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Private Law: Trusts

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TRUSTS

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PROHIBITED SUBSTITUTIONS

In *Succession of Materiste,*[1] a testamentary disposition in trust narrowly survived condemnation as a prohibited substitution. The will left certain immovable property to a bank trustee, naming as income beneficiaries the testatrix' mother, her eleven brothers and sisters and also naming certain successor and contingent income beneficiaries. Without identifying the principal beneficiaries as such, the will nevertheless provided that, at termination of the trust, ten percent of the corpus should be distributed to a church, 45 percent to certain named income beneficiaries and the remaining 45 percent

> among the descendants of my brothers and sisters by root. If any of my brothers or sisters does not leave descendants, then that portion shall go to the descendants by roots of the brothers and sisters who do leave descendants.[2]

The trial court held that the quoted disposition created a prohibited substitution in that it provided for a possible shifting of principal interests *subsequent* to the creation of the trust.[3] However, in order to salvage the disposition, the trial court exercised its power to sever the objectionable shifting provisions as is allowed by section 2251 of the Trust Code.[4] On appeal, the First Circuit speaking through Judge Crain took a more limited (and more charitable) view towards the quoted provision holding, in effect, that the shifting provision applied only in the event an intended principal beneficiary should die in the interval between the execution of the will and the testatrix' death and thus constituted no more than a vulgar substitution expressly permitted by article 1521 of the Civil Code.[5]

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1. 273 So. 2d 617 (La. App. 1st Cir. 1973).

2. *Id.* at 619.

3. LA. CIV. CODE art. 1520. Section 1972 of the Trust Code provides that upon a principal beneficiary's death his interest vests in his heirs or legatees except as to class trusts. Since no class trust was involved, the attempted shifting of principal *after the creation* of the trust would constitute a prohibited substitution. Crichton v. Succession of Gredler, 256 La. 156, 235 So. 2d 411 (1970).

4. "If a provision in the trust instrument is invalid for any reason, the intended trust does not fail, unless the invalid provision cannot be separated from the other provisions without defeating the purpose of the trust." LA. R.S. 9:2251 (Supp. 1964).

5. The disposition by which a third person is called to take the gift, the inheritance or the legacy, in case the donee, the heir or the legatee does not take it, shall not be considered a prohibited substitution and shall be valid.

The net result is the same whether one follows the reasoning of the First Circuit or the severance approach taken by the trial court. Indeed, one wonders whether either approach would have succeeded had writs to the supreme court been applied for. The quoted disposition is similar in many respects to the one stricken in *Crichton v. Succession of Gredler*,[6] since, at least arguably, it could operate to "shift" or "suspend" the vesting of principal until the termination of the trust. Moreover, in *Crichton*, the majority indicated that the severance provisions were inapplicable to dispositions taking effect only upon the *termination* of the trust. The result in *Materiste*, whether obtained by the severance route or by narrow construction of the quoted language appears consistent with the spirit the Trust Code, and, in particular, with section 1724 requiring that the Trust Code "shall be accorded a liberal construction in favor of freedom of disposition." One hopes that the supreme court will take the same view when presented with similar issues.

INVASION OF PRINCIPAL

Succession of Kaufman[7] is primarily concerned with the imposition of the Louisiana inheritance tax upon various beneficiaries of a testamentary trust. Mrs. Kaufman was survived by her husband, her only child, a daughter, and the daughter's three children. Her will placed her entire estate, consisting both of community and separate property, in a trust naming the three grandchildren as principal beneficiaries, her husband as income beneficiary to the extent of 85 percent of the income and her daughter as income beneficiary of the remaining 15 percent.[8] The will further purported to empower the trustee to invade principal to the extent

> *deemed advisable to care for my husband*, limited only by the law protecting the legitime of my daughter, and, after my husband's death to the extent *deemed advisable to care for my daughter*.[9]

For some years, Louisiana courts have consistently held that the "legal usufruct" of the surviving spouse, over the decedent's share of the former community property granted by article 916 of the Civil

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6. 256 La. 156, 235 So. 2d 411 (1970).

7. 274 So. 2d 471 (La. App. 1st Cir. 1973). Several commentators have already expressed their views as to the tax result. *See* Comment, 34 LA. L. REV. 46 (1973); L. OPPENHEIM AND M. NATHAN, SUCCESSIONS AND DONATIONS § 270, p. 405-07 (1973); *New Developments in the Law*, 21 LA. B.J. 55, 56 (1973).

8. Successor and contingent beneficiaries were also named.

9. Succession of Kaufman, 270 So. 2d 471, 472 (La. App. 1st Cir. 1973) (Emphasis added.)

Code, has its origin in the marriage contract.[10] For this reason, such legal usufruct is not acquired by an inheritance and thus is not property subject to the inheritance tax.[11] The same is true when such usufruct is "confirmed" by the will of the decedent spouse in community.[12] A similar result obtains where the surviving spouse receives an *equivalent* income interest in trust in lieu of the legal usufruct.[13] A principal issue in *Kaufman* was the extent to which the surviving spouse's income interest *was* equivalent to a legal usufruct and thus exempt from the inheritance tax. To the extent Mr. Kaufman was entitled to income from his wife's separate property there was no equivalency and thus no exemption, since the legal usufruct does not attach to the separate property of the decedent spouse. Accordingly, any inheritance tax exemption would apply only to his 85 percent interest in the income from trust property belonging to the community. The value of this income interest would have been exempt from the tax but for a power of invasion granted to the trustee.[14]

In *Succession of Lindsey*[15] and again in *Succession of Bellinger*,[16] it was held that the income beneficiary in whose favor the power of invasion is reserved is chargeable with the inheritance tax not only on the value of his income interest but upon the value of all of the property subject to invasion, as though such invasion were a legal certainty. The *Kaufman* court was satisfied that the Trust Code[17] prohibited invasion of that portion of the community property which

10. Succession of Marsal, 118 La. 212, 42 So. 778 (1907).

11. LA. R.S. 47:2404 (1950). *See also* In re Stelly's Estate, 185 So. 637 (La. App. 1st Cir. 1939).

12. *See* Succession of Lynch, 145 So. 42 (La. App. Orl. Cir. 1932). There, the will provided that the usufruct would not be forfeited upon the spouse's remarriage. The court indicated that continuation beyond remarriage does not subject the usufruct to inheritance tax. In *Kaufman*, there is no indication that any of Mr. Kaufman's income interest was to terminate upon remarriage. Assuming this is the case, his income interest was *more* than or *other* than the equivalent of a *legal* usufruct and thus arguably a testamentary usufruct. If testamentary, then it would be subject to the inheritance tax. The recent decision of the supreme court in *Succession of Chauvin*, 260 La. 828, 257 So. 2d 422 (1972) may add support to this view. See especially, Justice Tate's concurring opinion where he mentions the "unfortunate results" of the majority's rationale "such as (even though the widow never remarries in fact) estate [inheritance?] tax consequences (since the widow receives the usufruct *by will, not by law*) . . . ." *Id.* at 428 (Emphasis added.)

13. Succession of Bellinger, 229 So. 2d 749 (La. App. 1st Cir. 1969), *writ refused*, 255 La. 279, 230 So. 2d 587 (1970).

14. The court did not consider the factor of continuation beyond remarriage. *See* note 12 *supra*.

15. 179 So. 2d 669 (La. App. 2d Cir. 1965).

16. Succession of Bellinger, 229 So. 2d 749 (La. App. 1st Cir. 1969).

17. LA. R.S. 9:1847 (Supp. 1964).

constituted legitime and thus exempted from taxation the value of Mr. Kaufman's 85 percent income interest over that portion of the trust property. However, following *Bellinger*, the court held that the exemption did not apply to the value of his 85 percent income interest over the *disposable portion* of the former community property because such income interest was *not* the equivalent of legal usufruct. The marital contract did not establish the trustee's power to invade the disposable portion of the community property for Mr. Kaufman's benefit; rather such power was created by his widow's testament and the anticipated benefits from the exercise of such power constituted an "inheritance." It was the existence of a power of invasion which lost him the exemption and it is at this point where the court seems to have erred.

True, Mrs. Kaufman's will purported to invest the trustee with a power to invade trust principal on Mr. Kaufman's behalf. However, the invasion clause was insufficient. Section 2068 of the Trust Code provides that, except as regards the legitime trust:

> the trust instrument may direct or permit a trustee to pay . . . principal from the trust property to an income beneficiary for support, maintenance, education, medical expenses, or welfare *under objective standards set forth in the trust instrument*, even though the payment impairs the interest of another beneficiary.[18]

No such objective standards are found in the *Kaufman* will. Rather, the trustee was empowered to invade whenever "*deemed advisable* to care for my husband [or daughter] . . . ."[19]

Her executor sought to convince the court that invasion was so unlikely that the mere existence of the trustee's power to invade should have no bearing on the valuation of the income interest. That argument was rejected in *Kaufman* as it had been rejected earlier in *Bellinger*. However, a seemingly sound alternative argument would be that for want of objective standards the power of invasion could not be exercised by the trustee. Accordingly, since no community property was subject to invasion in his favor, his income interest thereon was exempt from taxation. Similarly, since none of his wife's separate property was subject to invasion, only the actuarial value of his income interest therein was subject to Louisiana inheritance tax.

18. LA. R.S. 9:2068 (Supp. 1964) (Emphasis added.)

19. Succession of Kaufman, 274 So. 2d 471, 472 (La. App. 1st Cir. 1973) (Emphasis added.)

TRUSTEE'S DUTY OF LOYALTY

Section 2082 of the Trust Code obligates the trustee to administer the trust "solely in the interest of the beneficiary." Two cases construing the duty of loyalty were decided during this past term. In *Martinez v. Alto Employees' Trust*,[20] an employee sued the trustee of a corporate retirement plan alleging that, upon termination of his employment, he had become entitled to a lump sum payment representing approximately 75 percent of his share in the plan. At the time he was first employed, the plan provided for such payment within 60 days after termination of employment. Subsequently, the plan was amended to give the trustees the discretion to withhold such distribution until the employees "normal retirement date" as defined by the plan. Mr. Martinez' employment was terminated subsequent to that amendment. When he thereafter demanded a lump sum payment of his share, the trustees refused on the ground that the amended plan permitted them to withhold the funds until his normal retirement date.

The evidence disclosed that the plan was self-administered and that the three trustees were the president of the employer corporation and his two sons, both of whom were also corporate officers.[21]

The plaintiff established that the trustees had uniformly honored all past requests for lump sum distributions from other employees whose employment was severed after the amendment to the plan discussed above. At the time of severance, Mr. Martinez had been employed by the company for twelve years and his account was the largest of any employee. It also appeared that he left his employment in order to go into competition with his former employer in the same line of business. There was testimony tending to establish that the trustees' sole reason for denying the lump sum distribution was to avoid, in effect the financing of a future competitor. Faced with these facts, the court had no difficulty in finding that the trustees had breached their duty of loyalty to their former employee-beneficiary and thus distribution of his account was ordered.

The federal tax law imposes adverse tax consequences upon employers who discriminate against their employees in the course of administering a pension, profit-sharing or other employee benefit plans.[22] The *Martinez* case should serve as a reminder that the Louis-

20. 273 So. 2d 735 (La. App. 4th Cir. 1973), *writ refused*, 277 So. 2d 675 (La. 1973).

21. Apparently a significant portion of the trust property consisted of purchase money notes acquired by the corporation in connection with trailer sales and thereafter negotiated to the trustees.

22. *See, e.g.*, INT. REV. CODE of 1954 § 401(a), (e). *See also* Treas. Reg. §§ 1.401-5, 1.401-12(f).

iana Trust Code applies to all such trusteed plans and provides its own set of rules and remedies for those against whom such discrimination is practiced.

REMOVAL OF THE TRUSTEE FOR CAUSE

Section 1789 of the Trust Code provides that a trustee may be removed by the proper court "for sufficient cause shown." What constitutes "sufficient cause" is not defined. This provision was tested by the Fourth Circuit in *Succession of Supple.*[23] Mrs. Supple's will created a trust naming her nephew as sole principal and income beneficiary and the Whitney National Bank of New Orleans as trustee. The principal trust property consisted of 20 percent of the outstanding shares of a closely held corporation whose principal corporate asset was a large sugar plantation. Prior to 1971, declining profits convinced all of the stockholders that the plantation should be sold and the corporation liquidated. However, the stockholders were divided as to an acceptable price. Current management, represented by the owners of 40 percent of the stock, were of the opinion that the plantation was worth in excess of $5,000,000; the owners of the remaining 40 percent (the non-management stockholders) thought that the corporation should accept an existing bona fide offer for $2,500,000 cash.[24] It was thus left to the corporate trustee to decide, by voting for or against continuation of present management, whether the offer would be accepted. At stockholders' meetings in 1971 and 1972 the trustee voted with management, effectively blocking the sale and liquidation of the company. Prior to both of these meetings, the beneficiary had urged the trustee to vote for the sale. The trustee's refusal to follow the beneficiary's wishes, coupled with the trustee's reputed relationship with the management group was alleged as "sufficient cause" for its removal. Specifically, it was argued that the trustee had breached the trust by retaining the corporate stock which yielded very little income.[25] Further, it was contended that the trustee prevented the sale and liquidation in order to retain the corporation's substantial commercial account and was thus guilty of self-dealing. This, the plaintiff failed to prove.

23. 274 So. 2d 790 (La. App. 4th Cir. 1973).

24. Had the offer been accepted, the trustee would have received $500,000 for its shares. At six percent yield, this amount would have generated trust income of $30,000 per year, which the trustee was obligated to distribute. Dividend income from the shares had been less than $2,000 per year. Of course, had an offer of $5,000,000 been secured, the trust's share, $1,000,000 might have been worth waiting for. The court noted that tax considerations might favor waiting for a higher offer.

25. *See* note 24 *supra*.

Prior to both the 1971 and 1972 stockholders' meetings, bank trust officers had assured him that the trust's stock would be voted against continuation of present management and thus in favor of the sale. Despite these assurances, a representative of the trust department attended the 1971 meeting and, under instructions from the bank's chairman of the board, voted to continue present management. At that meeting the stockholders appointed a committee to pursue the sale of the plantation. Alleging that the committee was inactive, the beneficiary thereafter pressed for the sale of the plantation or, alternatively, for the sale of the stock held in trust. He was advised that the trustee could not sell his stock without an appropriate court order and such order could not issue in absence of a bona fide offer. Undaunted, he persuaded a trust officer to execute a proxy in favor of the beneficiary's nominees to vote at the 1972 meeting. Again the bank's board chairman intervened and caused the proxy to be revoked and took steps to postpone the annual meeting. A large certificate of deposit was purchased by the corporation on the same day the proxy was revoked but the court was not convinced that these events were connected. Later, the beneficiary's attorney requested the bank to resign as trustee, but it refused. Shortly thereafter, the 1972 stockholder's meeting was held and again the trustee voted to continue present management.

Having eliminated self-dealing as an issue in the case, it remained to determine whether or not the trustee's actions constituted "sufficient cause" for removal. Unfortunately, the court added little meat to the "bare bones" concept of "sufficient cause":

> With the evidence before us, we cannot view the Whitney vote as inept or ill-advised. The bank supports present management who voted to explore the possibilities of selling their assets at a higher price than that offered by Burton. We make this observation because plaintiff has argued the Whitney has taken an irresponsible position in administering its finances. Under LSA-R.S. 9:1789, we think a trustee should be removed if the trust estate is *obviously being mismanaged*, whether there is or is not a conflict of interest. However, the record discloses no evidence of mismanagement but merely a conflict of *opinion* between the trustee and the beneficiary.[26]

Grounds for discharge of a fiduciary are articulated elsewhere in the law[27] and there is a considerable body of authority outside Louis-

26. Succession of Supple, 274 So. 2d 790, 794 (La. App. 4th Cir. 1973) (Emphasis added.)

27. *See, e.g.*, LA. CODE CIV. P. art. 4234 (removal of tutor for cause).

iana dealing with the discharge of a trustee for cause. In most instances, a breach of the trust must be proven although not every breach constitutes sufficient cause for removal. On the other hand, mere disagreement or unpleasant personal relations between the trustee and the beneficiary are usually insufficient. As is noted by Professor Bogert:

> the settlor has entrusted the management to the trustee and not to the beneficiary. The very fact that he created a trust showed that he did not want the beneficiary to be the controlling factor in the management of the property.[28]

In some circumstances, the hostile relations between the trustee and the beneficiary have resulted in the appointment of a new trustee, particularly where the trustee engages in malicious or vindictive conduct. It appears that the court was aware of these considerations which are reflected in its concluding statement:

> The plaintiff's animosity towards this trustee is understandable in view of the fact that the bank has reversed its position on several occasions. This has happened because the chairman of the board has overruled the decision of junior trust officers. As a consequence, plaintiff has been caused inconvenience and embarrassment. While we find the bank's conduct and attitude toward the trust beneficiary less than commendable from a public relations standpoint, we cannot conclude the bank has breached the fudiciary duty entrusted to it by Mary Eloise Supple in her last will and testament.[29]

On the facts as outlined in the opinion it appears that the legal result is correct although the trustee clearly lost on the public relations issue. The *Supple* case should be required reading for all who deal in that sensitive area of trustee-beneficiary relations.

ALLOCATION OF EXPENSES—ATTORNEY'S FEES

Short mention should be made of *Hughes v. Burguieres*[30] which involved the allocation of attorney's fees in connection with an alleged penalty clause which provided for the forfeiture of the interest of any beneficiary who should assert any claim against the settlor's estate, or attack his will in any respect, or contest the management

28. G. BOGERT, LAW OF TRUSTS § 160 (1973).
29. Succession of Supple, 274 So. 2d 790, 794 (La. App. 4th Cir. 1973).
30. 276 So. 2d 267 (La. 1973).

of the family corporation.[31] The beneficiary of one of twenty-six identical testamentary trusts instituted a stockholder's derivative action against the family corporation to enjoin certain action on the part of its directors and stockholders. The court of appeal held that such suit did not violate the penalty clause of the will but assessed the plaintiff's trust with all the attorney's fees and court costs. Writs were granted only on the narrow issue of whether the plaintiff should bear all of the attorney's fees and court costs or whether they should be allocated among all twenty-six trusts. Noting that the beneficiaries of all trusts were parties to the litigation and that all of their trusts would be affected by its outcome, the supreme court allocated the attorney's fees and costs among all twenty-six trusts. The result appears to be both equitable and correct.[32]

31. *See* L. OPPENHEIN AND M. NATHAN, SUCCESSIONS AND DONATIONS § 129, p. 254 (1973) (discussion of penalty clauses).

32. The court applied the Trust Estates Law since the will antedated enactment of the Trust Code. Section 2101(B) of the Trust Estates Law and section 2156 of the Trust Code provide for allocation of attorney's fees as between income and principal but not as between two or more trusts with an interest in the outcome of the litigation which are managed by the same trustee.