

TRAPS FOR THE UNWARY SOME ESTATE PLANNERS' DUTIES, PROSCRIPTIONS AND CONUNDRUMS

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TOPICS

- ☐ Trustee's "Duty of Loyalty"
- ☐ Modern Trust Design
- ☐ Duty to Advise

**IF YOU WANT TO GET EVEN WITH
YOUR WORST ENEMY, MAKE
HIM/HER YOUR TRUSTEE**

TRUSTEE SELECTION

- ☐ Some Popular Options
 - ◇ Family Members
 - ◇ Trusted Advisors
 - ◇ Professional Trustees
- ☐ Have Non-professional Trustees Stepped in Quicksand?*

*See Sandra D. Glazier, "No Good Deed Goes Unpunished Especially When Acceptance Means a Target on One's Back: Defending Breach of Fiduciary Duty Claims in the Context of Trust and Estate Administration", Bloomberg BNA Tax Management Estates, Gifts and Trusts Journal, Vol. 42, No. 4, p. 212 7/13/2017.

MODERN TRUST DESIGN STRATEGY

“(A)ll powers over the trust property which an unmarried competent owner has over individually owned property.”*

* UTC (2000) §815

MONITORING PROBLEMS OF BENEFICIARIES*

- ☐ Detection of Wrongdoing is Difficult
- ☐ Costs to Bring Action
- ☐ Difficulty of Proof
- ☐ Dealing with Unhappy Trustee
- ☐ Concern with In Terrorem Clause

*Daniel B. Kelly, “Remedies for Breach of Trust”

TOPIC #1

DUTY OF LOYALTY

“The most fundamental duty owed by a trustee to the beneficiary of a trust is the duty of loyalty.”

Scott, “The Law of Trusts”; See also Bogert & Bogert, “The Law of Trusts and Trustees”

SELF-DEALING IMPERMISSIBLE

- ❑ “It is generally, if not always, humanly impossible for the same person to act fairly in two capacities and on behalf of two interests in the same transaction.”*

◇ Especially Where His Own Interest is Involved

- ❑ Really? **

*Bogert & Bogert, Contra, see Langbein who points out that conflicts occur in the real world and that conflicts are not inherently harmful. Often, they are beneficial.
**Obviously, it is “possible” for the same person to act fairly without imperiling the interests of the beneficiaries.

DRACONIAN IMPLEMENTATION

“Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”*

- ❑ Imposed with “Uncompromising Rigidity”*
- ❑ Conclusive Presumption
 - ◇ Honest and Dishonest Trustees are Treated the Same
 - ◇ Violation Creates Liability

*Judge Benjamin Cardozo, *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928)

THREE “KEY” COMPONENTS

- ❑ “Sole Interest” Rule
 - ◇ Any Violation – Trustee Liable
- ❑ “Possibility” of Self-dealing Rule
- ❑ “No Further Inquiry” Rule

PROTECTIONS AGAINST TRUSTEE OPPORTUNISM

- ❑ Strict Liability
- ❑ Eliminate Incentive to Engage in “Efficient Fiduciary Breach”
 - ◇ Low Chances of Detection
 - ◇ Minimal Punishment
- ❑ Optimal Deterrence
 - ◇ Punitive Damages
 - ◇ Contract Law Damages Do Not Act as a Deterrence

RULE #1

“SOLE INTEREST” RULE

“(T)he duty of loyalty requires a trustee to act in the ‘sole interest’ of beneficiaries, not just the best interests of beneficiaries.”*

*Kelly, “Remedies for Breach of Trust”; p.20; See however, Langbein, “Questioning the Trust-Law Duty of Loyalty: Sole Interest or Best Interest?”, 114 Yale Law Journal 929, (2005) which advances the position that the “sole interest” rule is unsound.

“SOLE INTEREST” STANDARD

- ☐ Undivided Loyalty to Beneficiaries
- ☐ “Sole Interest” Rule
- ☐ Not “Best” Interest Rule

THE AUCTION*

- ☐ Trustee Consigns Property for Sale at Legitimate Public Auction**
- ☐ If Trustee Makes Highest Bid
 - ◊ Highest Bid Most Beneficial to Trust
- ☐ Trustee Resells for Profit Years Later
 - ◊ Profits Disgorged
 - ◊ Rescission

*See Langbein at 952

**E.g., Christies, Sotheby's, etc...

BIZARRE RESULTS

- ❑ Highest Bid Consequences
 - ◇ “Conflicted” Party Offers Better Price
- ❑ Interests of Beneficiaries Compromised

RULE #2

“POSSIBILITY” OF POTENTIAL CONFLICTS

- ❑ “(T)he duty of loyalty prevents a trustee from engaging in a transaction that involves a **potential conflict** of interest, **even if** the transaction is in **good faith and maximizes the interests** of the beneficiaries.”*
- ❑ “Not because there *is* fraud, but because there **may be fraud**.”**

*Daniel B. Kelly, “Remedies for Breach of Trust”, at p. 20

**Langbein, at 931, quoting Piatt v. Longworth’s Devisees, 27 Ohio St. 159, 195-96 (1875)

ELIMINATE TEMPTATION

“(L)oyalty can be preserved only if the relationship is stripped of the possibility of such conflicts. The duty of loyalty is, therefore, not the duty to resist temptation, but to **eliminate temptation**, as the former is assumed to be impossible.”*

STRICT ENFORCEMENT

“(T)he beneficiary need only show that the fiduciary allowed himself to be placed in a position where his personal interest **might** conflict with the beneficiary.” (Emphasis is the Court’s) **

*Boxx, “Of Punctillos and Paybacks: The Duty of Loyalty Under the Uniform Trust Code”; Missouri Law Review, Spring 2002

**Fulton Nat’l Bank v. Tate, 363 F. 2d 562, 571 (5th Cir. 1966)

RULE #3

“NO FURTHER INQUIRY” RULE

A court will not evaluate the good faith of the trustee or fairness of the transaction. Instead, if the transaction violates the sole interest rule, the court will make **“no further inquiry”** and find **the trustee has breached its duty of loyalty.***

*Kelly, “Remedies for Breach of Trust”; p.20

AGAIN, FOR GOOD MEASURE FROM THE LEADING TEXTBOOK ON THE TOPIC*

“If a trustee undertakes a transaction that involves self-dealing or a conflict between the trustee’s fiduciary capacity and personal interests, good faith and fairness are not enough to save the trustee from liability. In such case, *no further inquiry* is made, the trustee’s good faith and reasonableness of the transaction are irrelevant.” (Emphasis the authors)

*Dukerminer & Sitkoff, p. 591

OPTIMAL REMEDY ELECTION

- ☐ Profits – Defendant’s Gain
 - ◇ Disgorge the Profit
- ☐ Consequential Damages – Plaintiff’s Harm
 - ◇ Harm Exceeds Gain
- ☐ Rescission

PUNITIVE DAMAGES

- ❑ In Addition to Remedy Election
- ❑ Crucial for Deterrence
- ❑ To Offset Difficulty of Detecting and Proving Wrongdoing
- ❑ Prevent “Efficient Fiduciary Breach”

DEFENSES

- ❑ Settlor Authorization
 - ◇ Express
 - ◇ Implied
- ❑ Beneficiary Consent
 - ◇ After Full Disclosure
 - ◇ All Material Facts Which Might Affect Beneficiary’s Consent
- ❑ Judicial Approval
 - ◇ In Advance

CONFLICT SANCTIONED BY IMPLICATION

- ☐ A Child is Named Trustee of a Credit Shelter Trust
- ☐ The Child is a “Conflicted Trustee” at Inception
- ☐ Waiver Implied

TOPIC #2

MODERN TRUST DESIGN STRATEGIES

WHAT DO CLIENTS REALLY WANT?

- ☐ Many Modern Trusts are Created for Tax (and Creditor Protection) Purposes
- ☐ Not to Protect the Remaindermen from the Champagne and Caviar Tastes of the Primary Beneficiary
- ☐ Not to Protect the Beneficiary Against Himself or Herself

CONTROL IT; DON'T OWN IT*

- ☐ For the "Competent" Inheritor
- ☐ Full Control Plus Use and Enjoyment
 - ◊ Equals Outright Ownership
 - ◊ "Full Control" Defined
- ☐ Legal Title Harmful
- ☐ "Use" Trust
 - ◊ Preferential Treatment

*Attributed to John D. Rockefeller

MODERN TRUST DESIGN STRATEGIES

- ❑ Trustees May Engage in Any Conceivable Transaction that Might Enhance the Trust
- ❑ Primary Beneficiary Given Full Control, Use and Beneficial Enjoyment
 - ◇ Compress Constraints
 - ◇ Retain Good Faith Duty

“I’D GIVE IT OUTRIGHT IF NOT FOR THE TRUST SHELTERS”

- ❑ Adequate Control is Essential to a Beneficiary’s Happiness
- ❑ Often Conflicts With Prevailing Rules
- ❑ Is Self-dealing Inherently Wrong?
 - ◇ Sales to Grantor Trusts

BENEFICIARY CONTROLLED TRUST*

- ☐ Competent Inheritor
 - ◊ Has All “Safe” Controls
- ☐ Independent Trustee**
 - ◊ All Tax and Creditor Sensitive Controls
 - ◊ IRC §672(c)(2)
 - ◊ Rev Rul 95-58
- ☐ Competent Inheritor Controls the Identity of the Independent Trustee

* Greater control equals greater exposure.

** “Independence” does not require a confrontational relationship.

FIXING IT PERMITTING SELF-DEALING

- ☐ Settlor’s Express Authorization
 - ◊ “Notwithstanding any Rule of Law Relating to Self-dealing”
- ☐ Require “Good Faith”
- ☐ Require “Adequate and Full Consideration” in Money or Money’s Worth

RECOMMENDED TRUST PROVISIONS

- ☐ Permitted Self-dealing
- ☐ Elimination of Prudent Person and Impartiality Rules
- ☐ Broad Right to Fire and Replace Trustees
- ☐ Broad Special Powers of Appointment
 - ◇ Eliminate Any Complaining Beneficiaries
 - ◇ Shows Intention of the Settlor

TOPIC #3

DUTY TO ADVISE

For a Very Insightful Article on This Topic, See Randy Roth, "Liability Issues for Lawyers and Other Fiduciaries", 44 U. Miami Heckerling Inst. on Est. Plan., Ch. 16 (2010)

MISSED OPPORTUNITIES

- ❑ Current Popular Attacks
 - ◇ FLPs for Discounting
 - ◇ Asset Protection Trusts
 - ◇ Estate Depletion as a Result of Grantor Trust Status
- ❑ Duties to Raise Tax Planning Opportunities
 - ◇ Proactive Not Reactive
 - ◇ CYA Documentation
- ❑ Is it Defensible?

NOTA BENE

Even the most sophisticated estate planners may be missing the point of grantor trusts. It's a risk-free, transfer-tax free, effortless wealth transfer tool that is much more powerful than most advisors realize. It amplifies the benefit of any other wealth transfer tool. In fact, grantor trusts are so effective, **it could be malpractice to fail to suggest to a client that an irrevocable trust be structured as one.*** (emphasis added)

*David A. Handler, March 2006 Trusts and Estates

See also: Jerome M. Hesch and David A. Handler, Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth, NYU 68th Inst. on Federal Taxation (2009)

WHO ARE THE TARGETS?

❑ Expanding of Duties and Targets

“... I would argue that there may very well be an **affirmative duty** to talk to your clients about (an asset protection trust).” And, “...it could be **any advisor**.”*

*Skip Fox, “Current Financial and Estate Planning Trends”, CCH Financial and Estate Planning, (Nov 26,2007) at p. 83

PRIVITY EXPANSION OF PLAINTIFF POOL EXPANSION OF DEFENDANT POOL

“Most jurisdictions have relaxed or eliminated the common-law requirement of privity...This has contributed to a huge increase in malpractice against estate planners.”*

* Roth p. 16-8

PROOF

“Absent documentary evidence that the testator understood what he or she was doing, the lawyer will be faced with accusations that ‘Dad hated to pay taxes and would have told the lawyer to do everything possible to minimize the estate tax.’”*

- ☐ And, Mom would not want the assets lost to “predators”, such as divorcing or dissident spouses

*Hoffman, “A Survey of Potential Pitfalls for Estate Planners”, quoted in Roth p. 16-8

MARKETING MATERIALS INCREASE EXPOSURE

- ☐ If You Say You Are an Expert, You Will be Held to That Standard
- ☐ What Do Your Promotional Materials Say?

INCREASED FIDUCIARY STANDARD

“Union Trust, in holding itself out to plaintiffs and to the public as competent to accept fiduciary responsibility and manage significant assets necessarily holds itself out as capable of insuring compliance with the requisite accounting, tax and legal requirements incident to its responsibilities.”*

*Nevin v. Union Trust Co., 726 A2d 694 (Me..1999), highlighted by Prof. Roth, p. 16-26

IS THERE A DUTY TO ADVISE CLIENTS TO USE A MORE PROTECTIVE SITUS?

- ❑ “My Clients Want to Stay Local”
 - ◇ Did You Ask Them?
 - ◇ Really?
 - ◇ Prove It!
 - ◇ Was it Informed Consent?
 - ◇ Contemporaneous Documentation
 - ◇ Written Communications

INFORMED CONSENT/REJECTION

“(K)eep in mind that discussing a strategy is not necessarily the same as explaining it well enough for the client to make an informed consent.”*

*Roth, p. 16-24

THERE WILL BE EXPOSURE

- ☐ Creditor Protection
 - ◇ No Exception Creditors
 - ◇ “Piercing of Spendthrift Trusts” Courses for Divorce Lawyers
- ☐ State Income Taxes
- ☐ Reformation or Decanting an Inferior or Deficient Trust?

DICK NENNO

CREDITOR PROTECTION:

"Attorneys might face exposure if they do not advise the client to [engage in asset protection planning] and creditors later reach the client's assets."*

STATE INCOME TAXES:

"Managing state income tax liability is a critical aspect of planning and administering a trust. (N)o court has yet held an attorney or trustee liable for failing to minimize state income tax, but such a case probably is not far off. Accordingly, attorneys and trustees ignore this crucial issue at their peril."**

* "Planning With Domestic Asset-Protection Trusts," 40 RPP&T J. 263 at 284, (Summer 2005 – Cited by Prof. Roth (Fn. 105)

** "Planning to Minimize or Avoid State Income Tax on Trusts", 34 ACTEC Journal 131 (2008), at 146;

GIDEON ROTHSCHILD/DAN RUBIN

CREDITOR PROTECTION:

"...it is only a matter of time before clients make claims against estate planners who did not raise the subject of asset protection planning as part of the planning process-when it arguably would have worked."*

STATE INCOME TAXES:

Gideon has told me that the same concern applies to minimizing taxes and moving wealth to a situs without state income tax.

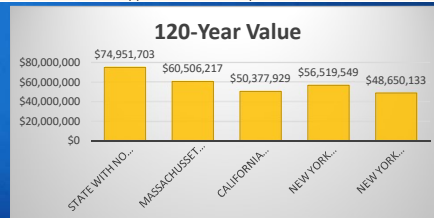
* "Asset-Protection Planning: Ethical? Legal? Obligatory?," Rothschild & Rubin, Trusts & Estates at 42 (Sept. 2003)

COMPARISON OF PAYING STATE INCOME TAXES AND NOT PAYING THE OVER TIME

Impact of State Income Tax on Dynasty Trusts

This model compares the impact of state income tax for a dynasty trust over the period of 120 years. The hypothetical trust has one group of stock that pays annual dividends at a constant rate (x% of principal). The stock's value grows by y% per year. We assume that all dividends, after tax, are reinvested in the same stock. All income is in the form of dividends, so it is taxed as ordinary income. We compare the ultimate impact of the state income tax by comparing the value of the trust assets depending on whether the trust is situated in New York (outside New York City and within New York City), California, Massachusetts, or in a state that does not impose an income tax. The income tax rates are based on 2014 state rates, updated for 2015 when available, and 2015 Federal income tax rates.

Trust Principal	\$1,000,000
Annual Dividends	6%
Annual Appreciation of Principal	0%



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MY PREFERENCE

- ☐ Family Trustee
 - ◇ Investment Trustee
- ☐ Independent Trustee
 - ◇ Distribution Trustee

INVESTMENT TRUSTEE

- ☐ Primary Beneficiary
 - ◇ Can Hire Investment Advisors
 - ◇ Can Hire Local Trust Company
- ☐ Can Fire and Replace
 - ◇ Investment Advisor/Trust Company
- ☐ Situs Irrelevant

FORUM SHOPPING INDEPENDENT TRUSTEE

- ☐ “Use” Trust
 - ◇ Keep in Trust Wrapper Goal
 - ◇ Ability to Add Third Trustee
- ☐ Independent/Situs Trustee
 - ◇ Tax Sensitive Powers
 - ◇ Creditor Sheltering – Standards Not Governed by the IRC
 - ◇ State Income Tax Shelter

DEALING WITH THE LAW'S TRAJECTORY

- ❑ Creditor's Rights Issues
 - ◇ Not Bound by What IRC Says
- ❑ Judge Threatens Contempt
 - ◇ Distribution Trustee
 - ◇ Fire and Replace



PROTECTIVE PLANNING DESIGNING THE SHEILD

- ☐ Fully Discretionary
 - ◊ No Entitlements
- ☐ Situs of Distribution Trustee
- ☐ Increased Control Equals Increased Exposure
 - ◊ “Use” – Who Controls?
 - ◊ Removal Rights Over Independent Trustee

RESTRICTIONS ON REMOVAL RIGHTS MAXIMIZE SAFETY

- ☐ By Management Trustee in Fiduciary Capacity
- ☐ “In the best interests of the trust”
- ☐ Only for Proper Cause
 - ◊ Not to Influence a Distribution or Other Trustee Action
 - ◊ Should Not be Objectionable
- ☐ Power to Resist Improper Removal