# Council Notes

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## Fiduciary Litigation Trends

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**STANDARD OF CARE FOR FIDUCIARIES ACTING WITH RESPECT TO PRIVATELY HELD BUSINESSES**

An issue arising more often in trust and estate litigation involves fiduciaries who are serving not only as a trustee or personal representative, but also as a partner, member, director or officer in a privately held business. Conflicts can arise when a fiduciary is wearing more than one hat, and these dual roles pose a number of questions for the fiduciary and his counsel. One of the major questions is: What standard of conduct applies to the fiduciary in his role as a director or officer; the standard of care under the business judgment rule or the higher standard of care applicable to trustees and personal representatives?

Under Colorado law, "officers, directors, and controlling shareholders of a corporation have a fiduciary duty to act in good faith and in a manner they reasonably believe to be in the best interests of the corporation and all of its shareholders."[1] The business judgment rule shields officers and directors who have adhered to this standard from liability and "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."[2]

The standard of care applicable to trustees and personal representatives under the Colorado Probate Code is that which "would be observed by a prudent man dealing with the property of another, and if the [fiduciary] has special skills or is named [fiduciary] on the basis of representations of special skills or expertise, he is under a duty to use those skills."[3] This standard of care is higher than that for corporate officers and directors. As explained by the venerable case *Meinhardt v. Salmon*, "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A Trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior…the level of conduct for fiduciaries [has] been kept at a level higher than that trodden by the crowd."[4]

When a trustee or personal representative is also serving as a fiduciary in a privately held business, for example, as the general partner of a partnership held by a trust, a conflict exists between these standards of care. Colorado does not yet have any case law addressing which of the standards govern. Certain sections of the Colorado Probate Code touch on this subject more broadly – in particular, C.R.S. §§ 15-1-413, 15-1-701, 15-1-702, and 15-1-804, but none are directly on point.

C.R.S. § 15-1-702 most closely addresses the issue and concerns certain actions taken by a fiduciary in connection with maintaining a family business and forming a successor entity to a family business. This section allows a fiduciary to maintain an interest in a family business entity if the governing instrument evidences an intent to retain the interest,[5] but does not address the standard of care that applies to the fiduciary's conduct in operating the business. The section also addresses the fiduciary's formation of a successor family business entity and provides that, except as otherwise provided in the governing instrument, the more lenient business judgment rule standard will apply with respect to the formation of the successor entity.[6] For example, the fiduciary "may vote and otherwise deal with respect to interests in the family business as the fiduciary believes in the good faith exercise of the fiduciary's business judgment, under the business judgment rule, to be necessary to complete such formation [of the successor family business entity] on such a favorable basis."[7]

A consistent approach to which standard of care governs fiduciary conduct when he is serving in dual roles has not been developed nationally, and different states have taken different positions.

One approach is that the fiduciary will be held to the higher standard of a trustee even when acting in a business capacity. This approach is illustrated by the New York case *In re Shehan*.[8] In *Shehan*, the fiduciary served as the personal representative under the decedent's will, as well as an officer and director of a related corporation and as a voting trustee of voting trusts with control of the corporation. The court examined the precedent and concluded that, regardless of whether the trust, estate, or fiduciary at issue owns a majority stake in the corporation, a fiduciary who serves in dual roles will be held to the higher fiduciary standard of care when acting with respect to the business. The court explained its understanding of the precedent as holding that "a trustee whose conduct as officer and director is motivated by self-interest, to the injury of beneficiaries whose welfare should be his sole concern, is guilty of breach of trust…[and the

holding] does not depend on majority ownership…The corporate entity has always been disregarded where necessary to prevent fraud."[9] The court then allowed broad discovery into the fiduciary's conduct as an officer and director of the corporation with respect to the conduct in dispute.[10]

Another approach is that taken by Georgia. Building off New York case law, the Georgia courts developed an exception to the position that the trustee standard governs actions taken when acting in a business capacity where (1) the settlor indicates an intent that the corporate standard of care should control, and (2) the trust owns a minority interest in the business. In such a situation, the corporate standard of care will apply to the fiduciary's corporate actions and duties.[11] The Georgia Supreme Court later made clear that the appropriate standard of care should be determined based on the capacity in which the fiduciary was acting and that both standards of care can apply to the same person in a given transaction depending on the particular role he is playing.[12] For example, in the breach of fiduciary duty case at issue in *Rollins*, the defendants served both as partners of a family partnership in their individual capacities and also as partners in their capacities as trustees of certain trusts.[13] The court found that, with respect to a claim that defendants breached their duties when they voted in their individual capacities to amend the partnership agreement, their conduct would be judged by the corporate standard of care.[14] On the other hand, with respect to a claim that they breached their duties when they voted as trustees of the trusts to amend the partnership agreement, their conduct would be judged by the trustee standard of care.[15]

While Colorado courts have not yet weighed in on what standard of care applies to Colorado fiduciaries serving in dual roles, the various positions taken by other states, as well as the position taken in C.R.S. § 15-1-702, provide useful guidance to both fiduciaries and attorneys advising fiduciaries on administration and defending against breach claims.

**TAX APPORTIONMENT**

Although we are seeing fewer taxable estates due to the current applicable exclusion amount of $5,490,000, [16] estate tax apportionment issues will likely continue to be litigated. It remains important to analyze each client's family and asset composition before selecting and drafting tax apportionment provisions.

A classic example of a tax apportionment scenario that may not fulfill the decedent's wishes is one in which a decedent with an $8M estate comprised of a $6M IRA and a $2M bank account provides that the residuary estate will bear the federal estate tax on all assets, including nonprobate assets. In such a situation, if the IRA passes to a significant other and the probate assets pass to the decedent's four children, the significant other receives the entire IRA estate tax free and each children receives only $249,000.[17] Any other& "blended family" scenario, such as a second or third marriage with children from prior marriages, also merits careful consideration of the appropriate tax apportionment provisions to accomplish the decedent's wishes.

In addition, the Colorado Uniform Estate Tax Apportionment Act (the "Act") may result in future litigation as the Act, much like the predecessor tax apportionment statute, applies only to the extent the dispositive document does not "expressly and unambiguously" direct the apportionment of estate tax.[18] Any perceived ambiguity (or discontent on the part of a beneficiary due to the apportionment provision in an estate planning document) could result in an action for judicial construction of the language in the estate planning document.

The Official Comment to the Act provide some guidance. For example, "a testamentary direction that 'all debts and expenses of and claims against me or my estate are to be paid out of the residuary of my probate estate' is not an express direction for the payment of estate taxes and will not control apportionment." The logic is that this may be mere boilerplate regarding the payment of expenses of administration rather than an express intent regarding apportionment of estate tax.[19] Furthermore, a statement that "all estate taxes be paid out of the residue of my estate" has been deemed ambiguous by some courts due to uncertainty as to the intent for the residue to pay tax on nonprobate assets as well. *Id.*[20]And, the Act overrules even an express and unambiguous tax apportionment provision to the extent it "increases the tax apportioned to a person having an interest in the gross estate over which the decedent has no power to transfer immediately before the decedent executed the instrument in which the apportionment direction was made," such as an irrevocable trust created by the decedent.[21]

C.R.S. § 15-12-1403(4) of the Act was added to address certain situations that might produce "ambiguity or impossibility of performance with respect to an estate tax payment direction in a dispositive instrument."[22] For instance, if an estate consists of substantial nonprobate assets that pass to beneficiaries other than the residuary beneficiaries under the relevant document and the tax apportionment provision is not express and unambiguous, a rule of construction provides that the nonprobate assets are subject to the apportionment provision.[23] This negates the need for litigation for this all too common scenario. In addition, even in the event that clear and unambiguous language provides that the residuary pay all the estate tax, if the residuary estate is insufficient in value to pay all the estate tax, the Act controls to enable apportionment, to the extent needed, to the pre-residuary gifts.[24]

The third situation addressed is the one in which either a marital or charitable gift made from the residuary estate might otherwise be subject to apportionment or one in which full apportionment amongst all assets would result in a reduction of the charitable or marital deduction. Under the Act, estate tax is apportioned amongst those interests that do not qualify for the marital or charitable deduction unless the relevant document contains express language to the contrary. Furthermore, "a direction to pay estate tax from the residue without 'apportionment' or 'right of contribution'" is insufficient to avoid the application of this portion of the Act.[25] These rules of construction are in accord with existing Colorado case law supporting equitable apportionment when the estate tax apportionment language in a document is not clear and intentional.[26]

Accordingly, some practitioners believe that the best drafting approach is a reference to the Act for apportionment purposes. The Colorado Estate Planning Forms (the Orange Book) now consistently reference Colorado law for estate tax apportionment.[27] Such an approach eliminates the uncertainty as to the interpretation of the tax apportionment provision in the governing document but may not be precisely in accord with an individual decedent's wishes. Furthermore, even with the default provisions, issues may arise as to rights of recovery for federal estate tax under the Internal Revenue Code. Thus, an intent to waive a right of recovery should also be expressly stated with a specific reference to the relevant recovery section of the Internal Revenue Code.[28] Some examples of specific tax apportionment language with waiver of specific recovery rights are included in the Orange Book Forms.[29]

**PROBABLE CAUSE AND NO CONTEST CLAUSES**

Despite common perceptions that no contest clauses constitute unenforceable boilerplate, the law in Colorado is that such clauses are actually enforceable. In general, a no contest clause is a provision in a will (and sometimes in a trust) designed to discourage beneficiaries from contesting the document by providing for the disinheritance of a contesting beneficiary.

While there is only limited authority in Colorado regarding litigation and enforcement of the clauses, Colorado is among the majority of states that allow for enforcement of no contest clauses. As the Colorado Supreme Court recently granted cert to a case involving a no contest clause, the clauses are a topic that is currently of interest to the courts of which litigators and planners alike should be aware.

There are two identical statutes in the Colorado Probate Code allowing for the enforcement of no contest clauses. C.R.S. §§ 15-11-517 and 15-12-905 provide that "[a] provision in a will purporting to penalize an interested person for contesting the will or instituting other proceedings relating to the estate is unenforceable if probable cause exists for instituting proceedings." This language has been interpreted by the Colorado Court of Appeals in *In re Estate of Peppler*[30] and *In re Estate of Sandstead*,[31] and the court's interpretation of this language is instructive for attorneys advising clients who are either bringing or defending against a contest.

*Peppler* was the first Colorado case to interpret C.R.S. § 15-12-905, in which the court adopted the definition of "probable cause" as set forth in the Restatement: "The existence, at the time of the initiation of the proceeding, of evidence which would lead a reasonable person, properly informed and advised, to conclude that there is a substantial likelihood that the contest or attack will be successful."[32] This formulation is commonly known as the "probable cause exception," i.e., the no contest clause will be enforced against the contesting beneficiary unless probable cause exists for bringing the contest. A majority of states allow for enforcement of no contest clauses subject to this probable cause exception.[33]

In determining whether probable cause exists for bringing a contest, the *Peppler* court noted that one factor to be considered is whether the contesting beneficiary sought the opinion of "disinterested counsel" in good faith and after full disclosure of the facts.[34] The court did not, however, provide guidance as to what is considered "disinterested counsel," and the phrase is not defined in the Restatement, but Colorado commentators have explained that "disinterested counsel" likely does not include the contesting party's counsel in the underlying litigation. If the advice and opinion of the attorney prosecuting the contest were sufficient, then that factor would be rendered essentially meaningless as it would nearly always be met.[35]

In addition to consulting with disinterested counsel, a contesting party and his attorney may also consider engaging in early discovery – for example, obtaining the drafting attorney's file and interviewing the drafting attorney and other key witnesses – as part of the process of determining whether probable cause exists and before filing a contest. Regardless of whether early discovery is done, the contesting party would be wise to regularly evaluate the available information in order to assess whether probable cause for the contest exists in the first place and continues to exist throughout the case. It is possible that facts will be developed throughout the course of the litigation that will change the probable cause assessment. If this happens, the contesting party may be able to save himself from disinheritance by withdrawing the contest if it later becomes clear that he no longer has probable cause.

More recently, the court of appeals again considered the issue of probable cause in *In re Estate of Sandstead*. In reaching its decision to enforce the no contest clause at issue, the *Sandstead* court adopted the definition of "probable cause" from *Peppler* and the Restatement.[36] The court also stated that "[c]ourts generally do not enforce [a no contest] clause when a beneficiary *acts in good faith* and has probable cause to challenge the will."[37] Including this "good faith" language, which also appears in *Peppler*,[38] raises a question about whether the courts were simply referring to the general proposition that litigants should bring their claims in good faith, or whether the language is intended to add an additional requirement for contesting beneficiaries to meet. If the language is intended as an additional requirement, then Colorado would join the minority of states that require a contesting beneficiary to have, in addition to probable cause, a subjective good faith belief in the merits of the contest.[39]

*Sandstead* is currently on appeal to the Colorado Supreme Court. One of the issues on which the court granted cert is whether probable cause existed for the contest.[40] The supreme court's opinion should, therefore, shed some light on whether contesting beneficiaries in Colorado must also meet the good faith requirement, in addition to having probable cause, in order to avoid disinheritance and should also provide additional guidance on the contours of the probable cause exception in Colorado.

**TANGIBLE PERSONAL PROPERTY AND UNUSUAL ASSETS**

While the big ticket items in an estate (and the focus of much litigation) tend to be cash, securities, and real estate, litigation continues to revolve around the division of tangible personal property and other miscellaneous assets. These cases appear to be increasing in frequency.

All too often beneficiaries do not want to hear that the relevant estate planning document controls. How often have we heard a variation of "…., but Mom said…?" Mom may have, for instance, verbally, at three different times, told three of her four children that they could have a particular item at her death and yet never indicated in her will or tangible personal property memorandum who should receive the item.

Mom may also have never known that her beautiful diamond was cubic zirconia and thus, by leaving it to a particular child, that child ends up with much less in value than the other children. Or, Mom may have thought that all of her art had nominal value, but one child ends up with what turns out to be a $10,000,000 original painting. And, even more frequently, family members tend to pursue litigation over items of sentimental value. One more open-ended issue is the appropriate disposition of three dogs when only one of the three is mentioned by name in the relevant document as going to a specific beneficiary.

Clients often want to provide a surviving spouse the ability to remain in the personal residence for a designated period of time without making specific provisions for the mortgage payments, taxes, and maintenance. Furthermore, even if a specific provision states that the surviving spouse is responsible for such expenses, what happens if the surviving spouse does not pay or is financially unable to pay such expenses? One case involved a life estate in a wine cellar. The issue was whether the life tenant was allowed to consume the wine.

Fiduciary responsibilities are litigated in this context as well. By way of illustration, what should the fiduciary do with older, ailing pets if there is no named beneficiary of such pets?

A pro rata division of intellectual property may not be the desired distribution of the beneficiaries and may be difficult to accomplish. If the fiduciary takes an alternative approach and allocates the intellectual property to one beneficiary and other assets to the remaining beneficiaries and the valuation of the intellectual property turns out to be inaccurate, the result can be an unequal division of the total assets. Furthermore, with respect to the valuation of the intellectual property, the future potential benefits, particularly for deceased celebrities, may be the most difficult to quantify.

We have already seen litigation nationwide regarding assisted reproductive technology ("ART") and anticipate more in the future. Unclear provisions in estate planning documents with respect to eggs, sperm, and embryos may result in litigation between the various beneficiaries and parties claiming rights to the genetic material. Furthermore, if the donor left specific written instructions as to the future use of the genetic material, those instructions may control even if they are not in the estate planning documents. For purposes of intestacy or class gifts, an adopted child may in certain situations still inherit from a parent whose parental rights were terminated.[41] In such a situation, a clear provision in the relevant estate planning document defining only named children as the children of the individual could avoid an unintended result. Additional issues may arise if a child conceived within forty-five months of the deceased parent's death is not included as a child in a distribution to the deceased parent's descendants.[42]

In addition to attempting to anticipate beneficiary conflicts, it is important to ascertain at the estate planning stage, the existence of ART, intellectual property, guns, drones, etc. in order to make appropriate distribution of such assets at the client's death. It may even make sense to dispose of certain assets, such as timeshare interests or guns, prior to death. Regardless, however, litigation is likely to continue if the distribution for any reason seems unfair to one of the beneficiaries.

[1] *Polk v. Hergert Land & Cattle Co.*, 5 P.3d 402, 405 (Colo. App. 2000); *see also* C.R.S. § 7-108-401.
[2] *Curtis v. Nevens*, 31 P.3d 146, 151 (Colo. 2001) (en banc) (internal quotation omitted).
[3] C.R.S. § 15-16-302; C.R.S. § 15-12-703 ("A personal representative is a fiduciary who shall observe the standards of care applicable to trustees as described by section 15-16-302.").
[4] *Meinhardt v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).
[5] C.R.S. §15-1-702(2).
[6] *Id.* at (3).
[7] *Id.* at (3)(b).
[8] *In re Shehan*, 285 A.D. 785 (N.Y. App. Div. 1955).
[9] *Id.* at 794.
[10] *Id.* at 795.
[11] *Rollins v. Rollins*, 755 S.E.2d 727, 715-16 (Ga. 2014).
[12] *Rollins v. Rollins*, 780 S.E.2d 328 (Ga. 2015); *Rollins v. Rollins*, 790 S.E. 2d 157 (Ga. Ct. App. 2016) (applying the rule).
[13] *Rollins*, 780 S.E.2d at 336.
[14] *Id.* at 337.
[15] *Id.* at 336.
[16] Rev. Proc. 2016-55, 2016-45 I.R.B. 706.
[17] 8,000,000 – 5,490,000 =2,510,000. 2,510,000 x .4 = estate tax of 1,004,000. 2,000,000 – 1,004,000 = 996,000. 996,000 ÷ 4 = 249,000 per child.
[18] C.R.S. § 15-12-1403(1)(a).
[19] Official Comment to C.R.S. § 15-12-1403.
[20] *Id.*
[21] C.R.S. § 15-12-1403(3).
[22] Colorado Comment to C.R.S. §15-12-1403(4).
[23] C.R.S. §15-12-1403(4)(a).
[24] *Id.* at (4)(b).
[25] *Id.* at (4)(c).
[26] Colorado Comment to C.R.S. §15-12-1403(4); *In re Estate of Kelly*, 584 P.2d, 640, 641 (Colo. App. 1978).
[27] *Colorado Estate Planning Forms (Orange Book Forms)*, Seventh Ed. (CLE in Colo., Inc. Supp. 2016) (hereinafter *Orange Book Forms*).
[28] C.R.S. §15-12-1403(5).
[29] *Orange Book Forms, supra* n.26, at Note on Use 4 in Tab A.
[30] *In re Estate of Peppler*, 971 P.2d 694 (Colo. App. 1998).
[31] *In re Estate of Sandstead*, 2016 COA 49 (Apr. 7, 2016).
[32] *Peppler*, 971 P.2d at 697 (citing Restatement (Second) of Property: donative Transfers, § 9.1, cmt.j (1981)).
[33] Baker et al., "You Can Take It With You – Assuring Compliance with Decedent's Wishes in an Era of Litigation and Flexibility," Chart 1, 2016 ACTEC Annual Meeting, Las Vegas, Nevada.
[43] *Peppler*, 971 P.2d at 697.
[35] Swank, "No Contest Clauses: Issues for Drafting and Litigating," 29 *The Colorado Lawyer* 57 (Dec. 2000).
[36] *Sandstead*, 2016 COA 49, ¶ 63.
[37] *Id.*
[38] *Peppler*, 971 P.2d at 697.
[39] Baker et al., *supra* note 32.
[40] *Sandstead-Corona v. Sandstead*, No. 16SC386, 2016 WL 6837326 (Colo. Nov. 21, 2016) (en banc). The other issue on appeal in *Sandstead*that relates to no contest clauses is "[w]hether the court of appeals erred in affirming the district court's extension of a no-contest clause from a trust into an accompanying pour-over will."
[41] C.R.S. §15-11-119.
[42] C.R.S. §15-11-705(7)(b).

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