THE LAW OF

TRUST REFORMATION

2010 Special Needs Trusts:
The National Conference

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I. <u>GENERAL CONSIDERATIONS</u>

A. REVOCABLE TRUSTS

1. At common law and in many states, a trust is **irrevocable** (it cannot be modified or revoked) unless the settlor in the trust instrument expressly reserves the right to modify or revoke.

UTC INNOVATION #1: UTC 602 reverses this common law rule by providing that a trust is revocable unless the terms of the trust expressly provide that the trust is irrevocable.

2. A revocable trust may be modified or revoked by the method set out in the trust instrument or, if none, "by any method manifesting clear and convincing evidence of the settlor's intent." (UTC 602)

3. UTC INNOVATION #2: A revocable trust may be modified by a subsequent *will* or *codicil* that refers expressly to the trust or that *expressly* devises property that would otherwise pass under the trust.

This revocation or amendment will become effective upon the probate of the will.

EXAMPLE: Cynthia sets up a revocable trust in 2008 and transfers to the trust all of her interest in her home, Greenacre. The trustee is to pay the income to Cynthia for life and, at her death, pay any remaining trust property to the American Lymphoma Prevention Society. In her will, Cynthia devises "my home, Greenacre, to my beloved companion, Dorothy." The will is executed on March 16, 2010.

4. "Sole Beneficiary" Issue: Merger and Special Needs Trusts

This important issue was first reported by Florida attorney David Lillesand at the 2002 Stetson Special Needs Conference. It is still an issue in many states, although Florida has now passed legislation to "fix" the problem.

THE PROBLEM: A SNT by law is required to be IRREVOCABLE. A well-drafted SNT will state in the instrument that the trust is irrevocable. However, some common law doctrines have been applied by the Social Security Administration (SSA) to deem a trust to be revocable even when by its terms it is not.

THE PROTOTYPE TRUST: In the context of a personal injury lawsuit settlement, the court orders the establishment of a trust for the now-disabled, injured party, with proceeds payable at the trustee's discretion for the benefit of the disabled individual during his life. At death any remaining trust property (after any required Medicaid reimbursement) is payable to the heirs of that individual (or, alternatively, to that individual's estate). The trust states that it is irrevocable.

THE ARGUMENT FOR REVOCABILITY: Two common law doctrines, the Doctrine of Worthier Title and the Doctrine of Merger, are cited to support the argument that this trust is in fact revocable.

Doctrine of Worthier Title: This Doctrine states that if a settlor sets up a trust that is payable to himself for life then to his heirs, this creates a reversion in the settlor. This makes the settlor the "sole beneficiary" of the trust, thus causing it to be revocable at the settlor's will.

Doctrine of Merger: If a beneficiary holds a life estate in property and that property is also payable at death to that beneficiary's estate or heirs, the interests merge, making the beneficiary the "sole beneficiary" and thus causing the trust to be revocable.

POSITION OF THE SOCIAL SECURITY ADMINISTRATION: The SSA publishes the Program Operations Manual (POMS) as its operating instructions for processing Social Security claims. The POMS for the regional offices purport to interpret the laws of the states in that region. Here is an example used in the Atlanta region:

> "For Alabama, Georgia, South Carolina and Kentucky, the trust must specify a particular person or entity as the residual beneficiary. In these states, if the trust states that after death the trust will go to a specifically named person or entity, or if it states that the trust is to go "to my children, or issue, or descendants", this is specific enough to identify a person and the trust is irrevocable.
>
> If, on the other hand, the trust language says that after death, the trust will go "to my estate" or "to the heirs" of the primary beneficiary (or some other non-specific general term), this is not sufficient. This trust would be revocable by the grantor because this wording is not specific enough to identify persons who, upon his death, may become his heirs.
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> For Florida, Mississippi, North Carolina and Tennessee, the above general principle is not followed." SI ATL01120.201

II. MODIFICATION AND TERMINATION

A. WAYS IN WHICH A TRUST MAY BE TERMINATED OR MODIFIED

1. Termination may occur "automatically" without the intervention by or consent of the beneficiaries, the trustee or a court.

2. Termination or modification by the settlor of a *revocable* trust.

3. Termination or modification by joint action of the beneficiaries and the settlor.

4. Termination or modification by unanimous consent of the beneficiaries.

5. Termination or modification by the court.

6. Termination or modification by the trustee.

7. Termination or modification by a trust protector.

B. TERMINATION WITHOUT INTERVENTION

Many trusts will terminate at some point in time without the intervention by or consent of a beneficiary, the trustee or a court. Possible events that result in "automatic" termination include:

1. The *merger* of all the trusts interests because the sole trustee is also the sole beneficiary.

2. The expiration of the trust in accordance with the terms of the trust.

EXAMPLE ONE: A trust that is set up to use the income to support the settlor's child until the child reaches age 25, and then pay the corpus to the child terminates when the child reaches age 25.

EXAMPLE TWO: A trust that is set up to pay the income to the settlor's spouse for life, remainder to the settlor's living descendants terminates when the spouse dies, at which point the trustee distributes the property to the descendants.

3. When "no purpose of the trust remains to be achieved, or the purposes of the trust have become unlawful, contrary to public policy, or impossible to achieve." (UTC 410(a)).

EXAMPLE ONE: The trust is to pay the income to settlor's spouse for life, then the income to settlor's child Joan for life, then the remainder to Joan's then-living children. When the spouse dies, if Joan is already dead, there is no further purpose of the trust to be achieved, so the trust terminates and the remainder is paid to Joan's then-living children.

i. In some states, the court must permit the termination. In other words, the reasons stated above do not result in an "automatic" termination of the trust. A court order decreeing the termination must be issued.

C. TERMINATION OR MODIFICATION WITH COURT INTERVENTION: WHO MAY BRING AN ACTION TO MODIFY OR TERMINATE A TRUST?

If a court-ordered termination or modification is sought, the following have standing to *request* such an order or to *object* to the requested order if someone else brings such an action (UTC 410):

1. A beneficiary;
2. The settlor:
    i. of a charitable trust;
    ii. in some states, in conjunction with the beneficiaries.
3. The trustee;
4. A trust protector (in some states).

<u>II. MODIFICATION OR TERMINATION BY THE BENEFICIARIES</u>

A. JOINT ACTION BY THE BENEFICIARIES AND THE SETTLOR

1. The rules in this section apply only to noncharitable trusts.

2. In some states, prior to the promulgation of the UTC, the settlor and the beneficiaries could come together to modify or terminate a trust even though the trust by its terms was *irrevocable*.

3. The original version of UTC 411 allowed a modification or termination of the trust with the unanimous consent of the beneficiaries and the settlor without court order "even if the modification or termination is inconsistent with a material purpose of the trust."

a. The settlor's power to consent can also be exercised by:

i. An agent under the settlor's power of attorney but only to the extent the power of attorney or the terms of the trust authorized the agent to do so;

ii. The settlor's conservator with the consent of the court that is supervising the conservatorship; or

iii. If there is no conservator, the settlor's guardian, with the consent of the court that is supervising the guardianship.

4. Tax experts in states that were considering the adoption of the UTC objected to inclusion of the original version of UTC 411 on the ground that allowing a settlor to join with the beneficiaries in consenting to the

modification or termination of an "irrevocable" trust would result in so much control by the settlor that the trust property could be treated as the settlor's own property for tax purposes, which often would result in undesirable and unanticipated tax consequences.

a. Some of these states did not adopt UTC 411 at all.

b. Some states allow the termination or modification, even if contrary to a material purpose of the trust, but only if a separate court order is granted.

5. Even in a state that has adopted UTC 411 in its original form, a settlor can override that section and thus insulate the trust against any challenge as to its irrevocability by providing in the trust instrument that under no circumstances may the trust be changed by an action of the settlor (either alone or in conjunction with the beneficiaries) without a court order.

B. ACTION BY THE BENEFICIARIES ONLY (WITHOUT THE SETTLOR'S CONSENT)

1. UNANIMOUS CONSENT OF BENEFICIAIRES: Under UTC 411(b), the beneficiaries may terminate or modify the trust by *unanimous consent* if the court concludes that continuance of the trust is not required to

achieve a material purpose of the trust and the proposed modification is not inconsistent with any material purpose of the trust.

a. *Effect of a Spendthrift Provision*:

i. UTC 411(c), as originally enacted, provided that "a spendthrift provision in the terms of the trust is *not* presumed to constitute a material purpose of the trust."

ii. This apparently was contrary to the common law in some states so those states either refused to enact the provision or rewrote it to reverse the presumption.

b. *Distribution upon termination*: If the trust is terminated by unanimous consent, the trustee shall distribute the trust property *as agreed by the beneficiaries*.

2. CONSENT IS NOT UNANIMOUS: Under UTC 411(e), a court may approve a modification or termination that is requested by fewer than all of the beneficiaries.

a. The court must ensure that the interests of any non-consenting beneficiary are adequately protected.

C. MODIFICATION OR TERMINATION BY COURT ORDER

1. MODIFICATION OR TERMINATION DUE TO UNANTICIPATED CIRCUMSTANCES (UTC 412):

a. *Administrative and Dispositive Provisions ("Equitable Deviation"):* A court, without the consent of the beneficiaries, may modify either the administrative or dispositive provisions of the trust if the court determines that circumstances that were not anticipated by the settlor are somehow impairing the purposes of the trust.

i. The modification must adhere to the extent practicable to the settlor's "probable intention."

EXAMPLE ONE: Trust was established to pay income to son for his life. It is obvious from other terms of the trust that the purpose of the trust is to support son throughout his life. Son becomes disabled and is unable to earn any income to support himself. The income earned by the trust is not adequate to support son. The court may allow a modification of the trust terms that would permit the trustee to "invade the principal" of the trust to provide adequate funds for son's support.

EXAMPLE TWO: Joshua leaves his entire estate in trust to pay the income to his spouse Wendy for life, remainder to their children. Included in the trust estate is the house in which Joshua and Wendy lived for thirty years. Joshua instructs the trustee that

> the house is not to be sold and that Wendy should be able to live in the house for the remainder of her life. At Joshua's death, the house (a small ranch house) is worth about $90,000. Two years after Joshua dies, the property on which the house is located is targeted as the site of a new shopping center. The developers of the center offer the trustee $500,000 for the house.

b. *Administrative Provisions Only:* The court may modify the administrative terms of the trust "if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration." No finding of unanticipated circumstances is necessary.

> EXAMPLE: The trust directs the trustee to invest trust funds only in the stock of one particular company. While that company, which manufactures rotary phones, was prospering when the trust was established, it becomes clear to the trust that the company will soon be going out of business. The court may grant the trustee the permission to invest in other investments.

2. MODIFICATION OR TERMINATION OF UNECONOMIC TRUSTS (UTC 414)

a. A court may modify or terminate a trust or remove the trustee and appoint a different trustee if the court determines that the value of the trust property is insufficient to justify the cost of administration. (UTC 414(b); see also discussion below of UTC 414(a)).

i. This may occur because the trustee's fees are too large in comparison with the value of the trust. The court may decide either to terminate the trust or, alternatively (particularly if it is advisable for the property to remain in trust), to replace the trustee.

3. REFORMATION TO CORRECT MISTAKES (UTC 415)

a. *Reformation*: Reformation differs from modification in that reformation rewords a trust for the purpose of *correcting a mistake of law or fact.*

i. The mistake may be a mistake of "expression" in that "the terms of the trust misstate the settlor's intention, fail to include a term that was intended to be included, or include a term that was not intended to be included." (Comment, UTC 415). Mistakes of expression may be made by the settlor or the scrivener.

ii. The mistake may be a mistake in the "inducement" in that "the terms of the trust accurately reflect what the settlor intended to be included or excluded but this intention was based on a mistake of fact or law." Mistakes in the inducement are typically made by the settlor.

b. Reformation can occur even if the trust terms are clear and unambiguous.

c. The court must have *clear and convincing evidence* of the settlor's intent and that the terms of the trust were affected by a mistake of fact or law.

4. MODIFICATION TO ACHIEVE TAX OBJECTIVES (UTC 416)

a. A court may modify the terms of the trust to achieve the settlor's tax objectives.

b. This is deemed a modification rather than a reformation because it is designed to effectuate the settlor's ongoing intent rather than the settlor's original intent.

c. Whether the modification is accepted by the Internal Revenue Service is a matter of federal rather than state law.

5. MODIFICATION OR TERMINATION OF CHARITABLE TRUSTS (UTC 413)

a. *Cy pres:* This common law concept has been codified in the UTC as a power designed to "save" a charitable trust if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful.

> EXAMPLE: A trust was created to fund research for a cure for a particular debilitating disease and such a cure is eventually found. The court may redirect the funds toward research on another debilitating disease, retaining the settlor's original charitable intent.

b. Unlike common law, the UTC allows a settlor to bring an action to modify a charitable trust.

D. MODIFICATION OR TERMINATION BY THE TRUSTEE

1. MODIFICATION OR TERMINATION OF UNECONOMIC TRUSTS (UTC 414)

a. *Small Trusts*: A trustee, without court permission, may terminate a trust if the trustee determines that the value of the trust does not justify the cost of administering the trust.

i. The suggested value of a trust for which the costs are presumed to outweigh the value is $50,000, although this value may be changed by the enacting states.

ii. Before terminating a small trust, notice must be given by the trustee to the qualified beneficiaries.

iii. A settlor may choose to state expressly in the trust instrument a specified value that would trigger the application of this subsection or may provide that this subsection could never be used by the trustee.

2. CONSOLIDATION OR DIVISION OF` TRUSTS (UTC 417)

a. A trustee, without court permission, may consolidate one or more trusts or to divide a trust into one or more separate trusts.

i. "The result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust."

ii. Before engaging in a consolidation or division, the trustee must give notice to the qualified beneficiaries.

iii. There is no requirement that the trusts that will be consolidated have identical terms or beneficiaries. However, as noted in the Comment to UTC 417, "[t]he more the dispositive provisions of the trusts to be combined differ from each other the more likely it is that a combination would impair some beneficiary's interest . . . ."

iv. Divisions of trusts may be desirable for both tax and non-tax purposes. However, the Comment cautions, it would be a breach of fiduciary duty if the trustee divides a trust into separate trusts solely for the purpose of increasing trustee fees.

v. A settlor in the trust instrument may expand or narrow or even prohibit the trustee's power to engage unilaterally in a consolidation or division.

E. MODIFICATION OR TERMINATION BY A TRUST PROTECTOR

1. TRUST PROTECTOR: This is a concept imported from off-shore trust practice.

a. Some states recognize the concept in their statutes and give the trust protector certain powers as to modification or termination of the trust.

b. UTC 808 recognizes that "the terms of a trust may confer upon a trustee or other person a power to direct the modification or termination of the trust."

i. The UTC provides that a person who holds such a power "is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries."

ii. Additionally, this person "is liable for any loss that results from breach of a fiduciary duty."