

LITIGATION REVIEW

UP-TO-DATE ANALYSIS FOR CLIENTS AND FRIENDS OF THE FIRM

Ignoring family relationships can lead to long, protracted litigation.

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Novack and Macey's lawyers are litigators, not estate planners. Yet, we have learned many lessons about estate plans in the course of our litigation work. Simply put, a great deal of litigation occurs because many seemingly excellent estate plans are ticking time bombs ready to explode.

How can this happen when a plan appears to cover all the bases? From a litigator's perspective, it appears that all too frequently an important element of the estate planning process is ignored; namely, that estate planning involves family relationships, which are often complex and not always ideal, to say the least. This holds especially true in situations where the person whose estate is at issue has had more than one spouse, has had children from different marriages, or, where one beneficiary of the estate at issue is estranged from the other beneficiaries or feels like an outsider.

Even without these special risk factors, if litigation is to be reduced, family relationships should be an important consideration in every estate plan. Indeed, many families that appear to get along become suspicious and turn to litigation when a wealthy family member dies and distribution of his or her estate is at stake. Unfortunately, such litigation can be protracted, can eat up a significant portion of an estate and can cause permanent damage to the family.

This article will touch on just a few of the potentially devastating mistakes in estate planning and administration that can give rise to litigation.

THE MISCONCEPTIONS

Although there are many misconceptions that can doom even a well-executed estate plan, there are some that arise time and again and which breed litigation. For instance, many people who are careful in their professional lives are not as careful when it comes to what they believe is "their" money. They behave as though:

- Trust assets are really no different from assets they own outright and, therefore, can be treated informally;
- Family members will work together as a group; and
- Any beneficiary or heir who objects to the disposition of the estate or to the conduct of the trustee or executor in managing the estate can be controlled by a "disinheritance clause" that is, a provision in a trust or will disinheriting any beneficiary who files any type of suit or claim against the trustee, the executor or a co-beneficiary.

These commonly held beliefs are wrong, however, and can leave executors, trustees, heirs and/or beneficiaries with substantial litigation exposure.

PAY ATTENTION TO FORMALITIES

Many people create one or more trusts as estate-planning devices. Unfortunately, in dealing with trust assets, people sometimes do not pay attention to formalities such as ensuring that a note is issued when money is loaned from one trust to another and, if a note is executed, seeing to it that the note

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is canceled when the debt is repaid. This happens because donors all too frequently forget that they do not own trust assets outright. That is understandable. After all, their hard

work generated the assets in the first place and, as far as they are concerned, the trusts are “all in the family” anyway. This problem is worsened when the donor continues to, at least indirectly, control all the assets of the various trusts created to preserve his or her estate. In such circumstances, people frequently forget that trust assets are no longer theirs and they pay little attention to formalities.¹

Contributing to this lack of attention to formalities is the often misguided notion that, after the donor dies, his or her family can and will work together to figure out which trust owns what and which trust owes money to another trust. However, family members, particularly those who believe they were slighted in the distribution of an estate, can become suspicious no matter how much money is at stake, and a lot of money can create a lot of suspicion. If the deceased has not paid attention to formalities and has not ensured that all transactions are well documented, trying to unravel what beneficiary has an interest in which asset can be like trying to keep the characters straight in a Russian novel. Even well-meaning beneficiaries can disagree, and everyone is left guessing what was intended in the first place. This creates problems and, ultimately, can lead to litigation.

A COMMON SCENARIO

Perhaps an example best illustrates this point. Suppose one trust has available cash and another’s cash is tied up in illiquid investments. It may make perfect business sense for the cash-rich trust to put up the cash for both trusts — that is, to loan money to the trust whose money is tied-up. The donor knows that the cash-poor trust owes the cash-rich trust money, and intends for the cash-poor trust to pay the money back when cash is available. If the donor has a large family with many trusts, numerous transactions may be made in this manner.

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To complicate matters further, maybe the initial loan is not paid back when cash becomes available in the illiquid trust

because that cash is needed for yet another investment. If the donor dies before these interrelated deals run their course, the situation can be extremely convoluted and difficult to sort out. This scenario, which is not unusual, creates a litigation time bomb.

There is nothing inherently wrong with one family member’s trust borrowing from another’s — as long as it is in both trusts’ interests. Such measures may make good business sense. But a trust is a separate legal entity, and a trustee has legal duties to it. No matter how many trusts have been created, the fact remains that the trusts are separate and distinct from the trustee and from each other. Accordingly, formalities must be followed — notes must be executed and canceled and other formalities followed. If formalities are ignored, after the donor dies, it will be up to his or her family to unravel the mess. One simply cannot assume that a family will work this out. Moreover, if the only one who really knows what transpired has died, there is no one around to fully explain what happened. In such circumstances, litigation may be inevitable.

AN ESTATE PLAN SHOULD BE DISCUSSED WITH THE BENEFICIARIES

Because the whole notion that a family will work out problems is often unrealistic; certain precautions should be taken. For example, an estate plan should be explained to the benefi-

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ciaries so that any resistance can be detected and, perhaps, resolved while the donor is still alive and can do something about it. In addition, to reduce the likelihood of disputes, documents should be drafted clearly.

An example is illustrative. Many people leave their assets in various trusts for the beneficiaries to “share and share alike.” Although it may make perfect sense to leave a family business to all family members, this scenario can create problems. Among other things, the beneficiaries who do not control the family business are frequently jealous and distrustful of those beneficiaries who do. On the other hand, the beneficiaries in

¹Failing to treat trust assets as distinct from personal assets may create tax complications and/or other problems. This article, however, will not discuss those matters.

control may be resentful of those who do not work for the family business, yet reap benefits through stock or otherwise. If the donor's intentions regarding the business are not discussed prior to his or her death and if the relevant trust provisions are not clearly drafted, resentment can easily be played out in court. If it appears that trouble may ensue, the donor should consider making other plans, or attempt to take steps which may lessen the chance of litigation. If the donor desires to leave assets in a trust to "share and share alike" such as a family business, the trust documents should address areas of potential friction, such as how shared assets are to be managed and the terms that govern any sale of such assets. Further, the terms of compensation for those who will be directing and controlling family assets should be specified. If these matters are not clearly drafted in the operative documents, protracted litigation is likely to ensue.

Moreover, any such litigation is likely to involve not only family members, but also, third parties such as non-family members who are directors and officers of the family business. By the time the litigation is over, family and other relationships are likely to be destroyed and the value of the jointly-held asset will have plummeted.

THE DISINHERITANCE CLAUSE

This leads to another misplaced assumption — the idea that a clause that disinherits any family member who challenges a will or trust will insulate a family from litigation. This assumption is wrong because courts frequently decide that disinheritance clauses are void because they are *against public policy*. If a court makes such a finding, the disinheritance clause will not be enforced. In all events, courts almost always recognize that a beneficiary has a right to know how his or her trust or other assets have been handled. Thus, at the very least,

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a beneficiary can usually bring an action for an accounting or allege that his or her trustee breached its fiduciary duty. Such actions usually will not cause a beneficiary to be disinherited even when there is a valid disinheritance clause.

Where does all of this leave someone trying to plan an estate?

- Remember that any assets held in a trust are the trust's assets and that trustees have duties to trusts.
- Proceed as though family members will not work things out and take the proper precautions — make certain that transactions are properly documented, that beneficiaries are aware of an estate plan and that trust provisions are clearly drafted.
- Further, if a disinheritance clause is warranted, make sure it is drafted properly, but understand that it will not stop all types of litigation.

In short, recognize that families do not always work well together and face this fact. This may save heirs and/or beneficiaries a great deal of pain, heartache and money in avoided litigation.

NOVACK AND MACEY'S LITIGATION EXPERIENCE WITH RESPECT TO ESTATES AND TRUSTS

Novack and Macey, and Karen L. Levine in particular, has handled many litigation matters relating to estates and trust and estate matters, including challenges to, and defenses of, sophisticated trusts and estate plans. For further information or questions about Novack and Macey's experience or this article, please contact Karen L. Levine.

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