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ILLINOIS' NEW TOTAL RETURN LEGISLATION

The total return concept has gained general acceptance over the years such that most large charitable and educational institutions' endowment funds currently employ the technique. Recent legislation in many states, now including Illinois, has brought fiduciary statutes up to date by authorizing total return. Such legislation is adding flexibility and creating opportunities with respect to existing irrevocable income-only trusts.

Overview and Genesis of Total Return Concept

The problem with an income-only spending policy is that it creates a conflict between the dual goals of maintaining or increasing current benefits while avoiding a loss to inflation of the purchasing power of capital. The maintenance or growth of income requires that the trust acquire either bonds, which provide no protection for inflation, or higher dividend-yielding stocks, which are not easily acquired in today's market. This strategy leads to a short-term emphasis by focusing on the current income of financial instruments. In addition, this focus on current yield can de-emphasize the more important task of maximizing total return. In other words, to provide sufficient current income, the temptation is towards a heavy weighting in bonds which provide no future inflation protection. Conversely, a heavy weighting in stocks will not provide the necessary or desired income for the trust income beneficiary.

A total return investment policy offers flexibility to those trusts that determine current distributions by reference to traditional trust accounting income. As compared to an income-only spending policy, a total return spending policy is better able to preserve the "real" or inflation-adjusted value of the trust while optimizing current benefits. This method, often referred to as a unitrust approach, distributes a fixed percentage of the market value of the trust assets on a periodic basis. Therefore, a total return policy establishes a direct relationship between current distributions and the portfolio's market value, which in turn creates compatibility between the dual goals of maintaining or increasing current benefits and long-term principal growth.

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FIDUCIARY RISK MANAGEMENT TIP

ATTORNEY REFERRALS

When an institutional trustee refers an existing client to an attorney for estate planning or other work, it is important to maintain independence between the financial institution and the attorney. That way, in the event the client ever sues the attorney for legal malpractice, the client cannot also accuse the bank of any impropriety on an agency theory (i.e. the attorney was not truly independent but was acting as the institution's agent) or on a negligence theory (i.e. that the institution negligently referred the client to an unqualified attorney).

To preserve the separation and independence between the referring institution and the attorney, consider taking the following steps:

(1) Always provide the client with the names of multiple attorneys.

(2) Memorialize your referral in correspondence emphasizing that the attorneys are only suggestions and that the client should also obtain referrals from other sources and take the steps necessary to ascertain the attorneys' qualifications to the client's satisfaction.

(3) Avoid numerous instances of "quid pro quo" referrals (i.e. the institution regularly refers clients to the attorney for legal work and the attorney regularly recommends that same institution for the designated fiduciary in estate planning documents that he/she is preparing).

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ATTORNEYS AT LAW

New Total Return Legislation

The new legislation allows a trustee to invest for "total return" while still maintaining the distributions to income beneficiaries. Maintaining "real" purchasing power requires the establishment of a well-diversified, long-term approach.

There are two types of total return legislation. The first approach, now adopted by Illinois, and also used in Delaware, Florida and New York, among others, gives the trustee the power to convert an income-only trust into a unitrust which determines distributions based on a percentage of the trust assets. By allowing the trustee greater flexibility with the types of investments and asset allocations, the total return trust balances the interests of the income beneficiary and the remainder beneficiary. Instead of paying just "income" to the lifetime beneficiaries, the trust pays the lifetime beneficiary a fixed percentage of the value of the total trust. In this way, all beneficiaries are "partners" in the success of the trust.

The other approach, used by at least 30 states including California, Colorado, D.C., Florida and New York, among others, revises the respective principal and income acts to grant the trustee the power to adjust distributable income by transferring principal to income (or vice versa). A few states, namely Florida, Maine, Maryland, Missouri, New York, Pennsylvania, and Washington, have both types of total return legislation.

Specifics of Illinois Legislation

The new Illinois legislation (SB 1697) amends the Trusts and Trustees Act and grants the trustee the power to convert an income-only trust to a unitrust which determines the distribution amount as a percentage of the trust assets revalued periodically. The Illinois law allows the distribution amount to be based on the lesser of the average of the values of the preceding three years or the period during which the trust has been in existence. Averaging helps smooth out peaks and valleys of the financial markets making distribution amounts more predictable. Additionally, Illinois has set the distribution percentage between 3% and 5% depending on whether the conversion is by the trustee, by agreement or by court order.

In order to convert the trust, the trustee must believe that conversion to a total return trust will be in the best interests of the beneficiaries and will allow the trustee to better carry out the trust's purposes. In addition, the trustee must give notice to the current and remainder beneficiaries. If any beneficiary objects to the conversion, the trustee must petition the court for approval. In this same manner, a beneficiary may request conversion to a unitrust, and if the trustee refuses, the beneficiary can petition the court. The court will order conversion only if it will better enable the trustee to carry out the trust's purposes. Thus, it remains to be seen how many trusts will actually be converted over the objections of a beneficiary or the trustee. Finally, conversion to a total return trust may be made by agreement between the trustee and all primary beneficiaries of the trust. Virtual representation is specifically authorized by the statute to bind minor and unborn beneficiaries.

For any trusts where a marital deduction was taken, conversion to a total return trust is allowed only if the distribution amount is not less than the net income of the trust. Total return would appear then to be available for QTIP trusts, as long as the net income is distributed in all situations and the surviving

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spouse beneficiary has the power to order that unproductive property be made productive.

Because administration of a total return trust can be difficult, especially with hard to value assets such as real estate, closely held business and limited partnership assets, the Illinois legislation allows the trustee to exclude certain assets from the computation for total return. Assets with no readily available market value and securities with no established market on a stock exchange can be excluded from the computation.

Conclusion

Conversion to a total return trust provides an opportunity to maintain or increase the distribution to the income beneficiary while increasing the value of the trust itself. Although the Illinois legislation specifically states that a trustee has no duty to inform beneficiaries about the availability of conversion and no duty to review the trust to determine whether any action should be taken to convert to a total return trust, if you are the trustee of an eligible trust, it may be prudent for you to review this new opportunity.

The effective date of the legislation is August 22, 2002.

CALIFORNIA

Remedy for Overcharges. In Carol F. Nickel v. Bank of America, 2002 D.J. D.A.R. (9th Cir., 2002), the lower court held that the remedy for a bank trustee's overcharging a number of trusts was repayment of the overcharge with simple interest, pursuant to the California Probate Code. The lower court also held that a determination of the profits of the bank was speculative because it was impossible to trace the amounts generated by the overcharges. The Ninth Circuit upheld the use of simple interest, but reversed as to the remedy of making the fiduciary disgorge profits. The Court found that there was no requirement to trace the overcharge amounts to the profits. It held that since the amount of the overcharges was known and the amount of the profits and assets of the Bank were known, the beneficiaries were to be awarded a *pro rata* share of the profits.

DELAWARE

Surcharge for Unequal Treatment of Beneficiaries. A Delaware Court recently surcharged a trustee for failing to treat trust beneficiaries equally with respect to both distributions of income and access to information. The trustees were administering a trust created during the donor's lifetime for the primary benefit of his wife, with sprinkling income to his children. During the first several years of the trust, the children were very young and did not receive any distributions. Once the children were adults, the trustees continued to make distributions solely to the donor's wife. During that time, one of the donor's sons, Hank, became estranged from his parents. Several years later, the trustees began making distributions to the children, but never made any distributions to Hank. When Hank requested information regarding the provisions of the trust, the trustees refused. The Court held that, despite an exculpatory clause in the will, the trustees were liable for breaching their duties to provide information

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and to act impartially. "A trustee has a duty to furnish information to a beneficiary upon reasonable request. Furthermore, even in the absence of a request for information, a trustee must communicate essential facts, such as the existence of the basic terms of the trust. That a person is a current beneficiary of a trust is indeed an essential fact." The trustees were ordered to make an equalizing distribution to Hank and were surcharged an amount equal to one-fifth of the fees they collected from the trust during the years Hank was denied distributions. McNeil v. McNeil, 798 A.2d 503 (Del. 2002).

DISTRICT OF COLUMBIA

Court of Appeals Honors Elderly Patient's Health Care Wishes. The D.C. Court of Appeals recently ruled in a high profile case that the lower court abused its discretion and violated statutory requirements by ignoring the wishes of an elderly woman and putting her under the care of court-appointed lawyers. In re Orshansky, 2002 D.C. App Lexis 488 (Aug. 15, 2002), prior to becoming ill with dementia, an elderly woman indicated her intent to be cared for by her relatives. Years before her illness, she created a trust for her sole benefit which gave her sister the authority to write checks and pay bills for her retirement, nominated her niece as her health care proxy to make health care decisions on her behalf, and stated to neighbors her desire to continue to live in her New York apartment located in the same building where her sister currently resides. When the elderly woman became ill and was removed from the hospital and taken to New York to be with her family, however, a Superior Court Judge ordered the woman to be returned to Washington D.C. and appointed a guardian and a conservator without taking into account the woman's own plans and wishes. The Court of Appeals reversed the decisions and orders of the Superior Court and vacated the appointments ordered by the Superior Court Judge, criticizing the Superior Court for ignoring or rejecting evidence demonstrating the woman's desire to be cared for by her family. The Court of Appeals cited further errors on the part of the lower court and the court-appointed guardian and conservator, including the fact that no guardian ad litem was appointed to assist the elderly woman, the patient was not present at any of the proceedings, and neither the court-appointed guardian nor the court-appointed conservator conveyed the patient's desires to the Court.

FLORIDA

Florida Amends the Probate Code. Earlier this year, Florida amended its statutes governing the administration of estates and trusts. Most of the changes do not take effect until January 1, 2003. Some of the noteworthy highlights include:

1. Retroactive amendment of the virtual representation statute to confirm that it applies not only to probate and estate proceedings, but also to proceedings involving trusts, as well as the administration of trusts.

2. Codification of the so-called Carpenter presumption of undue influence where a person in a confidential or fiduciary relationship to the grantor procures a change in the grantor's estate plan to his or her benefit.

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3. Statutory recognition for the first time of the validity of a trust for the care of an animal.

4. Codification of case law that in the event of an improper distribution, the recipient must return both the funds, as well as the income he or she received upon the funds from the date of the improper distribution; if the recipient no longer possesses the property, the value of the property on the date of disposition, including any gain received, must be returned.

5. Codification of the format of and requirements for trust accountings modeled after Florida Probate Rule 5.346 applicable to probate and guardianship proceedings.

6. Revision of the six-month statute of limitations for actions against trustees following disclosure. The amended statute now more clearly sets forth both the substantive standards for disclosure as well as the procedures the trustee must follow as a condition to reliance upon the short six-month statute of limitations.

ILLINOIS

Wrongful Death Claims. In Re Estate of Madison Rae Poole, 767 N.E.2d 855 (Ill App. 2002), revisits the Illinois Supreme Court case of Seef v. Sutkus 562 N.E.2d 606 (Ill App. 1991), which held that, under the Wrongful Death Act, a viable but unborn fetus was a "person" to the extent that a rebuttable presumption for loss of society existed in the parents of a stillborn child. Applying this logic, the Third District goes on to hold that the biological father of an illegitimate, stillborn child could be an "eligible parent" pursuant to Section 5/2-2 of the Illinois Probate Act. Noting that the recently amended intestacy statute is now constitutionally gender neutral such that the biological father of an illegitimate child can inherit from that child, the Court went on to hold that depending on proof of paternity, the biological father could qualify for letters of administration and receive distribution of Wrongful Death settlement funds from the stillborn child's "estate".

Standards for Taxing Probate and Nonprobate Assets. Also from the Third District, In re the Estate of Robert L. Maierhofer, 767 N.E.2d 850 (3rd Dist. 2002), reexamines Illinois' use of the "burden on the residue" rule for taxing probate assets and "equitable apportionment" of the estate tax liability for nonprobate assets. The case contains a clear explanation of the rules with appropriate history and citations. Application of the rules to this case, however, appears to create an inequitable result unintended by the testator. Of note is the specially concurring opinion of Justice Holdridge in which he urges the Illinois legislature to enact a statute implementing equitable apportionment as the default standard for imposing estate taxes on both probate and nonprobate assets.

Section 18-1.1 Survives Constitutional Challenge. In another case involving constitutional issues, the Illinois Supreme Court reversed and remanded a Cook County Probate Division decision dismissing a statutory custodial claim and holding that Section 18-1.1 of the Probate Act is unconstitutional. In Estate of Jolliff, 771 N.E.2d 346 (2002), decedent's daughter was the administrator of her father's estate. Decedent was totally disabled and had been cared for by his sister in her home for the 12 years preceding his death. In seeking to deny the sister's claim, the administrator claimed that the statutory custodial claim provisions of the Probate Act amounted to special

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legislation, violated due process, equal protection, separation of powers and was unconstitutionally vague.

In upholding this section of the Probate Act, the Supreme Court quoted extensively from the legislative history, including then Governor Thompson' s amendatory veto comments that the provision was "inequitable, unworkable, and will no doubt cause havoc with the handling of probate estates." The Court addresses each challenge individually and concludes that the classifications contained in the provisions are not arbitrary, pass constitutional muster under the deferential rational basis test, and do not encroach upon the powers of the judiciary. Moreover, while acknowledging that Section 18-1.1 is "not a model of clarity in legislative drafting", the Court held that it is not so vague that it cannot be applied. Finally, the Court held that the purpose of Section 18-1.1 is to "allow immediate family members to recover the additional opportunity and emotional costs of committing their lives to disabled relatives."

WISCONSIN

Homestead Rights Can Be Waived in a Prenuptial Agreement. In Jones v. Estate of Jones, 253 Wis.2d 158, 646 N.W.2d 280 (2002), the Wisconsin Supreme Court upheld the validity of a deed conveying homestead property without the signature of the non-titled spouse because the spouses had waived their homestead rights in a prenuptial agreement. Ruling on a question of first impression, the court held that language in a prenuptial agreement by which the spouses agreed that each spouse would hold his or her property "free from all rights or claims therein by the other" was an effective waiver of the non-titled spouse's homestead rights for purposes of the statute of frauds.

Right of a "Prevailing" Party to Have Attorneys' Fees Paid out of the Estate Is Clarified. The Wisconsin Court of Appeals held in Estate of Wheeler, 649 N.W.2d 711 (Wis. Ct. App., 2002), that for purposes of Wis. Stat. § 879.37, which allows a prevailing party to have his or her attorneys' fees paid by the estate in all appealable contested matters, a party is a "prevailing" party "if he or she achieves some significant benefit in litigation involving a claim against the estate." A beneficiary who defended the estate against a claim was a "prevailing" party because the amount of damages awarded was less than half of the amount the claimant had sought. The beneficiary was allowed to have her attorneys' fees paid out of the estate, even though the personal representative also incurred attorneys' fees to defend the estate against the claim. The court held that the doctrine of "equitable extraordinary circumstances," which would allow payment of the beneficiary's attorneys' fees only if the personal representative failed to defend the estate, was rendered inapplicable in Wisconsin by enactment of Wis. Stat. § 879.37.

Element of Dead Man's Statute Clarified; Personal Representative's Defense Against Removal Is an Administration Expense. In Estate of Christopherson, 2002 WL 1380307 (Wis. Ct. App., June 27, 2002), the Wisconsin Court of Appeals again attempted to clarify the applicability of the complex Dead Man's Statute codified at Wis. Stat. § 885.16. The court reiterated that the statute does not bar testimony of a party regarding a transaction or communication with a decedent if the party is called adversely by the opposing party. In such an instance, the party called adversely cannot raise an

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objection to his or her own testimony under the Dead Man's Statute. In the same case, the court decided that attorneys' fees incurred by a personal representative in successfully avoiding removal may be paid out of the estate under Wis. Stat. § 857.05 as "necessary expenses in the care, management and settlement of the estate."

No Right to a Jury Trial in a Will Contest. In Estate of Sharpley, 2002 WL 1434369 (Wis. Ct. App., July 3, 2002), the Wisconsin Court of Appeals, in construing Wis. Stat. § 879.45(1), held that there is no right to a trial by jury in a will contest. It distinguished Wickert v. Burggraf, 214 Wis. 2d 426, 570 N.W.2d 889 (Ct. App. 1997), which upheld the right to a jury trial in a civil action alleging tortious interference with an expected inheritance. The difference, the court said, is that in a tort case, the remedy is an award of damages against another party, but in a will contest, the remedy is the setting aside of the will, with no award of damages.

Power to Make Gifts Under a Power of Attorney Is Further Restricted. The Wisconsin Court of Appeals further restricted the ability of the holder of a power of attorney to make gifts to herself by holding that evidence of oral approval of such gifts is irrelevant. Praefke v. American Enterprise Life Insurance Co., 2002 WL 1857384 (Wis. Ct. App., Aug. 14, 2002). Since Alexopoulos v. Dakouras, 48 Wis.2d 32, 179 N.W.2d 836 (1970), it has been clear in Wisconsin that an attorney-in-fact may not make a gift to herself unless there is an explicit intent in the writing from the principal allowing the gift. However, the court has now adopted an additional rule disallowing evidence of "oral amendments" to the power of attorney. The court took this position because of the great potential for abuse that would arise from allowing oral grants of gifting powers.

Legal News: Estate and Trust Litigation
This publication is one of several newsletters published by Foley & Lardner's Tax, Valuation & Fiduciary Litigation [TVFL] team. TVFL provides a unique blend of skilled litigators along with tax, and estates and trusts attorneys to successfully represent clients in risk management, dispute resolution and litigation services. Specialties include Federal Tax Controversy, State Tax Controversy, Valuation Litigation, Insurance Tax Controversy and Estate and Trust Litigation.

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