

SPECIAL PROBLEMS IN INTERPRETING AND ADMINISTERING WILLS

- Robert E. Ciancola –

A. SPOUSE’S ELECTIVE SHARE AND HOMESTEAD ALLOWANCE

Arizona does not provide a liberal election against the will for a disinherited surviving spouse. Instead, the spouse’s share of community property in most cases provides the spouse protection against disinheritance. Because (absent a marital agreement to the contrary) property earned and acquired after marriage is community property, the surviving spouse will usually have significant property rights and the decedent’s will controls only the decedent’s one-half community property interest.. Nevertheless, Arizona does provide the following claims for surviving spouses and dependent children against all creditor claims and contrary provisions of the will. These allowances come before all claims except administrative expenses. Any express provisions in the will for the spouse or dependent children will offset the statutory allowances, as will an intestate share or a non-probate transfer, including property passing by right of survivorship. The allowances may be waived by the spouse in a valid pre- or post-nuptial agreement.

1. Homestead Allowance. The surviving spouse is entitled to an allowance of \$18,000 under § 14-2402. If there is no surviving spouse, the minor and dependent children are entitled to the allowance, to be divided among them. Although case law had established that the homestead, exempt property and family allowances were not effective against the non-spouse beneficiary of a life insurance policy,¹ this has been changed by statute.² Thus, to the extent the probate estate is insufficient to pay the allowances, the PR may claim against the recipient of a non-probate transfer.

2. Exempt Property Allowance. The surviving spouse or dependent children are entitled to personal property (household furnishings and appliances, automobiles and personal effects) from the estate of up to \$7,000 of value. § 14-2403. If the value of such property in excess of security interests is less than \$7,000, the deficiency may be taken against any other assets of the estate.

3. Family Allowance. Section 14-2404 provides for a family allowance of a “reasonable” amount for the spouse and dependent children during administration of the

¹ *Estate of Agans*, 196 Ariz. 367 (App. 1999)

² A.R.S. § 14-6102(A)

estate. This allowance is limited to one year if the estate is insufficient to pay all creditor claims.

4. Entitlement of Spouse and Children Under Will Executed Before Marriage or Birth. If a person executes a will and subsequently marries, Arizona law provides that the spouse may elect an intestate share against the will. § 14-2301. If there are no children of the decedent from a prior marriage, since the intestate share of the spouse is the entire estate, none of the devisees would take under the will. If, however, the decedent had children born prior to his marriage, the new wife's election will not reduce the children's share. Thus, if decedent executed a will leaving his entire estate equally to his two children (quite common) and later married, the pretermitted wife would receive nothing under the will. The wife would still be entitled to a homestead and exempt property allowance. Afterborn children are similarly allowed an intestate share.

B. SPENDTHRIFT CLAUSE

Title 14, Chapter 7, Article 8 of the Arizona statutes contains a series of provisions governing the rights of creditors to reach the interest of a beneficiary of a trust. The statutes contain no comparable provisions applicable to the beneficiaries of a will (except, of course, as to trusts established by wills). In general, a spendthrift clause is one which prohibits a beneficiary from voluntarily or involuntarily alienating his interest in a trust. Such a provision is generally effective against creditors of the beneficiary, as to both income and principal which the beneficiary has no current right to receive. §§ 14-7701 and 7702. § 14-7703 provides that a support trust – one whose purpose is to provide for the education or support of a beneficiary – is not subject to attachment by creditors until paid. § 14-7704 provides that if a trustee is given discretionary authority to make distributions to a beneficiary, a creditor cannot compel the trustee to make a distribution. However, absent a spendthrift clause, the trustee is liable to a creditor or transferor if, after being made aware of a transfer by the beneficiary or served with legal process by a judgment creditor of the beneficiary, the trustee makes a discretionary payment to or for the benefit of the beneficiary, to the extent the creditor was harmed thereby.

The above protections have several exceptions. The most significant is that they do not apply to the settlor of a self-settled trust. See § 14-7705. Under § 14-7706 a spendthrift clause is also ineffective if the sole beneficiary of the trust is also the sole trustee, even if that person is not the settlor. However, the sole trustee can be one of multiple beneficiaries, or the sole beneficiary one of multiple trustees³, without invalidating the spendthrift clause. Finally §§ 14-7707 and 7708 provide that a court may, if it deems it appropriate, allow a creditor to reach the trust principal for child or spousal support, if the creditor provided necessary services or products to the beneficiary, or products or services which benefited the beneficiary, or if the beneficiary was, under any law, responsible for the reimbursement of public support.

C. MINORS AND INCOMPENTENT PERSONS

Persons who are under disability which affects their ability to participate in probate proceedings, or who are under legal age, are provided special protections. In a formal proceeding, all parties are bound by proceedings and orders of the court, but if a party is a minor or incompetent person, a guardian ad litem would have to be appointed unless the party already had a conservator or guardian (§14-1403). While a proceeding in probate court which binds a guardian or conservator also binds the ward, a proceeding binding a parent will not bind the parent's minor child. In proceedings involving appointment of a PR, persons or higher or equal priority may consent to the appointment of a person as PR. For this purpose, a minor does not need to give consent, because under § 14-3203 a minor is not a "qualified person" eligible to serve as a PR. In family agreements, which can alter the way an estate is divided, minors and incompetents, not having the ability to contract, will not be bound. The PR, moreover, has an obligation to protect their interest. Consequently, here also a guardian ad litem should be considered.

If a minor or incompetent person is a beneficiary entitled to a distribution, the PR is authorized to make distribution to the legal guardian or conservator of that person (§ 14-3915). For distributions of amounts not exceeding \$10,000 going to a minor, the PR is provided more leeway: he can pay the funds to one, such as a parent, having care and

³ See, however, *In Re Pugh*, 274 B.R. 883 (Ariz. 2002), where the bankruptcy court determined that the trustee must be aware of the trust and his/her duties in it to exercise any discretion.

custody of the minor; to the minor directly, if the minor is married; or deposit the sum in a federally insured bank account in the minor's name (§ 14-5103). The PR may also petition the court to allow transfer of funds to a uniform transfer to minors act account, even if the amount exceeds \$10,000 (§ 14-7656).

D. THE IN TERROREM CLAUSE.

An "In Terrorem" clause refers to a provision of a will which seeks to disinherit any beneficiary who brings an action to contest the will. Such a clause might read as follows:

If any beneficiary under this Will in any manner, directly or indirectly, contests or attacks this Will or any of its provisions, any gift or other provision I have made to or for that person under this Will is revoked and shall be disposed of in the same manner provided herein as if that contesting beneficiary had predeceased me without issue.

One will often see this clause in wills and trusts, although, even if valid, it would have very little practical application. The reason is that one is likely to challenge a will if one is cut out of it or left only a nominal amount; in such a case, the disinheritance clause is meaningless, because the challenger has nothing to lose. The only case where it might have application is a situation where the person contesting the will was left a substantial share, but less than he or she had thought proper, and the estate is large enough for this discrepancy to lead to litigation.

1. Arizona Law. Arizona by statute declares an in terrorem clause invalid if the challenger had "probable cause" to believe the challenge could succeed. The statute reads:

14-2517. Penalty clause for contest; restriction

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 that action.

Because grounds to challenge wills usually involve either allegations of undue influence or lack of legal capacity, it appears that probable cause grounds will usually be present provided the challenger had made a factual inquiry and consulted qualified medical and/or legal professionals before launching the suit.

2. The Shumway Case. The Arizona Supreme Court had to interpret the meaning of “probable cause” as used in this statute in *In the Matter of Shumway*, 198 Ariz. 323, 9 P.3d 1062 (2000). In that case, the decedent executed a will six days before his death. The will was prepared by his helper and bookkeeper, Adelina Rodriguez, who used forms obtained from the internet for this purpose. The will named Rodriguez as personal representative and left her a bequest of 25% of the residuary estate. Previous wills by the decedent had not named Rodriguez as a beneficiary. Taking these factors into account along with the decedent’s declining physical and mental health meant that Rodriguez held a position of confidential relationship with the decedent, giving rise to a presumption of undue influence. The will was challenged by one of the decedent’s four children. The trial court, after considering the evidence produced by Rodriguez, concluded that the decedent was of sound and disposing mind and that Rodriguez overcame the presumption of undue influence. It also found that the will challenge was unreasonable and enforced the *in terrorem* clause to disinherit the daughter who challenged the will. The Supreme Court reversed the finding that the will challenge was unreasonable. It found that the trial court had considered the evidence produced at trial, whereas probable cause must be determined on the basis of the facts known to the challenger at the time. The Court adopted the test in the Restatement of Property which defines probable cause as “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” but goes on to state that the evidence required will be less where there are strong public policy reasons to support the challenge. The Court found that public policy favors the ability to access the courts and that the statute should therefore be “liberally construed” to disfavor *in terrorem* clauses. It consequently reversed the trial court and held the clause was not enforceable. After this decision it is hard to see how any will challenger, looking at a fact situation which amounts to a presumption of undue influence⁴, will face disinheritance if the challenge is launched.

⁴ “A presumption of undue influence arises when one occupies a confidential relationship with the testator and is active in preparing or procuring the execution of a will in which he or she is a principal beneficiary.” *Mullin v. Brown*, 210 Ariz. 545 (App. 2005).

E. ANTI-LAPSE, ADEMPMENT, EXONERATION AND OTHER DOCTRINES AFFECTING WILLS.

1. Pour-Over Wills. Wills which leave some or all property to a trust are specifically sanctioned. § 14-2511. The trust does not have to be in existence at the time the will is executed, provided that it is established during the testator's lifetime and the will adequately identifies the trust.

2. Revival. Where a will is executed revoking all previous wills and that later will is then revoked, the common law held that, absent a showing of the decedent's intent to the contrary, the previous will was revived. Under § 14-2509, revival will only occur if the previous will is still in existence, the second will is revoked by physical act (i.e., tearing or marking) and the decedent's intention was to revive the previous will. The decedent's intent may be shown by testimony as to the statements of the decedent.

3. Anti-Lapse. § 14-2603 sets forth Arizona's anti-lapse rule. If testator leaves a specific devise to A and A fails to survive the testator by 120 hours, the devise will pass to A's issue by representation. If A leaves no issue, the devise lapses into the residuary. This result is also true of residuary beneficiaries. However, if a residuary beneficiary predeceases the testator leaving no issue, that portion does not pass intestate but instead passes to the other residuary devisees. § 14-2604.

4. Securities. Specifically devised securities carry with them stock splits and stock dividends. § 14-2605.

5. Ademption. A specific devise of property which is sold before death but as to which proceeds have not been received is not considered adeemed; the proceeds will pass to the devisee. The same rule applies to insurance or condemnation proceeds. If the proceeds had been received by the testator prior to death, they will not pass to the devisee, even if specifically identifiable. If the decedent sells property taking back a promissory note, the note will pass to the devisee. If, however, the real estate is sold by a conservator or holder of a durable power of attorney acting when the principal is incapacitated, the devisee of the realty is entitled to a general pecuniary devise in the amount of the sales proceeds. These rules are found in § 14-2606.

6. Exoneration. Specifically devised property passes without exoneration. Thus, testator leaves Blackacre to A and his will contains a directive for his PR to pay all his just debts. If Blackacre is encumbered by a mortgage, it will pass to A subject to the mortgage and the general language about paying debts will not cause the mortgage to be extinguished from other estate assets.

7. Joint or mutual wills. Where there are children from a prior marriage, the following scenario has given rise to much litigation. H and W are married, both having been married before and each having children from a former marriage. H and W agree on an estate plan leaving all property to the surviving spouse; at the death of the surviving spouse, half of the estate is to go to H's children and half to W's. H dies and his estate passes to W. W lives another 20 years and late in life changes her will to make her children sole beneficiaries. Upon W's death, H's children present claims against her estate on the theory that W breached her contract with H when she changed her will. In Arizona, § 14-2511 provides that a contract to make a will is not to be inferred by the mere execution of joint or reciprocal wills. All contracts to make a will must be in writing. Therefore, the joint wills would need to contain language indicating that the parties intended to bind themselves by not altering their wills; alternatively, there would need to be a separate written agreement to that effect.

In this situation, a living or testamentary trust certainly seems like the best solution to carry out the parties' intentions. The trust would be irrevocable and have a provision under which the decedent's estate would benefit the surviving spouse for life and, upon the survivor's death, pass to the first decedent's children. The trust may or may not be elected for QTIP treatment, depending on circumstances. This arrangement has the added protection that the survivor cannot alter the trust after the first death. Although a written contract would provide the decedent's children with a claim against the surviving spouse's estate, it would not prevent her or him from writing a new will leaving out the first decedent's family. If QTIP treatment is desired, the trust must provide that all income is to be paid to the survivor for life. In addition, the spouse could be granted other withdrawal rights. However, unlimited withdrawal rights would, although preserving the marital deduction, allow the trust to be defeated by the simple expedient of withdrawing the entire principal, which would then pass by will.

Consequently, such a couple seeking estate planning advice should be counseled on this point and advised that prudent limitations on the withdrawal rights of the spouse should be included.

8. Advances and gifts. If testator provides by will that A and B are to take equal shares of his estate and, during life, gives B a large monetary gift, thus reducing the estate, is the gift treated as an advance of the bequest? § 14-2109 provides that a gift is to be treated as an advance only if the decedent declared this in a writing contemporaneous with the gift, or if the recipient acknowledges the nature of the gift as an advancement. Thus, if the testator specifically told A and B that the gift was to be taken into account in calculating B's share, this would be ineffective and B's share of the remaining estate would be one half. Where the gift is treated as an advancement, the value of the gift is determined as of the date of the gift.

9. Adopted Children. Adopted children are, unless a testamentary instrument specifically provides otherwise, considered on the same footing as other children. § 14-2114. Such children are, however, cut off as heirs of their birth parents. Consequently, if the natural parents of a child adopted by others want that child to inherit, the child must be specifically mentioned in a will.

10. Divorced Spouse. A divorce operates to revoke any beneficiary designation to the former spouse, or to the spouse's family, in a will, life insurance policy, annuity or similar instrument. § 14-2804. A designation of a spouse as PR is similarly deemed revoked. A mere expression of intent that the owner of the property intended to keep the former spouse as beneficiary is insufficient; the owner would need to make a new beneficiary designation after the divorce⁵. This statute does not apply to retirement plans governed by ERISA (*Egglehoff v. Egglehoff*, 121 S.Ct. 1322 (2001)).

F. PROBLEMS WITH THE RESIDUARY CLAUSE AND TAX ALLOCATIONS

Most wills have a clause devising the residue of the estate, very often to the surviving spouse or children (i.e., the principal beneficiaries of the estate). Most wills also have a

⁵ *Lamparella v. Lamparella*, 210 Ariz. 246 (App. 2005)

clause directing that expenses and taxes be paid by the administrator from estate assets; revocable trusts usually have a similar clause. Here is a typical clause:

I direct that the expenses of my last illness and funeral, the expenses of the administration of my estate, and all estate, inheritance and similar taxes payable with respect to property included in my estate, whether or not passing under this will, and any interest or penalties thereon, shall be paid out of my residuary estate, without apportionment and with no right of reimbursement from any recipient of any such property.

Such a clause is often included as boilerplate, without any thought as to its possible ramifications. By its language, such a clause specifically rules out equitable apportionment, which is the doctrine stating that items which cause or increase taxes and expenses should bear the cost of them. In many states equitable apportionment is the default rule but in Arizona it is not. However, if equitable apportionment is not provided for, severe and unexpected problems could result when an asset not thought by the drafter to be in the estate becomes part of it, or when an estate tax must be paid from the residuary marital devise, reducing the marital deduction and resulting in an increase in estate tax. These problems could come about in a number of ways:

- A life insurance policy of which the drafter was unaware, providing beneficiaries other than the residuary beneficiaries.⁶
- An asset of significant value which the client keeps hidden from the attorney or which unexpectedly goes not to the spouse but to another person.⁷
- Items of significant value which the planner erroneously believed were not includible in the decedent's gross estate but which turned out to be includible.⁸

Another way the problem surfaces is where assets pass outside of the will and the will is silent on apportionment of taxes.

In the *Lurie* case (see footnote 3) the decedent left an estate valued at nearly \$90 million, plus another \$40 million of assets in certain trusts to benefit his children. His estate planners apparently thought the children's trusts were not includible in his estate, but the

⁶ See *Estate of Fogelman*, 197 Ariz. 252 (App. 2000).

⁷ See *Estate of Kuralt*, 294 Mont. 354, 981 P.2d 662 (1999), and its progeny.

⁸ *Ann Lurie v. Commissioner of Internal Revenue*, 425 F.3d 1021 (7 Cir. 2005).

IRS disagreed. When the trusts were included in the Lurie estate, they increased the estate tax by about \$25 million, which had to be disbursed from funds otherwise going to the spouse. Consequently this tax reduced the marital deduction causing a *further* increase in estate tax of \$12 million – a wholly unnecessary increase if only the decedent had a better drafted residual clause! The clause in Lurie’s trust read as follows:

Debts and Taxes. Upon the death of the Grantor, the Trustee shall, to the extent that the assets of the Grantor's estate . . . are insufficient, pay . . . reasonable expenses of administration of his estate . . . all income, estate, inheritance, transfer and succession taxes . . . without reimbursement from the Grantor's Executor or Administrator, from any beneficiary of insurance upon the Grantor's life, or from any other person. . . . All such payments shall be charged first against the principal of the trust estate. . . .

The estate argued that under Illinois law, the doctrine of equitable apportionment would apply if the will were silent on apportionment. Under that doctrine, contrary to the common-law rule, all assets which passed from the decedent, whether or not probate assets, must bear an equitable portion of the estate tax. The court, however, thought the language the will was sufficient to override the equitable apportionment rule and cause all the taxes to be paid from the residuary, which was to go to the QTIP trust.

Note that in Arizona, the equitable apportionment rule is not observed.⁹ Consequently, except for insolvent estates, the *only* way assets passing outside the will can be made to bear a portion of the estate tax they caused is by including a properly drafted tax apportionment clause.

Finally, a poorly drafted residuary can cause problems also. In one case the IRS disallowed a marital deduction in a do-it-yourself will despite the fact that the residuary was left outright to the surviving spouse. The residuary bequest read:

All the rest, residue and remainder of my estate, both real and personal, of every nature and wherever situate, of which I may die seized or possessed, I give, devise and bequeath unto my wife, Marie L. Sowder, if she survives me, and if she does not survive me, or dies before my estate is distributed to her, to my issue surviving me, in equal shares per stirpes.

The use of the phrase “or dies before my estate is distributed to her” was sufficient to kill the deduction, according to the IRS. Although the IRS position was

⁹ *Matter of Estate of Mason*, 190 Ariz. 312, 947 P.2d 886 (App. 1997).

probably correct as a matter of law, the U.S. District Court allowed the deduction based on extrinsic evidence including articles on the estate tax which decedent had clipped from magazines. *Marie L. Sowder v. United States*, 96 AFTR2d ¶ 2005-5598 (U.S. Dist. Ct. WA, 2005).