

Question 5

Henry and Wynn married in 2000. During the first ten years of their marriage, Henry and Wynn lived in a non-community property state. Henry worked on writing a novel. Wynn worked as a history professor. Wynn kept all her earnings in a separate account.

Eventually, Henry gave up on the novel, and he and Wynn moved to California. Wynn then set up an irrevocable trust with the \$100,000 she had saved from her earnings during the marriage. She named Sis as trustee and Henry as co-trustee. She directed that one-half the trust income was to be paid to her for life, and that the other one-half was to be paid to Charity, to be spent only for disaster relief, and that, at her death, all remaining assets were to go to Charity.

Wynn invested all assets in XYZ stock, which paid substantial dividends, but decreased in value by 10%. Charity spent all the income it received from the trust for administrative expenses, not disaster relief.

Later, Sis sold all the XYZ stock and invested the proceeds in a new house, in which she lived rent-free. The house increased in value by 20%.

Henry has sued Sis for breach of trust, and has sued Charity for return of the income it spent on administrative costs.

1. What is the likely result of Henry's suit against Sis? Discuss.
2. What is the likely result of Henry's suit against Charity? Discuss.
3. What rights, if any, does Henry have in the trust assets? Discuss. Answer according to California law.

QUESTION 5: SELECTED ANSWER A

1. Henry v. Sis

As discussed in #3, Henry does not currently have a personal interest in the trust assets. However, he is the co-trustee of the trust, and this may be sufficient to give him standing as trustee to bring an action against Sis for breach of her fiduciary duty as trustee.

Trust creation

To be valid, an express private trust must have a settlor, an ascertainable beneficiary, res, a valid purpose, and a trustee. However, the court will appoint a trustee if one is not provided for, or the elected trustee declines to serve. Here, Wynn is the settlor, and she has designated herself and Charity as lifetime beneficiaries, and Charity as the remainder beneficiary. Any natural person, entity or government can be a beneficiary of an express private trust. Both are ascertainable beneficiaries because they are either persons or entities expressly named in the trust instrument. The res can be any property or present interest. Here it is the \$100,000 from Wynn's separate account. The trust appears to have two purposes: to provide lifetime income to Wynn; and to contribute to disaster relief via Charity. To be valid, a trust purpose must be able to be determined from the trust document, and must not be illegal. Neither of the purposes are illegal and are clear from the trust document. Wynn has designated Sis as trustee and Henry as co-trustee, and from the facts it does not appear that either declined to serve. They must be competent but there is no indication of incompetency in the facts.

Charitable trusts differ in that they must have a charitable purpose: something that contributes to societal good, such as abating hunger, education generally, religion, or the like. The beneficiaries of the trust must be indefinite, not a specific person. Here, because Wynn is a specific person, this could not be a charitable trust.

A valid express private trust was created.

Trustee powers

A trustee has the powers expressly granted in the trust document itself, and those implied in order to effect the purpose of the trust. Here, the trust instrument directed Sis to pay one-half of the income to Wynn, and the other half to Charity. This expressly gave her the power to make these distributions.

Trustee duties

A trustee has the duty of loyalty, to act for the benefit of the beneficiaries solely, and not in her own self-interest or that of third parties. This duty requires the trustee to be impartial as to multiple beneficiaries. Here, Sis has a duty to treat Wynn and Charity impartially. If this were a revocable trust, she would have a primary duty during Wynn's lifetime to Wynn as the settlor, but the trust is irrevocable.

As part of the duty of loyalty, a trustee has a duty not to self deal. Sis is living in the house owned by the trust, rent-free. Thus she is reaping personal benefit from her position as trustee. She has violated her duty of loyalty.

The trustee has a duty of care as well, which requires her to act as a prudent person would in handling their own affairs. This includes the duty to account regularly to the beneficiaries, and not commingle trust assets with her own.

As part of the duty of care, a trustee has a duty to invest the trust res as a reasonably prudent investor would. Under the traditional view, this limited the holdings of the trust to things such as blue chip stock, 1st trust deeds on real estate, government bonds and other conservative and safe investments. Each separate investment was considered separately in determining this. Modernly, the investments are looked at as a whole, and factors such as the need for income, tax consequences, and particular trust purposes are considered. Thus, the court will need to look at how Sis invested the trust res in light of whether the trust was intended more for lifetime income sources, or as a gift to

Charity at Wynn's death, at how the income would affect taxes, at what was reasonable as an investment in light of what was available to invest, at what reasonable investors were doing at the time.

Wynn originally invested the trust assets in XYZ stock, which provided substantial dividend income but lost value overall. This would seem to indicate a preference for lifetime income over growth of the principal.

Henry will need to be able to show that a reasonably prudent investor would not have sold the XYZ stock and invested it in a house. The sale of the stock itself may have been prudent given the loss in value. However, a trustee also has a duty to diversify in order to reduce the risk of loss and enhance income/growth opportunity, as would a reasonable investor. While the duty to diversify may have called for Sis to sell some or all of the XYZ stock, that same duty would generally preclude sinking all of the proceeds into one property. The trust res is then subject to any decline in real estate in the market, and will not benefit from any gains in other potential investments. Sis has probably violated her duty of prudent investment, and has certainly violated her duty to diversify.

The duty to make the res productive requires that Sis put the assets to work for the benefit of the beneficiaries. When she lived in the house rent-free, she violated this duty. The rental income from the house is to be distributed to Wynn and Charity, not retained for her benefit.

Sis has a duty to effect the purpose of the trust, by ensuring that income is maximized, based on the express and apparent intent of the settlor. She has not done so by selling the income stock and buying a house that currently provides no income to the trust.

Because Henry is currently subject to these same duties as co-trustee, he is obligated to prevent the wrongdoing of the other trustee. Thus he has standing to bring an action against Sis for her violations of duty, as a trustee of the trust.

Remedies available

The remedies available against a trustee who has violated their duties includes removal, surcharge for lost income/profits, disgorgement of any benefit wrongfully taken by the trustee. This benefit does not run to Henry, who is acting solely for the trust beneficiaries' benefit.

Henry will seek an accounting for the rent that should have been paid by Sis while living in the house owned by the trust. These funds must be paid personally by Sis. Additionally, he will seek surcharge for the lost income from the XYZ stock or similar investment that would have maximized lifetime income. Sis will have to make up the shortfall in income from her own funds.

Finally, Henry will seek removal of Sis as trustee. The court may then allow Henry to act as sole trustee or may appoint someone else.

Given Sis's breach of duty, the apparent purpose of the trust, the court will allow all of these remedies.

2. Charitable trusts are enforced by the attorney general, rather than by private action. If Charity is a charitable trust, Henry will not have standing to bring an action.

Assuming Henry has standing as the co-trustee of Wynn's trust, he can seek a constructive trust by tracing the funds from the trust to Charity as used for admin purposes. This will mean that Charity's sole duty as trustee of the constructive trust is to use the funds as directed.

3. California is a community property (CP) state. All property acquired during marriage while domiciled in CA or another CP state is presumed to be CP. All property acquired prior to marriage, or after separation, is presumed to be separate property. Additionally, all property acquired at any time by gift, descent, devise or bequest is presumed to be CP.

All property acquired during marriage while domiciled in a non-CP state that would be CP if domiciled in CA, is presumed to be quasi-CP (QCP). At termination of the marriage, to determine the character of property, a court will look at the source of the funds used to acquire property, any applicable presumptions, and any actions by the spouses that may change the character of the assets. A mere change in form does not alter the character of the asset.

Source:

Here, the source of the funds for the house, which is the sole trust asset, can be traced back to the XYZ stock and further, back to Wynn's earnings as a history professor. Because all earnings by community labor are CP, these earnings would be CP if the spouses had been domiciled in CA at the time they were earned. Thus, by definition, they are QCP (defined supra). During marriage, QCP remains the SP of the owning spouse. At divorce or death of a spouse, the character as QCP affects the property determination.

Presumptions:

All assets acquired during marriage are presumed to be CP. However, as noted, the source of the house is earnings that are Wynn's SP until termination of the marriage. Spouses can also take title in ways that raise a presumption, such as a gift to the community, which arises on death of a spouse under Lucas. However, Wynn kept the funds in a separate account, and then created an irrevocable trust with the funds, so no alteration in the title is shown in the facts.

Actions of the spouses

Spouses can by transmutation or other actions alter the character of their own SP. Henry may argue that the change from Wynn's separate account to a trust is such a transmutation. However, a transmutation, to be valid, must be in writing, signed by the adversely affected spouse and clearly express the intent to transmute. This is not evident here, so no transmutation has taken place.

Distribution of assets

At divorce, QCP is treated as CP, and this would entitle Henry to half of the QCP. Death also impacts the character, depending on which spouse dies. If the SP owner (Wynn) predeceases the non-owning spouse, the non-owning spouse may choose their forced share (take against the will) in order to get to QCP assets. However if the non-owning spouse dies first, they have no right to devise the QCP that belongs to the other spouse.

As a result, Henry has no immediate right in the trust assets. In the event of divorce or death of Wynn, he would acquire such rights as are discussed above.

QUESTION 5: SELECTED ANSWER B

1. What is the likely result of Henry's suit against Sis

A trustee owes fiduciary duties of loyalty and care to the beneficiaries of a trust. A trustee may bring suit against a co-trustee for breaching the fiduciary duties, and move to have the violating trustee removed from their position.

A. Duty of Care

Generally, a trustee owes a duty of care to the beneficiaries to act as a reasonably prudent person under similar circumstances. This includes the duty to prudently invest trust property in a manner that will create the greatest return for the benefit of the trust.

i. Prudent investment

A trustee has a duty to prudently invest trust funds so as to increase the benefits from investments for the trust beneficiaries. Here, Sis sold all of the XYZ stock in the trust and used the proceeds to pay for a house. Sis will argue that this is a prudent investment because XYZ stock had decreased in value by 10%, whereas the value of the house has appreciated 20%. This increased the value of the trust property. However, Henry will likely argue that to tie up all of the trust assets in one piece of property which potentially can fluctuate wildly in the real estate market is not a prudent investment. Instead he will argue that Sis should have diversified to different stock from other companies other than XYZ in order to keep a more stable and broad base for the trust property.

Based on these arguments, it is likely that Henry will prevail against Sis in arguing that exchanging all of the stock into one parcel of real property is not a prudent investment.

ii. Duty to diversify

A trustee also has a duty to diversify the stock held by the trust. Here, as discussed above, the trust initially only held XYZ stock. Henry will argue that Sis had a duty to diversify the stock to include stocks from other corporations, and that consolidating the trust assets into one piece of property which is less liquid and potentially subject to market fluctuations in price and value violated the duty to diversify.

A. Duty of loyalty

A trustee is a fiduciary and owes a duty of loyalty to the beneficiaries and the trustor of the trust. Therefore, Sis has a fiduciary duty of loyalty to act solely in the best interest for the trust.

i. Duty to avoid self-dealing

A trustee has a duty to avoid self-dealing with respect to trust assets. The trustee must obtain court approval before the sale of any property which benefits the trustee personally. Here, Sis sold all of the trust assets and used the proceeds from the sale to purchase a house in which she lives in rent-free. She is therefore using trust assets for her own personal benefit, which is impermissible absent court authorization. She has a duty to pay fair market rent to the trust for use of the property in order to avoid a claim of self-dealing.

Therefore Sis has arguably violated her duty to avoid self-dealing

ii. Fairness to all beneficiaries

A trustee also has a duty to act impartially and fairly towards both the income and the principal beneficiaries. The trustee cannot favor one beneficiary over another in terms of their investments or distributions. Here, whereas Wynn and Charity are both

income beneficiaries of the trust currently, Charity is the only principal beneficiary after Wynn's death.

(a) "Income"

Income beneficiaries are entitled to cash dividends from stocks, and rents from property held by the trust. Initially XYZ stock issued substantial dividends which are considered income to the trust and distributed to the income beneficiaries. Therefore Wynn and Charity were sharing the substantial income beneficiary. However, as noted above, the stock declined in value and therefore was worth 10% less, therefore reducing the future value for the principal beneficiary.

However, upon changing the stocks for the house, the principal beneficiary would obtain a 20% increase in value of the property. However, Sis is not paying any rent for the property, and therefore Wynn is no longer getting an income from the trust as a result of this change. This change, coupled with the lack of rental payments by Sis, means that Henry will likely be successful in arguing that Sis has violated her duty to act fairly and impartially towards both income and principal beneficiaries.

D. Conclusion

Because of the aforementioned breaches in duty, it is likely that Henry will prevail against Sis in claiming a breach of trust. The trust would likely be entitled to a constructive trust for the unpaid rent that was due on the property, and Henry may have Sis removed as trustee for breaching her duties of care and loyalty.

2. What is the likely result of Henry's suit against Charity for return of the income

A. Purpose of a charitable gift

A trust must have a valid purpose in order to be properly formed. Here, part of the trust's express purpose at the time of formation was for income from the trust to be delivered to Charity but only go towards disaster relief. Charitable contributions and trusts are considered valid purposes and therefore the trust is permissible.

B. Violation of a condition by a beneficiary

However, a violation by a beneficiary of an express condition of the trust violates the trust purpose. The court will look at the totality of the circumstances to determine whether the language was intended to merely express a wish on the part of the trustor, or rather if it is an express condition for receipt and use of funds. Here, the trust had an express condition that the share of income given from the trust to Charity was only to be used for disaster relief. However, the beneficiary here instead used the funds for administrative expenses, not disaster relief. The Charity will likely argue that it was only a general wish because they would receive the full benefit of the property upon Wynn's death and therefore should be able to use and dispose of trust income in any manner that benefits the charity. However, Henry will likely argue that the express terms of the trust are explicit in requiring that the funds only be spent on disaster relief. Therefore the beneficiary has violated an express term of the trust.

C. Remedy for violation by a beneficiary

If a beneficiary violates an express term of a trust, the trustee can sue for return of the income used in violation of the trust terms. Therefore Henry would likely prevail in a suit against Charity for return of the income.

3. What rights does Henry have in the trust assets?

All property acquired during marriage in CA is presumed community property (CP). However, property acquired by (1) gift or inheritance; (2) expenditure of separate property funds, (3) the rents, profits, or income derived from separate property; or (4)

acquired before the marriage are presumed to be separate property (SP) of the acquiring spouse.

A. Quasi-Community Property

If a married couple acquires property in a non-community property state that would have been community property had the couple been residents of a community property state, such items are considered "quasi-community property" (QCP) and are potentially subject to community property laws if the couple later moves to a community property state. During the marriage, the QCP is treated as SP of the acquiring spouse. However, upon divorce or death of the acquiring spouse, the QCP will be treated as CP and divided equally between the spouses. Upon the death of the non-acquiring spouse, the property will remain the SP of the acquiring spouse.

B. Wages earned during marriage

Wages, earnings, and pensions earned during marriage are considered CP, absent an agreement between the spouses agreeing otherwise. Here, Wynn earned a salary working as a history professor while living out of CA. Regardless of whether she kept the earnings in a separate account, in CA the earnings would be considered CP. The facts do not show that Wynn and Henry had any agreements changing the character of the property. Therefore upon moving to CA, Wynn's earnings are presumed to be QCP. However, as noted above, they retain their SP characterization until death or divorce.

C. The trust assets

Wynn and Henry are still married at the time that Wynn sets up the trust fund with \$100,000 of her earnings. Even though these funds are earmarked as potential QCP, during the marriage they are still considered the SP of the spouse who earned them. Therefore at this time, Henry does not have any interest in the trust assets because of

the ongoing marriage. Henry will not have any possible rights to the trust assets until death or divorce.