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Uniform Prudent Investor Act in Oregon

In 1995, Oregon joined several other states in adopting the Uniform Prudent Investor Act (the "UPIA"). The UPIA represents an evolution, not a revolution, in trust investing; it revises some features of Oregon trust law while merely restating others. There are three key changes, reflecting developments in investment theory and practice during the past generation. First, trust assets are now evaluated as part of an overall portfolio rather than individually, in isolation. Second, the UPIA recognizes that every investment involves a balancing of risk and return. Third, delegation of trust investing is now expressly permitted, with safeguards.

Sources of law and interpretation. The UPIA is codified at ORS 128.192- 218. Oregon's statute closely follows the final text of the model act approved in 1994 by the National Commissioners on Uniform State Laws. The Commissioners' comments on the model act were made part of Oregon's legislative record and are helpful in explaining the statutory text.¹ The model act, in turn, draws heavily upon the prudent investor rules adopted by the American Law Institute in the *Restatement (Third) of Trusts* (1996). Finally, because the UPIA is a uniform act, court decisions in other states with the UPIA are relevant authority. See ORS 128.216(1).

Scope. Subject to contrary provisions in a trust instrument, the UPIA applies to trusts created on and after September 9, 1995 and to investment decisions on and after that date for older trusts. It also applies to trusts that invoke various other investment standards, including "authorized investments," "legal investments" and "prudent man rule." ORS 128.214.

In addition to governing private trusts, the UPIA governs certain other relationships. It applies to investments by employee benefit trusts, see *Firestone Tire & Rubber Co. v. Bruch*, 489 US 101, 110-11 (1989); personal representatives, ORS 114.305(6); custodianships under the Uniform Transfers to Minors Act, ORS 126.842(2); and conservatorships, see ORS 125.445(5) (conservators, without court approval, may invest trust assets in same manner as trustee). Endowment funds of charitable organizations are subject to a separate but similar statute, the Uniform Management of Institutional Funds Act. ORS 128.310-355.

Provisions That Restate Prior Law

Basic rule. The prudent investor rule is a default rule that can be expanded or limited by the trust document. ORS 128.194, 128.196(1). It authorizes a trustee to invest in any kind of property as long as the choice is prudent and not prohibited by the trust document. ORS 128.196(5). This is similar to former ORS 128.057(1) (repealed 1995). It rejects two older rules as arbitrary: the "legal list," which restricted trustees to specific types of investments,² and a related rule that classified broad categories of investments as "speculative" and thus imprudent per se. In practice, those two rules often denied beneficiaries the fruits of worthwhile investments or condemned them to unnecessary risk. After World War II, common stocks were widely viewed as speculative, even as they were trading at bargain prices and were about to begin one of their greatest advances in history. Benjamin

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Graham, *The Intelligent Investor* 1-3 (4th rev ed 1973). During the late 1960s and 1970s, inflation punished holders of long-term government bonds—among the “safest” of investments—with negative rates of return and capital losses. Burton Malkiel, *A Random Walk Down Wall Street* 372 (6th ed 1996).

However, the prudent investor rule does not mean that anything goes. It is the trustee’s job to invest at a risk level suitable to the trust. UPIA § 2 cmt. Simple, conservative investments are still often the best. As Warren Buffett, perhaps this country’s most renowned living investor, has stated: “Investors should remember that their scorecard is not computed using Olympic-diving methods: Degree of difficulty doesn’t count.” Warren Buffet, “Chairman’s Letter to Shareholders,” *Berkshire Hathaway, Inc. Annual Report* 16 (1994). A recent example involves Long-Term Capital Management LP, a private hedge fund. The fund, guided by two Nobel laureates in economics and a former vice chairman of the Federal Reserve Board, boasted complex computer models, “market neutral” arbitrage techniques and the prospect of fabulous returns. This past August, market tremors not predicted by the computer models, coupled with the fund’s extreme leverage (borrowing for investment), vaporized 44% of the fund’s capital—nearly \$2 billion. Ultimately, the fund was rescued only by a \$3.5 billion bank bailout. Its strategy was exposed as high-stakes gambling. See Peter Truell, “An Alchemist Who Turned Gold into Lead,” *The New York Times* C1 (Sept. 25, 1998); “Failed Wizards of Wall Street,” *Business Week* 114 (Sept. 21, 1998).

Duty to diversify. The trustee must diversify investments unless special circumstances require otherwise. ORS 128.198. Not all eggs should go in one basket. Diversification reduces risk because stock price movements, as well as the returns on different classes of securities, such as stocks and bonds, are imperfectly correlated. UPIA § 3, cmt. Thus, according to modern investment theory, bundles of risky securities may be put together in such a way that the portfolio as a whole is actually less risky than any one of the individual securities in it. Conversely, for whatever level of risk the trust can tolerate, diversification permits the trustee to invest more aggressively, increasing the expected return. See *Restatement (Third) of Trusts* § 227 cmt g; Malkiel, *supra*, at 235-40 n 4; Franco Modigliani & Gerald Pogue, “Risk, Return, and CAPM: Concepts and Evidence,” *The Financial Analyst’s Handbook* 1147-53 (2d ed 1988).

Two examples may help to clarify these points. First, the expected long-term return of small-company growth stocks is greater than the expected return on common stocks in general, bonds or U.S. Treasury bills. See Malkiel, *supra*, at 234. In the aggregate, investors receive a premium to compensate for the greater risk of insolvency with small start-up companies. However, one cannot predict in advance which start-ups will fail, and trustees, for that reason, traditionally have shunned small-company stocks. Mutual funds and bank common trust funds now bring small-company investing more comfortably within their reach. As the number of such stocks in the portfolio increases, the more certain it becomes that the aggregate profits will exceed the aggregate of the losses. This principle is the simple basis of insurance underwriting and the house odds in roulette. Graham, *supra*, at 282-83.

A second example is combining stocks and bonds in a portfolio. The blend mitigates the risks of stocks alone (possible

periods of negative returns) and bonds alone (the inability to preserve the real value of principle against inflation). See *id.* at 16-25.

Special circumstances that can overcome the duty to diversify include the tax cost of selling a large block of low-basis stock and the wish to retain a family business. UPIA § 3 cmt.

Duty to review assets. The trustee must review and retain or dispose of assets within a reasonable time after becoming trustee. ORS 128.202; accord *Stephan v. Equitable S & L Assn.*, 268 Or 544 (1974) (prior law). This duty also applies to a trustee’s own investments that once were prudent but since have become improper. UPIA § 4 cmt. There is no fixed rule on what is a “reasonable” time to dispose of assets. See *id.*

Best interest of beneficiaries. The trustee must manage trust assets solely in the best interests of beneficiaries. ORS 128.204(1); *Marshall v. Frazier*, 159 Or 491 (1938). Self-dealing is improper, unless expressly authorized by statute or the trust document. *E.g.*, ORS 128.009(3)(f) (bank trustee may deposit trust funds with itself if the deposits are adequately secured); ORS 709.175(2) (bank may invest trust assets in mutual fund managed by bank or its affiliate). However, even authorized self-dealing must be objectively fair to the beneficiaries.

If there are two or more beneficiaries, the trustee must act impartially between them. ORS 128.204(2); *Windishar v. Windishar*, 83 Or App 162 (1986), *reconsidered* 84 Or App 580 (1987). Thus, it is ordinarily improper to endanger either the purchasing power of capital, by investing solely in bonds or utility stocks, or current income, by holding only low-dividend growth stocks. See *Restatement (Third) of Trusts* § 227 cmt i & § 232 cmt c (1992); *Estate of Cooper*, 913 P2d 393 (Wash App), *rev den*, 928 P2d 414 (Wash 1996).³ The trustee may not sacrifice the interests of beneficiaries through “social investing,” that is, deploying trust assets at lower returns or greater risk to promote social causes, however meritorious, such as local employment. UPIA § 5 cmt; see Department of Labor Interpretive Bulletin 9401, 59 Fed Reg 32,606 (June 22, 1994) (same rule for employee benefit plans).

Minimize costs. In investing, the trustee must incur only costs that are appropriate and reasonable. ORS 128.206. Wasting beneficiaries’ money is imprudent. UPIA § 8 cmt; see *Restatement (Third) of Trusts* § 227 cmt m. For example, a trustee should avoid mutual funds with abnormally high sales charges or expense ratios. The low cost of index funds is an argument for their consideration in a trust portfolio.

Higher standard for professional trustees. A trustee with special expertise is held to a higher standard. ORS 128.196(6); accord *Hatcher v. U.S. Nat’l Bank*, 56 Or App 643, *rev den*, 293 Or 373 (1982). Amateur trustees, such as family members, and trustees of small trusts are not excused from following the prudent investor rule or the duty to diversify. The drafters of the UPIA declined to create an exception for these trustees. However, the UPIA recognizes that pooled investments, such as mutual funds and bank common trust funds, are especially suitable for those trusts. UPIA § 2 cmt; see *Restatement (Third) of Trusts* § 227 cmt h, m.

Trustees are not insurers. Compliance with the prudent investor rule is not determined by hindsight. Rather, it is determined in light of the facts and circumstances existing at the time of the trustee’s decision or action. ORS 128.208. In other words, trustees are not insurers. UPIA § 8 cmt.

Provisions That Modify Prior Law

Portfolio standard. A trustee's investment decisions for individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust. ORS 128.196(2). This is a corollary of the rule of diversification. When the trustee assembles a prudent portfolio, he or she is not held accountable if, in hindsight, individual elements in the mix perform badly.

Risk and reward. The trustee must consider the trade-off between risk and reward. ORS 128.196(2). Returns correlate strongly with risk. Stocks promise the greatest long-term return but have the greatest short-term volatility. However, the tolerance for risk varies greatly with the purposes of the trust and the relevant circumstances of the beneficiary. UPIA § 2 cmt. An elderly widow whose sole support is a modest trust needs current income and cannot risk the losses in value that are possible with a portfolio that has a heavy dose of stocks. Similarly, a trust that will be drained in a year or two to pay for college or purchase of a house could be limited to cash equivalents. On the other hand, a trust for a young physician should emphasize stocks for long-term appreciation.

Consider a range of factors. Preservation of capital is no longer the sole measure of trust investing. A trustee should also consider other factors: general economic conditions; possible inflation or deflation; tax consequences; the role each investment plays in the overall trust portfolio; the expected total return of income plus capital appreciation; other resources of the beneficiaries; the need for liquidity, regular income and appreciation of capital; and an asset's special value to the trust or one or more beneficiaries. ORS 128.196(3). This analysis overlaps with the weighing of risk and reward.

Delegation of investing. A trustee is specifically authorized to delegate investment decisions. ORS 128.212(1). This is in contrast to former law, which disfavored delegation.⁴ The new rule recognizes that outside investment managers may possess specialized expertise or operating efficiencies. See UPIA § 9 cmt. Indeed, a trustee may be liable for failure to delegate when it selects investments, such as real estate or venture capital, that require special skills the trustee lacks. *Restatement (Third) of Trusts* § 171 cmt a & § 227 cmt j (1992).

The trustee is not liable for investment losses if it acts prudently in selecting, monitoring and setting guidelines for the outside investment manager. ORS 128.212(3). Instead, the beneficiaries must look to the outside manager, who owes a duty of due care to the trust. ORS 128.212(2). By accepting the delegation, the manager submits to the jurisdiction of Oregon courts. ORS 128.212(4).

Conclusion

The UPIA gives more flexibility for trust investing. It also demands more thought and attention from trustees than before, in tailoring portfolios to beneficiaries' needs and in weighing risk and return. At the same time, trustees are freer to enlist outside help, rather than going it alone in investing.

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Endnotes

1. *Hearings on HB 2650 Before the Subcomm on Civil Law and Judicial Admin of the House Judiciary Comm*, 68th Legis Ass (Mar. 1, 1995) (testimony of Alan Bennett, Vice President & Trust Officer, Pioneer Trust Bank). The official comments are reprinted together with the model act at 7B ULA 56 (Supp 1998).

2. The "legal list" approach was the rule in Oregon between 1925 and 1947. See James Heltzel & Alan Bennett, "Trust Investments," *Administering Trusts in Oregon* § 7.22 (OSB 1995).

3. Some commentators have argued that both income and remainder beneficiaries would be better off if the trustee could invest primarily in low-dividend growth stocks for a greater long-term total return, with a portion of the holdings sold periodically and the gains distributed as income. E.g., Robert B. Wolf, "Defeating the Duty to Disappoint Equally — The Total Return Trust," 32 *Real Prop, Prob & Tr J* 45 (1997). Regardless of its merits, such an approach would require changes in ORS chapter 129, Oregon's principal and income statute, or special language in the trust document.

4. E.g., *Restatement (Second) of Trusts* § 171, cmt h (1959) ("A trustee cannot delegate to another the power to select investments."). However, the old rule had already started to erode. See ORS 128.057(1) (repealed 1995) (permitting investment in common trust funds and mutual funds); ORS 128.009(3)(x) (permitting trustee to hire investment advisor); ERISA § 403(a)(2), 29 USCA, § 1103(a)(2) (1985) (employee benefit plan may provide that "authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers * * *").

Questions, Comments or Suggestions About This Newsletter?

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Placing a Minor's Conservatorship Assets into Trust

Many conservators of the estates of minor children, particularly conservators managing larger estates, lament their inability to continue to control the funds for the protection of the protected person after the protected person turns age 18. For many conservators, the prospect of leaving a large sum of cash or other assets in the hands of its rightful but very young owner leaves the conservator feeling impotent, similar to watching a horrible accident that the witness can do nothing to prevent.

When the conservatorship is for the protection of a minor, there may be an alternative to hapless observation. The conservator can attempt to place the assets into a trust for the benefit of the minor before the conservatorship terminates on the minor's 18th birthday. ORS 125.440 provides:

"A conservator may perform the following acts only with prior court approval:

* * * * (2) create revocable or irrevocable trusts of property of the estate. A trust created by the conservator may extend beyond the period of disability of the protected person or beyond the life of the protected person. A trust created by the conservator must be consistent with the will of the protected person or any other written or oral expression of testamentary intent made by the protected person before the person became incapacitated. The court may not approve a trust that has the effect of terminating the conservatorship."

One could argue that the reference to the will or other testamentary intent of the protected person indicates that the above quoted statute applies only to adult protected persons. Minors may not write a will, so they legally cannot have testamentary intent. ORS 112.225. Therefore, one may conclude that ORS 125.440(2) cannot possibly apply to minor protected persons.

However, the language does not expressly limit the application of this provision to conservatorships for adult protected persons. The reference to "or * * * other * * * testamentary intent" makes clear that the word "will" does not refer to the protected person's desires. Rather, "will" refers to the protected person's last will and testament. Therefore, the sentence referring to the protected person's will or other testamentary intent does not apply to minor protected persons. However, simply because one sentence does not apply to a particular class of protected persons does not lead to the conclusion that the rest of the paragraph does not apply to that class of protected persons. In this writer's opinion, the rest of the statute applies to all protected persons, including minors.

If ORS 125.440(2) applies to conservatorships for minor protected persons, it permits a trust created by the conservator with court authority to extend beyond the period of disability of the protected person. Although the "disability" from which a minor suffers is not defined in ORS chapter 125, it must be infancy. See *Hendrickson v. Warburton*, 276 Or 989, 998

(1976); *Slopak v. Corrections Division*, 21 Or App 414, 416 (1975). See also ORS 12.160 (suspending running of statute of limitations when potential plaintiff suffers from disability including being a minor). Therefore, for minors, this provision would mean that the trust may extend beyond the 18th birthday of the protected person.

The one clear limit imposed by the statute is that the trust must not have the effect of terminating the conservatorship. This proscription can be met in several ways. The bottom line would seem to be that placing the funds in trust cannot terminate the annual accountings and the court's control over the conservatorship assets.

One option is to fund the trust just before the conservatorship terminates (*i.e.*, just before the 18th birthday of the protected minor). If this option is taken, often the protected person is listed as the trustor of the trust. Also, it is common to give the protected person some special consideration in exchange for his or her agreement to place the conservatorship assets in trust. One such form of consideration is some significant amount to purchase a car. Obviously the amount of consideration should have some correlation to the total value of the conservatorship assets.

Another way to avoid causing a termination of the conservatorship by placing the conservatorship funds in trust is to place most, but not all, of the assets in the trust. This would leave a small amount of money or a single asset held outside of a trust. It would seem advisable to require the trustee to account to the conservator and the conservator to account to the court for all assets whether held in a trust or in the conservatorship itself. Often the conservator and the trustee will be the same person or entity.

Some practitioners combine both of the above options, placing nearly all of the conservatorship assets into the trust when the protected person is about 17 1/2 years old. The assets left outside the trust constitute the consideration the parties have agreed that the protected person would receive in exchange for agreeing to allow the conservator to place the rest of the assets in the trust. When the protected person turns 18, the remaining assets of the conservatorship pass to that person outright, once the final account is approved and the conservatorship is terminated.

The conservator and the protected person may also come to mutually agreeable terms that include placing the funds in trust and requiring the trustee to account to the court annually, just as the conservator would. The accounting requirement can terminate once the protected person turns 18. The trust can continue beyond that date, providing for distributions at specified ages so that the protected person can learn to deal with the wealth represented by the conservatorship assets.

The options available to the conservator to avoid having the creation of the trust from having the effect of terminating the conservatorship seem to be limited only by the conservator's creativity. Every situation will likely call for some variation of the above or other options.

Ultimately, the protected person's consent is not required before the funds may be placed in a trust; the conservator need only have the court's authority. In some Oregon counties, that authority will be readily forthcoming; in others, the conservator will be asked to prove that the protected person is in need of this special treatment. Some jurisdictions may require the con-

servator to prove by clear and convincing evidence that the protected person is financially incapable, similar to the burden of proof a petitioner faces in establishing a conservatorship.¹

Although annual accountings are relatively expensive, time-consuming and public, it may be appropriate to require accountings in particularly litigious situations. For example, the proposed trustee, who is a parent of the minor child, may be the ex-spouse of the parent whose death caused the need for the conservatorship in the first place. Or perhaps the source of the funds is a grandparent who shares the noncustodial parent's mistrust of the custodial parent's financial or other choices. Under any of these circumstances, it would seem advisable to have the trustee continue to provide annual accountings to the court or to the other interested parties, such as the parent of the deceased parent of the minor.

The conservator will also need to make decisions concerning the terms of the trust before placing the assets into the trust. For example, will the conservatorship trust look to an existing trust document for its terms? If not, how long will the trust last? Will it provide for support of the beneficiary? If so, will it be according to an ascertainable standard or in the discretion of the trustee? Will it be a spendthrift trust?² How will distributions be made?

The length of the trust term should depend on several factors. The most obvious is the amount of money at issue. For conservatorship assets that are relatively small, say under \$250,000, the term could be as short as the beneficiary's 21st birthday. For a conservatorship with a large amount of assets remaining, say in excess of \$1 million, the term should probably be at least the beneficiary's 30th birthday.

Whatever the length of the trust, it would seem advisable to provide distributions to the beneficiary of sufficient amounts of cash so that she or he can learn to manage and deal with money. The loss of a relatively small amount during the trust term may result in the beneficiary learning a valuable lesson that could save greater amounts later.

One of the most significant decisions the conservator will face is who should be the trustee. Frequently, the conservator will be an appropriate trustee. This is particularly true if the conservator is a professional fiduciary. Using an individual trustee will be less costly to the trust, but if no appropriate individual trustee exists the expense of a professional trustee may be acceptable when compared to the risk of dissipation of the protected person's assets.

Occasionally the conservator will face strong opposition to the conservator's acting as trustee, for any one of a number of reasons. If this occurs another individual or company should probably be selected. In determining who should be trustee, the court should appoint the most suitable person who is willing to serve as trustee after giving consideration to the specific circumstances of the case. The court should consider the following factors: any stated desire of the beneficiary, the relationship by blood or marriage of the proposed trustee to the beneficiary, any preference expressed by the parent of the beneficiary, the estate at issue and any impact on ease of administration that may result from the appointment, as required of the court in appointing a conservator or guardian in ORS 125.200.

The preference of the beneficiary should be solicited but not necessarily obliged. One might ask the beneficiary to set a hierarchy of three fiduciaries of which the conservator

approves. From that information, the conservator may be able to propose a trustee with minimal objection.

At a minimum the proposed trustee should be someone proficient at handling large sums of money and significant other assets. She or he must also be personally and professionally financially secure. Any proposed trustee should, as a matter of full disclosure, advise the court whether she or he has (1) ever been convicted of a crime, (2) filed for or received protection under the bankruptcy laws or (3) had a license revoked or canceled that was required by the laws of any state for the practice of a profession or occupation. ORS 125.055 requires disclosure and an explanation of these acts by proposed conservators. It seems appropriate to apply the same standards to a proposed trustee.

When the conservator moves to have assets placed in trust, the conservator should consider requesting that the court appoint a guardian ad litem and/or an attorney to represent the beneficiary in the process. This will almost invariably lead to additional up-front costs but will also result in an order that is well thought out and not as likely to be subject to collateral attack later, when the beneficiary is of age.

In conclusion, any conservator of a significant estate of a minor child should at least consider petitioning the court for authority to extend the financial protection afforded by the conservatorship in the form of a trust. It is not inconceivable that at some future point a minor may sue her or his conservator for failing to do so, claiming that the failure to at least attempt this protective procedure is a breach of the conservator's fiduciary duty. It would seem unlikely that such a suit would succeed, but it certainly could be costly, financially, personally and professionally, for the conservator.

Petitioning to place conservatorship assets of a minor protected person in a trust places the conservator in a good bargaining position. If the conservator and beneficiary have not already done so, once this issue is before the court they can negotiate the terms of the trust. In any case, a conservator of a minor child may have an alternative to standing idly by while the protected person squanders the assets shortly after turning age 18.

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Endnotes

1. Anecdotal evidence suggests that judges in Multnomah County are more likely to require this high level of proof of need. Judges in other Oregon counties seem more likely to accept a lesser degree of proof.

2. Even if the trust is created as a spendthrift trust, it is likely that the creditors of the protected person will be able to reach the trust assets just as the creditors of a trustor may reach the assets of a grantor trust.

The Section's Annual Meeting

The Estate Planning and Administration Section held its annual meeting at the Oregon State Bar offices on September 25, 1998.

Jennifer Roumell of the Continuing Legal Education Committee reported that the Basic Estate Planning seminar would be held in December and would cover Basic Estate Planning, Drafting Simple Wills, Drafting Wills for Parents of Minor Children, Planning for Minors, Use of Revocable Living Trusts, Second Marriage Planning and Planning for Incapacity. The seminar is usually well attended, in part because Valerie Vollmar presents and discusses her estate planning forms at this seminar.

Jim Berrien gave a report regarding loss prevention, stating that the PLF was gathering an accurate checklist to monitor the handling of probate and conservatorship assets. The Trust Legislation Subcommittee is drafting trust legislation, focusing its attention on creditors' rights. Bernie Vail reported on behalf of the Legislative Committee that a work group is working with the Oregon Law Commission to draft legislation revising the spousal elective share laws.

Rita Cobb reported regarding the Client Security Fund, stating that attention has focused around the issue of whether an attorney should act as a fiduciary and, if so, what securities should be in place to prevent loss of trust funds. The Client Security Fund has decided to cover losses of trust assets in such cases where the attorney fiduciary has acted inappropriately.

Chris Brown reviewed highlights of 1998, in particular the Executive Committee's production and release of the Advance Directive Video. The video is not only an excellent estate planning tool but has provided substantial income to the section.

Lastly, Dave Seulean, incoming Section Chair, thanked outgoing Section Chair Chris Brown for a great year and encouraged Section members to volunteer on various committees, especially the Trust Legislation Subcommittee.

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Born Again Drafting - Reborn

Valerie Vollmar, author of *Born Again Drafting*, has completed a major revision of her estate planning forms. Valerie notes: "Perhaps the most important changes are those affecting revocable living trusts—I have written new (and fairly lengthy) provisions dealing with the definition of incapacity, the procedure for determining incapacity and the settlor's desired quality of life following incapacity." She recommends that lawyers who have used the forms in the past substitute the new ones for the old.

Valerie described many of the changes at the OSB's December 4, 1998 CLE, Basic Estate Planning. If you missed the CLE, program materials, including the new forms, are available from the Oregon State Bar.

The Right To Revoke Joint Trusts

Many estate planners use joint revocable trusts to plan for the management and eventual disposition of a married couple's assets. Commentators have described the advantages and disadvantages of joint trusts, and an article in the October 1998 issue of this Newsletter warned readers about drafting errors that could lead to adverse tax consequences for clients with taxable estates. Stephen J. Klarquist, "Gift and Estate Tax Consequences of Joint Trusts," *Or Est Plan & Admin Sec Newsl* (OSB Oct 1998).

Practitioners who prepare joint trusts for nontaxable estates should be aware of a different sort of problem. A tax planning joint trust will provide that either spouse can unilaterally revoke up to one-half of the trust but not the entire trust. In drafting for a husband and wife whose combined estates are not likely to be subject to estate tax, a practitioner may permit either spouse to revoke the entire trust without adverse tax consequences.

The unilateral right to revoke the entire trust may be beneficial for medicaid planning purposes. If one spouse becomes incapacitated, the other spouse can revoke the trust and take appropriate planning steps. On the other hand, if the spouses both have children from prior marriages and want the trust assets to be divided between the two families following the second spouse's death, giving each spouse the right to revoke the entire trust may have unintended family consequences. If one spouse becomes incapacitated, the competent spouse can revoke the trust and redirect the assets remaining on the second death to the competent spouse's children. The incapacitated spouse's children will lose their inheritance.

In making a decision to permit either spouse to revoke the entire trust, the planner must consider both family issues and medicaid planning issues. The lawyer should advise the clients of the potential consequences of their decision regarding revocability and help them make an informed decision in view of their personal circumstances.

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Elder Law Newsletter Editor Search

The Elder Law Section is looking for a qualified person interested in serving as the editor of the Elder Law Newsletter. The editor position is a paid position and will require a commitment of editing six newsletters per year. The Section is looking for a person who is either a practicing or nonpracticing attorney with interest or experience in the elder law field and excellent writing and editorial skills. If you are interested, please contact Michael Levelle at (503) 227-1111 or fax (503) 248-0130.

What's New

Yager and Yager 155 Or App 407 (Aug 5, 1998)

After becoming engaged, Mr. Yager and his fiancée discussed Mr. Yager's various holdings. The fiancée learned of Mr. Yager's interest in a corporation and certain real and personal property. Mr. Yager also told her about his pension but did not explain the exact amount of benefits that he had accrued. Mr. Yager asked his attorney to prepare a prenuptial agreement. The attorney prepared a draft, to which he attached a copy of the property settlement from Mr. Yager's divorce from his former spouse. The property settlement listed Mr. Yager's assets but did not include the specific values of the assets. The draft prenuptial agreement provided that (1) each party retained ownership of all property owned by him or her as of the date of their marriage, (2) each made full disclosure to the other about his or her assets, (3) neither had any unanswered questions regarding the property owned by the other and (4) fiancée had read the settlement agreement attached to the prenuptial agreement. After Mr. Yager showed the draft agreement to his fiancée, she insisted that she be given a one-half interest in the house in which they resided. Mr. Yager had his attorney revise the draft agreement and urged his fiancée to seek separate counsel. Four days before the wedding, the fiancée selected an attorney, who then met with the fiancée briefly, before the parties executed the agreement in the fiancée's attorney's office.

The trial court held that the prenuptial agreement was not valid, in part because Mr. Yager's disclosure as to the nature and value of his assets was insufficient. The court of appeals reversed and remanded. The court stated the rule of *Baxter and Baxter*, 139 Or App 32 (1996), that the primary consideration is whether the parties were aware of the purpose of the agreement, and the nature and extent of the property affected by it, and whether the receiving party had sufficient time to seek counsel and review its terms. The court held, however, that "there is no hard and fast rule requiring the disclosure of the precise nature of the interest in, and the value of, each item of property."

Short and Short 155 Or App 5 (July 15, 1998)

During their marriage, Mr. and Mrs. Short established trusts for each of their children. The trust terms stated that the purpose of the trusts was to provide funds for the health, education, maintenance and support of the children. The trusts also contained the language commonly included in trust instruments that "no distributions shall be made which shall discharge any obligation of support which the person who is Trustee may have individually to the Beneficiary." (Editor's note: This language is commonly included in trust distribution provisions so that a trustee-parent is not deemed to hold a general power of appointment over the trust and thus have the trust estate included in the trustee-parent's taxable estate.)

In arriving at a support award to the children in marital dissolution proceedings, the trial court rejected Mr. Short's argument that because significant income was available to the children from their trusts, the children's needs should be considered zero, or at least reduced substantially. The court relied on the language prohibiting distributions to discharge support obligations. The court of appeals agreed with the trial court's conclusion and reliance on the language prohibiting distributions to discharge support obligations.

*Erik S. Schimmelbusch
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- January 10-17, 1999 (Sponsored by National Law Foundation) **1999 Mid-Winter Tax & Estate Planning Conference**, Frenchman's Reef Resort, St. Thomas, U.S. Virgin Islands. Telephone: (302) 656-4757.
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- February 5, 1999 (Sponsored by OSB) **Practical Tax: The Essentials of Individual and Estate and Gift Taxation with John Moore**, Oregon Convention Center, Portland, Oregon. Telephone: (503) 684-7413.
- February 10-12, 1999 (Sponsored by Intertec Trade Shows and Conferences) **Trust & Estates 10th Annual Conference on Estate Planning & Administration**, Fairmont Hotel, San Francisco, California. Telephone: Kim Greenway at (770) 618-0423.
- February 18-20, 1999 (Sponsored by ALI-ABA) **Advanced Estate Planning Techniques**, Grand Wallea Resort and Spa, Maui, Hawaii. Telephone: (800) CLE-NEWS.
- March 8-10, 1999 (Sponsored by National Law Foundation) **Sixth Annual Great Western Tax & Estate Planning Conference**, Monte Carlo Resort & Casino, Las Vegas, Nevada. Telephone: (302) 656-4757.
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Multigenerational Representation: Wandering Through the Ethical Swamp

A lawyer undertaking a multigenerational representation must consider three potential problems: ethical violations, which subject the lawyer to discipline by the Oregon State Bar; malpractice claims, which subject the lawyer to civil liability; and compromises of the client's estate plan by claims of undue influence by disgruntled beneficiaries, which, although they may not give rise to either ethical violations or civil liability, can damage the lawyer's relationship with the family as well as his or her professional reputation.

Oregon Rules of Ethical Conduct

Conflicts of interest. A lawyer engaged in multigenerational representation must identify conflicts inherent in that representation. Oregon Disciplinary Rule ("DR") 5-105 identifies two types of conflicts of interest between current clients: actual and likely. An "actual" conflict exists when the lawyer "has a duty to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client." DR 5-105(A)(1). A "likely" conflict exists in all other situations "in which the objective personal, business or property interests of the clients are adverse," other than situations in which the only conflict is of a general economic or business nature. DR 5-105(A)(2). In general, a lawyer may not represent multiple current clients in any matters when such representation would result in an actual or likely conflict. DR 5-105(E). However, there is an exception to this rule if two requirements are met: (1) the representation will not result in an actual conflict; and (2) each client consents to the multiple representation after full disclosure. If undertaking a multiple representation gives rise to an actual conflict, the lawyer may not proceed *even with full disclosure and consent from all parties*. An actual conflict ordinarily exists, for example, when a lawyer represents both sides of a sales transaction, debtor-creditor transaction or other, similar, transaction. See, e.g., *In re Jordan*, 300 Or 430 (1985); *In re Renn*, 299 Or 559 (1985).

Whenever disclosure and consent are required, DR 10-101(B) comes into play:

(1) "Full disclosure" means an explanation sufficient to appraise the recipient of the potential adverse impact on the recipient, of the matter to which the recipient is asked to consent.

(2) As used in DR 5-101, DR 5-104, DR 5-105, DR 5-107, DR 5-109 or when a conflict of interest may be present in DR 4-101, "full disclosure" shall also include a recommendation that the recipient seek independent legal advice to determine if consent should be given and shall be contemporaneously confirmed in writing.

For a discussion of the disclosure and consent process, see *The Ethical Oregon Lawyer ("EOL")* §§ 11.4, 12.17 (OSB CLE 1991 & Supp 1998). For a useful collection of disclosure and consent form letters with commentary, see "Beating Discipline and Malpractice: The How and Why of Effective Disclosure and Consent Letters" (OSB CLE Dec. 1993).

The Oregon State Bar has not addressed the conflicts inherent in multigenerational representation, but it has addressed an analogous situation. OSB Legal Ethics Op No. 1991-116 addresses three questions in connection with a lawyer's representation both of a charity and of a donor who wishes to make certain gifts to that charity. Of particular relevance to this discussion is whether "with full disclosure and consent * * * from

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Donor pursuant to DR 10-101(B),” a lawyer may prepare a will for the donor leaving property to a charity the lawyer also represents. The opinion states that DR 5-101(A) applies to the drafting of the will; therefore, the lawyer would have to disclose the lawyer’s representation of the charity and obtain the consent of the donor before drafting the will. This same logic presumably would apply, for instance, when a mother wishes to leave a bequest to her daughter and the lawyer represents both of them separately: The lawyer arguably has the duty to disclose to the mother that the lawyer also represents the daughter and to obtain the mother’s consent before drafting her will. (One also might argue that in such a situation, the daughter is a natural object of the mother’s bounty, so no likely conflict exists and no consent is required. However, if the mother favors the daughter over other children in the mother’s will, that logic may not hold.)

Conflicts may also arise in the representation of family members and their closely held businesses, particularly family limited partnerships and limited liability companies. The lawyer must determine who among the many parties to the transaction the lawyer represents—the entity, the manager(s) or general partner(s) or the non-managers. An actual conflict will not usually exist upon the formation of an LP or LLC, because all of the parties are seeking the same result. However, a likely conflict almost always exists between the partners or members, and particularly between the managing and non-managing partners or members.

The question of client identity in the context of corporations and partnerships is further complicated by the fact that, in some cases, representation of the entity may be equivalent to representation of the owners of the entity. OSB Legal Ethics Op No. 1991-85 states that, in general, an attorney who represents an entity represents the entity only, and not its employees, shareholders or owners.

However, there are two possible exceptions to this rule. First, in *In re Banks*, 283 Or 459 (1978), the court held that representation of a corporation whose stock is owned by a single individual or by a single individual and a member of the individual’s family constituted representation of the individual. This was so because at the time of the legal work in question the individual was the corporation and had no reason “to differentiate in his mind between his own and corporate interests.” *Id.* at 474. It is not clear whether the *Banks* rationale would apply to a family-owned entity in which all the family members were in agreement that the entity was actually a joint endeavor and not merely an alter ego for one of the family members. See generally *EOL* ch 6 (OSB CLE 1991 & Supp 1998). Second, if a lawyer leads a shareholder to believe that he or she is an individual client, a court could hold that the shareholder is a client under the so-called reasonable expectations test. See *id.* §§ 6.3-5, 166-67. Regardless of the conclusion the lawyer reaches about whom she should represent, she should make the representation clear through the use of engagement (and nonengagement) letters.

Client confidences and secrets. The keeping of client confidences raises two issues. First, all lawyers know that they may not reveal a client’s confidences or secrets. See DR 4-101. The Oregon State Bar has noted that client confidences potentially can be disclosed when a lawyer represents both a testator and a beneficiary. In OSB Legal Ethics Op No. 1991-116 (discussed above), the opinion states in a footnote that if a lawyer needs to disclose a beneficiary’s confidences or secrets in order to prepare a testator’s will, the lawyer must obtain the consent of the beneficiary before such disclosure can be made.

Second, although not technically an ethical issue, lawyers and non-lawyers alike know that there is a privilege against disclosing attorney work product. The privilege may be lost, however,

through disclosures to third parties. Whether the attorney-client privilege can be maintained over correspondence to a third party may depend upon the role that third party is playing. For instance, if an accountant serves merely as a conduit between the lawyer and the client, no privilege is available over communications to the accountant. *First Interstate Bank of Or. v. National Bank & Tr.*, 127 FRD 186 (D Or 1989). See generally Annotation, “Applicability of Attorney-Client Privilege to Communications Made in the Presence of or Solely to or by Third Person,” 14 ALR4th 594 (1982 & Supp 1998). Common sense indicates that, whenever possible, a lawyer should not include a third party in conversations or correspondence for which a client may wish to assert a claim of privilege unless that person’s involvement is necessary to provide legal advice.

Malpractice Liability

Lawyer liability arises when a lawyer has committed legal malpractice, which involves the four classic elements of negligence: duty, breach of that duty, causation and damages. A lawyer’s “duty” in this context is to use the care, skill and diligence that ordinarily would be used by lawyers in the community in similar circumstances. *Arp v. Kerrigan*, 287 Or 73 (1979). The most important issue is identifying the party to whom the attorney may be liable. Most lawyers believe that a lawyer is liable only to the client, not to third parties. However, the Oregon Supreme Court, in *Hale v. Groce*, 304 Or 281 (1987), held that an attorney can be liable to an intended beneficiary both under a third-party beneficiary claim and under a derivative tort claim based on negligence.

Conflicts of interest may also expose a lawyer to liability. A conflict must harm a client before it results in liability. In *Hilt v. Bernstein*, 75 Or App 502, 510 (1985), the court held that a conflict of interest alone was insufficient to create negligence liability because a violation of disciplinary rules “should not constitute negligence as a matter of law in a civil action for damages against the violator.” Nevertheless, the presence of a conflict in a malpractice action will at the very least cast doubt upon the lawyer’s credibility before a trier of fact. Further, if the lawyer’s involvement in multigenerational planning leads to a claim of undue influence, the lawyer may be found to have actually harmed the client as a result of the conflict and therefore may be exposed to a malpractice claim.

Undue Influence and the Estate Planner

A finding of undue influence by a court in connection with a client’s estate plan can set aside that plan completely. Undue influence can be proven in Oregon by showing the existence of several factors, including the participation of the beneficiary in the preparation of the will and the fact that the testator did not receive independent legal advice. *Troyer v. Plackett*, 48 Or App 497, 500-02 (1980) (citing *In re Reddaway’s Estate*, 214 Or 410, 419-20 (1958)). For example, in *Pluchos v. Boehle*, 219 Or 164, 166-67 (1959), the Oregon Supreme Court found that where “a will is drawn by an attorney for the beneficiary who enjoys a confidential relationship with the testator, a presumption of undue influence arises.” *Id.* at 166-67. This case involved an 84-year-old testator who, twelve days before being committed to a state hospital, drafted a codicil naming as a beneficiary a woman more than fifty years younger than the testator who had been focusing her “blandishments and ‘affectionate’ attentions” upon him daily. *Id.* at 166. The beneficiary selected the lawyer who although not “knowingly a party to [the beneficiary’s] fraud,” had never met the testator. *Id.* at 167.

The presence of a lawyer chosen by a beneficiary is not always

a factor tending to show undue influence, however. In *Sheppard v. Kartes*, 19 Or App 567 (1974), the court found no undue influence where a testator, en route to a hospital, requested that two of her daughters go to a lawyer to prepare a will leaving the testator's property to those two daughters and to grandchildren and disinheriting the testator's other children. In upholding the will the court relied on the fact that two years had elapsed before the testator's death, giving her plenty of time to change her mind, and on evidence showing a history of friction between the testator and the disinherited children.

Because the involvement of a lawyer who has been engaged by a beneficiary can be a factor in a finding of undue influence, a lawyer contemplating multigenerational representation should be wary. For example, is a lawyer who represents Child and who is subsequently engaged to draft a will for Parent, under which Child is named as sole beneficiary to the exclusion of other children, liable for malpractice? Such liability could arise if the lawyer knew or should have known that his or her participation in Parent's estate planning would lend even superficial credence to the disinherited children's allegation of undue influence. Put another way, does the lawyer have a duty not to represent Parent simply because the lawyer's participation makes litigation more likely, regardless of the merits of such litigation? There is no Oregon law on this point, and the more reasonable view, stated in *Sheppard*, is that such participation by itself, when there are independent facts demonstrating that disinheritance is appropriate, should not raise a presumption of undue influence. However, the beneficiaries in *Sheppard* undoubtedly spent much time and money on the subsequent litigation. Is that cost and frustration enough to lead a lawyer not to get involved in the first place?

Conclusion

When considering whether to undertake a multigenerational representation, an Oregon lawyer must not only identify who will be the clients, and the potential conflicts among them, but also determine whether the lawyer's mere presence in the planning process could give a third party the ability to challenge the estate plan through an allegation of undue influence. The risk of such an allegation being made will increase dramatically when the lawyer represents the members of the older generation and some but not all members of the younger generation.

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Elder Law Newsletter Editor Search

The Elder Law Section is looking for a qualified person interested in serving as the editor of the Elder Law Newsletter. The editor position is a paid position and will require a commitment of editing six newsletters per year. The Section is looking for a person who is either a practicing or nonpracticing attorney with interest or experience in the elder law field and with excellent writing and editorial skills. If you are interested, please contact Michael Levelle at (503) 227-1111 or fax (503) 248-0130.

State of Oregon Requirements for Registration of Charitable Trusts

With the rising popularity of charitable trusts, some confusion exists among practitioners about the Oregon requirements for registration of trusts that contain some type of charitable interest. Below are portions of a letter from Ross L. Laybourn, Attorney-in-Charge, Charitable Activities Section of the Department of Justice. The letter was the result of an inquiry as to whether a trust which paid income to a beneficiary for life but at death left a percentage of the estate to charity, was the type of "split interest" trust that should be registered.

Excerpts from the letter, printed below, clarify registration requirements.

Representatives from this office are called upon to review a wide variety of trusts with charitable interests, both living and testamentary trusts. To date, much of our guidance has depended upon "facts and circumstances." This correspondence is to advise you that we intend to adopt a new policy in order to provide greater clarity to our staff and practitioners.

ORS 128.650 directs the Attorney General to establish a register of charitable trusts "which hold property for charitable purposes...." Historically, OAR 137-10-005(1) has specified, in part, that registration is incumbent upon "trustees of charitable remainder trusts." To date, the statute and administrative rules have provided no additional guidance to trustees of split interest trusts. Effective immediately, it is the intention of this office to register such trusts only in the following described circumstances:

- (1) Split interest trusts characterized by the fact that the donor receives a charitable contribution deduction for the value of the income or the remainder interest. Typically, such trusts may be characterized as charitable lead trusts, pooled income funds, charitable remainder annuity trusts or charitable remainder unitrusts. These trusts are also typically identified by the federal requirement to file Form 5227 with the Internal Revenue Service.
- (2) Trusts characterized by the fact that the trustee is obligated to pay a portion of the annual income to charitable beneficiaries (typically in addition to noncharitable beneficiaries) regardless of whether the donor could claim a charitable contribution deduction.

Despite the fact that this office is prepared to acquiesce to the non-registration of certain nonqualifying split interest trusts, the Attorney General continues to have general common law and statutory authority over trusts devoted in whole, or in part, to charitable purposes. See, for instance, ORS 128.630, 128.680 and 128.710(2). Therefore, the exemptions described herein are only related to registration pursuant to ORS 128.650 and annual reporting as provided in ORS 128.670.

The above information should assist practitioners and clients in determining when and when not to register a trust if some portion of its corpus goes to charity.

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Representing Husband and Wife in Estate Planning

Multiple Client Issues

When a husband and wife seek estate planning advice, they probably expect a lawyer to represent both of them in developing the estate plan. But Oregon Disciplinary Rule DR 5-105(E) prohibits a lawyer from representing multiple current clients when such representation will result in an actual or likely conflict. Should this prevent the lawyer from representing them? Normally it does not.

Lawyers usually find that the husband and wife share major goals, such as a desire to reduce estate taxes and an intent to benefit the same persons or charities on the death of the second of them. Where the goals are the same, the disciplinary rules governing lawyer ethics are clear: there is neither a conflict, nor even a "likely conflict" as that term is used in DR 5-105, and representing the couple is not a problem.

Often the husband and wife, especially when it is neither's first marriage, wish to benefit different individuals. In that context, advising the couple about their planning has more of a potential to put the lawyer into a conflict of interest situation. Worse, either the husband or wife may disclose information to the lawyer which he or she wishes to keep confidential from the other spouse. Can the lawyer represent both individuals under either of these situations?

Assistance in resolving these issues comes from the Oregon Disciplinary Rules (the "Oregon Rules") and some insightful commentaries published by the American College of Trust and Estate Counsel (the ACTEC Commentaries) to the American Bar Association's Model Rules of Professional Conduct (the "Model Rules"). Although the Oregon Rules differ in significant ways from the Model Rules, it is not the purpose of this article to focus on those distinctions. For the purposes of most estate planners, the ACTEC Commentaries are a useful guide to issues governed by the Oregon Rules. The ACTEC Commentaries are available from the ACTEC Foundation, at its Web site, www.actec.org, or at 3415 South Sepulveda Boulevard, Suite 330, Los Angeles CA, 90034. References in this article are to the second edition of the ACTEC Commentaries (1995).

Estate planning is generally nonadversarial in nature. The common interests of husband and wife in getting cost-effective representation and achieving common objectives with a well coordinated plan — based on a full understanding of both spouses' assets and goals — usually are more significant than any different interests they may have. For these reasons, spouses are often best served if one lawyer represents them both.

The ACTEC Commentaries recognize two modes of representation for the lawyer representing husband and wife. The first mode, and the one most frequently used, is joint representation, treating both spouses as essentially one client. Joint representation is based on the assumption that on most issues, the two spouses are in agreement, or to the extent they do not agree, that they are sufficiently independent, so agreement is not required. Absent an agreement to the contrary, joint representation is assumed. ACTEC Commentaries at 66.

The second mode of representation recognized in the ACTEC Commentaries is separate representation. In this mode, the lawyer treats each spouse as a separate client. The lawyer does not share

information between the two clients, except to the extent that it fosters the purposes of each. Consistent with the view that joint representation is assumed absent an agreement to the contrary, the ACTEC Commentaries require advance approval of the clients for the lawyer to engage in separate representation. *Id.* at 87.

Because it is assumed to most closely match the expectations of the clients, joint representation does not require special disclosures. However, the ACTEC Commentaries recommend that lawyers discuss the mode of representation with the clients at the outset. This can help prevent one spouse from revealing a confidence to the lawyer which will have to be shared with the other spouse under the general rules of joint representation.

The separate representation approach, at least in theory, avoids the risk of sharing confidences. The lawyer in a separate representation context is required to keep the confidences of each spouse secret from the other. However, this might put the lawyer in a situation where the lawyer will learn a confidence from one spouse that creates an actual conflict with the other spouse, and thus requires that the lawyer discontinue representation, as described in DR 5-105 (A)(1). For this reason, many observers doubt that separate representation is a practical alternative to joint representation. See, e.g., John R. Price, *Contemporary Estate Planning* § 1.14.2 (1992 & Supp 1998) (contending that separate representation is inconsistent with lawyer's primary duty of loyalty).

Joint representation requires the lawyer to share information between the clients to the extent that the information is relevant to the purpose of the representation, or withdraw. Joint representation does not require that information be shared where the information is not related to the purpose of the representation.

A lawyer in a joint representation context who receives confidential information from one spouse must determine whether his or her duty of loyalty to the other spouse creates a conflict, keeping in mind the nondisclosure rules of DR 4-104. The first part of the analysis is to determine whether the confidential communication concerns the subject of the representation of the other spouse. Consider a husband and wife with a several-year marriage who consult with a lawyer for estate planning. During the preparation of the plan, the husband informs the lawyer of a past marital infidelity. Since it is doubtful that the husband's disclosure is relevant to the estate planning, the duty of loyalty to the other spouse does not create a conflict.

At the other extreme, assume that with respect to the same couple the lawyer recommends that the wife transfer some of her substantial assets to the husband, so that each has sufficient assets to fund a credit shelter trust. During the planning, the husband tells the lawyer that he is having an affair and plans to leave his wife after the assets are transferred. Here, the information is highly relevant to the representation of the wife. But DR 4-104 requires preservation of the confidence. Under these circumstances the ACTEC Commentaries recommend the lawyer encourage the husband to disclose the information to his wife or allow the lawyer to do so. If the husband will do neither, the lawyer should withdraw from representing either. ACTEC Commentaries at 67. The withdrawal itself may raise the wife's suspicions to the point that she ultimately discovers the confidence. But withdrawal under these facts may be inadequate to protect the wife and her interests.

Consider whether full discussion of joint representation or an appropriate engagement letter, advising both spouses that the lawyer cannot keep any such confidences and continue the representation, might have prevented the problem. If the ground rules are well understood, the husband is put on notice of the impact of disclosing confidential information.

If the husband and wife do not agree on goals in estate planning,

it is less likely that a lawyer will encounter a likely or actual conflict. Here, the issue does not involve keeping information secret. Many spouses in second or later marriages wish to leave their assets to different beneficiaries, and the use of marital trusts may affect the spouses differently. However, different choices by each spouse with respect to his or her own assets should not create a conflict.

A likely or actual conflict may well arise when the spouses disagree on issues in which only one spouse can prevail, such as disputes over ownership rights, or the characterization of property as separate, joint or community, or where the potential exists for one spouse to defeat the other's estate plan, as by using the elective share. If such disputes do come up, the lawyer can withdraw without triggering adverse consequences, since the nature of the dispute is known to both parties.

No single step can prevent the estate planning lawyer from running into potentially difficult situations in representing husband and wife. However, it seems obvious that the frequency with which those situations arise will decrease, and the satisfaction of the clients with the lawyer's handling of these issues will increase, if the lawyer includes in the first meeting a frank discussion of his or her responsibilities in representing both.

Former Client Issues

In OSB Legal Ethics Op No. 1997-148, the Oregon State Bar Board of Governors answered the question of whether a lawyer who had previously represented a husband and wife in family estate planning matters can now represent the wife in the dissolution of the marriage. The opinion discusses the issue from the assumption that the husband is a "former client," as that term is used in DR 5-105. The opinion does not state how the Board of Governors reached that conclusion.

In actual practice, estate planning lawyers may find it difficult to know when an estate planning client has become a former client. However, OSB Legal Ethics Op No. 1997-148 should not be taken as an endorsement of a position that estate planning clients automatically become former clients after the documents are signed. Of course, a lawyer can terminate the relationship after the wills or trusts are signed by sending a termination letter to the client, but such a practice would be contrary to the lawyer's self-interest and, I believe, to the client's best interest as well.

The relationship of the lawyer and client may go into a dormant phase after the documents are signed. It is likely that the client still thinks of the lawyer as his or her lawyer, but has no immediate need for services.

The existence of the lawyer-client relationship is generally viewed from the perspective of the reasonable expectations of the clients.

The Ethical Oregon Lawyer § 6.3 (OSB CLE 1991 & Supp 1998). The belief of the clients in a continuing relationship may be enough to establish that they are current clients, even though no current work is being done.

Although not directly related to estate planning, OSB Legal Ethics Op No. 1996-146 is instructive on the subject of whether an estate planning client remains a current client after the documents are signed. In that opinion, the Board of Governors pointed out that periodic reminder letters from an attorney after work is completed can create a current client relationship under the reasonable expectation of the client test.

If the lawyer sends periodic reminders to review estate plans, or retains the client's wills or other documents, the client may well have the subjective belief that representation continues, and that belief is supported by the objective facts. In order to avoid the conclusion that the client is still a current client, OSB Legal Ethics Op No. 1996-146 suggests that the lawyer would have to send a written notice of termination. Further, if the lawyer continues to send long-term docket notices, the opinion suggests he or she should add to them an advisory that the notice is not for the purpose of providing legal advice, but merely to serve as a reminder.

Lawyers who represented husband and wife in estate planning, and whose clients are divorcing, should consider the implications of OSB Legal Ethics Op No. 1996-146 before assuming that OSB Legal Ethics Op No. 1997-148 allows them to represent one of the parties in the dissolution.

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CLE: Advanced Will and Trust Drafting & Administration

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Designed for practitioners who want to refine their trust drafting skills, this practical program takes a "how to" approach to complex trust drafting issues. Our expert faculty will share drafting strategies, practice tips, and sample language for marital deduction and GST funding formula clauses, trust language in light of the Uniform Prudent Investor Act, and tax clauses. Learn about draft-

ing from a fiduciary's perspective and income tax and funding consequences for marital and GST clauses. The written materials will include a handy reference chart outlining formula and funding clauses and their consequences. This program is designed for the practitioner who has a basic working knowledge of trusts and who wants to examine their use in greater depth. Cosponsored by the Estate Planning and Administration Section. To register, or for more information, contact the OSB CLE Order Desk at (503) 684-7413, or toll-free in Oregon at 1-800-452-8260, ext. 413.

Report from the Legislature

The Estate Planning and Administration Section sent three bills to the Legislature with the approval of the Oregon State Bar. At the time of publication, both the House and the Senate have voted in favor of all three bills.

HB 2290. This bill adopts the 1993 Revisions to the Uniform Simultaneous Death Act. The bill amends ORS 112.575, *et seq.*, and provides that a person will be treated as surviving the decedent only if the person survives the decedent by at least 120 hours. Oregon already applies this rule for purposes of intestate succession and taking under the will of the decedent. ORS 112.085. By amending Oregon's Uniform Simultaneous Death Act, the bill will make the 120-hour rule applicable to other transfers occurring by reason of death, such as the right of a surviving joint tenant to take joint tenancy property or payments to a beneficiary designated under a life insurance policy. Of course, both the existing statute and the proposed changes apply to determine whether a person survived only if the decedent did not provide otherwise in the will, trust or contract that controls the disposition of the property.

HB 2291. This bill adopts the 1991 Revisions to the Uniform Testamentary Additions to Trusts Act. The bill amends ORS 112.265, which provides that a will may make a devise to a trust regardless of whether the trust is funded before the testamentary transfer, if the terms of the trust are in writing. The bill deletes the requirement that the trust document be executed before or concurrently with the will and permits the trust document to be executed after the will is executed.

HB 2292. This bill repeals ORS 112.017, the common law spouse statute.

The Guardianship Workgroup — a coalition of the Long-Term Care Ombudsman, the Douglas County Senior & Disabled Service Division, the Oregon Advocacy Center, the Oregon Law Center and the American Association of Retired Persons — has prepared two bills that are likely to be introduced this session.

LC 580-1. This bill amends the provisions of ORS Chapter 125 relating to the appointment of a guardian. The bill requires that counsel be appointed for a respondent in a guardianship proceeding upon recommendation by a court visitor or if a hearing is required either by the court or because of an objection to the petition.

The bill substantially expands the duties of court visitors in guardianship proceedings, requiring a court visitor to make specif-

ic factual findings and to assess the legal sufficiency of a petition. Under the bill, court visitors must be employees or officers of the court. The bill requires that the court visitor conduct a review of the guardianship one year after the appointment of a guardian and every two years thereafter, or more frequently if requested by the court visitor. The bill allows the court to approve payment of the visitor from the respondent or protected person's estate.

The bill expands the list of persons entitled to receive notice of the filing of a petition for guardianship to include (1) any attorney who has represented the respondent in any capacity within three years before the filing, (2) the office of the Long-Term Care Ombudsman if the respondent lives in a nursing home or residential facility and (3) an advocate of the rights of individuals with developmental disabilities if the respondent is a resident of a mental health treatment facility. The bill prescribes the type of notice that must be provided to the respondent.

LC 581-1. This bill modifies the law relating to professional fiduciaries who serve in protective proceedings. The bill defines a professional fiduciary as any fiduciary who is acting as a fiduciary for two or more protected persons who are not related to the fiduciary and who receives compensation for acting as a fiduciary. The bill provides that before being appointed, a professional fiduciary must submit detailed information to the court. The information must include the fiduciary's educational background, the fees expected to be charged, the number of protected persons for whom a professional fiduciary acts as a fiduciary, the results of a criminal record check of the fiduciary and the fiduciary's staff and whether the professional fiduciary and any staff have been certified by a national or state association of professional fiduciaries.

The bill also requires that a fiduciary obtain court approval before employing a person or entity in which the fiduciary has a financial interest. A fiduciary has a financial interest in another person or entity if the fiduciary has an ownership interest in, a business association with, or a financial involvement with the person or entity, or if the fiduciary obtains a financial benefit tied to the services provided by the person or entity to the protected person. The fiduciary must also obtain court approval for fees or expenses that exceed the amount that would have been incurred had the fiduciary provided the services alone.

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What's New

Kirkeby v. Covenant House, 157 Or App 309 (1998)

This case discussed two issues of interest to Oregon estate planning and probate lawyers: (1) whether the statutory requirement that a prior signature on a will be acknowledged in the presence of two witnesses was satisfied, and (2) whether an election against the will may be made by the personal representative of the surviving spouse.

Will must be acknowledged in the presence of witnesses. In July 1992, the decedent, Margaret, decided to change her will. After marking up changes in her prior will and a codicil to that

will, she asked a neighbor, Lyman, to type up a new will. Lyman typed it on two pages and delivered it to Margaret, who signed it the same day.

After signing the will, Margaret called Horton, a notary whom she knew, and told Horton that she had signed a document and that she wanted Horton to notarize it. Lyman took the second page of the will to Horton, who recognized Margaret's handwriting and notarized the second page. Horton did not know the document was a will and saw only the second page.

Ten days later, Margaret asked Lyman if she had had the will

witnessed. Lyman replied that she had not and took the will to her house to type "witness" lines on the second page. Margaret then called another neighbor and asked the neighbor to witness the will. When Lyman returned with the will, Margaret asked Lyman to take the will to the neighbor's house to have it witnessed. Lyman then took the second page to the neighbor's house, where the neighbor Margaret had talked to and another neighbor signed as witnesses. Lyman returned the will to Margaret. Margaret died a few weeks later.

The trial court held that the will was not properly witnessed by any of the three possible "witnesses," and the Court of Appeals affirmed. ORS 112.235 requires that the testator either sign the will or acknowledge a prior signature "in the presence of each of the witnesses." The court held that the will bearing the signature that the testator acknowledges must be before the witness at the time of the acknowledgment. In addition, the witnesses must be close enough at hand, if not in actual sight of the testator, to know that the instrument which was presented to them was the instrument which bore the signature that the testator acknowledged. In this case, none of the "witnesses" met that requirement, and none could have known whether Margaret had even actually signed the instrument at the time she stated her "acknowledgment." Interestingly, the court expressly did not resolve the question of whether a telephonic acknowledgment would satisfy the "in the presence" requirement. The court also held that the 1989 will, as originally executed, remained valid, applying the doctrine of "dependent relative revocation."

Election against will cannot be made by personal representative of surviving spouse. Shortly after the 1989 will was admitted to probate, the decedent's husband, Orrin, signed an election to take against the will. However, he told his attorney to hold the document and not to file it. Several days later, Orrin died. After Orrin's death and within the statutory period for filing the election, Orrin's attorney filed the election at the request of Orrin's personal representative. At issue was whether the election filed by the personal representative was valid. The trial court held that it was not, and the Court of Appeals affirmed. The court concluded that the right of election was for the surviving spouse's benefit, and was therefore personal to Orrin and could only be exercised during his lifetime. The court noted that with one express exception, ORS 114.105 and 114.145 specifically provide that the "surviving spouse" may make, serve, and file the election, and that there is "nothing in those provisions that suggests that the election can be served or filed by any other person, including the heirs of the surviving spouse." In the court's view, the only exception to this rule is ORS 114.155, which allows a court or conservator to elect against the will if additional assets are needed for the reasonable support of the surviving spouse. This opinion calls into question whether the election can be made by an agent or attorney-in-fact of the surviving spouse, a power commonly found in durable powers of attorney.

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Allen v. Hall, SC Case No. S45130, (Feb. 1999), (1999 WL 62458)

Oregon has now joined a growing number of states that recognize the tort of intentional interference with prospective inheritance. In a case of first impression on questions certified to it from the Ninth Circuit, the Oregon Supreme Court in *Allen v. Hall*, SC Case No. S45130, (Feb. 1999), (1999 WL 62458), held that the "new" tort was a reasonable extension of the well-established tort known as intentional interference with economic relations.

The plaintiffs had alleged that the defendants, the decedent's friends and sole beneficiaries under his will, spoke with the decedent's lawyer from the hospital and falsely told her that the decedent lacked testamentary capacity and was thus unable to execute the new will she had prepared benefitting the plaintiffs, the decedent's niece and nephew. As a result, the lawyer did not bring the new will to the hospital, and the decedent died without having executed it. The plaintiffs had no remedy in the probate court because they lacked standing (the decedent's mother and sister survived him) and there were no grounds for challenging the will admitted to probate. They filed a diversity action in federal court. The magistrate judge granted the defendant's motion to dismiss for failure to state a claim.

Justice Gillette, writing for the court, said that the tort of intentional interference with economic relations is applicable to a prospective inheritance and the same elements apply to the new tort—namely (1) the existence of an economic advantage, (2) an intentional interference with that advantage, (3) by a third person, (4) accomplished through improper means or for an improper purpose, (5) a causal effect between the interference and the harm to the advantage, and (6) damages. In saying that the same elements of the existing tort apply in both business and inheritance contexts, the court departed from the Restatement (Second) of Torts § 774B version of the tort of intentional interference with prospective inheritance, which requires that the defendant's conduct be "independently tortious" rather than merely "wrongful" because of improper motives or means. Justice Gillette reasoned that the existing tort already protects other prospective interests, such as prospective customers or employment, and that the fact that an inheritance is prospective does not mean it is not worthy of protection under the already-recognized claim. Justice Gillette also noted that prospects of inheritance long have been recognized as interests that are worthy of common-law protection—*e.g.*, suits to set aside deeds are allowed to be brought by heirs and beneficiaries, and *Hale v. Groce*, 744 P 2d 1289 (1987), permitted an intended beneficiary to sue a lawyer for failing to include a gift to the plaintiff in the decedent's will as directed by the decedent.

The opinion leaves open several questions: Can a tort claim be brought in circuit court even though the plaintiff also has a remedy in the probate court in the form of a will contest? What must be alleged to establish a "prospective" inheritance? Can the tort claim be brought while the testator or trustor is still alive?


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CALENDAR OF SEMINARS AND EVENTS

- May 13, 1999 (Sponsored by ALI-ABA) **VLR: Annual Spring Estate Planning Practice Update**, American Law Network, Live Satellite TV Nationwide. Telephone (800) CLE-NEWS.
- May 20, 1999 (Sponsored by ALI-ABA) **VLR: Estate Planning for Distributions from Qualified Plans and IRAs**, American Law Network, Live Satellite TV Nationwide. Telephone (800) CLE-NEWS.
- May 21, 1999 (Sponsored by The Estate Planning Council of Portland, Inc. & The Northwest Planned Giving Roundtable) **3rd Annual Advanced Charitable Estate Planning Strategies Seminar**, The Multnomah Athletic Club, Portland, OR. Telephone (503) 797-2666.
- May 24, 1999 (Sponsored by The Oregon Society of Certified Public Accountants) **Tax Wise Planning Strategies for Family Business Owners and Professionals**, Beaverton, OR. Telephone (810) 255-1470.
- May 25, 199 (Sponsored by Practicing Law Institute) **Use of Trusts in Estate Planning: Drafting Tips, Tax Consequences and Ethical Considerations**, New York, NY. Telephone (212) 824-5746.
- June 9, 1999 (Sponsored by The Oregon Society of Certified Public Accountants) **A Complete Guide to the Administration of Trusts and Estates**, Beaverton, OR. Telephone (800) 255-1470.
- June 10, 1999 (Sponsored by The Oregon Society of Certified Public Accountants) **Tax Wise Planning Strategies for Family Business Owners and Professionals**, Beaverton, OR. Telephone (800) 255-1470.
- June 10, 1999 (Sponsored by The Oregon Society of Certified Public Accountants) **Mastering the Fundamentals of Estate Planning**, Beaverton, OR. Telephone (800) 255-1470.
- June 10-11, 1999 (Sponsored by ALI-ABA) **Estate Planning Techniques**, Regal Alaskan, Anchorage, AK. Telephone (800) CLE-NEWS.
- June 13-18, 1999 (Sponsored by ALI-ABA) **Estate Planning in Depth**, University of Wisconsin, Madison, WI. Telephone (800) CLE-NEWS.
- June 18, 1999 (Sponsored by The Oregon Society of Certified Public Accountants) **Post-Mortem Estate Planning: Forms 706, 1041 and 1040**, Beaverton, OR. Telephone (800) 255-1470.
- June 24-25, 1999 (Sponsored by ALI-ABA) **Representing Estate and Trust Beneficiaries and Fiduciaries**, Stanford Court, San Francisco, CA. Telephone (800) CLE-NEWS.
- June 25, 1999 (Co-sponsored by Oregon State Bar and Estate Planning and Administration Section) **Advanced Will and Trust Drafting & Administration**, Portland, OR. Telephone (503) 684-7413.
- July 14-16, 1999 (Sponsored by New York University) **Introduction to Trusts & Estates**, New York, NY. Telephone (212) 790-1321.
- July 21-23, 1999 (Sponsored by ALI-ABA) **Basic Estate and Gift Taxation and Planning**, Hotel Loretto, Santa Fe, NM. Telephone (800) CLE-NEWS.
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- September 16-17, 1999 (Sponsored by ALI-ABA) **Sophisticated Estate Planning Techniques**, Fairmont Copley Plaza, Boston, MA. Telephone (800) CLE-NEWS.
- September 23-24, 1999 (Sponsored by Practicing Law Institute) **30th Annual Estate Planning Institute**, New York, NY. Telephone (212) 824-5746.
- September 30-October 2, 1999 (Sponsored by ALI-ABA) **Post-Mortem Planning and Estate Administration**, New York Hilton, New York, NY. Telephone (800) CLE-NEWS.
- October 4-5, 1999 (Sponsored by Washington State Bar) **Estate Planning**, Convention Center, Seattle, WA. Telephone (206) 727-8202.
- October 7-8, 1999 (Sponsored by Practicing Law Institute) **30th Annual Estate Planning Institute**, San Francisco, CA. Telephone (212) 824-5746.
- October 24-28, 1999 (Sponsored by New York University) **58th Institute on Federal Taxation**, New York, NY. Telephone (212) 790-1321.
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Elective Share Statutes: Policies and Problems

An elective share statute allows a decedent's surviving spouse either to accept the assets given to the spouse under the decedent's will or to elect against the will and take a statutorily set portion of the decedent's estate. An elective share statute thus prevents one spouse from disinheriting the other spouse. Two theories stand behind this restriction on testamentary freedom — the need-based theory and the marital partnership theory.

Theoretical Bases for the Elective Share

Need-based theory. The need-based theory reflects society's concern that the surviving spouse not be left to depend on the state for support. The decedent should not be permitted to leave the surviving spouse destitute, and the public's burden to care for the surviving spouse should be relieved, to a degree, by the decedent spouse's assets.

Marital partnership theory. The marital partnership theory views marriage as an economic partnership to which both spouses contribute productive effort and holds that each spouse is entitled to one-half of the economic gains of the marriage. Although one spouse may work at home and not contribute wages in building marital assets, that spouse does contribute economically as well as noneconomically to the marriage. The title-holding spouse should not be able to deprive the non-propertied spouse of his or her share of marital assets.

Marital Dissolution Uses Partnership Theory.

Family law has incorporated the marital partnership theory into the distribution of property that occurs when a marriage terminates by dissolution. In non-community property states, courts use equitable distribution to divide property on divorce. The trend is to give each spouse half of the marital assets, but the court considers many factors in dividing the property. Depending on the state, assets brought to the marriage or inherited during the marriage may be excluded.

In a divorce setting, both parties can bring forward evidence concerning which property is marital property and whether one spouse did not in fact adequately contribute to the marriage and therefore is not entitled to one-half of the assets. These issues are difficult to address in an elective share context where only one spouse is alive. In general, the probate process depends on fixed rules and limited judicial discretion. Providing a statutory elective share that applies fairly to a wide range of family situations presents many challenges.

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Structure of the Elective Share

An elective share statute has three components. The first is the share or percentage to be taken. The second is the estate subject to the elective share — the probate estate or an augmented estate. The third is how the elective share amount is paid — what offsets are taken and which assets are used first to fund the elective share amount.

Oregon. Oregon's elective share statute gives the surviving spouse the right to elect a one-fourth share of the decedent's probate estate. ORS 114.105. The share can be reduced if the spouse receives assets outside probate — the maximum the surviving spouse can receive is one-half of the decedent's probate and nonprobate assets, including gifts made within three years of death. ORS 114.125. However, the elective share will not be increased if assets pass outside probate to anyone other than the surviving spouse. Although a transfer to someone other than the surviving spouse could be challenged as fraud on the elective share, generally nonprobate transfers such as revocable trusts will not be subject to the elective share in Oregon.

The court may deny or reduce the elective share if the decedent and the surviving spouse were living apart when the decedent died. ORS 114.135. Further, the right to an elective share is personal to the surviving spouse. If a non-propertied spouse does not survive the title-holding spouse or if the non-propertied spouse survives but dies before filing the election, the non-propertied spouse's estate will have no right to a share of the marital assets. *Kirkeby v. Covenant House*, 157 Or App 309 (1998). A conservator may file an election for a surviving spouse, but only if "additional assets are needed for the reasonable support of the surviving spouse * * * ." ORS 114.155.

Uniform Probate Code. Prior to 1969, elective share statutes in most states gave the surviving spouse a one-third share of the decedent's probate estate. Changes in the way property is held, in particular the proliferation of non-probate transfers of assets, and changes in the composition of families have caused many legislatures to rethink the elective share statute. The Uniform Probate Code (the "UPC"), first promulgated in 1969 and significantly revised in 1990, has served as a model for reform efforts in many states.

To address the issue of multiple marriages and late-in-life marriages, the UPC's elective share applies a percentage that increases from 3% after one year of marriage to 50% after 15 years of marriage. The phase-in of the percentage reflects an attempt to create an elective share that approximates 50% of the couple's marital property.

To address the problem of nonprobate transfers, the UPC creates an augmented estate that includes most non-probate assets. The augmented estate concept is similar, although not identical, to the gross estate for federal estate tax purposes. (Imagine paying estate tax only on

amounts held in the probate estate.) The augmented estate includes the property interests of both spouses, regardless of who holds title to the property. Applying the elective share only to the decedent's assets could result in overfunding if the surviving spouse has significant assets of his or her own.

The UPC also creates a minimum elective share amount of \$50,000, designed to ensure that the surviving spouse has a minimal level of support. This "supplemental elective share" provides that a surviving spouse will be left with at least \$50,000, taking his or her own assets into consideration. If the spouses' combined assets are less than \$50,000, then the surviving spouse will take all the assets, leaving nothing for the beneficiaries named in the decedent's will.

The Future of the Elective Share in Oregon

Oregon continues to face the paradox that a spouse who leaves a marriage may be better protected financially under the rules of equitable distribution than a spouse who stays in a marriage only to be disinherited. Concerned that a spouse should not receive less if the spouse stays married than he or she would on divorce, an Estate Planning and Administration Section committee has begun reviewing Oregon's elective share statute. Discussions of elective share reform have raised a number of issues: What is fair from a policy standpoint? Should the share at death be comparable to a share on divorce? Should a needy spouse be entitled to support? Should the elective share apply to assets acquired before marriage? How complicated will the statute be? Will a new statute result in increased litigation? How should the equities be balanced when the decedent leaves children from a prior marriage? Would community property be a better approach?

As families continue to evolve and the number of multiple marriages increases, surviving spouses may turn more frequently to the elective share statute. Constructing an elective share that makes sense across a wide range of situations will be difficult. Community property — the property system used in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin — creates a property interest for each spouse in property earned during the marriage and lets spouses retain as separate property any interests in assets owned before the marriage or acquired through inheritance. Each spouse owns a one-half interest in the couple's community property, so each spouse has a right to control half the community property at death, regardless of which spouse dies first. Community property solves many of the problems discussed in connection with elective share reform and may be a path of law reform worth considering for Oregon.

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Elective Share: Fiduciary Duties and Investment Issues

In 1970, the state of Oregon abolished the old system of dower and curtesy, which gave a surviving spouse an interest in land and personalty. In its place, the legislature enacted an elective share statute, which gives a surviving spouse the choice to either take under the will or elect against the will to receive a one-quarter share in the value of the "net probate estate." See ORS 114.105. This article discusses how to avoid conflicts during the administration of the estate should a surviving spouse elect against the will.

Investment Risks

A spousal election against the will may create conflict in the investment strategy selected by the personal representative while settling the estate. In Oregon, personal representatives are fiduciaries subject to the prudent investor rule. ORS 114.305(6). A personal representative "shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries." ORS 128.204(2). Often assets subject to probate are not those that a prudent investor would have selected. The personal representative has a fiduciary duty to manage the assets during probate and may need to sell assets that violate the prudent investor rule and replace them with assets that comply with the rule.

In general, a surviving spouse may prefer income-generating investments rather than growth-oriented investments. In contrast, the devisees of the will may have an entirely different investment objective. For example, if the intended devisee is a charity, municipal bonds or treasury securities would be inappropriate investments because tax-free income provides no benefit to an entity already exempt from taxes. Alternatively, if the intended devisee is a testamentary trust with young beneficiaries, growth assets would be more appropriate.

Separate the Assets

ORS 114.145 gives a spouse 90 days from the date of the admission of a will or 30 days after the date of filing the inventory, whichever is later, to elect against the will. The personal representative should try to determine if there is a chance of a spousal election prior to liquidating any assets. If there is a possibility or if the surviving spouse does elect against the will, the personal representative should immediately determine which assets will be used to fund the elective share. These assets should be separated into a second estate account until the court grants an appropriate distribution order. The personal representative should determine the spouse's investment objectives and invest the second estate account accordingly.

It may be wise for the personal representative to obtain written information on the personal needs and wishes of each beneficiary and develop an investment plan that suits each beneficiary. It may also be wise to obtain some type of written assent to the investment strategy. If the personal representative is an individual rather than a professional fiduciary, the personal representative can obtain an objective risk assessment from an investment professional to provide support in case of a legal dispute. The original assets should then be invested according to the investment objectives of the devisees.

A recent case in Wasco County (*In the Matter of the Estate of Ernest A. Kuck*, No. P 92-24 (Oct. 27, 1995)) provides an example of what can happen when probate assets are not separated upon election. In that case probate distribution was extended an additional two years while the estate of the surviving spouse disputed issues that would have been moot had the assets been separated immediately upon election. Although the will granted broad investment authority, the electing spouse's estate objected to the way an experienced trust officer had handled the investments. The trust officer, shortly after marshalling the decedent's assets, had sold all the long-term high-yielding municipal bonds and reinvested the proceeds in "safe" money market funds that yielded a lower before-tax return. The investment decisions made could have easily been viewed individually had the probate accounts been separated upon the election.

A careful estate planning lawyer should be able to avoid most of these problems by simply recognizing the situation and advising a testator when a possibility of spousal election exists. The testator may then decide to revise the terms of the will to include at least a one-quarter interest for the spouse or a one-half interest in all probate and non-probate assets.

Conclusion

If an election does take place, the probate lawyer must be aware of the risk of conflicts during estate administration. The lawyer can help the personal representative find out the investment risk preferences of each beneficiary, document and receive acknowledgment for each investment strategy and separate the assets *prior* to distribution.

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Elective Share in the Medicaid Context

Some testators expressly disinherit their institutionalized spouses. Unless the disabled spouse seeks the elective share, the probate assets bypass the surviving spouse and go to the children or other heirs. At common law, the creditors of a surviving spouse may not force a spouse to claim the elective share. However, where the surviving spouse will have nursing care paid for by the state Medicaid program, then the state may assert the institutionalized spouse's elective share rights.

If the family intends that the state pay the costs of the institutionalized spouse's nursing care, then the family should understand that the state can, in some jurisdictions, force an elective share for the institutionalized spouse. An ill spouse's waiver of the elective share may also cause the ill spouse's disqualification for the Medicaid program. In some jurisdictions, a surviving spouse's refusal to claim the elective share will cause a period of Medicaid disqualification.

Bypass Planning Is Common Where One Spouse Receives Medicaid

An estate planning lawyer may encounter a client whose spouse has been institutionalized for nursing care. If the couple protected some assets, and the home, from nursing home costs by qualifying the ill spouse for Medicaid, the healthy spouse may, and usually does, alter his or her will to bypass the institutionalized spouse to some degree.

Should the healthier spouse unexpectedly die before the institutionalized spouse, the personal representative and heirs usually wonder if the institutionalized spouse will continue to receive public benefits. Inherited assets will disqualify the institutionalized spouse from Medicaid and must be spent down for care. Of course, some spouses intend to leave funds for the institutionalized spouse, knowing the spouse will then leave the Medicaid program and pay his or her own nursing costs until the funds are spent down.

Disclaimer by Surviving Spouse

When the lawyer meets with the personal representative and learns that a spouse who is an heir by intestacy or a devisee under the will is ill, but not yet in a nursing home, then the lawyer for the estate should be aware that Medicaid might be needed in the foreseeable future. If the surviving spouse is already in a nursing home, then the lawyer should learn who pays for that nursing home care.

If the decedent left the surviving spouse some or all of the estate, then an interested person may ask whether the spouse can disclaim. The lawyer must help the personal

representative understand the conflict between the interests of heirs who stand to benefit and the disclaimant. The lawyer should also consider whether the surviving spouse needs separate representation and who is likely to challenge the disclaimer for the disclaimant's lack of capacity. Simple disclaimer of an inheritance is a Medicaid-disqualifying transfer and will preclude immediate Medicaid eligibility. In the Maryland case of *Troy v. Hart*, 697 A2d 113 (Md Spec App 1997), the court advised Maryland to seek return of disclaimed assets by constructive trust suit.

Failure To Claim the Elective Share as a Medicaid Disqualifying Transfer

If a Medicaid beneficiary spouse is completely disinherited or receives less than the elective share under the will, the lawyer should explore whether the state can force the surviving spouse to elect against the will. The elective share is a personal right of the surviving spouse, ORS 114.105, and creditors may not force an exercise or levy against the elective share. Yet, in the Medicaid context, some courts treat the failure to exercise the elective share as a disqualifying transfer. In several recent cases dealing with the elective share rights of Medicaid recipients, courts have permitted the state agency to deny benefits to a surviving spouse. See, e.g., *Hinschberger v. Griggs County Social Serv.*, 499 NW2d 876 (ND 1993); *Flynn v. Bates*, 413 NYS2d 446 (1979); *Bradley v. Hill*, 457 SW2d 212 (Mo App 1970).

For the purposes of Medicaid eligibility, the Health Care Financing Administration ("HCFA") defines "assets" to include items that the recipient could get but did not receive due to action on his or her part. Examples of such action (including waiver of an inheritance) are given in HCFA Transmittal No. 64, State Medicaid Manual, part 3, § 3257.B (3), Eligibility (Nov. 1994), reprinted in *Medicare & Medicaid Guide (CCH)* 14,311.81 (Mar. 20, 1997). The courts have creatively interpreted the term "action" in the HCFA State Medicaid Manual to include "failure to act." *Tannler v. DHSS*, 564 NW2d 735 740 (Wis 1997) (emphasis added).

Forcing the Medicaid Recipient To Claim an Elective Share

To force the Medicaid recipient to claim an elective share, the state Medicaid agencies developed two basic approaches: (1) issue a simple denial of benefits notice and stop paying the nursing home bill and (2) petition the probate court for authority to make the claim for an elective share on behalf of the ill surviving spouse. Both approaches have been successful.

State Issues Denial of Benefits Notice. Whether the institutionalized spouse is competent or incompetent, the state Medicaid agency may pressure the recipient to make the election by issuing a denial of benefits notice. In most cases, the institutionalized spouse is incapacitated and a responsible child or relative is overseeing the

Medicaid-paid care. The responsible relative may be the person who benefits from the failure of a spouse to claim the elective share. If the nursing home is not paid, it looks to the responsible relative for payment. Fearing nursing home collection efforts, the responsible relative may simply cave in and arrange to have the elective share paid to the institutionalized spouse.

If the relatives stand firm, and the state denies benefits to the elder older adult, pressure from the care facility to get the bill paid or evict the ill spouse for nonpayment may bring the child or friend who signed the "responsible party" line on the nursing home entrance agreement to the lawyer's office.

This article will not go further into the interesting issues of relative responsibility for nursing home care, the enforceability of responsible party nursing home admission agreements, and the nursing home transfer prohibitions. But if the relatives do not pay, and the state continues to pay on a "hardship" theory after a disqualifying transfer, the state conceivably could sue the relatives who benefit from the transferred property for "improperly paid benefits" under some state statutes.

State Involves Probate Court To Make Election. In Oregon, the state can nominate a private attorney to be appointed as conservator of the institutionalized surviving spouse. The conservator can then claim the protected person's elective share. If the state seeks appointment of a conservator, the family can oppose the state strategy using two arguments: (1) the family members can object to appointment of a non-relative whose interests are solely those of the state, not those of the incapacitated person, or (2) the family can argue that the surviving spouse's circumstances would not be altered or improved if the elective share were exercised. In most cases, the ill surviving spouse remains in the same bed at the same nursing home receiving the same level of care whether the bill is paid from the inheritance or from public benefits. In a pre-OBRA '93 New York transfer case, *Matter of Street*, 616 NYS2d 455 (1994), the court denied a petition to claim an elective share where no actual improvement in care or benefit to the impaired spouse would have resulted.

Oregon has no reported cases on this situation. All cases in Oregon to date have been resolved by settlement (many by payment of some part of the elective share to the state-nominated conservator, who spends it down for care).

Use of Revocable Trust To Get Around Elective Share Backfires

Courts strongly criticize the avoidance of probate by use of a revocable living trust to bypass the Medicaid recipient spouse. See, e.g., *Bezzini v. Department of Social Services*, 715 A2d 791 (Conn App 1998).

Charles Bezzini, ill with prostate cancer, established and funded a revocable living trust in March 1993. The

trust contained no provisions benefitting Mrs. Bezzini. On June 3, 1993, Mr. Bezzini died. Four months later, in October 1993, Mrs. Bezzini went to a nursing home. In February 1994, eight months after her husband died, Mrs. Bezzini applied for Medicaid benefits. The agency found that a Medicaid-disqualifying transfer occurred *on June 3, the date of death*, when the sons became entitled to \$469,142.80 as sole beneficiaries of the husband's revocable trust.

The Connecticut Appellate Court agreed with the state agency, remarking that had the husband transferred his property by will, no disqualifying transfer would have occurred and Mrs. Bezzini would have been entitled to her elective share. Because a revocable trust was used, rather than a will, an actual transfer of an interest of the spouse occurred on the date of death, when the trust became irrevocable and the trustor's interest was extinguished. Use of the trust to bypass the spouse and benefit the children backfired. Mrs. Bezzini, who did not apply for benefits until a year after her husband created his trust and eight months after he died, was disqualified for Medicaid benefits. The law imposes a 60-month "lookback" period for transfers from a revocable trust. 42 USCA § 1396p(d)(3)(A)(iii) (Supp 1999).

Planning for Medicaid and an Elective Share Challenge

In light of the harsh reaction of courts to the complete disinheritance of the surviving spouse, a lawyer should rarely advise a client to completely bypass an ill spouse who may become eligible for Medicaid. Where one spouse is ill and on Medicaid, the lawyer may simply suggest the client leave the elective share outright to the ill spouse. If the spouse wanted to avoid spend-down of the entire elective share amount, the spouse could provide for "half a loaf" gifting in his or her power of attorney. However, some elder law attorneys are being more creative.

Waiver of Elective Share by Prenuptial or Postnuptial Agreement

Of course, some spouses may waive elective share rights in prenuptial or postnuptial agreements. Elective share waivers in prenuptial and postnuptial agreements are enforceable. *Day v. Vitus*, 102 Or App 97 (1990); ORS 114.115. However, at least one court in New York deemed execution of a postnuptial agreement waiving the elective share to be a disqualifying transfer. *Dionisio v. Westchester County Dept. of Social Services*, 665 NYS2d 904 (1997).

The New York Medicaid administrative agency issued a denial of benefits to Jeanette Dionisio, declaring that her execution of a waiver of elective share (two weeks before entering a nursing facility; 20 months before applying for Medicaid) was a disqualifying transfer. In a very unusual twist, the agency found that the period of disqualification *began with the date of death, not the date the waiver was signed*.

The estate argued that the postnuptial waiver fit an exception to the regular Medicaid transfer restrictions in that it occurred solely for regular estate planning reasons and not for the purpose of divestment of assets to qualify for Medicaid. The court held that a presumption existed that the postnuptial waiver of the elective share was for Medicaid qualification purposes, and that the personal representative had not rebutted that presumption in the hearing.

In the Medicaid context, transfers of assets made "exclusively for a purpose other than to qualify for medical assistance" are not disqualifying. 42 USCA § 1396p(c)(2)(C) (1992 & Supp 1999). Waivers executed long before an illness, as part of normal estate and marital planning, should withstand scrutiny. When conventional postnuptial agreements, which typically include waivers of elective share, are done, practitioners might document in the agreement all of the consideration, so that the estate planning (non-Medicaid) reasons are apparent on the face of the document.

How will a state Medicaid agency interested in forcing Medicaid recipients to exercise their elective shares learn about a recipient's inheritance after the death of a spouse? Each state will gather facts differently, but the estate or trust administration advisor should anticipate the inquiry. If an elective share waiver is a Medicaid-disqualifying transfer, when does the disqualification period commence?

Some planners are suggesting that the mutual waivers of the elective shares be for consideration other than mutual promises. For example, consideration could be the creation of an Elective Share Trust, of one of the varieties below, in the will of each spouse.

Creating an Elective Share Trust in the Will

Once an ill spouse has qualified for Medicaid, the healthier spouse usually reconsiders his or her own estate planning. If the institutionalized spouse is disinherited or receives insufficient assets to fully fund the elective share, then the estate risks an elective share claim. In Oregon, the elective share is reduced by the value of what is given under the will to the surviving spouse. In some states, such as New York, the spouse can reject what the will gives and claim the share outright.

Some of my clients with sick spouses on Medicaid leave all of their estates to the ill spouse, knowing that the inheritance will disqualify the survivor from public benefits but intending that the inheritance be used to pay the sick spouse's hospitals, nursing homes, care managers and other care providers. The well spouse's estate plan should, of course, include a spousal trust, to provide management of assets or income left to the institutionalized spouse. Most healthier spouses, however, leave only part of their preserved resources to the ill spouse.

If the client wants to preserve some assets for children or other beneficiaries, the lawyer should consider drafting

a trust for the elective share amount — a "Right of Election Trust." A Right of Election Trust can be full-support, completely discretionary, income-only or special needs in nature.

The Right of Election Trust can be a full-support spousal testamentary trust, intended to be spent down entirely on nursing and other medical care, without regard to public benefits eligibility. This sort of trust can be written with instructions to disregard the interests of remainder beneficiaries.

The Right of Election Trust can be a fully discretionary trust, but this sort of trust is difficult to value, and its value would not completely offset the elective share. Alternatively, the Right of Election Trust can restrict payments in some way and not be drafted as a full-support trust. In Virginia and New York, a form of income-only Right of Election Trust is sometimes used. The trust provides income only to the surviving spouse and may permit discretionary principal distributions for special needs.

In Oregon and other income cap states, the income-only Right of Election Trust produces excess income. While excess income can be managed currently with an Income Cap Trust, 42 USCA § 1396p(d)(4)(B) (Supp 1999), preserving benefits while reducing the use of tax dollars, I have been developing a special needs Right of Election Trust for use in Oregon. The special needs trust is funded with the elective share amount. The trustee is required to use income for special needs and has discretion to use principal also for special needs.

I have found that my clients routinely execute new wills after a spouse is institutionalized. More than half of my clients choose to leave the elective share amount in Oregon (25%) to a special needs trust for the spouse. However, the Right of Election Trust in the special needs format does not prevent the state from claiming the elective share.

A spousal trust in any form (full-support, income-only or special needs) pleases the clients, who want the children, rather than a state-nominated conservator, to determine how the inheritance is spent. Should the state seek appointment of a conservator for an institutionalized spouse after the death of the community spouse, then a special needs trust design permits the personal representative to argue that simply spending down an elective share for the \$4,000/month nursing home bill will not benefit the ill surviving spouse as much as special needs expenditures. The personal representative will value the special needs trust and offset its value against any elective share claim.

*Cynthia L. Barrett
Portland, Oregon*

Legislative Update

The governor signed three estate planning bills on April 26, 1999:

- HB 2290 amended ORS 112.575, *et seq.*, to provide that a person will be treated as surviving the decedent only if the person survives the decedent by at least 120 hours. The statute applies to all transfers occurring by reason of death.
- HB 2291 amended ORS 112.265 to provide that a pourover will can validly transfer assets to an unfunded revocable trust, even if the decedent executed the trust after the decedent executed the will. Of course, the will must adequately identify the trust.
- HB 2292 repealed ORS 112.017, the statute that defined "spouse" for intestacy purposes to include a common-law spouse.

The following two bills have been returned to committee for minor revisions and will come before the House and Senate again before the end of the session:

- HB 2759 modifies the law relating to the appointment of professional fiduciaries in protective proceedings. The bill requires that before being appointed, a professional fiduciary must submit detailed information to the court, including disclosure of fees to be charged, and must undergo a criminal background check.
- HB 2760 creates a pilot program for Multnomah County that will expand the involvement of court visitors in the assessment of guardianship proceedings and require that court visitors be employees of the court. The bill amends guardianship laws to require that notice of a petition for guardianship be given to the following: (1) any lawyer who has represented the respondent in any capacity within three years before the filing, (2) the office of the Long-Term Care Ombudsman if the respondent is residing in a nursing home or residential facility, and (3) an advocate of the rights of individuals with developmental disabilities if the respondent is a resident of a mental health treatment facility. The bill also requires that the notice given to the respondent describe the repercussions of the appointment of a guardian and the respondent's rights to object more thoroughly than is required under the current law.

What's New

Matter of J. Marvin Benson, 59 (Or St B Bull [41] (Feb./Mar. 1999)

In this disciplinary proceeding, Benson was the attorney for Senior Financial Planning Services ("SFP"), which sold estate planning documents and services through non-lawyer agents. Benson trained and advised the agents. The agents met with the individual clients and obtained personal and financial information. The agents then delivered the information to Benson, who prepared the legal documents. The non-lawyer agents collected the fees and paid Benson a portion of the fees for his services.

The Disciplinary Board found that the activities of the non-lawyer agents constituted the practice of law by non-lawyers and found that Benson knew that the non-lawyer agents were engaged in the practice of law. Benson stipulated to aiding non-lawyers in the unlawful practice of law, to sharing legal fees with non-lawyers and to allowing somebody other than the individual clients from whom compensation was accepted to direct his professional judgment.

Benson also stipulated to failing to provide competent representation to an elderly couple. The documents that a non-lawyer agent sold to the couple were neither necessary nor appropriate for their circumstances. Benson

relied on the non-lawyers to attend to the proper execution of the couple's documents, which were not properly executed. Finally, Benson failed to adequately advise the couple about funding the trusts established for them.

As a result of these actions, the Board suspended Benson from the practice of law for 60 days. Benson agreed not to work for SFP in the future.

*Emily V. Karr
Stoel Rives LLP
Portland, Oregon*

Elder Law Newsletter Editor Search

The Elder Law Section is looking for a qualified person interested in serving as the editor of the Elder Law Newsletter. The editor position is a paid position and will require a commitment of editing six newsletters per year. The Section is looking for a person who is either a practicing or nonpracticing attorney with interest or experience in the elder law field and with excellent writing and editorial skills. If you are interested, please contact Michael Levelle at (503) 227-1111 or fax (503) 248-0130.

CALENDAR OF SEMINARS AND EVENTS

- July 21-23, 1999 (Sponsored by ALI-ABA CLE) **Basic Estate and Gift Taxation and Planning**, Hotel Loretto, Santa Fe, New Mexico. Telephone: (800) CLE-NEWS.
- July 29-31, 1999 (Sponsored by ALI-ABA CLE) **Estate Planning for the Family Business Owner**, Knickerbocker Hotel, Chicago, Illinois. Telephone: (800) CLE-NEWS.
- August 13, 1999 (Sponsored by Oregon State Bar) **Basic Estate Planning**, Oregon State Bar Center, Lake Oswego, Oregon. Telephone: (503) 684-7413.
- August 26-27, 1999 (Sponsored by ALI-ABA CLE) **International Trust and Estate Planning**, Four Seasons Hotel, Toronto, Canada. Telephone: (800) CLE-NEWS.
- September 23-24, 1999 (Sponsored by Practising Law Institute) **30th Annual Estate Planning Institute**, New York, New York. Telephone: (212) 824-5700.
- September 30, 1999 (Sponsored by OSB CLE and OSB Elder Law Section) **Planning for Your Client's Long Term Care**, Oregon Convention Center, Portland, Oregon. Telephone: (503) 684-7413.
- September 30-October 2, 1999 (Sponsored by ALI-ABA CLE) **Post-Mortem Planning and Estate Administration**, Hilton Hotel, New York, New York. Telephone: (800) CLE-NEWS.
- October 4-5, 1999 (Sponsored by Washington State Bar) **44th Annual Estate Planning Seminar**, Washington State Bar Association Offices, Seattle, Washington. Telephone: (206) 727-8292.
- October 7-8, 1999 (Sponsored by Practising Law Institute) **30th Annual Estate Planning Institute**, San Francisco, California. Telephone: (212) 824-5700.
- October 15, 1999 (Sponsored by Oregon Law Institute) **Estate Litigation/Planning**, Northwestern School of Law of Lewis & Clark College, Portland, Oregon. Telephone: (503) 243-3326.
- October 24-26, 1999 (Sponsored by Chaminade University Tax Foundation and Chaminade University of Honolulu) **1st Annual Estate Planning Institute - Estate and Gift Planning**, Hawaiian Regent Hotel, Honolulu, Hawaii. Telephone: (808) 943-3130.
- October 24-29, 1999 (Sponsored by Chaminade University Tax Foundation and Chaminade University of Honolulu) **36th Annual Hawaii Tax Institute - Estate and Gift Tax Planning**, Hawaiian Regent Hotel, Honolulu, Hawaii. Telephone: (808) 943-3130.
- October 28-30, 1999 (Sponsored by ALI-ABA CLE) **Uses of Insurance in Estate and Tax Planning**, W Hotel, San Francisco, California. Telephone: (800) CLE-NEWS.
- November 5, 1999 (Sponsored by The Law School University of Southern California Continuing Legal Education Program) **Probate and Trust Conference**, Westin Bonaventure Hotel, Los Angeles, California. Telephone: (213) 740-2582.
- November 15-19, 1999 (Sponsored by ALI-ABA CLE) **Planning Techniques for Large Estates (limited enrollment)**, Ritz-Carlton Hotel, San Francisco, California. Telephone: (800) CLE-NEWS.
- January 10-14, 2000 (Sponsored by the University of Miami School of Law) **The 34th Annual Philip E. Heckerling Institute on Estate Planning**, Fontainebleau Hilton Resort and Towers, Miami Beach, Florida. Telephone: (305) 284-4762.
- January 28, 2000 (Sponsored by the Estate Planning Council of Portland and Northwestern School of Law) **29th Annual Estate Planning Seminar**, Portland Convention Center, Portland, Oregon. Telephone: (503) 233-1224.
- February 24-26, 2000 (Sponsored by ALI-ABA CLE) **Advanced Estate Planning Techniques**, Grand Wailea Resort & Spa, Maui, Hawaii. Telephone: (800) CLE-NEWS.

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Annual Report to Members Estate Planning & Administration Section

Executive Committee

The Executive Committee met six times during the 1998 fiscal year in various locations throughout the state. Activities of the Section were carried out by the Section's subcommittees.

Continuing Education Subcommittee (Christopher P. Cline and Richard R. Kilbride, Co-Chairs)

The CLE subcommittee presented two seminars in the past year. In November 1998, the Section and Bar cosponsored a program on "Basic Estate Planning." In June 1998, the Section and Bar cosponsored "Advanced Will and Trust Drafting and Administration." Both programs were well attended by the members with consistently high ratings of both the content and speakers. The subcommittee is planning a CLE for the annual Bar meeting on "Fiduciary Management and the Prudent Investor Act" and a CLE for December 1999 on "Administering the Taxable Estate."

Newsletter Subcommittee (Lisa N. Bertalan, Chair)

The Section publishes a newsletter four times annually. Susan Gary serves as Editor-in-Chief and is assisted by a six-person editorial board. The newsletter is designed to keep Section members aware of current issues and developments in estate planning and administration.

Legislative Subcommittee (Bernard F. Vail, Chair)

The legislative subcommittee has reviewed and commented upon many legislative proposals that were introduced during the 1999 legislative session.

Trust Legislation Subcommittee (David P. A. Seulean and Jeffrey C. Thede, Co-Chairs)

The subcommittee reviewed and tabled a proposal to the OSB Board of Governors to sponsor legislation that would create an optional summary procedure by which a trustee could notify creditors and other claimants that the trustor has died and that assets are about to be distributed. The subcommittee is continuing to review this topic and is also considering whether the rules of construction of wills should be applied to trusts and other nonprobate transfers at death. The subcommittee plans to continue

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the preparation of draft legislation in these two areas for submission during the 2001 legislative session.

Loss Prevention Subcommittee (James D. Berrien, Chair)

The loss prevention subcommittee assists the PLF in identifying practice areas of concern. The subcommittee continues to review procedures for restricting assets in estates and conservatorships to avoid the need to post a bond.

Advance Directive Subcommittee (Wesley D. Fitzwater, Chair)

The Section completed the production of an educational video, which is available for sale. The video is designed for clients and features a doctor discussing the medical issues associated with the Oregon Advance Directive. The Oregon State Bar Public Relations staff will assist with future marketing of the production.

Web Site Subcommittee (Wesley D. Fitzwater, Chair)

The Web Site Subcommittee is working to create a Section web site to provide information regarding current issues and developments in estate planning and administration and to contain copies of the Section's newsletter. Persons interested in assisting with the web site development should call Wes Fitzwater.

Respectfully submitted,

David P.A. Seulean, Chair
Christine P. Brown, Past Chair
Wesley D. Fitzwater, Chair Elect
C. Craig Heath, Treasurer
Ron D. Bailey, Secretary
James D. Berrien, Member
James R. Foster, Member
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Richard A. Pagnano, Member
Lisa Bertalan, Member
Jeffrey C. Thede, Member
Bernard F. Vail, Member
Sarah Rinehart, Board Liaison
Jennifer R. Roumell, Staff Liaison

**Questions, Comments or Suggestions
About This Newsletter?**

Contact:

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From the Bench

Suggestions for Preventing or Solving Disputes

The most important factor in avoiding disputes in probate matters is for those involved to have trust in the legal system. Trust can be improved if the fiduciary allows a free exchange of information and responds to reasonable requests. It is a good idea for the fiduciary to provide the interested parties with information, such as a copy of the will and a copy of the inventory, beyond that which the statute requires the fiduciary to provide. Giving parties a general summary of the process, including an estimated timeline, can also help to minimize conflict. The attorney for the personal representative of a decedent's estate should make certain that the beneficiaries understand that the attorney does not represent the beneficiaries. Otherwise, the beneficiaries may have unreasonable expectations of the attorney. Overall, prompt responses to questions by interested parties will help keep the level of trust high.

An attorney for an interested party who is considering objecting in a probate matter should call the attorney for the fiduciary to collect information and determine whether an informal basis exists for resolving the concern. If the time for filing the objection is short, the objecting attorney could ask the fiduciary's attorney to agree to extend the time for objection. If the fiduciary's attorney agrees, the objecting attorney should then get court approval for the time extension.

If an objection is filed and a status conference or other court proceeding is scheduled, the attorneys should discuss the matter *before* appearing in court. In Marion County, a status conference is regularly scheduled after an objection is filed. Surprisingly, many times the attorneys have not spoken to each other before the status conference.

If all else fails and the parties cannot settle informally, the attorneys should consider mediation. Marion and Multnomah counties (and possibly others) have formal probate mediation programs. Even if the court has no formal program, an attorney should suggest the idea to the judge and opposing counsel. Mediation allows the parties to participate in determining the result, and mediation gives parties a better chance of preserving relationships than does a full hearing.

A small amount of time spent providing information, responding to questions and working informally with interested parties and their attorneys can pay off in big savings to the estate by avoiding litigation.

Jennifer B. Todd
Circuit Court Judge Pro Tem
Marion County

Income Tax Traps for Family Partnerships with Marketable Securities

Family investment partnerships and LLCs (references to partnerships in this article also include LLCs) are popular and effective estate planning tools, for many tax and nontax reasons. They provide a useful way for two or more persons to invest in and manage both real property and financial assets. Partnerships can facilitate gifts of portions of a securities portfolio to younger family members, while permitting retention of the portfolio as a single fund controlled by the general partners and invested with their favorite investment advisor.

Lawyers often form partnerships with little or no consideration of the income tax consequences involved. Many lawyers assume that no gain or loss is recognized on the contribution of property to a partnership and that distributions are nontaxable unless too much money is distributed. Unfortunately, the rules are not so simple. This article addresses two major income tax traps, one associated with the contribution of securities to a partnership and the other with distributions. This is not a comprehensive guide; the intent is to alert practitioners to the possible traps.

Formation Traps

Partnership treated as an investment company. The “investment company” rules of the tax code contain a tax trap that can create problems at formation. Generally, an investment company is an entity established for the pooling of the investment portfolios—often called “exchange funds” or “swap funds”—of its partners. Brokerage houses have formed swap funds as public investment vehicles.

The investment company rules have been on the books since 1966, but the proliferation of family partnerships warrants a reminder of their impact. Briefly, if the partnership meets the definition of an “investment company,” then, under certain circumstances, all of the assets transferred to the partnership will be treated as if sold by the contributing partners, with the resultant gain taxed to the contributors.

Congress enacted the investment company rules to prevent investors from using entities to diversify their portfolios without the recognition of gain. For example, if partner A contributes 1,000 shares of Microsoft to the partnership and partner B contributes 1,000 shares of Ford Motor Co., each will enjoy, as partners, the benefit of the more diversified partnership portfolio. To diversify without the formation of an entity, each of them would

have had to sell a portion of their holdings and invest the proceeds in the other company. The sale would have resulted in a taxable gain to the extent the fair market value of the stock exceeded its basis.

IRC § 351(e)(1) provides that the nonrecognition provisions of § 351 will not apply to “a transfer of property to an investment company,” leaving most of the details for the regulations. The rules of § 351(e) originally applied only to corporations, but § 721(b) applies the rules to partnerships. Under the regulations, a transfer will be treated as a transfer of property to an investment company if—

- (1) The transfer results in diversification of the transferor’s interests and
- (2) The transferee partnership holds, after the transfer, readily marketable “stocks or securities” comprising 80 percent of the total assets (excluding cash and nonconvertible debt obligations). Treas Reg § 1.351-1(c)(1).

Congress amended § 351(e) in 1997 (Taxpayer Relief Act of 1997, Pub L No. 105-34, § 1002, 1997 USCCAN (111 Stat 788, 909)) to add a laundry list of assets to be treated as stock and securities. The list includes money, stock in a corporation, evidences of indebtedness, precious metals and other assets that normally would not be considered a security. A careful review of the list should be made before assuming that a client’s asset is not a “security” under the rules. While not clear from a reading of the new law, the committee report explaining the new law states that the listed assets are to be included *in addition to* readily marketable stock and securities. Thus stock and debt instruments issued by a privately held family corporation would be included. In addition, the exception for cash and nonconvertible debt appears to be overridden by the 1997 law. Fortunately, real estate is not included on the list. The new law is not intended to change other aspects of the regulations, including the diversification requirement.

The diversification requirement. Perhaps the easiest way to avoid the investment company rules is to flunk the first requirement; that is, to make sure that the transfer does not result in diversification. As a general rule, diversification results if two or more persons transfer nonidentical assets to the partnership. Treas Reg § 1.351-1(c)(5). If only one person transfers property, or if two or more persons transfer identical assets, diversification will not occur. For example, if Mom and Dad contribute their joint brokerage account to a newly formed partnership,

diversification will not occur. The IRS may aggregate transfers that result in diversification or are part of a plan to avoid the nonrecognition rules. A de minimis rule applies, with an example providing a safe harbor of 1 percent.

If two or more contributors transfer non-identical assets, diversification will not occur if *each* partner contributes a diversified portfolio of stocks and securities. A portfolio is diversified if (1) not more than 25 percent of the total assets transferred by each transferor consists of stock and securities of a single issuer and (2) not more than 50 percent of the value of the total assets transferred by each transferor consists of stock and securities of five or fewer issuers. Treas Reg § 1.351-1(c)(6) (incorporating by reference IRC § 368(a)(2)(F)(ii)).

For example, if the portfolio consists of 20 stocks, the stock of no single company is worth more than 25 percent of the total value of the portfolio, and the stock of the five top holdings is worth (in the aggregate) no more than 50 percent of the portfolio, the portfolio is diversified. The second part of the test in effect requires that the portfolio consist of a minimum of 10 securities, and, practically speaking, a few more than that (unless the portfolio consists in part of government securities, explained below). There is no way to allocate less than 50 percent of the asset value to five or fewer securities in a portfolio consisting of nine or fewer stocks.

The test gives government securities special treatment. Unless acquired to enable the transferor to pass the test, government securities are included in total assets (the denominator of the tests), but are not treated as securities for purposes of the numerator of the tests. A portfolio with substantial government securities can pass the 25 and 50 percent tests much more easily than a portfolio without government securities. For example, if 60 percent (by value) of the portfolio consists of Treasury bonds and just two other stocks, each worth 20 percent of the total portfolio, the portfolio will pass the tests. The value of neither stock alone would exceed 25 percent of the total portfolio (remember, the Treasury bonds are ignored), and the two stocks together make up only 40 percent of the total asset value.

The rule is also relaxed in the case of mutual funds. The 25 and 50 percent tests incorporate a look-through rule that treats a person holding stock in a regulated investment company (*i.e.*, mutual fund) or REIT as holding the underlying securities. IRC § 368(a)(2)(F)(ii). Thus the contribution of even a single mutual fund to a partnership is permissible, because the transferor is treated as contributing the underlying securities, which almost certainly are diversified.

The diversification exception applies only if *each* contributor contributes a diversified portfolio. Where some

contribute securities and some contribute cash, the IRS has held that those contributing securities will recognize gain (but not loss) under IRC §1001. Rev Rul 87-9, 1987-1 CB 133; IRC § 721(b).

The 80 percent requirement. The second part of the investment company definition is met if the partnership assets consist of securities (as defined by IRC § 351(e)) aggregating more than 80 percent of the value of the company immediately after the contribution.

Consequently, if the partners cannot contribute identical assets or diversified portfolios, then keeping the value of § 351(e) "securities" below 80 percent can be another way to avoid the investment company trap. This is commonly accomplished by the contribution of rental real estate to the partnership. (But as discussed below in connection with § 731(c), advantages exist in limiting the assets of the company to marketable securities.) A look-through rule that treats a parent entity as owning the assets of a 50 percent subsidiary applies. Treas Reg § 1.351-1(c)(4).

The Senate Report discussing the amendments to § 351(e) states that while money counts toward the 80 percent test, "where money is contributed and, pursuant to a plan, assets not treated as stock or securities under the bill are either purchased or contributed by other parties, the investment company determination would be made only on the basis of the entity's assets after such events." S Rep No. 105-33 at n 70 (1997). It is unclear how this rule would affect the outcome of Rev Rul 87-9, cited above, if the contributed cash were used to acquire a diversified portfolio. Presumably, the result should change. The IRS has privately ruled that where some investors contribute diversified portfolios, and some solely cash, no gain would be recognized by the investors contributing the portfolios. PLR 199909045.

Tax consequences to contributors. If the contribution meets both the diversification and 80 percent requirements, then all contributors will recognize gain on all assets contributed. This rule applies to all contributors at formation, if all the contributions are made at or near the time of formation pursuant to a plan among the partners or upon a later, separate contribution by one or more partners, if at that later time the contribution meets both tests. Subsequent transactions by the partnership (such as the taxable sale of some of the contributed assets) do not affect the tax consequences under the investment company rules. *See, e.g.*, PLR 9607005 (approving the borrowing of cash by partnership to buy securities). Nontaxable transactions engaged in to avoid the rules may present a problem.

Finally, in perhaps the most hidden trap of all, if an asset such as land is contributed to a partnership after formation and the partnership meets the definition of an

investment company, the contribution of the land will trigger gain unless after the contribution the partnership is not an investment company because it failed to meet the 80 percent test. If the partnership was an investment company at the time the land was contributed, the contribution will trigger gain even if the partnership was not an investment company when originally formed and even if the contribution occurred years after the partnership was formed.

Distribution Traps

Unwary clients and practitioners may also experience unpleasant surprises upon the distribution of securities from a partnership. Although, in general, gain is not recognized by the distribution of property from a partnership to a partner, gain is recognized to the extent money distributed exceeds the basis of the partner's partnership interest. IRC § 731(a)(1). In 1994, Congress modified this rule to provide that, with some exceptions, for purposes of § 731(a)(1) (and § 737), "money" includes marketable securities. Consequently, the distribution of marketable securities to a partner may result in gain recognition if the aggregate value of the securities, and money, distributed exceeds the partner's basis.

Significant exceptions apply. First, securities contributed by the partner are excluded. Treas Reg § 1.731-2(d)(1)(i). Second, if certain conditions are met, securities that were not marketable when contributed are excluded. Treas Reg § 1.731-2(d)(1)(iii). Third, § 731(c) does not apply to the distribution of marketable securities by an investment partnership to an eligible partner. IRC § 731(c)(3)(A)(iii).

An "investment partnership" is one that has never held any assets other than money and financial assets and has never engaged in a trade or business, other than investing, trading or dealing in securities. IRC § 731(c)(3)(C)(i). An eligible partner is one who has contributed solely

money or financial assets. The types of assets included are listed in the tax code and regulations.

A final exception reduces the gain recognized on the distribution by the distributee partner's share of the appreciation inherent in its marketable securities. IRC § 731(c)(3)(B). A detailed explanation of § 731(c) is beyond the scope of this article; practitioners should carefully analyze the tax consequences of any proposed distribution of financial assets, if lucky enough to be called by a client before the fact.

As an aside, it is interesting that Congress has carved out a special exception for marketable securities. Practitioners have sometimes expressed concern regarding the validity of partnerships holding solely marketable securities for investment. Yet Congress acknowledges "that certain partnerships are formed for the purpose of holding marketable securities for investment or for sale to customers." HR Rep No. 103-826(I) at 188 (1994), *reprinted in* 1994 USCCAN 3773, 3960 (enacting IRC § 731(c)).

Summary

If a conclusion is to be drawn from all this, it is that it is imperative that clients and their lawyers not take for granted the income tax consequences of the formation of a partnership, particularly when the partnership holds marketable securities. The already complex partnership provisions of subchapter K of the tax code have gotten more complex in recent years, as Congress has cracked down on real or perceived abuses. Especially when marketable securities are involved, the lawyer should determine the tax consequences of the transaction and should not assume the usual rules apply.

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What's New

Butler and Butler, 160 Or App 314 (1999)

In a proceeding for the dissolution of a marriage, Husband challenged the property division by the trial court by arguing that Wife failed to rebut the presumption of equal contribution with regard to her inheritance. ORS 107.105 provides that whenever a court grants a decree of marital dissolution it has power to divide the property of the parties as is just in all the circumstances. ORS 107.105(1)(f) provides that there is a "rebuttable presumption that both spouses have contributed equally to the acquisition of property during the marriage, whether such property is jointly or separately held." In general, an inheritance acquired during a marriage is a marital asset and is subject to the statutory presumption. If the marital asset is an inheritance, the presumption of equal contribution may be rebutted by evidence that the gift or inheritance was acquired by the recipient spouse free from any contribution of the other spouse and that the other spouse is not the object of the donor's intent. Any evidence concerning whether the asset was commingled with the family finances is also pertinent, as is evidence concerning the degree of control asserted over the asset by the parties. If the court decides that the presumption has been rebutted, it distributes the marital assets without regard to any presumption, but in a manner that is just and proper.

Because Wife's inheritance in this case was acquired before the dissolution, it was a marital asset subject to the statutory presumption. Although Wife testified that she acquired the entire inheritance free from any contribution of Husband and that Husband was not the object of the donor's intent, there was evidence that the first installment of \$50,000 was deposited into a joint checking account and that Husband wrote at least one check on that account to pay off a joint debt. Therefore, with regard to that installment, Wife did not rebut the statutory presumption of equal contribution because the funds were commingled.

As to the remainder of the inheritance, the court held that Wife had rebutted the presumption. The final two installments of the inheritance had been received after the parties had separated and after they had closed their joint accounts. There was no commingling of the inherited money with the money in the parties' joint accounts and Wife had full access and control, in contrast to the first installment. To the extent that Wife contributed to the parties' joint assets and obligations from the last two installments of her inheritance, she did so on her own volition. Therefore, the court found the remaining inheri-

tance to be the sole property of Wife.

Husband had also challenged the property division, arguing that because he had previously used a gift from his mother for home improvements and family expenses, it would be unfair to hold that Wife's inheritance was separate. He also asserted that he and Wife had discussed how to spend Wife's inheritance. The court rejected these arguments because when the money came from Husband's mother, it was used for joint purposes at a time when the parties were cohabitating. In addition, merely because the parties discussed uses for Wife's inheritance does not mean that they actually had a meeting of minds on that subject. Nonetheless, the court found that the parties had agreed that the funds be set aside for the education of their children. The court cited this fact in support of its decision to order that a portion of Wife's inheritance be placed in trust for the children's benefit. The court viewed the award to the children's trust as inuring to the benefit of both parties.

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FTC v. Affordable Media, 179 F.3d 1228 (9th Cir 1999)

Offshore asset protection trusts—self-settled spendthrift trusts located in foreign countries that do not honor American judgments—have garnered billions of dollars of assets in recent years. Touted by some lawyers and financial planners, these trusts are designed to permit settlers to elude pursuing creditors while retaining control of their funds. However, it is now clear that at least one common form of offshore trust exposes clients who use it to the risk of jail.

Starting in 1997, Denyse and Michael Anderson took part in a Ponzi scheme that bilked investors of at least \$13 million. The sponsors promised annual returns of 200 percent or more for participating in the sale, on late-night television, of talking pet tags, plastic wrap dispensers and water-filled barbells. In spring 1998, the Federal Trade Commission sued the Andersons in federal court in Nevada to halt further securities fraud. The court ordered the Andersons to repatriate any assets held for their benefit outside the United States. At the time, the Andersons retained an estimated \$6.3 million in sales commissions in an irrevocable trust they had established in 1995 under the law of the Cook Islands.

The Andersons' trust had several common features of offshore trusts. The Andersons were cotrustees with

AsiaCiti, a Cook Islands company beyond the reach of American courts. Cook Islands courts generally do not recognize U.S. judgments or other legal processes, such as asset freezes. The Andersons were named as trust “protectors” with authority to control AsiaCiti’s actions. Most significantly, the trust agreement included a “duress” clause, by which AsiaCiti could remove the Andersons as trustees and ignore their demands to repatriate funds if it believed they were acting under compulsion of a court order. The Andersons could then assert that it was literally impossible for them to return their funds to American shores, and, therefore, they should not be held in contempt for violating the order.

At first, the duress clause worked as planned. In response to the preliminary injunction, the Andersons instructed AsiaCiti to deliver an accounting and the trust assets to the district court. AsiaCiti invoked the antiduress clause and refused. Facing contempt for disobeying the court order, the Andersons argued that compliance was impossible. However, the court then deviated from the script and threw them in jail. When released from custody six months later, the couple still had not pried loose their funds.

On appeal, the Ninth Circuit upheld the trial court’s finding of contempt. The appeals court questioned, without deciding, whether *self-inflicted* impossibility could be defense to contempt. Instead, the appeals court

affirmed because the Andersons had not met their burden of proving “categorically and in detail” why repatriation was impossible. Both courts were skeptical that “a rational person would send millions of dollars overseas and retain absolutely no control over the assets.” The appeals court also noted that the Andersons were previously able to withdraw more than \$1 million from the trust to pay their taxes and that they remained as protectors, with broad powers over the trustee, well into the litigation.

The effect of *Affordable Media* on the other types of offshore trusts or on domestic asset-protection trusts remains to be seen. Perhaps the outcome will be happier for settlors who lack the broad trust powers retained by the Andersons as cotrustees and trust protectors. On the other hand, the language of the Ninth Circuit’s opinion suggests a deep judicial hostility to trusts whose very purpose is to hog-tie American courts. It is also significant that the Andersons were required to retrieve funds from a trust established two years *before* they unleashed their Ponzi scheme. For now, it is clear at least that clients who use offshore trusts with antiduress clauses should be prepared to “bring their toothbrushes to court” (to paraphrase the trial judge) to prove that repatriation really is impossible.

Jonathan A. Levy
Portland, Oregon

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