trusts and other estate planning documents, this time focusing on amendment, decanting (both in New York and in other states) and statutory protections against drafting errors, as well as the likely federal tax consequences of each. Joseph La Ferlita reports on the recent amendment of New York's decanting statute, which gives trustees more flexibility in transferring assets to new trusts and provides important safeguards intended to prevent abuse, including new notice provisions and procedures for objection by settlors and beneficiaries. Former Surrogate Radigan and Raymond Radigan review the lessons gleaned from New York court rulings on the trustee's duty to diversify. Their article—an expanded version of one that appeared in the *New York Law Journal*—explains how retention language and other special circumstances affect the duty to diversify, when it may be appropriate to diversify a concentrated holding over time, how damages for failure to diversify should be measured and what steps trustees should take to protect themselves when making trust investment decisions. Daniel Rubin and Ira Zlotnick discuss an often overlooked method to achieve grantor trust status, and Gary Bashian offers advice to litigators on how to win summary judgment for beneficiaries of trusts and estates in contested accounting proceedings.

In our second installment of the "Florida Update," David Pratt and Jonathan Galler report on legislative activity and noteworthy decisions pertaining to Florida trusts and estates law, including the recently enacted omnibus trusts and estates bill and the new power of attorney statute.

This issue also features an introduction to the TELS Diversity Committee by Anta Cissé-Green, Jeffrey St. Clair and Dwayne Bentley. Their article includes sobering data about the gender, racial and ethnic make-up of our Section, highlighting the continuing need to encourage diverse attorneys to join our practice area and to nurture diverse attorneys already practicing in the field. The authors review the Committee's efforts in this regard over the past year and discuss important new projects, including the development of a mentoring program for minority attorneys. I hope that as many lawyers as possible will take up their invitation to mentor young minority attorneys and students. By increasing the diversity of our profession, we can help the profession better serve our clients and our community.

The editorial board is soliciting submissions for the Summer 2012 *Newsletter*. We welcome articles and columns, case reports and materials from continuing legal education or other presentations (either original or adapted for publication here), as well as opinion pieces and letters to the editor. The deadline for submission is March 15, 2012.

Cristine M. Sapers

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Fixing Estate Planning Documents: Part II

By Carlyn S. McCaffrey

This is the second in a two-part article about the various tools available under state law to fix wills and irrevocable trusts. The first part, published in our Fall 2011 issue, explored construction and reformation proceedings. This part discusses amendment, decanting and statutory protections against drafting errors.

I. Amendment

In General

The power to amend a trust instrument can derive either from the terms of the instrument or from state law, generally a statute.[1] When drafting a trust instrument, particularly one that is intended to last for many years or even generations, it is a good idea to provide the trustees and the beneficiaries with the flexibility to deal with changes in circumstances by giving some combination of trustees and beneficiaries the power to amend. In drafting an amendment power, it is important to provide sufficient restrictions so that the holders of the power are not treated as holding general powers of appointment over trust property.

Likely Tax Consequences

An amendment to a trust, if valid under local law, can affect the future tax status of the trust and its beneficiaries. A beneficiary whose consent to the amendment was necessary may be treated as having made a gift, however, if the amendment deprives her of some degree of interest in the trust.

There is no explicit generation-skipping transfer tax effective date protection in the Treasury Regulations for amendments made to GST protected trusts, even when those amendments are authorized under the original trust instrument. This is a curious omission since there are private letter rulings issued before the effective date regulations that protected such amendments.[2] The regulations do, however, protect the exercise of a trustee's discretionary power in favor of a new trust if authorized under the trust instrument.[3] Trustees who are interested in amending an exempt trust ought to consider whether their goals could be accomplished by means of a distribution to a new trust.

II. Decanting (and Exercise of Powers of Appointment)

In General

Powers of appointment, particularly those exercisable in favor of other trusts, provide the same sort of flexibility that amendment powers provide. Generally, to be effective, powers of appointment have to be part of the original instrument. If an appropriate person holds a power of appointment over a trust that is not amendable, she can exercise the power to create a new trust with the desired terms.[4]

Decanting is a technique similar to exercising a power of appointment. The term "decanting" generally refers to the appointment by the trustee of an irrevocable trust of trust property to a new trust which contains terms different from the original trust. The authority of a trustee to make such an appointment generally comes from a state statute, but some find a basis for it in common law. In some cases, a provision in the trust agreement or will creating the trust can provide such authority.

Decanting can be a useful tool in a variety of situations. Suppose, for example, a trustee has an unlimited invasion power exercisable in favor of the primary beneficiary of a trust and that the beneficiary is entitled to receive all of the trust property outright on her thirty-fifth birthday. Suppose the trustee has concluded that an outright distribution to her at that time would be inappropriate because of problems she is having with creditors, with her husband or with life in general. Without the authority to decant, the trustees would have no choice but to make the required distribution. With the authority to decant, prior to the beneficiary's thirty-fifth birthday, the trustee might be able to appoint all of the trust property to a new trust which will extend beyond the beneficiary's thirty-fifth birthday—perhaps until her death.

The rationale behind statutory provisions and case law permitting decanting is based on a belief that if the trustee has the authority to distribute property outright to a beneficiary or for his or her benefit, the trustee should be able to distribute such property to another trust for the benefit of such beneficiary. In effect, the trustee has a special power of appointment exercisable in favor of a beneficiary, and she should be allowed to exercise the power in further trust. This was the rationale of New York Assemblyman Stephen B. Kaufman as expressed in his memorandum written in connection with the passage of New York's decanting statute, the first decanting statute.[5]

Currently, ten states have enacted a decanting statute. Some of these state statutes, as well as the common law origins of decanting, are discussed briefly below.

Decanting Under Common Law

Case law of at least three states arguably recognizes a trustee's authority to invade principal in favor of another trust. The three states are Florida, Iowa and New Jersey, and of these, only Florida has enacted a decanting statute. The Florida and New Jersey case law are discussed below.

Florida: *Phipps v. Palm Beach Trust Co*. In *Phipps v. Palm Beach Trust Co.* a settlor created a trust for the benefit of her children naming her husband as the individual trustee and a trust company as the corporate trustee.[6] The trust agreement authorized the corporate trustee, upon written direction by the individual trustee, to pay over and transfer any portion of the trust fund as the individual trustee determined. The individual trustee determined it was appropriate to pay the trust fund to a new trust for the benefit of the settlor's children with the added provision that income could be payable to the wife of one of the children, if such child so provided in his will. The corporate trustee was unsure whether complying with the individual trustee's direction was consistent with the terms of the trust agreement.[7] The Supreme Court of Florida was thus presented with the issue as to whether a trustee, authorized to direct distributions of any portion or all of a trust fund, could direct distributions be paid over to a new trust. The court, finding that the exercise of the power of appointment by creation of a second trust had been upheld many times, approved the individual trustee's exercise of discretion and ordered the corporate trustee to comply with the individual trustee's direction.[8]

Although the court approved a decanting by the trustees, this case is distinguishable from most fact patterns where a decanting is attempted. The individual trustee's authority to direct the corporate trustee to pay any portion of the trust fund was exercisable by him during his life or upon his death, thereby granting the individual trustee a lifetime and testamentary special power of appointment. Such a power is broader than the typical power of a trustee to distribute trust property. Therefore, while this case is helpful to the proposition that a trustee with authority to invade principal can do so by distributing it to another trust, it is not decisive.

New Jersey: *Wiedenmayer v. Johnson*. The trustees of the original trust in *Wiedenmayer v. Johnson* had authority to pay to the beneficiary outright so much of the trust property as they deemed to be in the beneficiary's best interest.[9] The trustees exercised their discretion by paying the trust property to the beneficiary who in turn contributed the property to another trust for the benefit of the beneficiary. The court approved this distribution, finding that since the trust indenture expressly stated that distributions could be made outright for the beneficiary's best interests, "it seem[ed] logical to conclude that the trustees could, to safeguard the son's best interests, condition the distribution upon [the son's] setting up a substituted trust."[10]

This case deals with trustees with more typical authority to invade, at least as compared to the *Phipps* case. For this reason it is stronger authority for the proposition that a trustee with authority to invade principal can decant to a new trust. However, if the transaction is dissected, it is not the trustees who are the persons adding the property to a new trust. Instead, the trustees first made a distribution to the beneficiary (albeit on the condition that such property is added to a new trust) and then it was the beneficiary who added the assets to a new trust. When viewed in this light, this case is weaker support for a trustee's authority to decant than the *Phipps* case.

State Decanting Statutes

Given the rocky ground on which the common law authority to decant lies, it is generally better for a trustee to decant pursuant to a state statute. There are ten states that currently have a decanting statute: New York, Alaska, Delaware, Tennessee, Florida, South Dakota, New Hampshire, Arizona, North Carolina and Nevada.[11] In each of these states, the trustees may act without court approval, and in some states, the trustees may act without notifying the beneficiaries. Trustees are authorized to obtain court approval, which they may wish to do to protect themselves from future suits by beneficiaries who may object. Some of the statutes are discussed below.

New York. Prior to the amendment of New York's decanting statute in 2011, Section 10-6.6(b)(1) of the New York Estates, Powers & Trusts Law (EPTL) permitted a trustee who had the absolute discretion under the terms of a will or irrevocable inter vivos trust agreement to invade principal for the benefit of the beneficiaries of a trust to exercise that discretion by appointing any part of the principal of the trust in favor of a trustee of another trust. This power could be exercised without the consent of the beneficiaries, but the beneficiaries had to be notified.[12] The only restrictions were that the exercise be in favor of only one or more of the beneficiaries of the trust, that it not reduce the fixed income interest of any beneficiary, that it not violate the rule against perpetuities and that it not violate EPTL 11-1.7, which prohibits granting certain powers and immunities to testamentary (but not inter vivos) trustees.

The requirement that the trustee have absolute discretion to invade principal made New York's decanting statute one of the more restrictive ones. In *In re Estate of Mayer*, the New York County Surrogate's Court held that a trustee whose authority to distribute principal was limited by an ascertainable standard did not have absolute discretion and could not decant.[13]

In August of 2011, legislation was enacted to liberalize New York's decanting rules. Under the amended statute, a trustee may decant trust principal to another trust even if the trustee's power to invade is subject to an ascertainable standard. In that event, the decanting power is subject to certain restrictions—e.g., the current remainder beneficiaries of the new trust must be the same as the old trust. Broader decanting powers remain where the trustee has absolute discretion to invade, and the law expressly provides that the power to invade for the beneficiary's best interests, comfort, welfare or happiness constitutes absolute discretion.[14]

Alaska. In 1998, Alaska followed New York's lead and enacted its own decanting statute.[15] Alaska's statute authorizes a trustee under a will or an irrevocable inter vivos trust agreement governed by Alaska law[16] who has authority to invade the principal of a trust for the benefit of a beneficiary to appoint any part or all of the principal in favor of another trust so long as the exercise does not reduce any fixed income interest of a beneficiary, is in favor of the beneficiaries of the original trust, does not violate the rule against perpetuities and "results, in the appointed trust, in a standard for invading principal that is the same as the standard for invading principal in the invaded trust."[17]

Like the recent New York legislation, Alaska law permits a trustee whose authority to invade is limited by an ascertainable standard to invade in favor of another trust, even if the reason for the invasion is not consistent with the limitations on the trustee's authority to invade. The only restriction is that the new trust must contain the same limitation (i.e., the ascertainable standard) as the original trust.[18] Unlike in New York, the trustees need not provide notice to the beneficiaries of the original trust to effectuate a decanting.

Delaware. In Delaware, a trustee can decant if she possesses any discretionary authority to invade principal and, unlike Alaska, the standard for invasion need not be maintained in the new trust, but the reason for the invasion must comply with such standard.[19] The only other restrictions are that (i) the exercise must be in favor of only one or more of the beneficiaries of the trust, (ii) may not reduce any income interest for which a marital deduction was claimed,[20] (iii) may not extend the vesting date for any property the transfer of which was treated as a gift qualifying for the gift tax annual exclusion and (iv) may not be exercised over any portion of the trust that is currently withdrawable by a beneficiary.[21] Again, the statute does not require notice to, or consent of, the beneficiaries of the original trust.

Florida. Florida enacted its decanting statute in 2007. The statute replaces the *Phipps* case as the authority for decanting. Florida permits decanting where a trustee possesses absolute discretion and explicitly provides that a power to invade for the beneficiary's best interests, welfare, comfort or happiness constitutes absolute discretion for purposes of the statute.[22] Decanting is not permitted where discretion is limited by an ascertainable standard.

The other limitations of Florida's statute are that the beneficiaries of the recipient trust include only beneficiaries of the first trust and that the recipient trust not reduce any fixed income, annuity or unitrust interest of the first trust.[23] This latter requirement is broader than New York's, Alaska's and Delaware's. Florida also includes a tax savings provision which provides that if any contribution to the first trust qualified for a marital or charitable deduction, the recipient trust must not contain any provision that, if included in the first trust, would have prevented the first trust from qualifying for such deduction.[24] Florida's statute requires the trustees to give all qualified beneficiaries sixty days' notice but gives the beneficiaries the right to waive the notice requirement.[25]

Likely Tax Consequences

Generation-Skipping Transfer Tax Risks. The impetus behind New York's decanting statute was to save generation-skipping transfer tax exempt trusts from terminating before the expiration of their perpetuities dates.[26] A trust that was irrevocable on September 25, 1985[27] (and thus protected from the generation-skipping transfer tax) may have provided for outright distributions to a beneficiary at a certain age. Paying such assets outright would result in a loss of such protection. EPTL 10-6.6(b)(1) permitted those trustees with absolute discretion to invade principal to transfer the assets of the protected trust to one that lasted for the lifetime of the beneficiary and then passed to his or her descendants in further trust, thereby maintaining its protection from the generation-skipping transfer tax for longer.

However, as discussed in Part I of this article, a GST-protected trust should only be modified in a manner consistent with one of the safe harbors outlined in Treasury Regulation § 26.2601-1(b)(4), of which only one may protect a modification by way of a decanting that is authorized under a law that was not in effect on September 25, 1985.[28] The available safe harbor is found in Treasury Regulation § 26.2601-1(b)(4)(i)(D). It protects decantings to recipient trusts that do not shift a beneficial interest to a beneficiary who occupies a lower generation than the persons who held the beneficial interest in the original trust. In addition, the terms of the recipient trust may not extend vesting beyond the perpetuities period that applied to the original trust. This latter requirement is straightforward and a requirement of most of the decanting statutes. The former is less clear.

Treasury Regulation § 26.2601-1(b)(4)(i)(D)(2) attempts to clarify when a shift to a lower generation occurs by providing that a shift occurs "if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer." This would happen when, for example, grandchildren are added as current beneficiaries because distributions to them would permit generation-skipping transfers that were not permitted before the decanting. The same would be true when grandchildren are added as discretionary current beneficiaries, because Treasury Regulation § 26.2601-1(b)(4)(i)(D)(2) provides a default rule for modifications that cannot be immediately determined. The rule is that the modification is deemed to shift a beneficial interest to a lower generation.[29] Therefore, when it cannot readily be determined if there is a shift, the IRS takes the position that there is, in fact, a shift.

Unless a trustee is completely confident that there is no shift, the trustee risks the IRS deeming the distribution as a shift to a lower generation, thus jeopardizing the generation-skipping transfer tax protection of the original trust and the recipient trust. If such protection is lost, the trustee may have caused a future generation-skipping transfer tax liability upon a distribution to a grandchild. Prior to 2011, a trustee could protect herself from both of these results by obtaining a court order and a Private Letter Ruling. For example, in Private Letter Ruling 200520023, a trustee of three separate trusts, one for each child of the settlor, petitioned a state court to modify such trusts so that the trustee could decant to three separate new trusts.[30] The court approved the modification, subject to the receipt of a favorable ruling from the IRS that the decanting would not affect the generation-skipping transfer tax exempt status of the assets transferred. The IRS so ruled in the Private Letter Ruling. As a result, the trustee was protected against suits from all current and future beneficiaries and from the imposition of a tax liability by the IRS.

Unfortunately, trustees can no longer obtain such comfort prior to decanting. The IRS recently announced that, while it is studying the issue, it will no longer rule on whether the distribution of property by a trustee from an irrevocable generation-skipping transfer tax exempt trust through a decanting to another irrevocable trust will be deemed to shift a beneficial interest to a lower generation.[31] Decanting now leaves trustees who exercise their power to decant vulnerable to risks of liability. Unless there is no possibility of a prohibited shift, a trustee of a protected trust should not decant pursuant to a state statute.

To protect against inadvertent loss of effective date protection, a trustee who decants from a protected trust into a new trust should consider using language in the new trust similar to the following:

> Notwithstanding anything in this trust agreement to the contrary, the trustees may not exercise their distribution powers in such manner as to shift a beneficial interest in the property held in the Trust from the beneficiaries who held such interests under the [name of original trust] to a beneficiary who occupies a lower generation than the such beneficiaries within the meaning of Treasury Regulation § 26.2601-1(b)(4)(i)(D).

Gift Tax Risks. A gift tax may be imposed when a beneficiary participates in a decanting, either by acting as the trustee accomplishing the decanting or by consenting to the decanting, and the beneficiary's interest passes to another beneficiary.

Generally, a trustee-beneficiary should avoid being involved in a decanting because when any portion of her interest shifts to another beneficiary, she may be subject to gift tax.[32] North Carolina prohibits a trustee/beneficiary from decanting pursuant to its statute under all circumstances. The statute further provides that the remaining trustees may act or "the court may appoint a special fiduciary with authority" to decant.[33]

Nevada is the only state that requires consent and only when property specifically allocated to a beneficiary is no longer so allocated. Some state statutes permit actions which may be tantamount to giving consent. New York, Florida and North Carolina require a trustee to give notice to beneficiaries of her proposed decanting, and Florida and North Carolina further provide that such notice is waivable by the beneficiaries.[34] Nevada also permits a trustee to give 30 days' notice to beneficiaries which, if given, will be waived by the beneficiaries if they consent to the proposed action.[35] If a beneficiary consents to a decanting or is deemed to have consented to a decanting and the beneficiary's interest passes to another beneficiary, then the beneficiary may be deemed to have made a taxable gift.[36] The IRS might take the position that a beneficiary who waives a notice period or fails to object has made a gift.[37] The argument that the failure to object constitutes making a gift becomes more tenuous when the decanting is initiated by the trustee and the beneficiary remains unaware, which is likely to occur in those states where notice is not required. Again the IRS made it more uncomfortable for trustees who wish to decant but are worried about gift tax consequences when it announced that it will no longer rule on whether a decanting resulting in a change in beneficial interests is a gift under I.R.C. § 2501.[38]

III. Statutory Protections Against Drafting Errors

Some state legislatures have eliminated the need for certain fix-up types of reformations by creating statutory fix-ups that apply generally to trusts unless there is specific language to the contrary.

Problematic Powers of Appointment

If, for example, a trustee has the power to make distributions to herself, she could be treated as having a general power of appointment for federal estate and gift tax purposes unless the power is limited by an ascertainable standard relating to her health, education, support or maintenance or unless exercisable only with the consent of another person who has a substantial interest in the trust adverse to the exercise of the power (an "adverse party"). Most settlors do not intend that their trustees have general powers of appointment by reason of their trustee powers. In order to prevent this result, several states have statutes that limit the power of trustees to exercise discretionary distribution powers in favor of themselves. New York law[39] and Florida law,[40] for example, have prohibitions against a trustee exercising a discretionary distribution power in favor of herself other than powers that are limited by an ascertainable standard relating to the health, education, maintenance or support of the power holder. The laws of several other states permit trustees to exercise discretionary distribution powers in favor of themselves, but cut the power back to one that may be exercised only to make distributions for the power holders' health, education, support or maintenance.[41]

Power to Remove and Replace Trustees

The IRS took the position in Rev. Rul. 79-353[42] that the reservation by the settlor of the power to remove a trustee and appoint another trustee is equivalent to a reservation of the trustee's powers even if the settlor did not have the power to appoint herself as trustee. As a result, if a settlor created a trust the terms of which gave the trustee the power to make discretionary distributions to beneficiaries unrestricted by a standard, and the settlor had the power to remove and replace the trustee, the trust would be included in the settlor's gross estate under I.R.C. §§ 2036(a) and 2038. This principle was extended in private letter rulings to apply to beneficiaries who had the power to remove and replace those trustees who could exercise discretionary distribution powers in their favor or in such a way as to discharge their support obligations to other persons.[43] After a number of courts had refused to follow Rev. Rul. 79-353,[44] the IRS issued Rev. Rul. 95-58.[45] This ruling revoked Rev. Rul. 79-353 and announced a new rule dealing with the replacement of trustees. The new rule provides that a person who has the power to remove and replace a trustee will be treated as having the powers of the trustee only if she has the power to replace the removed trustee with a person who is related or subordinate to her (within the meaning of I.R.C. § 672(c)). After the publication of this ruling, several states passed laws designed to confer on beneficiaries the protection offered by this ruling. The District of Columbia, New Jersey and Pennsylvania all passed laws that prohibit beneficiaries from removing and replacing their trustees with persons related to them if those trustees have the power to make discretionary distributions to them unless that discretion is limited by an ascertainable standard.[46] Alaska took another route. It prohibits a related trustee from exercising a discretionary distribution power in favor of a beneficiary who has the power to remove her unless the discretion is limited by an ascertainable standard.[47]

Endnotes

1. See Fla. Stat. § 737.0412, which permits the trustees and beneficiaries of a trust to amend it without judicial approval, and Cal. Prob. Code § 15404 and N.Y. Estates Powers & Trusts Law (EPTL) 7-1.9, both of which permit the settlor and all the beneficiaries of a trust to amend it without judicial approval.
2. *See, e.g.*, PLR 8926028 (March 31, 1989).
3. Treas. Reg. § 26.2601-1(b)(4)(A).
4. As is the case with amendment powers, it is important to provide sufficient restrictions so that the holders of the power are not treated as holding general powers of appointment over trust property. An error that often occurs in connection with drafting powers of appointment is the failure to prohibit the holder of the power from appointing trust property in a manner that would discharge her obligation to support another person. Such a power would be a general rather than a limited power of appointment.
5. Memorandum of Assemblyman Kaufman in support of L 1992, ch 591, 1992 NY Legis Ann, at 364-367.
6. *Phipps v. Palm Beach Trust Co*, 196 So. 299 (Fla. 1940).
7. *Id*. at 300.
8. *Id*. at 301.
9. *Wiedenmayer v. Johnson*, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969).
10. *Id*. at 536.
11. EPTL 10-6.6; Alaska Stat. § 13.36.157; Del. Code. Ann. tit. 12, § 3528; Tenn. Code Ann. § 35-15-816(27); Fla. Stat. § 736.04117; S.D. Codified Laws § 55-2-15; N.H. Rev. Stat. Ann. § 564-B:4-418; Ariz. Rev. Stat. Ann. § 14-10819; N.C. Gen. Stat. § 36C-8-816.1; Nev. Rev. Stat. § 163.556.
12. Former EPTL 10-6.6(d).
13. *In re Estate of Mayer*, 672 N.Y.S.2d 998 (N.Y. Co. Surr. Ct. 1998).
14. The amendments to the decanting statute are discussed in more detail by Joseph T. La Ferlita in his article beginning on p. 10 of this issue.
15. Alaska Stat. § 13.36.157.
16. Alaska's statute also applies to trusts whose governing law is changed to Alaska law. Alaska Stat. § 13.36.157(b)(1).
17. Alaska Stat. § 13.36.157(a).
18. *Id*.
19. Del. Code. Ann. tit. 12, § 3528(a) and (a)(5).

20. This restriction is narrower than New York's and Alaska's restriction that the exercise not reduce any fixed income interest.
21. Del. Code. Ann. tit. 12, § 3528(a)(1) through (4).
22. Fla. Stat. § 736.04117(1).
23. Fla. Stat. § 736.04117(1)(a)(1) and (2).
24. Fla. Stat. § 736.04117(1)(a)(3).
25. Fla. Stat. § 736.04117(4).
26. Memorandum of Assemblyman Kaufman in support of L 1992, ch 591, 1992 NY Legis Ann, at 364-367.
27. A testamentary trust that was created under a will executed before October 22, 1986 of a decedent who died before January 1, 1987 would also be protected from the generation-skipping transfer tax.
28. Treas. Reg. § 26.2601-1(b)(4)(i)(A) provides a safe harbor for distributions of trust principal from an exempt trust to a new trust where the distribution is pursuant to the terms of the trust agreement governing the exempt trust or pursuant to a state law in effect "at the time the exempt trust became irrevocable," or September 25, 1985. Because none of the statutes discussed above were in effect on September 25, 1985, this safe harbor will not apply to an exempt trust decanted pursuant to one of the above statutes. When a state statute is a codification of common law that existed prior to September 25, 1985, one can argue that state law permitting decanting was in effect at the required time and thus rely on this safe harbor. This may be the case in Florida, but for the reasons discussed above, this position relies on shaky grounds.
29. Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2).
30. PLR 200520023 (January 28, 2005).
31. Rev. Proc. 2011-3.
32. Treas. Reg. § 25.2511-1(c)(1).
33. N.C. Gen. Stat. § 36C-8-816.1(d).
34. EPTL 10-6.6(j)(2); Fla. Stat. § 736.04117(4); N.C. Gen. Stat. § 36C-8-816.1(f)(2) and (3).
35. Nev. Rev. Stat. § 164.725.
36. Treas. Reg. § 25.2511-1(c)(1).
37. *Snyder v. Comm'r*, 93 T.C. 529 (1989) (holding that a preferred shareholder's failure to convert preferred shares entitled only to noncumulative dividends into cumulative preferred shares was a series of taxable gifts to the corporation's common shareholders).
38. Rev. Proc. 2011-3.
39. EPTL 10-10.1.
40. Fla. Stat. § 736.0814(2). The laws of Alaska, Connecticut, Minnesota and West Virginia contain similar provisions. Alaska Stat. § 13.36.153; Conn. Gen. Stat. § 45a-487; Minn. Stat. § 501B.14; and W. Va. Code § 44-5-13. Florida enacted its statute in 1991. Because of concern that the passage of the statute would cause a lapse of a general power of appointment by trustee-beneficiaries who formerly had unlimited discretion to make distributions to themselves, the statute gave the trustees and beneficiaries of existing trusts the right to opt out of its application. In Rev. Proc. 94-44, 1994-2 C.B. 683, the IRS took the position that the new statute would not be treated as causing the lapse of a power of appointment.
41. *See, e.g.*, D.C. Code § 21-1722; Md. Code Ann., Est. & Trusts § 14-109; N.J. Stat. Ann. § 3B:11-4.1; and 20 Pa. Cons. Stat. § 7504.
42. Rev. Rul. 79-3531979-2 C.B. 325.
43. PLR 8916032 (January 19, 1989).
44. *See, e.g., Estate of Vak v. Comm'r*, 973 F.2d 1409 (8th Cir. 1992), and *Wall v. Comm'r*, 101 T.C. 300 (1993).
45. Rev. Rul. 95-58, 1995-2 C.B. 191.
46. D.C. Code § 21-1722(c); 20 Pa. C.S. § 7506; N.J. Stat. Ann. § 3B:11-4.1.d.
47. Alaska Stat. § 13.36.153.

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New York's Newly Amended Decanting Statute

By Joseph T. La Ferlita

On August 17, 2011, Governor Cuomo signed into law Assembly Bill A8297, which substantially modified Section 10-6.6 of the New York Estates, Powers & Trusts Law (EPTL), otherwise known as the "decanting" statute. The decanting reference is based on the imagery of decanting wine (here, trust assets) from one bottle (the old or "invaded" trust) to another bottle (the new or "appointed" trust). The power of a trustee to decant depends on the trustee's authority to invade and distribute the principal of an irrevocable trust to or for the benefit of a beneficiary. Since decanting can be of enormous benefit to trustees and beneficiaries, trusts and estates practitioners would be well served to familiarize themselves with the revised statute in order to better advise their clients. This article discusses the basic principles of decanting and highlights key differences between New York's former and revised decanting statutes.

I. A Brief History and Some Basic Principles of Trust Decanting

A trust decanting involves a trustee's exercise of a power to invade the principal of an irrevocable trust by paying over some or all of the principal to a separate trust. It is rooted not in a power to amend the invaded trust, but rather in the trustee's limited power of appointment over it. This limited power of appointment is usually not expressed in the trust instrument as a power of appointment *per se*, but rather is part of the trustee's discretion to invade and distribute trust principal.

New York State was a pioneer in the decanting area, having enacted the nation's first decanting statute in 1992. The principal purpose of the statute was to allow certain trusts to enjoy continued exemption from the federal generation-skipping transfer (GST) tax, which was enacted as part of the Tax Reform Act of 1986. As originally enacted, Section 10-6.6 required a trustee to obtain either court approval or the beneficiaries' consent in order to decant. This requirement was stricken from the statute in 2001, a year after the Treasury Department issued regulations indicating that the requirement would disallow continued exemption from the GST tax. Thus, after the 2001 amendment, decanting in New York became fully discretionary for trustees of certain trusts (as discussed below), although the statute preserved the ability of a trustee to seek either the beneficiaries' consent or the court's permission if the trustee saw fit to do so.

Sophisticated trusts and estates practitioners quickly realized that decanting also offered a multitude of non-GST-related opportunities, particularly by allowing greater flexibility in administering an otherwise irrevocable trust. For example, if an irrevocable trust's administrative provisions, such as those governing the appointment of successor trustees, became impractical due to changed circumstances, a trustee could decant to an appointed trust containing provisions better suited to the new circumstances. Another opportunity might arise if, after a trust's creation, a beneficiary became eligible for governmental assistance. In that event, a trustee could decant to a supplemental needs trust and thus protect the trust's assets from the government's reach. The former statute could also allow a trustee to reduce a trust's New York State income tax exposure by decanting some or all of the trust's assets to another trust not considered a New York resident trust.

"Since decanting can be of enormous benefit to trustees and beneficiaries, trusts and estates practitioners would be well served to familiarize themselves with the revised statute in order to better advise their clients."

Regardless of the many reasons for decanting, some practitioners asked whether the statute gave trustees too much discretion. The concern was that decanting created a tension between the goals of promoting greater efficiency and/or flexibility in trust administration, on the one hand, and of fulfilling the settlor's intent, on the other. In an attempt to balance the two potentially competing goals, key safeguards were built into the revised statute, which are highlighted below.

II. Former Section 10-6.6

Under the former EPTL 10-6.6, a trustee of an irrevocable lifetime trust or testamentary trust could appoint some or all of the principal to a separate trust as long as: (1) the invaded trust gave the trustee absolute discretion to invade principal, unfettered by any ascertainable or non-ascertainable standard; (2) the

decanting did not reduce any fixed income interest in the invaded trust; (3) the decanting was in favor of "the proper objects of the exercise of the power" to invade; and (4) the appointed trust did not violate the limitations of EPTL 11-1.7 (prohibiting, among other things, a trustee's exoneration from liability for failing to exercise reasonable care, diligence and prudence).

Procedurally, the former statute required the decanting to be by a written instrument, signed and acknowledged by the trustee and filed in the office of the clerk "of the court having jurisdiction over the trust." The trustee was required to serve a copy of the decanting instrument on all persons interested in the trust[1] by registered or certified mail, return receipt required, by personal delivery or by any other manner directed by the court.

In practice, the statute left many practitioners unsure about the scope of a trustee's power to decant. For example, who are the "proper objects" of a decanting? Could an appointed trust exclude some of the beneficiaries of the invaded trust? Could an appointed trust have beneficiaries who were not beneficiaries of the invaded trust? Did the statute permit the appointed trust's term to extend beyond that of the invaded trust? Could a trustee be found liable for failing to decant?

In part because of these types of questions, and the fact that other states had adopted their own, more liberal decanting statutes, some New York trusts and estates practitioners called for revisions to EPTL 10-6.6.

III. The Newly Amended Decanting Statute

The newly amended decanting statute, which took effect immediately and applies retroactively, answers many of the questions raised by the former statute. As with the former statute, its terms apply unless the trust instrument provides otherwise.

When approaching the rather lengthy amended rules for the first time, it is helpful to divide them conceptually into three categories: (i) rules that apply when trustees have unlimited discretion to invade;[2] (ii) rules that apply when trustees do not have unlimited discretion; and (iii) rules that apply in either case.[3]

Rules Applicable When Trustees Have Unlimited Discretion

The amended statute provides more guidance for trustees with unlimited discretion to invade principal in favor of one or more "current beneficiaries."[4] For example, it explicitly allows trustees to decant in favor of one, more than one or all current beneficiaries, to the possible exclusion of the other current beneficiaries, and the appointed trust may benefit one, more than one or all of the successor and remainder beneficiaries, to the possible exclusion of the other successor and remainder beneficiaries.[5]

The amended statute explicitly permits trustees to grant to one, more than one or all current beneficiaries, to the possible exclusion of one or more current beneficiaries, a discretionary power of appointment if the beneficiaries could receive principal outright under the terms of the invaded trust.[6] Also, if the beneficiaries of the invaded trust are described as a class (*e.g.*, the settlor's children), then the beneficiaries of the appointed trust may include present or future members of such class (*e.g.*, children born to the settlor after the invaded trust's creation).[7]

Rules Applicable When Trustees Have Limited Discretion

One of the key differences between the former and amended statutes is the new ability to decant even when trustees do not have unlimited discretion to invade principal.[8] However, different, and more restrictive, rules apply in this case. Most importantly, the appointed trust must have the same current beneficiaries, and successor and remainder beneficiaries, as the invaded trust.[9] Thus, if the trustee of an invaded trust is permitted to distribute principal to A or B for their health, education, maintenance and support (known as the "HEMS standard") for so long as A and B are alive, with the remainder going outright to C, the appointed trust must have A and B as current beneficiaries and C as a remainder beneficiary.

Another key rule requires the appointed trust to contain the same distribution standard as did the invaded trust.[10] Thus, using the facts of the previous example, the appointed trust must contain the HEMS standard for distributions to A and B and may not, for example, grant the trustee the additional authority to distribute to A for A's "happiness."

If the appointed trust has a longer term than that of the invaded trust (the power to extend the trust's term is discussed below), the appointed trust must contain the same standard regarding distributions as the invaded trust during the invaded trust's original term.[11] Thereafter, the standard can be different. For example, assume that the invaded trust permits the trustee to distribute to A for A's health, education, maintenance or support until A reaches age 35, when the trust must terminate and its remainder be distributed to A. In this case, distributions from the appointed trust must be subject to a HEMS standard until A reaches age 35. After that time, the trustee of the appointed trust may have absolute discretion to invade principal for A's benefit.

Similarly, if the invaded trust grants a power of appointment to a beneficiary, the appointed trust must grant the identical power of appointment to the beneficiary, and the class of permissible appointees of such power must be the same.[12]

Finally, if the beneficiaries of an invaded trust are described as a class, the beneficiaries of the appointed trust must include all "present or future members of such class."[13]

Select Rules Applicable Regardless of the Trustees' Discretion

A number of provisions of the amended statute apply whether or not the trustee has unlimited discretion. Perhaps the most notable of these explicitly allows the appointed trust to have a longer term than that of the invaded trust.[14] For example, if an invaded trust must terminate and its remaining principal be distributed to A when A reaches age 35, the appointed trust's term may continue for A's lifetime or longer. Thus, despite the terms of the invaded trust, it is possible that A will never receive an outright distribution of the appointed trust's principal.

The Legislature was not unmindful of the discretion the new rules confer on trustees. As a result, it included a number of provisions designed to prevent abuse and safeguard the settlor's intent. For example, the amended statute:

- Explicitly imposes on the trustee a fiduciary duty to decant in the best interests "of one or more proper objects" of the power to invade as a prudent person would under the prevailing circumstances.[15]
- Prohibits a decanting if there is "substantial evidence of a contrary intent of the creator and it could not be established that the creator would be likely to have changed such intention under the circumstances existing at the time of the exercise of the power."[16] Little guidance is given as to what constitutes "substantial evidence" of a contrary intent except that the terms of the invaded trust, alone, do not constitute substantial evidence.[17] Thus, it seems likely that the courts will be called upon to clarify its meaning.
- Requires trustees not only to give notice of the decanting but also to provide copies of the invaded and appointed trust instruments to (i) all "persons interested in the invaded trust"[18] and the appointed trust, (ii) the settlor, if living, and (iii) "any person having the right, pursuant to the terms of the invaded trust, to remove or replace" the trustee exercising the decanting power.[19]
- Requires the filing of the original decanting instrument with the court having jurisdiction over any invaded trust other than a lifetime trust that has never been the subject of a proceeding in the Surrogate's Court.[20] Notably absent is any requirement to file copies of the invaded or appointed trusts with the court.
- Postpones the effective date of the decanting until thirty days after the completion of service of notice of the decanting[21] and authorizes interested persons to serve the trustees with written notice of objection to the decanting prior to its effective date, although the failure to object does not constitute consent.[22] This thirty-day period also provides interested persons with the opportunity to seek a judicial stay of the decanting and/or to compel the trustees to account for their decision to decant.
- States that an interested person's receipt of the decanting instrument does not affect the person's right to (i) compel the trustees to account specifically for the decision to decant, (ii) compel the trustees to account generally or (iii) file objections to the trustees' account.
- Requires the decanting instrument to explicitly state whether the decanting comprises some or all of the invaded trust's assets and, in the former case, imposes an additional duty to state the "approximate percentage of the value of the principal of the invaded trust that is subject to" the decanting.[23] Moreover, if the decanting comprises all of the invaded trust's assets, any subsequently discovered assets and principal paid to or acquired by the invaded trust after the decanting belongs to the appointed trust.[24] If the decanting comprises only some of the invaded trust's assets, then such after-acquired property belongs to the invaded trust.[25]
- Requires trustees to consider the tax implications of the decanting.[26] Note that, with certain explicit exceptions,[27] trustees can decant even if the decanting has a negative tax result. Trustees will be shielded from liability in this case only if they can show that the decision to decant was prudent in light of the "prevailing circumstances."[28] For example, if decanting Subchapter S stock from the invaded trust to an appointed trust would cause a termination of the company's Subchapter S election but, at the same time, result in a more valuable reduction of the trust's New York State income tax exposure, the decanting might be appropriate. Of course, the trustees may be called on to account for such a decision in a judicial accounting proceeding.[29]
- Prohibits any change to trustee commissions absent a court order.[30]

There are other important generally applicable provisions. One expressly allows trustees to decant in favor of a supplemental needs trust, provided that all of the section's other requirements are satisfied.[31] Another confirms a trustee's authority to decant even when there is not a current need to invade principal.[32]

IV. Some Questions Raised by the Amended Statute

The amended statute raises some interesting questions, especially concerning the interplay between the new notice provisions and the right to object to a decanting. For instance, would an objection to a proposed decanting, duly served on the trustees by an interested person, prevent the decanting from becoming effective at the end of the thirty-day notice period? Since the statute explicitly states that the consent of interested persons is not required,[33] an objection arguably would not prevent the decanting. But, if it does not prevent the decanting, what effect would an objection have? Perhaps nothing more than putting the trustees on notice that an interested person is likely either to seek a judicial stay of the decanting or to hold the trustees liable for their decision to decant. An important question is whether service of an objection, or the failure to object, starts the running of the statute of limitations, especially given the statute's provisions that (i) failure to object does not constitute consent[34] and (ii) receipt of notice of a decanting does not affect an interested person's right to compel the trustees to account for the decanting or foreclose an interested person from objecting to an account or compelling a trustee to account.[35] In particular, is the act of decanting the functional equivalent of the trustees' open repudiation of their obligation to account, or does the act bring to an end the invaded trust relationship, thus triggering the running of the statute of limitations?[36]

Also, what effect would the settlor's objection have, assuming he is not deemed a person interested in the invaded trust? It seems reasonable to conclude that such an objection might constitute "substantial evidence of a contrary intent of the creator" and thus could divest the trustees of the authority to decant.[37] Moreover, it should be noted that while the settlor is entitled to notice of the decanting, the settlor is not necessarily part of the class of interested persons who can serve objections to the decanting.[38] Perhaps the reason for this discrepancy is to ensure that the settlor is not deemed by the taxing authorities to have a retained power over the trust, thus minimizing any potential estate tax inclusion under Section 2036 of the Internal Revenue Code.

It remains to be seen how the courts will resolve these issues.

V. Conclusion

The recent amendment to EPTL 10-6.6 addresses many unanswered questions raised by the former statute and promotes greater flexibility in trust administration without losing sight of the settlor's intent.

Endnotes

1. "All persons interested in the trust" was defined under the former statute as "all the persons upon whom service of process would be required in a proceeding for the judicial settlement of the account of the trustee, taking into account" N.Y. Surrogate's Court Procedure Act 315.
2. A newly defined term meaning "the unlimited right to distribute principal that is not modified in any manner." N.Y. Estates Powers & Trusts Law (EPTL) 10-6.6(s)(9). The definition further provides that "[a] power to pay principal that includes words such as best interests, welfare, comfort, or happiness shall not be considered a limitation or modification of the right to distribute principal." *Id*.
3. It should be noted that if a trustee of an invaded trust has unlimited discretion, and the same or another trustee also has a separate, limited power to invade principal, the trustee with absolute discretion is permitted to decant. EPTL 10-6.6(f).
4. A newly defined term meaning those to whom a trustee may currently distribute principal. EPTL 10-6.6(s)(4).
5. EPTL 10-6.6(b).
6. EPTL 10-6.6(b)(1).
7. EPTL 10-6.6(b)(4).
8. EPTL 10-6.6(c).
9. *Id*.
10. EPTL 10-6.6(c)(1).
11. EPTL 10-6.6(c)(2).
12. EPTL 10-6.6(c)(4).
13. EPTL 10-6.6(c)(3).
14. EPTL 10-6.6(e).
15. EPTL 10-10.6(h).
16. EPTL 10-10.6(h).
17. *Id.*
18. The definition of "interested persons" is essentially unchanged under the amended statute. *See* EPTL 10-6.6(s)(7).
19. EPTL 10-6.6(j)(2).
20. EPTL 10-6.6(j)(6).
21. EPTL 10-6.6(j).
22. EPTL 10-6.6(j)(4).
23. EPTL 10-6.6(j)(3).
24. EPTL 10-6.6(i)(1).
25. EPTL 10-6.6(i)(2).
26. EPTL 10-6.6(o).
27. *See, e.g.,* EPTL 10-6.6(n).

28. *See* EPTL 10-6.6(h).

29. *See* EPTL 10-6.6(j)(5).

30. EPTL 10-6.6(q).

31. EPTL 10-6.6(n)(1).

32. EPTL 10-6.6(g).

33. EPTL 10-6.6(j)(1).

34. EPTL 10-6.6(j)(4).

35. EPTL 10-6.6(j)(5).

36. *See Tydings v. Greenfield, Stein & Senior, LLP*, 11 NY3d 195 (2008) and *Matter of Barabash*, 31 NY2d 76 (1972).

37. EPTL 10-6.6(h).

38. *See* EPTL 10-6.6(j)(4).

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Achieving Grantor Trust Status Through Code § 679

By Daniel S. Rubin and Ira W. Zlotnick

Daniel S. Rubin

There are many useful tools that estate planners might utilize in crafting a successful estate plan. These include, of course, the annual gift tax exclusion under I.R.C. § 2503(b), the gift and estate tax exclusion amount under I.R.C. § 2010(c) and the unlimited marital deduction under I.R.C. §§ 2056 and 2523.[1] However, one might posit that the single most effective tool available for successful estate tax planning does not even relate directly to the estate, gift and generation-skipping transfer taxes. That tool is part of the income tax law—specifically, Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, entitled "Grantors and Others Treated as Substantial Owners," and more commonly referred to as the "grantor trust" rules of I.R.C. §§ 671-679.

The grantor trust rules provide that when a trust is treated as a "grantor" trust, the grantor is personally liable for the payment of the income tax attributable to any taxable income earned by the trust. Specifically, I.R.C. § 671, entitled "Trust income, deductions, and credits attributable to grantors and others as substantial owners," provides, in pertinent part, that:

> Where it is specified in this subpart that the grantor…shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor…those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.[2]

The effect of the grantor trust rules is to enable a grantor, through the payment of the income tax attributable to the income of the grantor trust, to effectively make transfers to the trust and, of equal importance, to do so without risk that the Internal Revenue Service might seek to characterize the payment of such income tax by the grantor as a taxable gift by the grantor to the trust.[3] Also important is the fact that the circumstances under which a trust would be treated as a grantor trust pursuant to I.R.C. §§ 672-679 (generally, by reason of the grantor, either directly or through attribution, having retained an "excessive" level of control over the trust), are not necessarily coincident with the circumstances pursuant to which trust property would be included in a decedent's gross estate under the so-called "string" provisions of the Code, such as I.R.C. § 2036.

Ira W. Zlotnick

As noted above, the powers that would cause a trust to be treated as a grantor trust are contained in I.R.C. §§ 672-679. Although much has been written about I.R.C. §§ 672-678, curiously little attention has been paid to I.R.C. § 679, which concerns the tax treatment of certain "foreign" trusts. I.R.C. § 679 provides, in pertinent part, that:

> A United States person who directly or indirectly transfers property to a foreign trust…shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.[4]

The authors suspect that the reason why I.R.C. § 679 has generally been left unexplored in commentary, and is rarely utilized (at least intentionally) to cause a trust to be deemed a grantor trust, is because of the stigma that often attaches to foreign trusts. It is the intent of the authors through this article to promote the use of I.R.C. § 679 as a so-called "grantor trust power," under appropriate circumstances, and to demonstrate the power, precision and flexibility of this section of the Code as a planning device when grantor trust status is the desired result.

I. Background

Of significant value to the estate planner is the certainty of obtaining an intended result. Where the desired result is a grantor trust there are, in fact, most often two results sought. The first is that the trust's income, deductions and credits will be attributed to the grantor of the trust for income tax purposes. The second is that the income tax treatment will not cause the trust fund to be included in the grantor's gross estate for estate tax purposes.

Unfortunately, some of the most frequently used grantor trust powers set forth in I.R.C. §§ 672-678 leave

some uncertainty as to whether full grantor trust treatment has actually been attained. For example, questions exist regarding:

- whether the power of a non-adverse person to distribute or accumulate income for the grantor or the grantor's spouse results in grantor trust status pursuant to I.R.C. § 677(a)(1) and (2) only as to trust income;[5]
- whether the power of a non-adverse person to use trust income to pay life insurance premiums on the life of the grantor or the grantor's spouse results in grantor trust status pursuant to I.R.C. § 677(a)(3) in excess of the sums actually used to pay insurance premiums;[6] and
- whether the grantor's right to borrow from the trust without adequate interest or adequate security results in grantor trust status pursuant to I.R.C. § 675(3) if no loan is actually outstanding during the year.[7]

Conversely, the use of other grantor trust powers, which might convey greater certainty as to grantor trust status, might place the exclusion from the grantor's gross estate for estate tax purposes in doubt. For example, while a trust can clearly be structured as a grantor trust under I.R.C. § 674(a) if the grantor retains a right to the beneficial enjoyment of the trust property or the power to dispose of the trust property,[8] the grantor's retention of a right to the beneficial enjoyment of the trust property will result in estate tax inclusion under I.R.C. § 2036(a),[9] and the grantor's retention of a power to dispose of the trust property will result in estate tax inclusion under I.R.C. §§ 2036(a) and 2038.[10]

Similar estate tax inclusion issues exist in connection with the grantor's retention of those "administrative powers" set forth under I.R.C. § 675, including (1) the power to deal with the trust fund for less than adequate and full consideration, (2) the power to borrow from the trust fund without adequate interest or adequate security, (3) the power to vote trust stock or other securities of a corporation in which the holdings of the grantor and the trust are significant in terms of voting control and (4) the power to control the investment of the trust funds to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.

Even I.R.C. § 675(4)(C), which speaks to the grantor's retention of the "administrative" power to reacquire the trust corpus by substituting other property of an equivalent value, and which arguably was sanctioned by the issuance of Revenue Ruling 2008-22,[11] provides only a relative degree of comfort that the intended income tax and estate tax results can be obtained. For example, uncertainty may remain as to whether a power of substitution could be exercised to acquire any voting stock of a "controlled corporation" for purposes of I.R.C. § 2036(b). Additional issues exist in guaranteeing that the substituted properties are, in fact, of equivalent value and that the substitution power not be exercised in a manner that can shift benefits among the trust beneficiaries.[12] However, the IRS did recently clarify that a power of substitution does not create an impermissible "incident of ownership" that would cause estate inclusion under I.R.C. § 2042 where the trust owns one or more life insurance policies on the grantor's life.[13]

Finally, the use of other grantor trust powers that would likely cast no uncertainty as to either the income tax or estate tax results often prove unpalatable to grantors for more visceral reasons. For example, I.R.C. § 674(a) provides that grantor trust status will result not only where the trust is subject to a power of disposition exercisable by the grantor (which would necessarily cause estate inclusion), but also where the trust is subject to a power of disposition exercisable by a "nonadverse party"[14] (which would not cause estate inclusion). However, grantors are often unwilling to give a third party the power to divert trust assets from the grantor's otherwise intended disposition irrespective of all assurances that the likelihood of such a power actually being exercised might, as a practical matter, be negligible.

II. I.R.C. § 679

While the aforementioned examples illustrate some of the issues that exist with the more traditional grantor trust powers, no such uncertainty exists under I.R.C. § 679. I.R.C. § 679 merely requires that (i) the trust be a "foreign trust," and (ii) the trust have a "United States beneficiary." Both of these terms are clearly defined under the Code and the Treasury Regulations.[15]

The test of whether the trust is a "foreign trust" is an objective one. I.R.C. § 7701(a)(31)(B) defines a "foreign trust" as any trust that is not a United States person, and I.R.C. § 7701(a)(30)(E) provides, in pertinent part, that the term "United States person" means any trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust (known as the "court test"), and (ii) one or more United States persons have the authority to control all "substantial decisions" of the trust (known as the "control test"). Thus, a "foreign trust" is a trust that fails either one, or both, of the court test and the control test.

Under Treas. Reg. § 301.7701-7(d)(ii), the term "control" means having the power, by vote or otherwise, to make all of the "substantial decisions" of the trust, with no other person having the power to veto any such decisions. To determine who has control, it is

necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

Under Treas. Reg. § 301.7701-7(d)(ii), "substantial decisions" are those decisions that are not ministerial and that persons are authorized or required to make under the terms of the trust instrument and applicable law. Ministerial decisions concern matters such as the bookkeeping, the collection of rents and the execution of investment decisions. Substantial decisions include, but are not limited to, decisions concerning (i) whether and when to distribute income or corpus; (ii) the amount of any distributions; (iii) the selection of a beneficiary; (iv) whether a receipt is allocable to income or principal; (v) whether to terminate the trust; (vi) whether to compromise, arbitrate or abandon claims of the trust; (vii) whether to sue on behalf of the trust or to defend suits against the trust; (viii) whether to remove, add or replace a trustee; (ix) whether to appoint a successor trustee to a trustee who has died, resigned or otherwise ceased to act; and (x) investment decisions. (Note, however, that if a United States person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.)

A "United States beneficiary" is a trust beneficiary who is a citizen or resident of the United States.[16] In addition, Treas. Reg. § 1.679-2(a)(i) provides that:

> [a] foreign trust is treated as having a U.S. beneficiary unless during the taxable year of the U.S. transferor (i) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and (ii) If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.

Pursuant to Treas. Reg. § 1.679-2(a)(ii), "[t]his determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event."

III. Issues

Since the requirements for satisfying I.R.C. § 679 are clearly set forth in the Treasury Regulations and easy to effect one way or the other (for example, through the appointment of a foreign person as the trustee or even as a co-trustee), it is a wonder why estate planners do not employ I.R.C. § 679 more often, especially when trying to reconfigure an existing irrevocable trust that has been erroneously drafted as a non-grantor trust or that uses one or more of the grantor trust powers discussed above that leave at least some uncertainty concerning whether or not full grantor trust status has been achieved.[17]

The reason is that while qualification under I.R.C. § 679 may be fairly simple and certain, unique issues do exist in connection with foreign trusts. First, foreign trusts carry additional tax reporting requirements. Most significantly:

- A United States person treated as an owner of a foreign trust must file a Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts,* on an annual basis. The failure to file a timely and complete Form 3520 will result in a penalty of up to thirty-five percent.
- A United States person treated as an owner of a foreign trust with one or more U.S. beneficiaries is responsible for ensuring that the foreign trust file a Form 3520-A, *Annual Return of a Foreign Trust with U.S. Beneficiaries*, setting forth a full and complete accounting of all trust activities, trust operations and other relevant information. The failure to file a timely and complete Form 3520-A will result in a penalty of up to five percent to apply.

In addition, and beyond mere reporting issues, I.R.C. § 684(a) treats any transfer of property by a United States person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred. Importantly, an exception exists under I.R.C. § 684(b) for a transfer to a trust by a United States person to the extent that any person is treated as the owner of such trust under section 671. Therefore, the trick is in avoiding or minimizing the consequences of gain recognition when the trust is no longer a grantor trust (as will be the case, for example, upon the grantor's death). Several techniques exist for addressing this issue, as follows:

- The trust can be domesticated prior to the grantor's death by having the foreign trustee resign (or by removing the foreign trustee), perhaps at a time when the trust would be more appropriately structured as a non-grantor trust than as a grantor trust.[18]
- The trust can be invested and reinvested with an eye towards minimizing the capital appreciation that will exist at the grantor's death.

- A nominally funded sister trust, structured as a domestic trust, can be created and given a general power of appointment over the assets of the foreign trust effective upon the grantor's death. The mere existence of such a power of appointment, whether or not actually exercised, should cause the foreign trust to remain a grantor trust with a United States person (i.e., the domestic sister trust), as its grantor, following the death of the individual grantor.

IV. Conclusion

Through the simple expedient of naming a foreign person as a trustee, or even a co-trustee, of a trust, I.R.C. § 679 ensures grantor trust status to the entire trust without the potential additional, and most certainly unwanted, side effect of estate tax inclusion. The use of I.R.C. § 679 should therefore be considered as a planning device where grantor trust status is a goal and other options leave less than certain results or are simply not available. However, care must be taken to ensure that the benefits of grantor trust status through I.R.C. § 679 are not offset, if the trust remains a foreign trust upon the grantor's death, by the effect of a deemed sale or exchange of the trust's property pursuant to I.R.C. § 684.

Endnotes

1. All references herein to the Code and to the I.R.C. are references to the Internal Revenue Code of 1986, as amended.
2. I.R.C. § 671.
3. *See, e.g.,* Rev. Rul. 2004-64, 2004-27 I.R.B. 7 ("[w]hen the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries.")
4. I.R.C. § 679(a)(1).
5. *See* Treas. Reg. § 1.677(a)-1(g) Ex.1. *But see* PLR 9504021, PLR 9451056 and PLR 9415012.
6. *See Moore v. Comm'r*, 39 BTA 808 (1939), *acq.* 1939-2 C.B. 25; *Rand v. Comm'r*, 40 BTA 233 (1939), *aff'd*, 116 F.2d 929 (8th. Cir. 1941); *Iversen v. Comm'r*, 3 TC 756 (1944); *Weil v. Comm'r*, 3 TC 579, *acq.* 1944 C.B. 29. *But see* PLR 8103074, PLR 8126047 and PLR 8118051.
7. *See Benson v. Comm'r*, 76 TC 1040 (1981); *Bennett v. Comm'r*, 79 TC 470 (1982).
8. Section 674(a) provides that "[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party."
9. Section 2036(a) provides that "[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."
10. Section 2038(a)(1) provides that "[t]he value of the gross estate shall include the value of all property…[t]o the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death."
11. 2008-16 IRB 796. Rev. Rul. 2008-22 provides that "[a] grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under §2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries."
12. *Id*.
13. Rev. Rule. 2011-28 (2011-49 IRB 830).
14. Section 672(b) provides that "[f]or purposes of this subpart, the term 'nonadverse party' means any person who is not an adverse party." Section 672(a) provides that "…[t]he term 'adverse party' means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust…"
15. Prior to the enactment of I.R.C. § 679, a United States person could establish a foreign trust in a no-tax jurisdiction and invest the trust assets in a manner that would generate only foreign-source income. This strategy would enable the trust to accumulate income free of United States income tax if the trust were structured as a non-grantor trust.
16. *See* I.R.C. § 7701(a)(30)(A).
17. Although the "decanting" of such a trust might be posited as a solution in such situations, decanting is sometimes either impracticable or impossible.
18. For reasons beyond the scope of this article, however, and irrespective of I.R.C. § 684, it may be important for the trust to be domesticated following the death of the grantor since the accumulation of income in a foreign non-grantor trust with U.S. beneficiaries can have significant adverse tax consequences.

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Rulings on Trustee's Duty to Diversify: What Have We Learned?

By Hon. C. Raymond Radigan and Raymond C. Radigan

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In 1987, the New York Court of Appeals held in *In re Janes* that a bank trustee was negligent for failing to adequately diversify a trust's holdings of Kodak stock.[1] Since then, several New York cases, including *In re Rowe*,[2] *In re Saxton*,[3] *In re Chase Manhattan Bank*,[4] *In re Hyde*,[5] *In re Hunter*[6] and *In re Knox*,[7] have examined whether a bank trustee was negligent for failing to diversify investments.

In each of these cases, a bank was acting as either trustee or co-trustee of a trust the vast majority of whose assets consisted of one or two stock holdings (such as Kodak, IBM, Marine Midland and Woolworth). The bank trustee initially decided to retain the concentrated holding. The retained stock eventually decreased in value, and the beneficiaries alleged that the bank negligently managed the trust's investments. At the trial level, each case except *Hyde* held that the bank trustee was liable for damages for retaining the concentrated positions and not diversifying the portfolio. The damages were measured by the value of the lost capital, which was determined by (1) calculating the stock's value on a date the court found it should have been sold; (2) subtracting the potential capital gains tax that would have been paid if the stock had been sold (this was done in *Saxton*, *Chase Manhattan Bank* and *Hunter*, but not *Knox*); (3) taking the hypothetical proceeds and compounding it annually at 9% in most instances during the course of administration; and (4) subtracting the dividends received and the value of the retained stock at the end of the accounting period (or the proceeds received from the sale of the previously retained stock).

To date, only *Chase Manhattan Bank* was reversed on appeal. At issue in all these cases is whether the trustees took an undue risk by retaining the concentrated positions and not diversifying the portfolio.

Most of the subject trust instruments lacked definitive language allowing the absolute retention of the large holdings. The trustees were further criticized because of alleged lack of documentation either justifying retaining the stock or explaining their overall investment process. In certain instances, the courts held that the trustee did not adequately or regularly communicate with the beneficiaries to explain the appropriate investment strategy for the trust or to determine the need for income or discretionary distributions.

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These cases raise a few questions that deserve closer scrutiny.

I. Does a Trustee Have an Absolute Duty to Diversify Investments?

No: the trustee's duty to diversify depends on the circumstances and the retention language in the governing instrument.

In New York, "a trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard," as set forth in N.Y. Estates, Powers & Trusts Law 11-2.3 (EPTL), which became effective January 1, 1995.

The prudent investor standard requires a trustee "to diversify assets unless the trustee reasonably determines that it is in the interest of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument."[8] The duty to diversify is presumed because it can help minimize firm-specific risk (also known as "inherent risk") without sacrificing return. Firm-specific risk refers to the risk that the price of a particular stock may decline due to an event that negatively affects a particular company but not necessarily the broader market. Firm-specific risk can be minimized significantly by creating a diversified stock portfolio.[9]

Unfortunately, even a diversified stock portfolio cannot protect against market risk. One way a fiduciary may minimize the impact of market risk is to use a comprehensive asset allocation model when constructing a trust portfolio. Asset allocation is the process of dividing an investment portfolio among different asset classes that are not highly correlated to each other in an effort to help increase risk-adjusted returns while reducing volatility in the portfolio.

Special Circumstances

Sometimes it may not be appropriate to diversify investments, given the terms and purpose of the governing instrument or the circumstances involved. For example, suppose dad dies and funds a trust exclusively with closely held stock of a family business and names his minor children as beneficiaries. They are to receive an outright distribution of their share of the trust assets at age 35. Does the trustee have a duty to diversify the stock?

Arguably, the rule of diversification should not apply to this trust given the property's special relationship to the beneficiaries and the fact that dad is simply using the trust as a vehicle to retain the family business stock until the children reach age 35. The grantor's intent to retain the property should be upheld, even without specific retention language. The safer approach, especially under present law, however, is to include specific retention language and provisions that explain the intent of the grantor.

A similar issue was raised in *In re Hyde.*[10] This was an intermediate accounting proceeding involving three trusts that held large concentrations of non-voting Class B stock of the Finch Pruyn Paper Company, Inc. ("Finch Pruyn"), a closely held corporation. A bank and an individual were acting as co-trustees of each trust.

The beneficiaries alleged that the trustees should have sold 95% of the Finch Pruyn stock in 1995 and used the sale proceeds to create a diversified portfolio. They further claimed that the trustees' negligent failure to do so resulted in damages exceeding $10 million.

The trustees proved, however, that Finch Pruyn had a very unusual capital structure that made it virtually impossible to sell the Class B stock to the voting shareholders. Also, evidence indicated that despite repeated efforts to sell the Class B stock, there was no market for the Class B stock on a stand-alone basis, and a fair price for the stock could be obtained only if the entire company was sold. The trustees also offered proof that (1) the trust would have incurred an inordinate amount of capital gains tax if the stock was sold; (2) the stock paid out considerable dividends; and (3) the grantor intended that Finch Pruyn be sustained as a family business. The Appellate Division affirmed the Surrogate's decision that it was not in the beneficiaries' best interest to diversify the stock.

Retention Language

The prudent investor standard applies "except as otherwise provided by the express terms and provisions of a governing instrument within the limitations set forth by section 11-1.7,"[11] which provides that the attempted exoneration of a fiduciary from liability for failure to exercise reasonable care, diligence and prudence is contrary to public policy. Thus the statutory standard will generally apply unless there is specific language in the governing instrument to the contrary. Does this mean that an instrument can eliminate the duty to diversify?

Theoretically, a grantor can create a trust that includes an ironclad retention clause directing a trustee to retain an asset that cannot be sold under any circumstances. Such a retention clause ought to (1) include an explanation of why the grantor wants a particular asset to be retained; (2) include a direction that the retention is mandatory, not permissible, and that the trustee has no authority to dispose of the asset; (3) expressly relieve the trustee of any duty to diversify; and (4) exonerate the trustee from liability if the value of the retained asset decreases.

An ironclad retention clause can be problematic because the trustee would then have no flexibility to sell the asset, especially if the circumstances change dramatically. Furthermore, a true ironclad retention clause is extremely rare. None of the previously discussed cases had an ironclad retention clause, although *Chase Manhattan Bank* came the closest.

In *Chase Manhattan Bank,*[12] the testamentary trust stated that it was the testator's desire for the Kodak stock to be retained and to be distributed to the ultimate beneficiaries, that the trust should "not dispose of such stock for the purpose of diversification" and that the trustee should "not be liable for any diminution in the value of such stock."[13] However, the trust went on to say that these provisions should not prevent the trustee "from disposing of all or part of the [Kodak] stock in case there shall be some compelling reason *other than diversification of investment for doing so*"[14] (emphasis added).

In essence, the trustee was directed not to sell the stock just for the sake of diversification, but the trustee could sell the stock if there were some other compelling reason to do so. In *Chase Manhattan Bank*, the beneficiaries tried to prove that the trustee should have sold the Kodak stock due to its poor performance, not merely for the sake of diversification.

What if a trust had the following language?

> I absolutely direct my trustee to retain my sailboat that was built by my father. I give the trustee complete discretion to allow my son to use the sailboat during his lifetime, but at his death, I direct that the sailboat be given outright to my granddaughter X. The trustee shall not sell the sailboat under any circumstances. I specifically eliminate my trustee's duty to diversify this

investment and the trustee will not be liable if the value of the sailboat depreciates. Furthermore, my trustee has no responsibility to maintain the sailboat, but may use the cash in this trust to pay for any maintenance expenses, if the trustee so chooses.

One of the primary responsibilities of the trustee is to carry out the intent of the grantor, as long as it is not contrary to public policy. Many times a trustee must follow the terms of the trust document even if the trustee disagrees with the grantor's intent—for example, "make outright distribution to my children when they are 20" or "do not invest in equities—only cash and bonds." In the above example, the trustee should carry out the intent of the grantor and retain the sailboat. The grantor's intent also should govern if the trustee was mandated to retain a particular security.

Arguably, the portion of the clause providing that the trustee "has no responsibility to maintain the sailboat" would violate EPTL 11-1.7(a), as would any instructions to destroy the property. Stated differently, even if a trustee is mandated to retain the asset, the trustee still must use reasonable care, diligence and prudence regarding all other facets of trust administration.

II. Should a Concentrated Holding Always Be Fully Diversified All at Once?

No, especially if there is a capital gains tax to consider.

All the cases noted above, except *Hyde*, established a certain date when a trust portfolio should have been diversified. Thereafter, the bank trustee had 30 days to sell between 90%–95% of the concentrated holdings (the "90/30 rule"). The courts held that the bank trustee was negligent if the stock was retained beyond 30 days. The New York Bankers Association contended that these holdings "created an inflexible 90/30 rule," an argument rejected by the *Saxton* court. This is an important issue because depending on the circumstance, it may be prudent to diversify a concentrated holding over a period of time.

To illustrate, suppose a trustee determines that it is appropriate to diversify a concentrated holding valued at $5.1 million. Further assume that the holding has a $100,000 cost basis and the combined federal and New York capital gains tax rate is 23.97% (15% federal, 8.97% New York).

One option is for the trustee to sell the stock immediately and pay a total capital gains tax of $1,198,500 ($5 million x 23.97%). Another option is to sell half the stock immediately, and sell the other half in the following year so that the capital gains tax is paid over a two-year period. Alternatively, it might be appropriate to diversify the position over a three- or four-year period. Sales also might be accelerated or delayed depending on expected changes in the capital gains tax rate.

A trustee who decides to follow any one of these strategies should explain and document its decision as part of the trustee's investment process. Meanwhile, if the position is large enough, the trustee can consider using hedging strategies (e.g., buying a protective put option or creating a cashless collar) while the concentrated position is retained.

III. Should the Potential Capital Gains Tax Be Considered When Measuring Damages?

Yes, if the fair market value of the concentrated holding is higher than the cost basis.

The *Saxton*, *Chase Manhattan Bank* and *Hunter* cases subtracted the potential capital gains tax when calculating damages. In *Knox*, the court chose not to do so on the theory that it would result in "double taxation"—meaning the trust would essentially be taxed when the capital gains tax was deducted and taxed again when the damages were awarded to the beneficiaries.[15]

Fiduciaries argue that if a concentrated position has appreciated in value, then the trust would have paid a capital gains tax if the position had been sold and kept only the net proceeds. Second, to say that accounting for capital gains tax results in "double taxation" of damages is inapposite because a trustee is likely to make several purchases and sales of securities held in the trust account during the course of administration. Some experts estimate that the average portfolio turnover rate for an actively managed mutual fund is 92%.[16] Assume, however, that a portfolio turnover rate of 30% is more appropriate for a long term trust. This still means that the average security is traded every three or four years. Consequently, the same proceeds in a long term trust could be subject to a capital gains tax on several occasions as long as the assets are consistently appreciating in value.

IV. Should the Statutory Interest Rate Be Changed?

Yes: the statutory interest rate applied in calculating damages should instead be a variable rate that reflects current market conditions.

The diversification cases determined damages by annually compounding the value of the capital lost because of a failure to diversify by the statutory interest rate.[17] The problem, however, is that the statutory interest rate in New York is 9%.

As a matter of background, New York adopted a statutory interest rate of 6% effective September 1, 1972, at a time when inflation was rising at an annual rate of 3.19% and the 10 year U.S. Treasury Bond was

yielding 6.55%. The statutory interest rate was raised to 9% on June 25, 1981, when inflation was rising at an annual rate of 13.13% and the 10 year U.S. Treasury Bond was yielding 14.28%.

Yet, as of October 2011, when inflation was rising at an annual rate of 3.9% and the 10 year U.S. Treasury Bond was yielding 2.18%, the statutory interest rate remained at 9%. Clearly, damages based on the statutory interest rate are designed to make beneficiaries "whole," but this rate is too high and beyond compensatory given current market conditions. In fact, to a certain extent a fixed rate of 9% may be considered punitive.

To illustrate, assume a trust account consists of 60% equities and 40% fixed income securities. Further, assume the equity component of the portfolio is measured by the S&P 500 Index and the fixed income component is measured by the Barclays Capital U.S. Aggregate Bond Index. As of June 30, 2011, the investment performance of the portfolio over the prior 20 years would be as follows:

Term	Annualized Return
1 year	20.6%
5 year	4.4%
10 year	3.9%
15 year	6.4%
20 year	7.9%

Only the one-year annualized return would have exceeded 9%, and that is because the S&P 500 Index generated a 30.68% annualized return during that period.

One proposal to mitigate this problem is to change the statutory interest rate to a floating rate equal to the rate of return on the 1 year U.S. Treasury Bill plus 3%.[18] In any event, a variable rate of some sort would better reflect current market conditions.

Another criticism is that the courts invariably have used the maximum statutory rate of 9% to determine damages, even though they have discretion to use a lower rate, if appropriate. Surrogate Holzman in *In re Tydings* exercised his discretion and used a lower rate of 5%.[19] Furthermore, surrogates should have the discretion to determine that compounding may not be warranted under certain facts and circumstances.

V. What if a Beneficiary Is Not Sure When an Investment Should Have Been Diversified?

Failure to establish when a concentrated portfolio should have been sold can be problematic when drafting the pleadings in a case seeking damages for failure to diversify.

In *Chase Manhattan Bank*, the Appellate Division held that once the Surrogate determined that the beneficiaries failed to establish that there was a compelling reason to sell the concentrated holdings of Kodak stock on January 31, 1973, it was an error for the Surrogate to look beyond the pleadings to determine that there was a compelling reason to sell the stock a year later. The beneficiaries neither alleged nor offered proof that a compelling reason for the sale of Kodak existed on January 31, 1974. The court concluded that the Surrogate's determination was "impermissibly based on nothing more than hindsight."[20]

Based on the foregoing, it might be difficult to draft pleadings for a beneficiary who believes that a trustee is negligent for retaining a concentrated holding but is having difficulty determining the exact date that the stock should have been sold. Do you pick a conservative date and allege that the stock should have been sold no later than that particular point in time? Do you allege various courses of action using different dates to determine when the stock should have been sold? Whatever method is used, it appears that the beneficiary is obligated to establish the date, not the court.

VI. Can Damages Be Awarded in an Intermediate Accounting Proceeding?

Yes, but the results can be interesting.

In *Rowe*, a trust was funded solely with 30,000 shares of IBM stock on September 8, 1989 when the stock was worth $116 a share. Ultimately, the bank trustee filed an intermediate accounting indicating that as of December 31, 1994, the trustee still retained 19,398 shares of IBM stock which was then worth $73.50 a share. This represented a 21.51% decrease in value during the accounting period, or an annualized return of -4.7%.

The beneficiaries filed objections to the accounting alleging that the bank trustee was negligent for retaining the concentrated holding of IBM stock. The Surrogate's Court and the Appellate Division upheld those objections, and the bank was directed to pay $630,279 in damages and was removed as trustee. Interestingly, the Appellate Division's opinion specifically rejected the contention that the surcharge was improperly calculated because it was based on an annualized paper loss during an intermediate accounting rather than a final account. The court reasoned that it would have been patently illogical to allow the trustee to continue with its negligent management of the trust simply because 10 years remained on the trust term.

Although the court's position appears to be sound and logical, ironically, from the time the trust was funded (September 8, 1989) until the time the Appellate Division issued its decision (August 10, 2000), IBM stock generated a total return (including dividends) of 432%, which represents an annualized return of 18.6%.

VII. What Is the Best Way for Trustees to Protect Themselves When Making Investment Decisions in a Fiduciary Capacity?

Trustees should document the investment process in some form.

The Prudent Investor Act provides that a fiduciary should be judged "by a standard of conduct, not outcome or performance" and that "compliance with the prudent investor rule is determined in light of facts and circumstances prevailing at the time of the decision or action of a trustee."[21]

This means that a fiduciary should not automatically be held liable merely because the value of a portfolio declined or because the portfolio did not perform as well as the appropriate benchmarks. The fiduciary is not a guarantor of performance. Instead, the decisive factor is whether the strategy and the investment decisions made by the fiduciary were prudent at the time they were implemented.

This is why it is important for a fiduciary to document the investment goals and objectives of the trust and to specify in writing why a particular investment strategy and asset allocation model is being utilized. Once the investment strategy is in place, the portfolio needs to be reviewed regularly to ensure that the investment decisions remain prudent, given current economic and market conditions, and if not, changes should be made accordingly. Most importantly, however, the trustee should prepare detailed documentation showing the portfolio is being reviewed on a regular basis and adjustments are being made, when appropriate. The safest approach is to then communicate this information to the beneficiaries on a timely basis.

VIII Conclusion

So what have we learned from *Janes* to *Knox*? First, trustees have a presumed duty to diversify investments and may be liable if they neglect to do so. If diversification is appropriate, a concentrated holding can be sold immediately or sold over a period of time if there is a considerable potential capital gains tax to consider. There may be an exception to the rule of diversification based on factual circumstances or the language contained in the governing instrument. In any event, it is critically important for a fiduciary to document every major facet of the investment process in case its decisions are questioned in the future.

If a trustee negligently fails to diversify, the court will calculate damages based on when the concentrated holdings should have been sold. If the concentrated holdings have appreciated in value, the potential capital gains tax should be deducted in calculating the damages. The court should then have discretion in determining the amount of the surcharge, but a maximum award should be based on a variable statutory rate that reflects current market conditions, and the use of compounding should be done on a case by case basis.

Endnotes

1. *In re Janes*, 90 N.Y. 2d 41, 659 N.Y.S. 2d 165 (1997), *reargument denied*, 90 N.Y. 2d 885, 661 N.Y.S. 2d 827 (1997).
2. 274 A.D.2d 87, 712 N.Y.S. 2d 662 (3d Dep't, 2000).
3. 274 A.D. 2d 110, 712 N.Y.S. 2d 225 (3d Dep't, 2000).
4. 26 A.D.3d 824, 809 N.Y.S. 2d 360 (4th Dep't, 2006).
5. 44 A.D.3d 1195 (3d Dep't, 2007), *appeal denied*, 9 N.Y. 3d 1027 (2008).
6. 27 Misc. 3d 1205(A), 910 N.Y.S.2d 405 (Sur Ct., Westchester Co. 2010).
7. 30 Misc. 3d 1203(A) (Sur Ct., Erie Co. 2010).
8. N.Y. Estates, Powers & Trusts Law (EPTL) 11-2.3(b)(3)(C).
9. *See* Radigan and Radigan, *Fiduciary Investing in a Challenging Economy*, New York Law Journal, May 4, 2009.
10. 44 A.D.3d 1195 (3d Dep't, 2007), *appeal denied*, 9 N.Y. 3d 1027 (2008).
11. EPTL 11-2.3(a).
12. 26 A.D.3d 824, 809 N.Y.S. 2d 360 (4th Dep't, 2006).
13. *Id.* at 826.
14. *Id.*
15. 30 Misc. 3d 1203(A), *5 (Sur Ct., Erie Co. 2010).
16. *See* John Boyle, *Flying with the Fundamentals,* Better Investing Magazine, June 2006. Investors refer to the portfolio turnover rate as a measure of how frequently assets are bought and sold within an account during a 12-month period. For example, if an account consists of 100 securities of equal value and 30 securities are bought and sold during the course of the year, then the portfolio turnover rate for the account is 30%.
17. *In re Janes*, 90 N.Y.2d at 55, *supra* note 1.
18. *See Report of the Advisory Committee on Civil Practice to the Chief Administrative Judge of the Courts of the State of New York*, January, 2011, page 94.
19. *See In re Tydings*, 32 Misc. 3d 1204(A), (Sur. Ct., Bronx Co. 2011).
20. 26 A.D.3d 824, 828, 809 N.Y.S. 2d 360 (4th Dep't, 2006).
21. EPTL 11-2.3(b)(1).

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How to Win Summary Judgment for Objectants in Contested Accounting Proceedings

By Gary E. Bashian

In contested accounting proceedings, summary judgment has traditionally been an almost exclusive tool of fiduciaries seeking to have their accounts approved. The case law is replete with examples of fiduciaries who have successfully moved the court to dismiss objections to their accounts as a matter of law pursuant to N.Y. Civil Practice Law & Rules 3212 (CPLR).

"[T]he path to summary judgment for the objectant to an accounting is not as Sisyphean a labor as it might seem."

There are several reasons for this. Fiduciaries often have little trouble establishing the propriety of expenses incurred on behalf of an estate or showing that an objecting beneficiary has offered insufficient proof to rebut an accounting. Fiduciaries are also often successful when objectants pursue liability for failure to maximize the value of estate assets, particularly where objectants allege speculative or potential losses that the court will, and should, not consider under the principles of the Prudent Investor Act. Finally, motions for summary judgment challenging an accounting are often denied due to issues of fact regarding the appropriateness and legitimacy of expenses or, in some cases, because the fiduciary is shielded by having acted in good faith.

Nevertheless, the path to summary judgment for the objectant to an accounting is not as Sisyphean a labor as it might seem. Despite the challenges described above, an objectant can achieve a pre-trial victory by moving for summary judgment against a fiduciary if he is careful in choosing his issues and avoids falling into the types of arguments regarding issues of fact that a fiduciary's counsel will undoubtedly pose. Indeed, the party who frames the issues in a litigation very much becomes the architect of the proceeding as a whole, a principle that comes into sharp focus in contested accounting proceedings.

The discussion below is a conceptual blueprint that may help litigators construct the best arguments available when moving for summary judgment on behalf of an objectant in a contested accounting proceeding.

The Burden of Proof

The burden for a movant on summary judgment is that he must make a "prima facie showing of entitlement to judgment as a matter of law, tendering sufficient evidence to demonstrate the absence of any material issues of fact."[1] Where the movant's burden has been satisfied by a showing of sufficient proof, the burden then shifts to the opposition to show that there are questions of fact regarding the movant's claims that preclude the granting of summary judgment.[2]

In an accounting proceeding, the initial burden is on the fiduciary to prove the propriety of expenses and administration costs.[3] This initial burden is admittedly low, as a fiduciary need only make a prima facie showing that the nature and character of the expenses incurred were fair and reasonable[4] and that they were incurred on the estate's behalf.[5] Thereafter, the beneficiary objecting to an accounting bears the burden of showing that the account is inaccurate or incomplete. If the objectant can show, by a fair preponderance of the evidence, the lack of sufficiency of the account as a matter of law, the burden then shifts back to the fiduciary to prove that the account is accurate and complete.[6]

Accounting proceedings often seem to present questions of fact that at first glance make it appear impossible for objectants to meet their burden of proof. The nature and character of objections to an accounting almost inevitably lend themselves to the assumption that their legitimacy cannot be determined as a matter of law. The reasons for this are clear: objectants to an accounting contest the amounts paid for individual expenses check by check, dollar by dollar. They essentially allege that the amounts a fiduciary paid or received on behalf of an estate were not fair prices for services rendered or assets sold. Objectants then argue all of the ways a fiduciary mismanaged the assets to the detriment of the estate and its beneficiaries or their failure to obtain a better price for the same.

Where an objectant alleges an expense to be improper, and the allegation is supported by sufficient proof, the fiduciary simply has to offer sufficient proof establishing the legitimacy of the expense in rebuttal. Before long, each and every contested expense sufficiently rebutted, no matter how innocuous, becomes a

viable issue of fact ripe for trial and, more importantly, a roadblock to relief for an objectant on summary judgment.

In light of these constraints, the objectant's counsel must carefully select issues when moving for summary judgment. Clearly, simply contesting the value or cost of estate expenses offered in an account will not be a path to success.

In some situations, the objectant can move for summary judgment in challenging not the amount of an expense but the propriety or legitimacy of the expense in the context of the fiduciary's duty of loyalty. For example: was the expense reasonable and necessary and did it benefit the estate? Was the expenditure a product of self-dealing? Did the fiduciary reap a gain from the estate in connection with the expense? Alternatively, the entirety of the fiduciary's account can be challenged by an objectant, and shown to be insufficient as a matter of law, for failure to detail the financial history of the estate with necessary particularity. In either of the above situations, and absent any questions of fact, a fiduciary can be surcharged with the statutory 9% interest for any improper expenses that he or she authorized to be paid by the estate.[7]

Duty of Loyalty

The foundation of a successful strategy for summary judgment lies in the fiduciary's duty of loyalty to the estate. This is the first and primary duty the law imposes upon a fiduciary, measured by something stricter than the "…morals of the marketplace. Not honesty alone, but the punctilio of an honor most sensitive, is the standard of behavior."[8]

Implicit in this principle, indeed the most fundamental characteristic of the duty of loyalty, is the duty not to self-deal.[9] It is only when acting on behalf of the estate with this highest loyalty, without accruing any benefit to himself in the execution of this duty, that a fiduciary is authorized to undertake his charge. A fiduciary may not make unreasonable and unnecessary payments from estate assets, or to himself, his family or his friends, unless so directed by the terms of a Will. This necessarily high standard is designed to protect not only the estate and its beneficiaries but to preserve a testator's intent as closely as possible.

Importantly, a fiduciary's duty of loyalty to the estate is also an integral part of his duty to account. "As accountability is the primary principle of the fiduciary relationship,"[10] the account can be nothing less than a complete history of the estate administration.[11] It is no surprise that both accuracy and transparency are essential to all accounts and that each account must provide everything necessary to make the story of the administration intelligible to those who read it.[12] Clearly, a fiduciary's duty to "account" is no small undertaking; indeed, the Surrogate's Court Procedure Act devotes the entirety of Article 22 to "Accounting."

When an objectant moves for summary judgment in a contested accounting proceeding, it is his counsel's task to prove, where applicable, that the expenditures contained in the accounting were made in violation of the fiduciary's duties to the estate, i.e., to prove the impropriety of the expenses of administration as a matter of law. The successful strategy is not to argue that such expenses were merely excessive or a "bad deal," but to show that the expenditures were a breach of fiduciary duty as a matter of law.

Where the record establishes particularly egregious breaches of a fiduciary's duty to an estate, the task of the objectant's counsel is made easier. Missing sums of money or other assets, undervalued assets, exorbitant fees paid for simple services, fees paid for unauthorized or illegal services, etc., can all be surcharged against the fiduciary and are appropriate for determination on summary judgment.

Sometimes less obvious are payments made by a fiduciary to himself, his corporation, family or friends for tasks that could have been undertaken by neutral parties for an equal or lesser cost. Payments and expenses such as these can and often do qualify as self-dealing and are subject to surcharge.

The law is clear that the prohibition against self-dealing is absolute. There is

> a duty of undivided loyalty to the trust and to each of its beneficiaries. This duty is designed to prevent self-dealing. Hence, where a trustee is given absolute discretion, he must not use it to "feather his own nest." He must avoid all situations where his interests or those of a third party with whom he is aligned conflict with those of the beneficiaries.[13]

Where there is evidence that an expenditure constituted self-dealing, an objectant can seize on the breach and move for a surcharge upon the fiduciary for the entire amount of the expenditure, with interest, from the date of payment. Again, the objectant's task is not to get bogged down in questions of the economic prudence or reasonableness of the expense but to attack the legitimacy of the expense as a whole in the context of fiduciary duty.

Completeness and Accuracy

Another less obvious but equally valid ground for summary judgment may arise if an account lacks

transparency or is insufficient and fails to offer a complete and accurate accounting free of omissions. The expenses in an account that are incompletely disclosed, or worse, remain opaque, can be surcharged against the fiduciary in some scenarios. Commonly, a fiduciary will offer a line item expense for a professional, maintenance or other fee. A failure to itemize such an expense with enough specificity so that the beneficiaries can understand the nature of the transaction, the reason for the expense and its reasonableness in light of the benefits conferred to the estate, is a breach of the fiduciary's duty and constitutes an insufficient accounting.

Where a fiduciary is permitted to amend an accounting and fails to supplement or fully articulate the listing of expenses beyond line items or the bare offering of an amount without explanation where needed, the breach is only exacerbated and invites further scrutiny by both the court and objectant's counsel. Surcharges in situations such as these can be for the full line item amount if the fiduciary fails to cure the defect in the account when given the opportunity.

All doubts about the sufficiency of the account will be resolved against a fiduciary who fails to keep accurate records.[14] Accordingly, an objectant need only show that the accounting fails to fully account or is not transparent to shift the burden back to the petitioner. No argument need be made about the validity or value of the actual expenses which would, in turn, potentially create fatal issues of fact.

Gifts

Gifts are another area that should be considered when drafting a motion for summary judgment on behalf of an objectant to an accounting by the executor of an estate. Some executors will attempt to remove assets from an estate for one reason or another by claiming that they were gifted by the decedent immediately prior to death. As a matter of law, an executor has the burden to show by clear and convincing evidence that donative intent existed for such alleged gifts and that delivery and acceptance of the gift were completed prior to death.[15] Furthermore, where there is a confidential relationship between a decedent and the executor, the executor must not only establish by clear and convincing evidence the three elements constituting a legally valid gift, but also that the transfer was made voluntarily and free from undue influence or restraint.[16] Notably, a confidential relationship may exist where there is a sibling relationship.[17] Failure by an executor to prove all of these elements can result in a surcharge of the "gifted" asset for failure to include it as an estate asset.

Conclusion

When considering a motion for summary judgment on behalf of an objectant to an accounting, attorneys must first and foremost focus on issues of self-dealing and the fiduciary's duty of loyalty and on whether the fiduciary has met his duty to account accurately and completely. Although this strategy will not guarantee success in every matter, it should help practitioners to avoid inadvertently creating issues of fact in a contested accounting proceeding where none exist.

Endnotes

1. *Alvarez v. Associated Fur Mfrs., Inc.*, 46 N.Y.2d 1065 (1979).
2. *Id.*
3. *In re Taylor*, 251 N.Y. 257 (1929).
4. *In re Seabury*, N.Y.L.J. May 17, 1995, 82:3 (Sur. Ct., Bronx Co.).
5. *In re Basso*, N.Y.L.J. July 17, 1987, 14:6 9 (Sur. Ct., Nassau Co.).
6. *In re Schnare*, 191 A.D.2d 859 (3d Dep't 2003).
7. *See generally In re Carbone* (unpublished) (Sur. Ct., Westchester Co. April 13, 2011).
8. *Meinhard v. Salmon*, 249 N.Y. 458 (1928).
9. *In re Carner*, N.Y. Slip Op. 52317(U) (Sur. Ct., Westchester Co. 2009).
10. Groppe et. al., 2 Harris N.Y. Estates: Probate Admin. & Litigation, "The fiduciary relationship and the duty to account," § 18:1 (2011).
11. *In re Iannone*, 104 Misc. 2d 5 (Sur. Ct., Monroe Co. 1980).
12. Groppe et. al., 2 Harris N.Y. Estates: Probate Admin. & Litigation, "Contents of a fiduciary accounting," § 18:27 (2011).
13. *In re Estate of James*, N.Y.L.J., Oct. 23, 2002, p. 24 (Sur. Ct., Kings Co.).
14. *White v. Rankin*, 18 A.D. 293, 295 (2d Dep't 1997).
15. *See Gruen v. Gruen*, 68 N.Y.2d 48 (1986); *In re Kelly*, 285 N.Y. 620 (1941).
16. *Matter of Gordon v. Bialystoker Center & Bikur Cholim*, 45 N.Y.2d 692 (1978).
17. *In re Silverman*, N.Y.L.J., Jan. 2, 2009, p. 25, col. 1 (Sur. Ct., Westchester Co.).

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Mr. Bashian gratefully acknowledges the contributions of Andrew Frisenda, an associate at Bashian & Farber, LLP, for his assistance in the composition of this article.

Introducing the TELS Diversity Committee

By Anta Cissé-Green, Jeffrey St. Clair and Dwayne Bentley

Trusts and estates practice is one of the most interesting and diverse practice areas in the legal profession: it is an interdisciplinary practice that thrusts you into family law, tax law, elder law, real property law, contract law and other practice areas; it has a vast, economically diverse client base—clients will need a trusts and estates lawyer whether their net worth is $25,000 or $25 million; and most importantly, the broad issues addressed by the practice area—death, taxes and money—will inevitably touch every single person in the world.

But as diverse as a trusts and estates practice may be, its professional composition is somewhat homogenous. The Trusts and Estates Law Section of the NYSBA has the largest membership of any Section, with 5,201 members (as of February 25, 2011). Yet the diversity of its membership remains staggeringly low. As of February 25, 2011, there were 1,681 women in the Section (reflecting 32.74% of the entire Section membership). The Section's racial and ethnic makeup is even lower, with 57 Asians (1.66%), 57 Black/African-Americans (1.66%), 33 Hispanics (.96%), and 9 Native Americans (.26%). According to the NYSBA 2009 Section Diversity Report Card,[1] these numbers reflect an overall increase in the Section's female, racial and ethnic members in the past two years. Despite this increase, the Section's minority membership highlights an increased need to catapult efforts to recruit and nurture minorities to join the Section and, generally, the trusts and estates practice.

While increasing the cultural and ethnic diversity of our profession has long been a goal of the NYSBA, the Trusts and Estates Diversity Committee is one of the first efforts to expand the diversity of a particular practice area. The necessity for diversity in the trusts and estates practice is obvious given the historical underrepresentation of minorities in the area of wealth preservation and inheritance. In this regard, the diversity of attorneys is important because, in addition to traditional concerns, a person from a minority group may face a host of issues and concerns unique to his or her group. The estate plan or estate administration prepared using traditional methodology (with a focus on tax savings) may be adequate, but an estate plan and/or administration that also accounts for specific cultural and ethnic issues would better serve each client.

Past Section President Gary Friedman recognized the apparent discrepancy in the Section's representation of minorities and, as a result, formed the Section's new Diversity Committee. Through his leadership, Lori Anne Douglass, an African American partner in the Trusts & Estates department of Moses & Singer, and Anne Bederka, a gay partner at Greenfield Stein & Senior, led the Committee into its inaugural year in March 2010. Supported by five initial committee members, Lori, Anne and the Committee worked to develop a mission statement with the overall goal of attracting underrepresented attorneys to the trusts and estates practice.

The Committee's Mission Statement sets forth the following goals:

- Educating minority students concerning the opportunities available as trust and estates practitioners and the rewards of the practice, and thereby increasing the pool of applicants for employment in the field.
- Advising minority practitioners on how to integrate a trusts and estates law component into their practices.
- Providing a mentoring program for young minority attorneys who have selected trusts and estates as their primary practice, and in particular, helping them to attain expertise in the field and advising them on effective methods for developing a client base.
- Advising the trusts and estates bar at large on estate planning and administration issues unique to minority communities.
- Increasing the diversity of the New York State trusts and estates bar.

In its inaugural year, the Committee held a seminar on April 15, 2010, entitled *Opportunities in Trusts & Estates: It's A Matter of Life, Not Death.* The seminar was attended by approximately 100 potential and current trusts and estates practitioners and law students. Lori was the moderator of the program, which consisted of several minority practitioners, including in-house counsel to a major bank, a big-firm trusts and estates partner and a current judge who was previously a principal law clerk in Kings County Surrogate's Court. The speakers discussed their entry into the trusts and estates practice, their attraction to the field and their current practice. Each speaker also provided the audience with his or her insights on succeeding and thriving as a trusts and estates lawyer.

With its newly expanded committee membership, the Diversity Committee has developed plans to fulfill its mission statement and increase the diversity of the Section, including a nuts and bolts CLE program on estate planning and administration offered in the fall of 2011.

The Committee's most immediate task is to develop and implement a mentoring program geared at pairing minority attorneys entering the trusts and estates practice with seasoned minority attorneys who can help new attorneys learn about trusts and estates and become proficient in the area. To that end, the Committee encourages all minority trusts and estates practitioners to come forward and volunteer to help, support, instruct, guide and coach minority attorneys and students entering or considering the practice. Please email Lori (Ldouglass@mosessinger.com) or Anne (ABederka@gss-law.com) to volunteer as a mentor, join the Committee or learn about how you can help the Diversity Committee fulfill its mission. The Committee Chairs and members look forward to hearing from all of you and seeing you at the Committee's next event.

Endnote

1. Available at http://www.nysba.org/AM/Template.cfm?Section=Committee_on_Minorities_in_the_Profession_Home&Template=/CM/ContentDisplay.cfm&ContentID=47013.

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Florida Update

By David Pratt and Jonathan Galler

David Pratt

Legislative Update

Omnibus Trusts and Estates Legislation

Florida recently enacted an omnibus trusts and estates bill covering a wide range of topics. Most notably:

Intestate Share of Surviving Spouse. Several significant amendments to the law governing a surviving spouse's intestate share became effective October 1, 2011. Under these amendments, when a decedent dies without a Will and is survived by one or more descendants, all of whom are also descendants of the surviving spouse, and the surviving spouse has no other descendants, the surviving spouse receives the entire intestate estate. If there are one or more surviving descendants of the decedent who are not lineal descendants of the surviving spouse, the surviving spouse receives one-half of the intestate estate. If there are one or more surviving descendants of the decedent, all of whom are also descendants of the surviving spouse, but the surviving spouse also has one or more descendants who are not descendants of the decedent, the surviving spouse receives one-half of the intestate estate. Fla. Stat. § 732.102.

Will Reformation and Modification. Florida's probate code now authorizes judicial reformation of the terms of a Will, even if unambiguous, to conform to the testator's intent if it is proven by clear and convincing evidence that the testator's intent and terms of the Will were affected by a mistake of law or fact. The court may consider evidence of the testator's intent even where the evidence contradicts the plain meaning of the Will. In addition, the probate code now authorizes judicial modification of a Will in order to achieve the testator's tax objectives. The modification may have retroactive effect. The legislature also enacted fee shifting provisions for actions to reform or modify a will. Fla. Stat. §§ 733.615, 733.616 and 733.1061.

Fiduciary Lawyer-Client Privilege. An amendment to the evidence code clarifies that communications between a lawyer and a client acting as a fiduciary are privileged to the same extent as other lawyer-client communications. The term fiduciary includes, but is not limited to, personal representatives, trustees, guardians and attorneys-in-fact. Fla. Stat. § 90.5021.

Jonathan Galler

Motions for Costs and Attorneys' Fees. An amendment to the trust code clarifies that any party seeking an award of costs and attorneys' fees in a trust action must serve a motion no later than 30 days after a judgment is filed. However, this deadline does not apply to applications for a trustee's payment of compensation or reimbursement of costs from trust assets to persons employed by the trustee. Fla. Stat. § 736.0201(6).

New Power of Attorney Act

Florida's new power of attorney statute became effective October 1, 2011. The new statute tracks the Uniform Power of Attorney Act but makes certain modifications for consistency with other Florida statutes.

A valid Florida power of attorney executed prior to the effective date will remain valid. If it is durable, it will remain durable. And even though the new act prohibits springing (or conditional) powers, any valid springing Florida power of attorney executed prior to the effective date will remain springing.

The new act permits the appointment of successor agents and co-agents, and it also permits compensation for qualified agents. In the case of co-agents, unless the document provides otherwise, each agent may act independently.

Both durable and nondurable powers executed after the effective date must be signed by the principal and two witnesses and be notarized. An exception exists for powers of attorney created and properly executed under the laws of another state, which promotes portability between states. A principal may revoke a power of attorney by any writing, and all that is required to effectuate the revocation is a signature (no witnesses or notary necessary).

Like Florida's trust code, the new power of attorney statute provides for mandatory duties and default (but modifiable) duties. Among the mandatory duties are the duty to preserve the principal's estate plan and the duty to keep adequate records.

An agent may exercise only specifically granted powers. A general provision granting all permissible

powers is insufficient to grant such general authority to the agent.

The new statute singles out certain powers that could affect the principal's estate plan, such as making gifts and creating and amending revocable trusts. Each such power may be granted only with additional formalities and is subject to specifically identified restrictions. The powers must be specifically enumerated, and the principal must sign or initial next to each one. The agent may exercise these powers only in a manner that is consistent with the mandatory duty to preserve the principal's estate plan. Additionally, these powers may not override a term of the governing document (e.g., a trust) that is to be affected by the power.

The new statute also provides a framework for acceptance or rejection of the power of attorney by third parties. It requires that a third party accept or reject a power of attorney within a reasonable amount of time (four days is presumed reasonable for banking or investment purposes), requires a third party that rejects a power of attorney to explain why it has done so and provides protection to a third party who has accepted a power of attorney in good faith.

Case Law Update

Objections to Qualifications of Personal Representative

Resolving a conflict between two of the state's appellate courts, the Florida Supreme Court held that the statutory time limit for objecting to the qualifications of a personal representative will bar an untimely objection even when the personal representative was never qualified to serve. Florida's probate code provides that objections "to the validity of the will, the qualifications of the personal representative, the venue, or the jurisdiction of the court" must be filed within three months of service of the notice of administration. Fla. Stat. § 733.212(3). The probate code also provides that a nonresident cannot qualify as a personal representative unless the person is a spouse, sibling, uncle, aunt, nephew or niece of the decedent or someone related by "lineal consanguinity" to the such person. Fla. Stat. § 733.304. In the case before the supreme court, the objecting party acknowledged that the objection postdated the three-month time limit but argued that the time limit should not apply where the personal representative failed to meet the qualifications required for a nonresident and, thus, was never qualified to serve. The court disagreed and concluded that, absent fraud, misrepresentation or misconduct, the statutory time limit does apply.

Hill v. Davis, 2011 WL 3847252 (Fla. 2011) (not yet final).

Disposition of After-Acquired Assets in Absence of Residuary Clause

In our last column, we summarized a decision by the First District Court of Appeal, which we identified as not yet final, holding that, in the absence of a residuary clause, property acquired after the execution of a Will passes to the sole remaining named beneficiary, even if that beneficiary is a specific legatee. We also highlighted the "emphatic and lengthy dissent" of one judge on the panel who argued that the decedent's unambiguous intent should trump Florida's presumption against partial intestacy and that because the decedent made specific bequests to a named beneficiary and did not provide for the disposition of the residue, the after-acquired property should pass subject to Florida's intestate succession rules. Apparently, we were not the only ones impressed with the dissent. On rehearing, the court withdrew its own opinion and issued a new one, this time siding with the previously dissenting judge. The court has certified the issue to the Florida Supreme Court as a question of great importance.

Basile v. Aldrich, 2011 WL 3696309 (Fla. 1st DCA 2011) (not yet final).

Timing for Appeal of Appointment of Personal Representative

In a case with an unusual procedural posture, the First District Court of Appeal concluded that an appeal of the trial court's appointment of a personal representative was both too late and too early. Specifically, the court held that the appeal of an order appointing the personal representative was untimely, while the appeal of the issuance of letters of administration was premature. Although the order appointing a personal representative is often entered at the same time as the issuance of letters, the trial court in this case entered the order first and conditioned the issuance of letters upon the posting of a bond and filing of an oath. The court held that because "[t]he duties and powers of a personal representative commence upon appointment," Fla. Stat. § 733.601, the appellate clock began ticking upon rendition of the order. The court also held that because the subsequent issuance of letters did not, in and of itself, dispose of the pending objections to the appointment of the personal representative, the issuance of letters did not yet constitute an appealable final order.

Naftel v. Pappas, 2011 WL 3678004 (Fla. 1st DCA 2011) (not yet final).

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Preference of Minor Heirs in Appointment of Personal Representative

The Second District Court of Appeal held that the trial court erred by denying three minor children an opportunity to cast their vote for the personal representative of the estate of their father, who died intestate when his crop-dusting airplane crashed. In appointing the personal representative of an intestate estate, Florida's probate code gives preference first to the surviving spouse (here, the decedent was not married at the time of death) and, next, to the person selected by a majority in interest of the heirs. Fla. Stat. § 733.301(1)(b). Interestingly, where some or all of the heirs are minors, the votes of those heirs are cast *not* by their parent and natural guardian but, rather, by the guardian of their property. Fla. Stat. § 733.301(3). Here, the trial court held that because the children's mother had never been appointed as the guardian of their property, the vote cast by her on their behalf was of no consequence. Although the appellate court agreed with that determination, the court held that the trial court should have afforded the children an opportunity to have a guardian of their property appointed so that their vote could be counted.

Long v. Willis, 2011 WL 3587411 (Fla. 2d DCA 2011) (not yet final).

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Recent New York State Decisions

By Ira M. Bloom and William P. LaPiana

Ira M. Bloom

William P. LaPiana

ATTORNEYS' FEES

Surrogate Must Determine Reasonableness of Fee Under Retainer Agreement

An attorney agreed to represent a party in a contested probate proceeding. The probate proceeding was settled approximately four weeks after the execution of the retainer agreement, under which the attorney received a $5,000 retainer and a contingent fee of $585,000. The client brought a proceeding to fix the attorney's fee under N.Y. Surrogate's Court Procedure Act 2110 (SCPA), and the Surrogate granted the attorney's motion for summary judgment.

On appeal by the client the Appellate Division reversed, holding that in a proceeding under SCPA 2110 the Surrogate must consider not only whether a contingency fee retainer agreement was wrongfully procured but also the reasonableness of the fee and the reasonableness of the agreement itself. *Matter of Talbot*, 84 A.D.3d 967, 922 N.Y.S.2d 552 (2d Dep't 2011).

Surrogate Cannot Award a Fee in Excess of That in Retainer Agreement

Co-executors entered into a retainer agreement with an attorney to represent them in the administration of their mother's estate. The agreement set the attorney's fee at 5% of the tax value of the estate and provided for additional payments for legal work justified by "extenuating circumstances" to be billed at a rate of $250 per hour.

Two years after the decedent's death, one of the co-executors brought a proceeding seeking an accounting and a determination of the attorney's fee under SCPA 2110. The Surrogate set the fee at slightly more than that calculated using the $250-hour rate and directed that 20% be assessed against the other co-executor's share of the residuary estate because her actions caused the estate to incur unnecessary legal expenses.

On appeal, the Appellate Division affirmed the Surrogate's allocation of a portion of the fee to the respondent's share of the residue under the authority of *Matter of Hyde*, 15 N.Y.3d 179, 906 N.Y.S.2d 791, 933 N.E.2d 194 (2010), stating that the respondent's behavior was "undoubtedly responsible for some of the acrimony that has characterized the administration of this estate." The Appellate Division reversed the Surrogate's determination of the amount of the fee, however, because the Surrogate did not determine whether services required by extenuating circumstances were performed, whether the executors gave prior approval of such work as required by the retainer agreement and whether the total fees were reasonable. In addition, the court noted that although the Surrogate was not bound by the retainer agreement in setting the fee, the Surrogate could not award fees in excess of what had been agreed to in a valid retainer agreement. *Matter of Benware*, 86 A.D.3d 687, 927 N.Y.S.2d 173 (3d Dep't 2011).

JOINT ACCOUNTS

Claim of Unjust Enrichment Can Be Made Where Agent Withdrew More Than Principal's Moiety from Account

Using authority granted by her father's power of attorney, an agent withdrew funds from two joint accounts in the name of her father and her brother. After the father's death, the brother brought an unjust enrichment action against his sister. The Appellate Division affirmed the Supreme Court's dismissal of the count dealing with one of the accounts from which the sister withdrew less than the father's moiety. It reversed dismissal of the counts dealing with the second account because the withdrawals did invade the brother's moiety and the sister's papers did not eliminate triable issues of fact as to whether the second account was indeed a joint account and the source of the funds used by the father to open the account. *Rosenzweig v. Friedland*, 84 A.D.3d 921, 924 N.Y.S.2d 99 (2d Dep't 2011).

POWER OF ATTORNEY

An "X" Is Not the Equivalent of Initials When Granting Authority Using Statutory Short Form

Decedent executed a statutory short form power of attorney under pre-2009 law. The form, like the current form, directed the principal to place her initials in the designated spaces on the form to indicate a specific grant of authority. In this case the principal placed an "X" in the space next to line "Q" (line "P" on the current form), which granted all of the powers listed on line "Q" to the agent under the power of attorney. Reversing the Surrogate, the Appellate Division held that in this case the "X" was not the equivalent of the principal's initials. While an "X" or another mark may be a person's signature when the person routinely signs his or her name with a mark (for example, where the person lacks capacity to make a standard signature), this principal signed the power of attorney form, clearly showing that she had the ability to place her initials on the form and that she did not routinely sign documents by making a mark. The power of attorney granted no authority to the agents and therefore a purported transfer of real property by one of the named agents was a nullity. *Matter of Marriott*, 86 A.D.3d 943, 927 N.Y.S.2d 269 (4th Dep't 2011).

TRUSTS

Boilerplate Provision Stating That Plural Includes Singular Does Not Apply to Provision Governing Amendment of Trust

Mother and father created a lifetime irrevocable trust naming their three children as beneficiaries and reserving to the "grantors" a special power of appointment allowing them to change the identity of the remaindermen. Five months after the father's death, the mother executed a purported amendment to the trust naming one of the three children as sole beneficiary. The mother died less than a month later.

The other two children brought an action seeking a declaration that the purported amendment was invalid and that they were still beneficiaries. The Supreme Court granted their motion for summary judgment, and the Appellate Division affirmed. The trust terms unambiguously reserved the power to change the remaindermen to the "grantors," and the meaning of "grantors" could not be changed by another provision in the trust allowing the plural usage of a word to include the singular whenever the context required. *Whitehouse v. Gahn*, 84 A.D.3d 949, 922 N.Y.S.2d 546 (2d Dep't 2011).

Separation Agreement Requiring Certain Provisions in Party's Will Does Not Apply to Party's Lifetime Revocable Trust

Decedent and his then-wife entered into a separation agreement which required the decedent to execute and keep in force a Will treating their daughter, Kimberly, no less favorably than any child of the decedent born afterwards. The parties divorced. Decedent then created a revocable lifetime trust which at his death divided into two subtrusts, one for the benefit of his daughter Margaret born after his divorce and one for his ex-wife. The decedent named Margaret's subtrust as beneficiary of both his IRA and his life insurance policy. On the same day he created the trust, the decedent executed a Will which poured over the residuary estate to the revocable trust.

On appeal from the Surrogate's disposition of the action begun by Kimberly and her mother after the decedent's death, the Appellate Division held that the terms of the separation agreement did not apply to the revocable trust. The agreement could have expressly provided that a lifetime trust would be deemed part of the decedent's estate and subject to the provision that the decedent's children be treated equally under his Will. However, the Will did not treat the children equally because the trust into which the Will poured over the residuary estate benefited only Margaret and the decedent's ex-wife. Therefore, the residue of the decedent's estate had to be apportioned equally between Kimberly and Margaret.

The trust included a no contest clause. Because no party appealed the Surrogate's dismissal of the cause of action seeking a declaration that the no contest clause was void, the ex-wife's share of the trust was reduced by an amount equal to one-half of the value of the residue, *i.e.*, that portion of the residue that would have been added to her subtrust. *Matter of Wenzel*, 85 A.D.3d 563, 925 N.Y.S.2d 474 (1st Dep't 2011).

WILLS

Nonmarital Children Unknown to Testator at Time of Execution of Will Are Not After-Born Children Under EPTL 5-3.2

The decedent was survived by both marital and nonmarital children. His nonmarital children were born before the execution of his Will, but he learned of their existence only about a year before his death. The nonmarital children filed a petition asking to be granted the rights given children of a testator born or adopted after the execution of the testator's Will by EPTL 5-3.2. The Surrogate entered an order denying the petition and the children appealed.

The Appellate Division affirmed. After a thorough discussion of both the relevant case law and the legislative history of EPTL 5-3.2, the court held that the children were not entitled to relief under the statute because they were born before the execution of the Will and that any exception for "after acknowledged" children would have to come from the legislature. *Matter of Gilmore*, 87 A.D.3d 145, 925 N.Y.S.2d 567 (2d Dep't 2011).

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 co-authors of Bloom and LaPiana, *Drafting New York Wills and Related Documents* (4th ed. LexisNexis).

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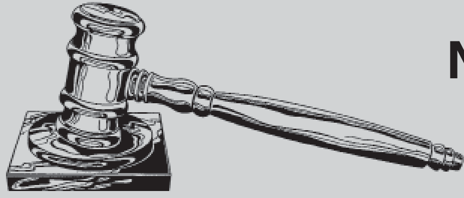

Case Notes—New York State Surrogate's and Supreme Court Decisions

By Ilene Sherwyn Cooper

Attorney-in-Fact

In a miscellaneous proceeding, the decedent's daughter, one of three beneficiaries of a totten trust account, requested an order granting her summary judgment requiring the decedent's surviving spouse to turn over the proceeds of the account, which had been removed by her prior to the decedent's death.

According to the petition, the spouse removed the funds in issue under a power of attorney executed seven years previously by the decedent. The daughter further alleged that at the time of the withdrawal, the decedent was dying of metastatic cancer and was confused, disoriented and in no condition to make financial decisions. The daughter's allegations were supported by his medical records and a letter from his treating physician. Additionally, she submitted proof that the decedent and his spouse had been separated since 1995 and that the decedent was involved in a relationship with another woman at the time of his death.

In opposition to the motion, the spouse alleged, among other things, that she and the decedent were never separated, had multiple residences and a relationship built on love, and that although they lived apart, they spoke on the telephone several times a day. The spouse stated that she was aware of the decedent's relationship with another woman and that the petitioner did not have a close relationship with her father. The spouse admitted withdrawal of the funds with the use of the power of attorney but maintained that she did so at the decedent's behest, at a time when he was competent.

Relying upon the opinion in *Matter of Ferrara* (7 NY3d 244), the court opined that the gift-giving authority in a power of attorney is circumscribed by the requirement that the gift be in the best interests of the principal, i.e., designed to fulfill the principal's financial, estate or tax plans. The authority of the attorney-in-fact is further limited by the presumption of impropriety and self-dealing that arises when an attorney-in-fact makes a gift to himself of the principal's monies. Under such circumstances, the presumption can be overcome only with the clearest showing of intent on the part of the principal to make the gift in question.

Based upon the foregoing, the court held that the spouse had failed to demonstrate that the withdrawal of funds from the totten trust account was in the decedent's best interests and that he intended her to be the beneficiary of the account. The court found that the spouse's submissions as to the decedent's capacity were self-serving and unsubstantiated and contrary to the record presented.

Accordingly, upon review of the evidence, coupled with the fact that the power of attorney did not grant the attorney-in-fact the power to conduct banking transactions, summary judgment was granted.

Matter of the Application of Brock, N.Y.L.J., May 10, 2011, p. 39 (Sur. Ct., Kings Co.).

Attorney-Fiduciary

In a probate proceeding, the attorney co-fiduciary and draftsman of the propounded instrument filed a separate written acknowledgment of disclosure signed by the testator in the presence of a witness. The acknowledgement was dated the same date as the Will but contained only three of the four required disclosures set forth in N.Y. Surrogate's Court Procedure Act 2307-a (SCPA). Specifically, the acknowledgment omitted the requisite statement, added to the statute in a 2004 amendment, that "absent execution of the disclosure acknowledgment the attorney who prepared the will…and who serves as an executor shall be entitled to one-half the commissions he or she would otherwise be entitled to receive."

Based on the failure of the acknowledgment to comport with the statutory language, the commissions of the attorney-fiduciary were limited to one-half the statutory entitlement pursuant to SCPA 2307-a(5).

In re Estate of Mayer, N.Y.L.J., Aug. 11, 2011, p. 27 (Sur. Ct., Bronx Co.).

Attorneys' Fees

Before the court was an application by the petitioners for attorneys' fees and disbursements incurred in connection with a proceeding to hold the respondents in contempt.

The court opined that pursuant to the provisions of N.Y. Judiciary Law § 773, the amount of a contempt fine must be sufficient to indemnify the aggrieved party for actual loss or injury caused by the misconduct. While criminal contempt penalties are punitive in nature, civil contempt fines are intended to compensate victims for their losses. Absent proof of actual damages, the court may impose a fine that includes the aggrieved party's costs and expenses, including reasonable legal fees and disbursements incurred.

In support of the requested fees and disbursements, petitioners' counsel submitted contemporaneous time records, reflecting that he spent over 46 hours on the contempt proceeding, at the rate of $350 per hour. To this extent, the court noted that when an aggrieved party has documented the costs and expenses caused by another party's contempt, the amounts are considered prima facie reasonable, and the sums documented should be awarded "'unless the opposing party can prove with particularity that [s]he should be obligated to pay less,'" or the court finds a basis for diminishing or reducing certain fees.

Within this context, the court found that the petitioners had sufficiently documented the fees and disbursements sought and that the respondents had failed to adequately demonstrate that they should not be awarded. Accordingly, the petitioners' request for an award of fees and disbursements was granted.

In re Estate of Passalacqua, N.Y.L.J., Apr. 1, 2011, p. 38 (Sur. Ct., Kings Co.).

Burial

The surviving spouse of the decedent commenced a proceeding in the Supreme Court to disinter the body of her late husband, alleging that it was the decedent's wish to be buried at her side, and the cemetery in which he was buried would not, for religious reasons, allow her to be buried there. The application was opposed by the decedent's mother and sister. The Supreme Court granted the application, and the mother and sister appealed.

In affirming the order of the Supreme Court, the Appellate Division held that in the absence of consent, the court may order disinterment of a body for good cause shown and substantial reasons for the relief. The Court found that the testimony at the hearing before the Supreme Court supported the conclusion that the decedent's concern was to be buried alongside the petitioner, which was not possible given the rules of the cemetery and the lack of available space.

Matter of Eirand-Herskowitz v. Mt. Carmel Cemetery Assn., 82 A.D.3d 1231 (2d Dep't 2011).

Exoneration Clause

In a contested trust accounting proceeding, the court had the opportunity to opine on the effect of the exoneration clause in an inter vivos trust, commissions and the legal fees incurred by the petitioner and objectant. The objectant in the proceeding was the grantor and income beneficiary of the trust, who had a discretionary interest in the principal. The ultimate remainderman of the trust was the grantor's infant son.

The trust instrument authorized the trustee to retain an original investment for any length of time without liability for its retention and to act on behalf of the trust and herself or another entity with regard to any transaction in which the trustee and the trust or the other entity had an interest. The trust also provided that the trustee would not be responsible for any loss to the trust unless the loss resulted from bad faith or fraud on the part of the trustee, and that the trustee would not be disqualified from acting because the trustee held an interest in any property or entity in which the trust also held an interest. The court noted that several of the objections raised in the proceeding hinged, among other things, on the enforceability of this exoneration clause.

The court opined that despite the absence of a statute applicable to exoneration clauses in lifetime trusts (*cf.* N.Y. Estates, Powers & Trusts Law 11-1.7(a)(1) (EPTL)), the enforceability of such clauses was nevertheless subject to certain limitations. For example, the court observed that a trustee of a lifetime trust who is guilty of wrongful negligence, impermissible self-dealing, bad faith or reckless indifference to the interests of the beneficiaries will not be shielded from liability by an exoneration clause. Moreover, when an attorney, named as trustee, is the draftsperson of the instrument containing an exoneration clause, the clause limiting the trustee's liability to bad faith acts is void as against public policy. Further, the court noted that while improper self-dealing will not come under the umbrella of an exoneration clause, the rule of undivided loyalty due from a trustee may be relaxed by appropriate language in the trust instrument that acknowledges (directly or indirectly) that the trustee may be in a position of conflict with the trust.

The court held that the trustee would not be liable for retaining an interest-free loan that pre-dated the creation of the trust and that was transferred to the trust by the grantor. On the other hand, the court found the trustee liable for interest-free loans made by the trust after the inception of her stewardship. The court concluded that the trustee's conduct exhibited a complete indifference to the best interests of the current beneficiary and mandated that she be surcharged at the rate of 5% per annum for the income lost on the loan transactions.

Additionally, the court found that the exoneration clause in the instrument did not bar the objectant from recovering lost profits from the trustee attributable to her use of trust funds, without consideration, to benefit an entity in which she was personally interested.

As to the balance of the objections, the court concluded that the current beneficiary was either estopped from raising the issues or that they did not warrant the imposition of a surcharge.

With respect to the issue of commissions, the court opined that while not every surcharge warrants a denial of commissions, when the fiduciary has engaged in conduct evidencing bad faith, a complete indifference to his or her duties and responsibilities, or some act of malfeasance or misfeasance, commissions will be denied. Based on the record, the court found that the trustee was lax in managing the financial aspects of the trust. Indeed, although the court concluded that the trustee had not acted in bad faith, it nevertheless held, particularly based on the interest-free loans that had been made, that she had exhibited indifference to her duties and, accordingly, sufficient misfeasance to warrant a denial of commissions. The court also denied the trustee annual commissions on the grounds that she had failed to establish that she had furnished the objectant with an annual statement pursuant to the provisions of SCPA 2309(2), that the objectant had waived her right to receive the statement, or that there was sufficient income retained by the trust in any particular year from which she could pay herself income commissions.

Finally, with regard to the issue of legal fees, the court held, in the exercise of discretion, that the trustee and the beneficiary should each, individually, bear responsibility for their legal fees and expenses. The court observed that while many of the objections to the petitioner's account had not been sustained, the petitioner could not seek payment of fees from the trust for defending objections for which she was surcharged. Moreover, the court opined that a strong case could be made for holding the trustee responsible for the expert witness fees incurred by the current beneficiary in proving the trustee's liability in connection with the transactions for which she was surcharged. On the other hand, the court noted that the beneficiary vigorously pursued, and caused the trustee to defend, numerous objections to conduct of which she was aware and that she had approved prior to their occurrence. Accordingly, under all the circumstances, the court determined it would be most equitable to have the trustee and the beneficiary personally satisfy their own legal fees in connection with the proceeding.

Matter of the Accounting of Tydings, N.Y.L.J., July 7, 2011, p. 26 (Sur. Ct., Bronx Co.).

Security for Costs

In a contested probate proceeding, the proponent, a nephew of the decedent, moved for an order directing the non-domiciliary objectant to post security for costs pursuant to SCPA 2303. The decedent died survived by seven nieces and nephews. The propounded Will nominated one of the decedent's nephews as executor, bequeathed her diamond ring to one of her nieces and bequeathed $50,000 equally among her remaining nieces and nephews. Two of the decedent's nephews, one of whom was a non-domiciliary, filed objections to probate, and the proponent moved for an order directing that he post security for costs.

The court opined that an application pursuant to SCPA 2303 is discretionary based upon considerations of whether (1) the non-domiciliary has an interest in the estate that can be resorted to if unsuccessful in the proceeding and (2) there is substantial merit to the objections.

In support of his application, the proponent argued that the objectant was a non-domiciliary who stood to lose his bequest under the Will, if unsuccessful, by virtue of the *in terrorem* clause in the instrument. The proponent further argued that the objectant had limited income and insufficient assets to cover any costs that might be imposed.

In opposition to the motion, the objectant maintained that he had a good faith basis for the objections: that the decedent was suffering from breast cancer, and was rushed to the hospital on the date she executed the propounded instrument, and died eight days later. The objectant alleged that the decedent's poor physical and mental condition prevented her from executing the instrument on her own and submitted in support of this claim an affidavit from the decedent's niece/beneficiary of her diamond ring, averring that she had assisted the decedent in executing the Will.

The court denied the motion. In reaching this result, the court noted that when there are resident and non-resident objectants, the court will not compel the non-resident objectants to post security for costs. The court further noted that security will not be required of a non-resident objectant unless the moving party demonstrates that the non-resident is using his or her "'non-residence as a precaution against the consequences of an ill-funded, vexatious claim.'"

In re Ruoti, N.Y.L.J., May 10, 2011, p. 38 (Sur. Ct., Kings Co.).

Standing

In a contested accounting proceeding, the petitioner sought to dismiss objections on the grounds, among other things, that the objectant lacked standing. The court opined that a person who has no interest in the estate of the decedent lacks standing to file objections to an accounting.

The court noted that the objectant was not a person entitled to share as a beneficiary of the decedent's estate, inasmuch as she was only an alleged legatee under a Will that had not been located or offered for probate. Moreover, the court held that while the decedent died intestate, the objectant was neither a distributee nor an alleged distributee. At most, the objectant was a first cousin once removed of the decedent, which was a relationship too remote from the decedent to afford her with standing as a distributee. *See* EPTL 4-1.1(a)(6).

Accordingly, the petitioner's motion was granted and the objections dismissed.

In re Estate of Maroni, N.Y.L.J., June 29, 2011, p. 29 (Sur. Ct., Queens Co.).

Summary Judgment

In a contested probate proceeding, the objectant, daughter of the decedent, moved for summary judgment dismissing the probate petition that had been filed by her sister, another daughter of the decedent. The propounded instrument left the decedent's entire estate to the petitioner. Objections to probate were based on allegations that the Will was not duly executed, that the decedent lacked testamentary capacity on the date of its execution and that the Will had been procured by undue influence and fraud. The motion for summary relief was limited solely to the issue of due execution.

The propounded instrument was prepared by an attorney and contained an attestation clause followed by the signature of two witnesses, one of whom was the attorney-draftsperson.

The court initially noted that the objectant failed to annex a copy of the pleadings to the motion, which could prove fatal to the relief sought. Nevertheless, because dismissal of the motion on this ground was subject to renewal, the court in the interests of judicial economy addressed the merits of the motion.

The court observed that when an attorney supervises the execution of a Will, there is a presumption of due execution. The objectant argued that the presumption was inapplicable because the attorney-draftsman and attesting witnesses failed to establish a consistent procedure for the execution of Wills in compliance with the provisions of EPTL 3-2.1. More specifically, the objectant claimed that the petitioner had not demonstrated that the testator had signed in front of both attesting witnesses and whether the witnesses had signed in front of the testator and each other. The objectant relied upon the fact that one of the witnesses had no specific recollection of the Will execution ceremony. Further, the objectant alleged that at the time of the Will's execution, the attorney-draftsperson had no knowledge that the decedent had a spouse and four children.

In opposition to the motion, the petitioner argued that a presumption of due execution attached to the instrument because its execution was supervised by an attorney, who testified that he followed a consistent procedure when executing Wills. The petitioner further argued that this procedure was confirmed by the deposition of the witness to the Will, who testified that it was the usual practice of the draftsman to first discuss and read the Will to the testator and then to call her into the room to witness its execution. The petitioner also relied on the fact that the instrument contained an attestation clause and attesting witness affidavits.

The court opined that the existence of an attestation clause creates a presumption of due execution of a testamentary instrument, although it is nevertheless incumbent upon the court to ensure its validity. The court noted that the mere fact that an attesting witness cannot recall the circumstances surrounding the execution of a Will is not fatal to its admission to probate, although it intensifies the scrutiny given by the court to the document.

Under the circumstances, the court found a triable issue of fact on the issue of due execution and denied the objectant's motion.

In re Pannone, N.Y.L.J., July 13, 2011, p. 30 (Sur. Ct., Kings Co.).

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