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Landmines in Executing Trust and Estate Plans Involving Passion Assets: From Valuation Dilemmas to Fiduciary Push-Backs

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Passion assets of high-wealth clients have become an increasingly significant part of clients' net worth. Once representing simply a number, proportionately small at that, at the bottom of a client's balance sheet, trust and estate practitioners today must understand the nuanced issues surrounding this asset class in order to create effective estate settlement, succession and related philanthropic plans.

In this article, we focus on collectibles as a broad category of TPP – from fine art, vintage motorcars, rare stringed instruments, important books and manuscripts to museum-quality jewelry. Practitioners can encounter single objects in estates which alone are potentially worth millions of dollars (or pounds or Euros) yet unexpectedly find that it is challenging to anchor the value of these assets and the integrity of the trust and estate plan built around them.

Two issues have growing importance and complexity for practitioners: (i) what constitutes a legally-compliant appraisal of these passion assets for tax-valuation purposes; and (ii) why are fiduciaries (who are retained to take custody and control of these assets and to transfer them as part of trust and estate plans) pushing back and increasingly disinclined to manage precious TPP assets.

The Enhanced Paradigms for TPP Valuation

The answer to the first question rests in the regimes for valuing TPP in effect in the U.S. by quasi-government regulation and in the U.K. and other EU countries by industry adoption of best practice standards.

In the U.S., the Uniform Standards of Professional Appraisal Practice (USPAP) is the Internal Revenue Service (IRS)-mandated standard for all valuation appraisals of TPP (as well as non-TPP assets) when used for estate tax or charitable gift-income tax deduction purposes.[1]

For an appraisal to constitute a "credible" (legally-compliant) appraisal under USPAP, in addition to other requirements that are not germane here, the appraiser must explicitly state the "extraordinary assumptions" and "hypothetical conditions" on which the appraiser based the value.[2] At the heart of every TPP valuation are two seminal assumptions or conditions (identified by USPAP) affecting the value of objects: authenticity and clear legal title.

The former issue of authenticity is well-known, well-understood and well-managed in the market through authenticity experts including connoisseur scholarship and scientific testing. The second issue of legal title is less-understood and arguably more seminal, widespread and represents an equal or greater exposure in the art and collectibles market and in its impact on valuation.

The impact of the legal title issue was dramatically illustrated in the recent U.S. case involving Robert Rauschenberg's famous assemblage *Canyon* – to which a bald eagle was affixed. Because it is illegal to

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sell, trade, gift or even possess bald eagles in the U.S. (the national emblem and a protected endangered species; Rauschenberg originally acquired the "*Canyon* bald eagle" from an heir of a member of then-Colonel (later U.S. President) Theodore "Teddy" Roosevelt's Rough Riders Cavalry before enactment of this proscriptive law)[3], the value of this work was questioned in the context assessing estate tax.

After first rather curiously advocating that the work had a significant value of $65 million, even if it was a reduced fair market value on the "black market," in November 2012 the IRS reached a settlement with the owners of *Canyon* (heirs of the late art dealer Ileana Sonnabend); the IRS agreed that the value of the work was $0 and dropped all estate tax assessment of the work; in return, the owners agreed to the same $0 value premise and not to claim any tax deduction for donating the work to the Museum of Modern Art in New York.

Analytically, the *Canyon* case confirms the obvious relationship between legal title and value. Without substantiated clear legal title, TPP has a reduced to zero fair market value or at least a significantly discounted value (to account for the arguable fact that certain, risk-appetite buyers might take a hedge on the marketability and purchase a work that has unconfirmed legal title).

The extension of this title-value principle has serious repercussions under USPAP and similar international regimes as follows: appraisers are not equipped – and generally are not permitted under their professional indemnity insurance policies – to render opinions on legal title when they appraise (value) works. And (or but) USPAP-like standards require appraisers to identify assumptions and hypothetical conditions that support the valuation.

For the practitioner, this means that a trust or estate plan will be built on either: (i) a non-compliant appraisal (one that does not state the necessary assumptions or hypothetical conditions and ignores legal title) or (ii) a compliant appraisal – one that contains these mandatory qualifications (e.g., "This appraisal assumes, and I have not independently vetted, that the owner has clear legal title to this work.") but that becomes the effective equivalent of a "<u>Qualified</u> Audit Report" untenable and lacking adequate meaning in the financial world.

The requirement to identify assumptions and hypothetical conditions underlying the valuation of TPP also exists at least impliedly in the RICS Appraisal and Valuation Standards (RICS Red Book) in use in the U.K. and other EU and non-EU countries.[4]

What, then, does the practitioner do with a USPAP-styled-compliant appraisal? Suppose the carefully-crafted trust or estate plan presupposes selling a multi-million dollar object to pay estate taxes and thereby preserve real estate holdings and defer or extinguish related taxes – but the work unexpectedly proves to be unsalable and of no value because of defective legal title.

Why Fiduciaries are Troubled by Passion Assets

If a practitioner does not address these issues, then the independent fiduciary will (or should if it is performing its fiduciary duties effectively) – and here the issue gets still thornier. For simplicity in this part of the discussion, we focus only on legal title, having already discussed the binary relationship of title to valuation.

When international banks or trust companies sell trust or estate assets, purchase assets with trust resources or publicly exhibit trust assets at museums, they must certify (as fiduciaries) to the demand-side of the

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market (auction house, buyer, museum, etc.) that its client (the trust, estate and putative owner of the asset) has clear legal title to the offered work.

Fiduciaries, who know that they must eventually represent and warrant the client's clear legal title to the TPP putting itself at risk of liability, are increasingly requiring reliable assurance of clear legal title of the TPP before accepting it into a trust or other entity on behalf of which (and its beneficiaries) it is willing to act as fiduciary.

This asset-integrity benchmark requirement impacts everything from executing consignment agreements by which fiduciaries can sell trust assets (for self-directed grantor trusts, the fiduciary cannot ask the grantor to execute this paperwork as it will nullify the trust) to directing and reporting to beneficiaries the calculation and confirmation of the total value of the entire trust base. Fiduciaries know or should know that a legally-complaint appraisal must be qualified by all relevant assumptions and hypothetical conditions.

A knowledgeable, experienced fiduciary also knows or should know that prior assurances of clear legal title from the still-living owner or from the beneficiaries of the deceased owner do not suffice. Similar to what the financial industry knows as "Management Assertions" under GAAP[5] and parallel EU accounting rules for asset ownership in the preparation of financial audit reports,[6] owner-assurances of clear legal title of assets that are traded in opaque and unregulated markets (as is the case with collectible TPP) alone are insufficient to provide the necessary, independent factual and legal support.

If the fiduciary seeks outside legal advice to avoid the risk of liability for title-related losses incurred by trust beneficiaries, this, too, is problematic. The trust and estate community learned this in the closely watched 2011 case, *United States v. Jicarilla Apache Nation*, 564 U.S. __, 131 S. Ct. 2313 (2011), which highlighted the general validity though some inconsistent treatment at both the U.S. state and federal levels of the long-standing and somewhat forgotten rule under U.S. common law jurisprudence – premised on the English common law – that there is a "fiduciary exception" to the attorney-client privilege.[7]

As a result, if and when a fiduciary seeks legal advice on the status of legal title (or value) of TPP in executing their duties to the beneficiaries of a trust or other tax-driven entity, the obtained advice will very likely be discoverable – and "Exhibit A" – in litigation over resulting loss. And, because the fiduciary-sought legal opinion will be discoverable, the advice is likely to be watered-down, making it of limited or no utility. (*Id;* questioning by U.S. Supreme Court Chief Justice Roberts during oral argument suggested that as a result of the fiduciary exception legal advice may become "bland, mushy, hedging.").

Conclusion

The intertwined relationship among – (i) enhanced appraisal requirements for TPP, (ii) legal precedent on the relationship between legal title and the valuation of TPP and (iii) the opaque and unregulated nature of the markets in which TPP assets trade – creates new and challenging issues both for practitioners who are developing and executing trust and estate plans for such assets and for the fiduciaries who are entrusted to manage these assets.

Practitioners should seek to educate themselves about the unique risks surrounding TPP and how best to serve their clients and simultaneously reduce their own liability when transacting around and managing high-valued, precious collectible objects. As a starting point, practitioners should try to find ways to

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buttress appraisals of passion TPP in order to assure the integrity of trust, estate and philanthropic plans built around these assets, which represent an ever-increasing portion of the value of trusts and estates.

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[1] USPAP broadly governs and provides quality, performance standards for real and personal property appraisals as well as consulting and business valuations. Initially drafted in 1986-87 by the Appraisal Standards Board of the Appraisal Foundation, see http://www.appraisalfoundation.org/, along with other major appraisal societies and substantially overhauled in 2006 with updates on a 2-year cycle since, compliance with USPAP is mandated through the U.S. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Public L. 101-73, codified at 12 and 15 U.S.C., which governs all federally-related transactions, and under U.S. state appraiser certification and licensing boards as well as local agencies and various trade associations.

[2] *See* USPAP Standard 7, Rule 7-1 for the general requirement to produce a "credible" appraisal and Rule 7-2, subsections (f) and (g), respectively, for the requirement to identify "extraordinary assumption(s)" and "hypothetical condition(s)" that are "necessary in or for" the appraisal report; and Comments to Rule 7-2 for the description of these factors (generally as "required to properly develop credible opinions and conclusions"). *See also* Rule 7-1, b. ("appraiser must . . . not commit a substantial error of omission or commission that significantly affects an appraisal") and 7-2 (e) (iii) ("appraiser must . . . identify all other physical and economic attributes with a material effect on value").

[3] Barbara Rose accounts in her book entitled "An interview with Robert Rauschenberg" (New York; Vintage Books; 1987) that Rauschenberg acquired the bald eagle from items being discarded from the estate of a neighbor, who was one of Roosevelt's Rough Riders. After the neighbor passed away, when much of his property was being thrown away, a friend of the deceased neighbor asked Rauschenberg if he wanted the bald eagle.

[4] *See* http://www.rics.org. The Royal Institution of Chartered Surveyors (RICS) Valuation - Professional Standards "Red Book" outlines mandatory rules, best practice guidance and related commentary for asset valuation. It seeks to reconcile valuations through providing broad guidance for valuation experts. The latest edition in effect since March 30, 2012 represents the first time that the International Valuation Standards (IVS) have been published with the Red Book. The IVS initially published in 1980 are globally recognized as one of the leading professional standards for property valuation.

[5] *See* Generally Accepted Accounting Principles (GAAP), related Generally Accepted Auditing Standards (GAAS) (guidelines on among other items gathering evidence to test and confirm "Management Assertions" including on "Rights and Obligations" ("The entity holds or controls the rights to its assets . . . ") and related "Financial Statements Assertions" ("Rights and Obligations") (same effect). The International Financial Reporting Standards (IFRS) in use outside the U.S. contain comparable provisions on management assertions; *see* companion International Standards on Auditing (ISA) Rules 315 and 200 ("Rights and Obligations").

[6] For general precedence on fiduciary liability when, for example, a fiduciary might provide representations and warranties about clear legal title of TPP (and on valuation) but knows or suspects that the information is incomplete, inaccurate or untruthful, *see cf. Varity Corp. v. Howe*, 516 U.S. 489 (1996) (finding employer breached fiduciary duty by false representations to participants in ERISA plan about security of transferring accounts); *Cristallina S.A. v. Christie, Manson & Woods Int'l.*, 117 A.D.2d. 284 (N.Y. App. Div. May 13, 1986) (holding auction house acting as fiduciary agent should use reasonable effort to provide accurate information on vital issues); *Keach v. U.S. Trust Co., N.A.*, 256 F. Supp. 2d 840, 842 (C.D. Ill. 2003) (concluding that failure to inquire and investigate investments with prudence may be breach of fiduciary duty); *Smith v. Van Gorkom*, 488 A.2d 858, 870, 975 (Del. 1985) (assessing breach of fiduciary duty of blind reliance in face of inadequate documentation).

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[7] The Court in *Jicarilla* broadly embraced the common law fiduciary exception to the attorney-client privilege but disallowed its application under 25 U.S. C. §§ 161-162a and the American Indian Trust Fund Management Reform Act of 1994, §4001 *et seq*., finding that the government's actions did not resemble a private trustee. ("[W]e [have] analogized the Government to a private trustee . . . in limited contexts . . . but that does not mean the Government resembles a private trustee in every respect," 564 U.S. [at 9] (2011)). In delineating when a governmental function resembles that of a private trustee, the Court juxtaposed situations where laws, statutes or regulations "clearly establish fiduciary obligations of the Government in some areas," *id.* [at 13], versus, as in the case before it, the responsibility is "a sovereign function subject to the plenary authority of Congress," *id.* [at 11].

As the majority noted in *Jicarilla*, some courts today differ on whether the attorney client privilege is available for communications between the trustee and counsel regarding the administration of the trust, *id* [at 7, note 3]; Justice Sotomayor calculated that the fiduciary exception is *well recognized* in both federal and states courts, *id* [Sotomayor, J., dissenting, at 3 and n.1 (citations omitted) (italics supplied)]. A few U.S. jurisdictions have enacted legislation abrogating the exception, *see Jicarilla Apache Nation: U.S. Supreme Court Throws Heat, but Little Light, on the Fiduciary Exception to the Attorney-Client Privilege*, Gerard G. Brew, Dana G. Fitzsimmons Jr., American Bar Association Probate & Property Magazine, Vol. 26, No. 22 (May-June 2012) (discussing Florida (total abrogation) and New York (limited abrogation; non-absolute rule); *see also The Attorney Client Privilege and the Fiduciary Exception: Why Frank Discussions Between Fiduciaries and Their Attorneys Should be Protected by the Privilege,* Mike W. Bartolacci, Tyler Short, Bruce Talen, American Bar Association Real Property, Trust and Estate Law, Vol. 48, 1 (Spring 2013) (suggesting that the fiduciary exception should be eliminated; however, as a practical matter, attorneys and the fiduciaries they represent should tread cautiously about the availability of the privilege to their communications where a statute or decision has not explicitly abandoned the exception). Some non-U.S. courts have cut back on the exception at least for routine matters to prevent beneficiaries from burdensomely micromanaging fiduciaries*. See Schmidt v. Rosewood Trust Limited (Isle of Man)* [2007] UK PC 26. For courts which limit the exception to prevent discovery of a legal opinion to prove *ipso facto* negligence, it remains open to debate whether these courts will permit discovery and admissibility of the information for other purposes such as to prove knowledge of a risk or feasibility of alternative risk management solutions borrowing from U.S. state, federal and non-U.S. jurisdiction counterpart rules, for example, on the admissibility of subsequent remedial measures in negligence actions to prove corollary issues such as ownership, control or feasibility of precautionary measures if controverted or for impeachment purposes, *see, e.g.,* U.S. Fed. Rule Evidence. 407. When all is said and done it is highly likely that a legal opinion which a fiduciary seeks in order to manage trust asset risk – secured by a fiduciary and paid for with trust assets – will be available to the beneficiaries in determining whether the fiduciary trustee acted prudently with respect to the opinion and assessed risk.

Termed under English common law the "trustee rule" versus the "fiduciary exception" (in the U.S.) to the attorney-client privilege, both regimes recognize that the rule or exception is subject to a caveat for "litigation privilege," that is, although a beneficiary is entitled to see opinions obtained by a trustee in matters relating to the administration of the trust, legal opinions are protected under a litigation privilege if the purpose of seeking the advice is for the fiduciary's own defense in litigation. See generally, *Wynne v. Humbertson* 54 Eng. Rep. 165 (1858); *Talbot v. Marshfield* 62 Eng. Rep. 728 (1865); *2 Drew & Sun* 549; *Gouraud v Edison Gower Bell Telephone,* (1888) 57 L.T. Ch. 498*; W. Dennis & Son Ltd. v. West Norford Farmers' Manure & Chem. Co, (1943) 112 L.J.Ch. 239,* on which *Garner v Wolfinbarger,* 430 F.2d 1093, 1103-1104 (5th Cir. 1970) and *Riggs Nat & Bank of Washington D.C v. Zummer*, 355A. 2d 709 (Del.ch.1976) relied in first introducing the fiduciary exception into U.S. law. *See Jicarilla*, 564 U.S. [at 7] (2011). For a more recent U.K. decision recognizing this doctrine, see the leading case of *Schmidt v. Rosewood Trust Limited, supra*.

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