

By Terence S. Nunan



## WHAT IS A UNITRUST?

A unitrust is a trust that allocates the economic rights of current and remainder beneficiaries of a trust in a different way. Since the 14th century when trusts were first invented, the rights of a current beneficiary in a trust have traditionally been defined as the right to receive the income of the trust. For example, if the assets of a trust were real property, the current (income) beneficiary would be entitled to the annual rents of the real property. The real estate itself would be considered principal, which would eventually pass to the remainder beneficiaries when the income beneficiary died. In the case of stocks and bonds, the income beneficiary would be entitled to the dividends and interest earned by such financial assets.

Most trusts continue to allocate rights between multiple generations of beneficiaries based on this basic distinction between income and principal. The Uniform Principal and Income Act (Probate Code Section 16320 et seq.) is the last version of an elaborate set of rules for defining the exact amount of income to which an income beneficiary of a trust is entitled.

A unitrust is different. Rather than define the economic rights of the current beneficiary of a trust by reference to income, a unitrust defines the current beneficiary's right by reference to a percent of the value of the trust estate. For example, a typical unitrust might provide the current beneficiary with a right to 5% of the current value of the trust estate each year. The concept of a unitrust first became recognized in the federal tax law in 1969 when charitable remainder unitrusts were defined as a type of charitable remainder trust that qualify for favorable income and estate tax treatment.

Often the unitrust is drafted so that the percentage is based on the average of the asset values for the

last three years. This structure tends to diminish radical changes in the amounts distributed to the current beneficiaries on a periodic basis. In other cases, a low percentage unitrust can, in effect, be used to transfer more of the trust estate to the remainder beneficiaries, particularly if the trust assets tend to generate high levels of ordinary income.

In the case of non-charitable trusts, the use of unitrusts has been a subject of considerable debate over the last fifteen years. Some legal scholars believe that, as dividend rates of publicly traded stocks have declined in the last 20 years, it is unfair to the current beneficiary of a trust to be limited to the dividend income. Other analysts believe that unitrusts will permit a trustee to invest the trust assets for "total return" including capital gains, but still provide a reasonable level of economic benefits to the current beneficiaries. California recently adopted a law (Probate Code Section 163364) that permits the conversion of a traditional income/principal trust into a unitrust.

Unitrusts have their own complexities. Determining the value of a percentage of publicly held stocks and bonds is fairly easy. Determining the value of closely held corporations, mineral interests, or fractional interests in real property is more complicated.

The fiduciary income tax rules for unitrusts are also complicated. The Internal Revenue Services in 2004 issued new regulations concerning the income tax treatment of unitrusts but, like all tax regulations, there are unanswered questions that only future cases and rulings will answer.

The attorneys at Rutter Hobbs & Davidoff have been involved in several matters concerning unitrusts and their taxation and can provide you with guidance on this complex area of tax and trust law. For example, I recently acted as court appointed guardian ad litem in connection with unitrust conversions of a set of

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## PENNY WISE AND POUND FOOLISH:

### “Saving Costs” During Contract Formation Can Turn into Big Litigation Bills Later



by **Andrew M. Apfelberg**

Spending money to have a lawyer draft or review a business agreement is often perceived as a luxury that can be foregone when belts need to be tightened. What many fail to consider is that they will have to live with these agreements over the long term and, without assistance from an attorney, significant legal fees or other expenses might be incurred if the relationship between the parties goes south, or an unforeseen circumstance arises.

Take the example of Acme Skin Care.\* Acme and Star Manufacturing signed an agreement drafted by Acme's lawyer that named Star as an exclusive supplier of certain component elements of Acme's products. After several years, a principal of Star met with Acme's president to discuss the continuing relationship and did not involve its lawyer in those discussions. Acme's president wrote on a sheet of paper what he believed to be a minor modification to the company's agreement with Star, which both he and Star signed.

Later, Acme's relationship with Star began to sour and Acme terminated its relationship by providing 30 days notice as permitted under their original agreement. Star filed suit, claiming the “modification” was a separate agreement for a fixed 10-year term with no early-termination provision and claimed \$10 million in damages. In just the first few months of litigation Acme spent more than \$50,000, and their counsel estimates that it will spend at least another \$150,000 litigating the case to conclusion—with no guarantee of success. How did Acme get into this position?

The problem lies with the actual wording of the “modification.” Read literally, that document, consisting of only five short paragraphs, says nothing about Acme's prior agreement with Star and contains no mention of any right to terminate the relationship on 30 days notice or otherwise. On the other hand, it does mention a 10-year term and contains other language that suggests the “modification” is really a separate agreement. Even though Acme may have intended otherwise, the document reads in a way that is favorable to Star and,

not surprisingly, Star now claims that the document contains clear contract language which accurately states the intention of the parties.

The difficulty for Acme is that California courts try to interpret contracts based solely on the written language contained within the four corners of the document, without looking to other evidence that may bear upon the intent of the parties. The Civil Code provides that:

- The language of a contract is to govern its interpretation, if the language is clear and explicit, and does not involve an absurdity (§1638).
- When a contract is reduced to writing, the intention of the parties is to be ascertained by the writing alone, if possible (§1639).

What can you do to avoid the kind of problem Acme now faces? Make sure that you and the other party clearly understand the general terms of your deal. You may want to jointly prepare a term sheet that is explicitly non-binding and that contains bullet-points of the outline of the potential business transaction. Then, get your lawyer involved.

Once a formal contract is prepared, be sure to read it and all of its revisions because, if the deal goes south, you will be held to what the document actually says, not what you may have meant or understood in your head. If you and the other side decide later to amend or alter the deal, make sure that any change is put in writing and reviewed by your lawyer before it is signed.

As for costs, wouldn't you rather spend \$5,000 now to save \$200,000 later?

\*Company names have been changed to protect privacy.

*Andrew Apfelberg is a corporate and securities attorney who serves as a primary outside counsel to middle-market companies and entrepreneurs across a wide range of industries. He specializes in mergers and acquisitions and in advising on issues such as entity formation, finance and securities, licensing of intellectual property, and critical agreements with employees and third parties. Andrew can be reached at (310) 286-1700 or [aapfelberg@rutterhobbs.com](mailto:aapfelberg@rutterhobbs.com).*

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trusts having a value well in excess of \$25 million. The proceedings included court approval of seven separate petitions with respect to the trust conversions.

*Terry Nunan is a specialist in probate, estate planning and trust law and has successfully represented clients in both trial and appellate courts. He provides practical solutions for wealth preservation as well as*

*representing fiduciaries, beneficiaries and creditors in contested probate, trust and conservatorship matters. He represents executors and trustees in post death administration proceedings, and he has special expertise in both estate tax and fiduciary income tax matters. Terry can be reached at (310) 286-1700 or [tnunan@rutterhobbs.com](mailto:tnunan@rutterhobbs.com).*

## *Practicing the Possible™ for One Third of a Century*

### *Recent Corporate & Securities Related Engagements Completed by RHD*

#### **MERGERS & ACQUISITIONS**

- Advised national film script-writing software company in acquisition of company that publishes magazines and produces conferences on script writing.
- Advised leading multi-state limousine/motor coach company in acquisition of San Diego based competitor.

#### **FINANCING**

- Assisted leading manufacturer of lift gates with \$13 million in debt financing secured by personal property assets.
- Assisted private investment company with an initial round private placement transaction and a follow-on offering relative to the purchase of equity in an environmentally themed outdoor media company.

#### **SECURITIES & EQUITY INCENTIVE PLANS**

- Advised Advanced Biotherapy, Inc., a publicly-traded biotechnology company, with a \$6.5 million equity placement, \$6.8 million debt restructuring and proposed follow-on stockholder rights offering.
- Prepared stock appreciation rights plan for a multi-national management and information technology consulting company.

#### **INTELLECTUAL PROPERTY**

- Assisted prominent skin care clinic in the licensing of certain trademarks and other intellectual property to the developer of hotels in Florida and Chicago.

- Assisted franchisor of golf instructional methods with the negotiation of a sponsorship agreement with a prominent golf equipment company that included a license to utilize name, likeness, image and other intellectual property of such company and a professional golfer.

- Prepared Privacy Policy and Terms & Conditions of use for e-commerce website for leading multi-state distributor of communications systems.

#### **SUPPLIER & DISTRIBUTOR AGREEMENTS**

- Assisted highly regarded direct response company in obtaining the exclusive worldwide distribution rights of a flat iron for infomercial, world wide web, catalogue and other retail purposes.

- Assisted supplier of ferrous wire and bars with the structure of a relationship and preparation of an exclusive supply and joint venture agreement with a multi-national importer of iron rod from China.

#### **ENTITY FORMATION**

- Assisted digital post-production company with its incorporation and organization, including a buy-sell agreement between the principals.

- Assisted producer and distributor of wireless entertainment content with the structure and formation of a holding company for intellectual property rights to an animated motion picture and with the formation of affiliated entities to produce first episode of series, video game and ancillary products.

Andrew Apfelberg was a panelist presenting "Technology Start-ups 101: Creating the Technology Company" at **USC's Center for Technology Commercialization**.

September 11, 2006: Greg Sater was a panelist presenting "Script Writer versus Lawyer" at the **Electronic Retailing Association's Annual Trade Show**.

September 2006: **Tax Management Estates, Gifts & Trusts Journal** published "Dead Man Talking: Is there Life After Death for the Attorney-Client Privilege?" by Terry Nunan.

September 2006: **electronicRetailer** published "Costly Faux Pas" regarding new remedies to combat counterfeiting by Greg Sater.

August 22, 2006: Brian Davidoff was cited in the **Los Angeles Daily Journal** article "J.T. Thorpe's Successful Plan of Reorganization Related to Asbestos Litigation".

August 2006: **The Bottom Line** published "Latest News on Sexual Harassment" by Olivia Goodkin.