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Court Denies Retroactive Effect to Unitrust Statute

There are various ways one may seek to apply the unitrust method of defining income to a trust. The unitrust method is based on a flat percentage of the value of the trust assets, and is governed by Optional Unitrust Provision, EPTL 11-2.4 (b).

The unitrust method may be applied (i) when the creator so states in a governing instrument; (ii) upon obtained consent from all interested persons before Dec. 31, 2005, the trustees may elect the unitrust method of determining income for pre-Jan. 1, 2002, trusts; (iii) same as (ii) if the trustee so determines within his or her discretion; (iv) upon consent obtained from all persons interested before the end of the second full trust year after creation of the trust if the trust in question was created on or after Jan. 1, 2002; (v) same as (iv) if the trustee so determines within his or her discretion; and (vi) by bringing on a petition to the court having jurisdiction of the trust requesting that the Uniform Principal and Income Act, EPTL §11-A, not apply to the trust and that the unitrust provision found in EPTL 11-2.4 apply instead.

The election method can be referred to as the "(e)(1)(B)" method for ease of description and the petition method can be referred to as the "(e)(2)(B)" method.

Let's assume that one brings on a petition to apply the unitrust statute; the (e) (2) (B) method. So far so good. But as of what date may the petitioner seek to apply the unitrust regime to a trust that is already in existence? Or more pointedly, as of what date should a petitioner be allowed to apply the unitrust regime to a trust that has already been in existence before Jan. 1, 2002?

The unitrust provision creates a relatively fixed definition of income — the unitrust amount — which the statute has ordained as a reasonable balance between principal and income. Given this safe harbor, trustees now can create optimal portfolios and do not have to allocate any of the assets of a trust to income production if they so choose since they simply need pay out the unitrust amount to the income beneficiary. Instead of having to invest in a manner to create a fixed dollar amount of income from investment, the portfolio can ebb and flow with the cycles of the market. Trustees will, under this portion of the new statute, be able to build a portfolio designed to grow at an annualized rate equal to the unitrust percentage plus an additional amount to pay costs and outpace inflation.

This rationale would seem to indicate that application of the election to the first year in which assets became subject to the trust would provide the most flexibility in applying the new investment theory, but more on that later.

EPTL 11-2.4 contains two provisions that could arguably be applied to answer the timing question. The first is EPTL 2.4 (d)(1), which states:

> The interest of a current beneficiary or class of current beneficiaries in a unitrust amount begins on the dates specified in the governing instrument, on the date specified in an election to have this section apply pursuant to clause (e)(1)(B), on the date specified by the court pursuant to clause (e)(2)(B) or, if no date is specified, on the date assets first become subject to the trust.[1]

Seemingly, the election could therefore be made as of any date specified in the election even retroactively to the first day assets became subject to the trust.

The second section speaking to timing is EPTL §11-2.4 (e)(4)(A), which states:

> This section shall apply to a trust with respect to which there is a direction in the governing instrument in accordance with clause (e)(1)(A), an election in accordance with clause (e)(1)(B), or a court decision rendered in accordance with clause (e)(2)(B) as the first year of the trust in which assets first become subject to the trust, unless the governing instrument or the court in its decision provides otherwise, or unless the election in accordance with clause (e)(1)(B) is expressly made effective as of the first day of the first year of the trust commencing after the election is made.

Thus, both sections contain language seeming to permit the election as the first year of the trust in which assets first become subject to the trust.

In the *Estate of Jacob Heller* (NYLJ, Jan. 23, 2004, p. 25), the trustees elected on March 1, 2003, to apply the unitrust method as of a date 14 months prior to the date of the election and that being Jan. 1, 2002. Jan. 1, 2002, is also the effective date of the statute.

The trust in question was established many years before the election date in 1990. The attorney-in-fact for the income beneficiary of the trust petitioned the court on March 28, 2003, to deny effect to the retroactive date and to annul the election. The court found in partially granting a motion for summary judgment that the first timing provision mentioned above, EPTL §11-2.4 (d)(1), was not intended to apply to preexisting trusts. The court essentially reasoned that EPTL 11-2.4 (d)(1) did not apply because EPTL 11-2.4 (e)(4)(A) is the proper section governing the time when a unitrust provision could apply to a trust in existence before Jan. 1, 2002.

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The opinion stated that "it is clear that the date of funding provision [(d) (1)] was not intended to apply to preexisting trusts that had been funded prior to the effective date of the statute on January 1, 2002." Of course, one will quickly note that EPTL 11-2.4 (e)(4)(A) quoted above also contains the language "as of the first year in which assets first become subject to the trust".

The court reasoned, however, that there is a proposed amendment to the language of EPTL 11-2.4(e)(4)(A) in pending Senate Bill SO40704 which would change the language of EPTL 11-2.4(e)(4)(A) to state " that an election pursuant to EPTL 11-4 (e)(1)(B) shall apply: as of the date specified in the election, which may be any day within the year in which the election is made or the last day of the year... made."

The court found that the intended meaning of the existing language of the statute was the same as the proposed amendment. This court decision thus comports with the decision in *Matter of Edward J. Ives* (NYLJ, July 28, 2002, p. 28) in finding that retroactive application of the unitrust method will not be permitted.

In *Ives*, however, the court had before it a petition to apply the unitrust method. In (e)(2)(B) the language of the statute includes the provision that the effective date is subject to the decision of the court.

Compare *Heller* where the court had before it a discretionary election to apply the unitrust method. The decision in *Heller* thus applies the *Ives* rule to elections now also. The court has thus flushed out yet another aspect of the timing issue. The surrogate found that the discretionary election would only be effective as of Jan. 1, 2004, that being the first day of the year commencing after the election was made notwithstanding an apparently effective election choosing an earlier date.

Impact of Amendment

Does the proposed statutory amendment limit the usefulness and intended effect of the unitrust option? As stated previously by this author, trustees under the unitrust statute will be able to use modern portfolio theory to build a portfolio designed to grow at an annualized rate equal to the unitrust percentage plus an additional amount to pay costs and out pace inflation. The problem with the law as it existed prior to the unitrust amendment was that trustees were typically balancing the needs and rights of the remainderman with those of the income beneficiary.

So, for instance, a portfolio having a mix of 80 percent equities and 20 percent fixed income would address future growth for the remaindermen but leave the income beneficiary with insufficient income. And the reverse portfolio mix of 20 percent equities and 80 percent fixed income investments would leave our hypothetical remainder beneficiaries crying foul due to lack of growth.

Many trustees, it is reasonable to believe, would essentially invest 50 percent equities and 50 percent fixed income so that neither party was satisfied but perhaps neither party could prevail in court. In applying the unitrust option retroactively perhaps the thought was that the trustee could recoup funds from an income beneficiary by opting into the unitrust retroactively and then use those funds to rebalance our hypothetical 50-50 portfolio to the 80 percent equity/20 percent fixed income scenario but at the same time being able to satisfy the income beneficiary with the fixed unitrust payout fueled by capital gains from the equities.

Removing this ability on the part of the trustee by only allowing the prospective application of the statute may leave a trustee in the 50-50 investment scenario with insufficient funds to repurchase equities in a short enough time frame to effectively engage modern portfolio investment theories. In fact, the trustees in *Heller* made this very claim when they denied they abused or exceeded their discretion or breached a fiduciary duty by electing into the unitrust regime.

Why then did they suffer the result in the case? The reasons are obvious Their economic and investment theory broke down for the court when we discover that the effect of the *Heller* trustee's exercise of discretion in making the unitrust election was to leave their 95-year-old beneficiary with annual maintenance costs of $160,000, annual income distributions of $190,000 before application of the unitrust method, and annual income distributions after the unitrust method of only $70,000. An astonishing $120,000 reduction in annual income!

The trustees were also the 40 percent presumptive remainderman of the trust. The court ruled, however, that such a conflict did not automatically prevent their exercising the unitrust option and denied summary judgment to the beneficiary on that issue.

But couldn't the existing statute maintain its current flexibility in allowing a retroactive application by simply ruling that the trustees abused their discretion? The court seems to purposely avoid this approach. The general rule is that courts do not intervene in discretionary decisions by fiduciaries.[2]

Exceptions are noted for situations where trustees failed or refused to consider the use of a discretionary power, where they deliberately did not considered arguments pro and con, acted arbitrarily, behaved capriciously, acted under a misunderstanding, or made a mistake.[3]

Having these myriad of cases and the general hands off approach to intervening in discretionary powers in mind, leads one to readily appreciate grounding the decision on something other than a finding of an abuse of discretion since the exceptions mentioned all seem to miss the *Heller* target.

The discretion exercised by the trustees was further granted by statute which puts yet another spin on the issue. Surely the *Heller* trustees appear to have acted egregiously from a fiduciary perspective thus justifying the reaction of the court and perhaps one could argue that the legislation is necessary in order to put a swift end to the unintended manipulation of the statute by such trustees, but the price is a reduction in the flexibility of the election.

There could be situations where an income beneficiary readily accepts the kind of result in *Heller*. For instance, where a beneficiary is otherwise adequately provided for and desires to adjust the portfolio to encourage growth. By maintaining the flexibility to apply the election retroactively to consent elections only, trustees could make the unitrust adjustment within the protection of the statute in more appropriate circumstances and when all the parties agree.

Under the proposed amendment and the decision in *Heller*, such a possibility seems to be removed.

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(1) The date assets first become subject to the trust is particularly defined in EPTL 11-2.4 (d)(1)(A), (B), (C), (D) and (E).

(2) *In Re Kohler*, 160 NYS 309, 96 Misc. 433 (1916).

(3) See Bogert, Trusts and Trustees §560 for citations to many cases in this area of the law.