

Question 3

Hank and Wendy married, had two children, Aaron and Beth, and subsequently had their marriage dissolved.

One year after dissolution of the marriage, Hank placed all his assets in a valid revocable trust and appointed Trustee. Under the trust, Trustee was to pay all income from the trust to Hank during Hank's life. Upon Hank's death, the trust was to terminate and Trustee was to distribute the remaining assets as follows: one-half to Hank's mother, Mom, if she was then living, and the remainder to Aaron and Beth, in equal shares.

Trustee invested all assets of the trust in commercial real estate, which yielded very high income, but suffered rapidly decreasing market value.

Hank, who had never remarried, died three years after establishing the trust. At the time of his death, the trust was valued at \$300,000. Subsequently, it was proved by DNA testing that Hank had another child, Carl, who had been conceived during Hank's marriage to Wendy, but was born following dissolution of the marriage. Wendy, Carl's mother, had never told Hank about Carl.

Wendy, Mom, Aaron, Beth, and Carl all claim that he or she is entitled to a portion of the trust assets.

1. At Hank's death, what claims, if any, do the trust beneficiaries have against Trustee? Discuss.
2. How should the trust assets be distributed? Discuss. Answer this question according to California law.

Answer A to Question 3

At H's Death, What Claims do the beneficiaries have against the trustee?

Duty of Care – Prudent Investing

A trustee has a duty to manage income as a reasonably prudent investor. Under old common law, this meant that each individual investment had to be relatively safe. Under the more modern standard, risky investments are permissible, as long as the portfolio as a whole has a relatively low level of risk. The trustee will not necessarily be liable for investment losses, as long as the investments had an acceptably low level risk. Here, investing all of the trust in real estates, a fairly risky investment, violated the duty of prudent investing. The portfolio as a whole would have a very high level of risk.

Duty of Care – Investment Diversification

Related to the prudent investor duty is the duty to diversify investments. T invested 100% of the trust assets in one form of investment – commercial real estate – a clear violation of the duty to diversify investments. T should have invested in a mix of stocks and bonds, and perhaps a small percentage could be in real estate.

Duty of Loyalty to Residuary Beneficiaries

When a trust is divided between an income beneficiary and a remainder beneficiary, the trustee owes a duty of loyalty to fairly protect the interests of both beneficiaries. This includes not making investment decisions solely for the benefit of the income beneficiary, and at the detriment of the remainder beneficiary. Here, T invested all the trust assets in real estate, which produces a lot of income (which would go to H, the income beneficiary) but will have very little principal left over due to rapidly decreasing market value. This violated T's duty of loyalty to the remainder beneficiaries M, A & B.

Duty of Communication

A trustee has a duty to keep the beneficiaries updated (at least yearly) as to the general status of the trust, and investment allocations. It's not clear on the facts here if T did this – T most likely did not, as the remainder beneficiaries would undoubtedly have complained earlier if they found out the trust was 100% invested in commercial real estate, solely for the income benefit of H. So T most likely breached his duty to communicate the status of the trust.

Remedies

The beneficiaries may sue Trustee personally for the loss in market value of the real estate (they may also sue for the increase in value that would have happened if T made a reasonably safe and diversified investment).

How should the trust assets be distributed?

Pretermitted Spouse

If a will (or trust) is formed before a marriage, and the spouse is omitted from the trust, it will be presumed that the omission was accidental and the spouse will be entitled to his or her intestate share. However, if divorce has occurred in the interim, it will be presumed the spouse was intentionally omitted and the spouse gets nothing. Here, H's trust was formed after marriage to W, but they had already been divorced for 1 year by the time the trust was formed, so W cannot claim to be a pretermitted spouse.

Community Property Law

Because California law applies here, W should have already received 1/2 of all community property (property acquired during marriage by the skill or labor of either spouse). So I'll assume H's trust was made only with his separate property, and the 1/2 share of CP he got upon dissolution. This means W has no rights to it unless H makes a gift to her.

Pretermitted Heir

If a will (or will substitute such as a trust) is formed before a child was born, and the child was omitted from the will, it will raise a presumption that the child was accidentally omitted, and the child will be entitled to his or her intestate share. When a child was born before the will or trust was executed, the testator did not know of the child's existence, the child will be treated as a pretermitted heir and will get the intestate share.

Here, it appears C was born before the trust was made (C was born right after dissolution and the trust wasn't made until 1 year after the dissolution). So normally C would not be a pretermitted heir; however, H had no idea C existed when H made the trust, as W never told H about C. And it's understandable H wouldn't have noticed, as the couple divorced soon after conception, so H may not have seen W much during the following year. And the child is H's child, suggested by the fact that C was conceived during marriage, and proved by DNA testing. I don't believe it matters that C was born following the dissolution of the marriage. Thus, C will be considered a pretermitted heir and will be entitled to an intestate share.

C's Intestate Share

Property is distributed intestate to the deceased person's spouse and issue, per capita, with right of representation. Per Capita means the property is distributed in equal shares at the first level of a living heir. Normally, a spouse gets 1/3 of the estate intestate if there are also living children. However, the spouse gets nothing intestate if divorce has already occurred when the settlor or testator dies. Here, divorce has already happened when H died, so W would get nothing intestate. H has three living children, so they each would be entitled to 1/3 of the \$300,000. Since there are living children, Mom would not get anything. This is in California, and divorce has already occurred by the time H died, so I'll assume W's share was already taken care of by community property law. This means C's intestate share would be \$100,000.

Abatement & Distribution

Abatement is the process by which money is cleared up for a new gift by reducing previously existing gifts. I believe that, unlike abatement when the estate is insolvent, abatement for a pretermitted heir is taken pro rata from both the residuary and general gifts (gifts or money or stock). Here, there is \$300K in the trust. M has a general gift of 1/2, and A & B get the remainder. Thus, before C's gift, M would get \$150K, and A & B would split \$75K each. C's gift of \$100K will take \$50 K (1/3) from M, and \$25K (1/3) from both A & B.

After abatement, C will end up with \$100K. M will get \$100 K. And A & B will get \$50K.

Answer B to Question 3

What claims do the Trust beneficiaries have against Trustee?

A trustee holds title to assets for the benefit of others, beneficiaries, and as such owes them certain duties. A trustee's violation of these duties can render him personally liable to the trustees.

Breaches of the Duty to Invest

A trustee has a duty to invest the assets of a trust and to do so with ordinary care a prudent person would use in investing their own money. Many states provide lists of acceptable investments. Likewise a trustee may consult professional investors to determine what is reasonable. In any event, two specific obligations must be met: 1) the trustee must diversify, and 2) the trustee must not speculate.

In this case, the trustee did not diversify and so has violated the duty to invest because all the trust assets were invested in real estate. Similarly, a court could find that the trustee was speculating in making these investments, which is also a violation.

Breach of the duty of loyalty

Trustees owe the beneficiaries a duty of loyalty and they owe this duty to each beneficiary equally. Favoring one beneficiary over others is a violation of this duty. In this case the trustee appears to have favored H (who was a beneficiary since income went to him during his life) over the other beneficiaries by making investments which maximized income, benefiting only H, and actually resulted in harm through diminished corpus value to the other beneficiaries. Trustee is personally liable for this breach to the beneficiaries.

Breach of the duty of care

Trustees owe beneficiaries a duty of care to act as a reasonably prudent person and the failure to properly manage the trust funds as described above is also a violation of this duty.

Other

It's also possible trustee breached his duty of accounting if he was not providing the beneficiaries with regular statements of the account balance. We need additional facts but the decrease in value indicates this could be the case.

How should the trust assets be distributed?

H created an inter vivos trust which terminated at his death and provided for 2 of his children (A & B) and his mother (if she was living). This trust was created while H was single and he never remarried. Hank died intestate but his inter vivos trust will be subject to the same probate rules as a will would have been.

Does W have any right to trust assets?

W is claiming an interest in trust assets but the trust was made after dissolution to her marriage to H. Absent some evidence that community property which should have gone to W under the court's continuing jurisdiction was used to establish the trust, W has no claim to the trust.

Carl's claim

Carl is H's child and he was conceived during but born after dissolution of the marriage. He was also apparently born before the creation of the trust since the trust was created a year after dissolution of the marriage. A child who is born after all testamentary instruments have been executed (including inter vivos trusts) or not provided for in them is pretermitted and will have a claim on decedent's estate. Here, that is not the case

since Carl was born before the trust was created and would therefore normally not have a claim. However, there is an exception when it appears that the only reason the child born before the execution of testamentary instruments was not provided for is that the parent did not know of his existence. That is the case here and so Carl will be considered a pretermitted child (his having been born after the marriage was dissolved is irrelevant).

What share does a pretermitted child take?

An omitted (pretermitted child) is entitled to take an intestacy share of the decedent's estate. The rules of intestacy would first provide for the decedent's spouse and children. Here, however, H leaves no spouse (as discussed above W has no interest in the trust) and so the intestacy rules would look to H's children. Under intestacy, children would take equally so Aaron, Beth, and Carl's share would be 1/3 each of the \$300,000 corpus. Thus, Carl's share as a pretermitted child is \$100,000.

What do the others take from the trust?

The trust provides that Mom gets 1/2 the corpus (assuming she's still living as appears to be the case) and the A & B split the remaining 1/2. Absent Carl's claim, Mom would've gotten \$150,000 and A & B would've each received \$75,000. Here, however, those amounts must be abated in order to pay for Carl's share.

In abating shares to pay for the claim of a pretermitted child the other beneficiaries will have their benefit reduced in proportion to the value they receive. Here Mom got 1/2 so she will have her share reduced by 1/2 of the amount due to Carl (i.e., \$50,000). A & B each got 1/4 so their amounts are each reduced by 1/4 the amount owed to Carl (\$25,000 each). Thus, the final distribution will be: Mom gets \$100,000, Carl gets \$100,000, Aaron and Beth each get \$50,000 and W takes nothing.