

The Elements of a Trust

**2010 Special Needs Trusts:
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I. IN GENERAL

A. WHAT IS A TRUST?

1. A **trust** is a relationship with respect to **property** involving *three* players:

The **SETTLOR** is the person who transfers property into the trust.

Other terms: Grantor, Trustor, Donor, Maker

The **TRUSTEE** is given **legal title** to the property. The trustee's job is to hold and manage the property in accordance with the instructions in the trust document.

The **BENEFICIARY** is given the “benefit” of the property – that is, an equitable interest in the property.

EXAMPLE: Samuel transfers \$1 million and his farm, Blackacre, to Theresa, instructing Theresa to invest the money and to rent out Blackacre, with all investment income and rent proceeds to be paid to Bonnie for life. At Bonnie's death, the remaining property in the trust, including Blackacre, is to be transferred to Benjamin.

Samuel is the **SETTLOR**.

The trust **PROPERTY** is \$1 million and Blackacre.

Theresa is the TRUSTEE and she owes a **FIDUCIARY DUTY** to both of the beneficiaries.

Bonnie is the “income” or “life” BENEFCIARY.

Benjamin is the “principal” or “remainder” BENEFCIARY.

B. TYPES OF TRUSTS

1. **EXPRESS TRUSTS** are created by the settlor "on purpose."

IMPLIED TRUSTS are *imposed by the courts* when a trust fails or when property is in the hands of the "wrong" person.

a. Resulting Trusts

b. Constructive Trusts

2. Trusts may be created for **PRIVATE** purposes or for **CHARITABLE** purposes.

3. Trusts created in wills are called **TESTAMENTARY** trusts while trusts created during the settlor's life are called *inter vivos* or **LIVING** trusts.

Inter vivos (LIVING) trusts may be created by:

a. DECLARATION OF TRUST

“I, Settlor, declare myself trustee of Blackacre.”

b. DEED OF TRUST

“I, Settlor, transfer Blackacre to Theresa to hold as trustee.”

4. Trusts may be **REVOCABLE** (which means they may be revoked or modified) or **IRREVOCABLE**.

5. Trusts may be **SPENDTHRIFT TRUSTS**.

6. Trust provisions may be **MANDATORY** or **DISCRETIONARY**.

Compare “Trustee shall pay all income monthly to my spouse”
with “Trustee may distribute to my child whatever amount of the trust income or principal the trustee deems appropriate.”

C. GOVERNING LAW

1. Every STATE has its own trust law, whether by statute (e.g., “The Florida Trust Code”) or by common law (cases) or both.

2. UNIFORM TRUST CODE (UTC):

Twenty-two states and the District of Columbia have adopted in whole or in part this uniform law, which was drafted in 2000 and amended in 2001, 2003, 2004, 2005.

3. CHOICE OF LAW (UTC 107):

The UTC allows a settlor to choose which state's laws will control the meaning and effect of a trust, unless those laws are contrary to the public policy of the state that has the "most significant relationship to the matter at issue."

If the settlor does not choose a specific state's laws, the governing law is that of the state that has the "most significant relationship to the matter at issue."

D. TRUST CODE AS A "DEFAULT" LAW

1. The UTC and other state trust codes make clear that most of the statutory provisions are "default" provisions – that is, provisions that will apply if the trust instrument does not say otherwise.

2. UTC 105 contains a list of provisions in that Code that cannot be varied or waived by the settlor in the trust instrument. These include:

(1) the requirements for creating a trust;

(2) the duty of a trustee to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries;

(3) the requirement that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;

(4) the power of the court to modify or terminate a trust under UTC Sections 410 through 416;

(5) the effect of a spendthrift provision and the rights of certain creditors and assignees to reach a trust as provided in UTC Article 5;

(6) the power of the court under UTC Section 702 to require, dispense with, or modify or terminate a bond;

(7) the power of the court under UTC Section 708(b) to adjust a trustee's compensation specified in the terms of the trust if the compensation is unreasonably low or high;

(8) the duty under UTC Section 813(b)(2) and (3) to notify qualified beneficiaries of an irrevocable trust who have attained 25 years of age of the existence of the trust, of the identity of the trustee, and of their right to request trustee's reports;

(9) the duty under UTC Section 813(a) to respond to the request of a qualified beneficiary of an irrevocable trust for trustee's reports and other information reasonably related to the administration of a trust;

(10) the effect of an exculpatory term under UTC Section 1008;

(11) the rights under UTC Sections 1010 through 1013 of a person other than a trustee or beneficiary (that is, a third party dealing with the trustee);

(12) the periods of limitation for commencing a judicial proceeding;

(13) the power of the court to take such action and exercise such jurisdiction as may be necessary in the interests of justice;

(14) the subject-matter jurisdiction of the court and venue for commencing a proceeding as provided in UTC Sections 203 and 204.

II. CREATION OF A TRUST: REQUIREMENTS FOR A VALID TRUST

A. UTC Requirements

The UTC provides that a trust must meet the following requirements (UTC 402):

- 1) the settlor must have the **capacity** to create the trust;
- 2) the settlor must have the **intent** to create the trust
- 3) there must be at least one **definite beneficiary**;
- 4) there must be **duties** for the trustee to perform; and
- 5) the *sole* trustee and the *sole* beneficiary **cannot be the same person**.

B. Requirements that do not appear in the UTC:

1. The UTC does not require the trust to be in **WRITING**.
 - a. A writing is required in many states, particularly if the trust holds real property.

i. PRACTICE POINTER: Always memorialize the terms of the trust in a writing signed by the settlor.

2. The UTC does not contain a specific requirement that a trust have **PROPERTY**. However, common law makes it clear that a trust must have trust property.

C. Requirement of a Settlor who has CAPACITY

A settlor must have the **capacity** to transfer property. So, for example, if the settlor had been declared incapacitated and a conservator had been appointed, the settlor probably would lack the capacity to create a valid trust.

IMPORTANT UTC INNOVATION: The UTC assumes that many people use *revocable* trusts as “will substitutes”:

EXAMPLE: Samuel places most of his property in a revocable trust, with himself as trustee for life. At his death, the property is to pass outright to his then living children. His property will be distributed by his trustee when he dies without the need of probating a will. (In many states, probate is both *expensive and time-consuming*.)

UTC 401 thus provides that the capacity required to create, amend or revoke a *revocable* trust is the same as that required to make a will.

In some states, an “incapacitated” individual (e.g., an individual for whom a conservator has been appointed) may still have the TESTAMENTARY CAPACITY (the capacity to make a valid will).

D. Requirement of INTENT to create a Trust with a VALID PURPOSE

1. T's will contains a bequest of \$500,000 "to Anne to be used to support my two children, Sandra and Simon." Does Anne hold the money in trust for T's two children even though the word "trust" does not appear anywhere in T's will?

No formal words are necessary to create a trust, but the words must indicate an *intent* to bind Anne to act solely in the interests of the beneficiaries.

Compare: "To Anne, *with the hope that* (or *it is my wish and desire that*) she will look after Sandra and Simon." (This is commonly referred to as “precatory language,” and thus a valid trust is not created.)

2. T's will contains a bequest to "the Second National Bank of Columbus, as trustee for my brother Bob for life, then to Benita. However, if Bob does not divorce his current wife Inez within 90 days of my death, he shall forfeit his interest in this trust." Is this a valid trust?

The trust is valid but the *forfeiture provision* is probably void because it violates public policy.

Related Areas: Provisions that compel the beneficiary to stay unmarried for no reasonable purpose, encourage the commission of crimes, and provisions restraining the practice of religion.

One commonly *acceptable* forfeiture provision is to provide for the support of a surviving spouse so long as the spouse remains unmarried. This provision is considered “reasonable” under the theory that a new spouse will take over that spouse’s support.

UTC 404 requires the trusts purposes to be “lawful, not contrary to public policy, and possible to achieve.”

E. The requirement that a trust have at least one DEFINITE BENEFICIARY.

1. T's will left \$250,000 "to my friend Sarah, in trust for ten years for the use and benefit of my professors at The Old Law School who are surviving one year after the date of my death. After ten years, the remainder is to be paid to The Old Law School Alumni Fund." Valid trust?

Does it matter that the beneficiaries are not ascertainable at T's death?

Beneficiaries must be ascertainable WHEN PAYMENT IS DUE THEM.

2. T's will left \$250,000 "to my friend Sarah, as trustee, in trust for the law school professors I liked the best."

a. Is "the law school professors I liked the best" an **ascertainable** class of beneficiaries?

UTC 402(c) allows the settlor to give the trustee the power to select a beneficiary from an indefinite class.

3. EXCEPTIONS TO THE DEFINITE BENEFICIARY RULE

a. Charitable Trusts (UTC 405):

“I give \$1 million in trust to be used to feed the hungry in Fulton County, Georgia.”

b. Trust of Limited Duration for a Noncharitable Purpose (UTC 409)

Most common: Trust for care of a cemetery plot

c. Trust for the Care of an Animal (UTC 408)

- i) Trust created during the lifetime of the settlor;
- ii) The animal is alive during the settlor’s lifetime;
- iii) The trust lasts for the duration of the animal’s life;
- iv) The trust is enforced by someone chosen by the settlor or appointed by the court;
- v) During the animal’s life, the trust property can be used only to support the animal unless the court determines that the amount in the trust is excessive;
- vi) At the animal’s death, any leftover funds are distributed to the settlor (if still living) or the settlor’s successors in interest.

4. The SOLE BENEFICIARY/SOLE TRUSTEE Prohibition

Remember that the SOLE beneficiary and the SOLE trustee cannot be the SAME person.

If that happens, their interests will *merge* and there is no trust.

5. QUALIFIED BENEFICIARIES

The UTC distinguishes certain beneficiaries as worthy of greater rights (e.g., the right to notice of the existence of the trust) than other contingent and more remote beneficiaries. These are referred to as “qualified beneficiaries.”

In UTC 103, a “qualified beneficiary” is defined as:

- (A) a distributee or permissible distributee of trust income or principal;
- (B) a beneficiary who would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in subparagraph (A) terminated on that date without causing the trust to terminate; or
- (C) a beneficiary who would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date.

EXAMPLE: Sarah establishes a testamentary trust with the following terms: “income to my spouse Henry for his life; at his death, income to my children who survive Henry; at the death of the last surviving child, principal paid outright to my grandchildren who are surviving at the time.” At the time the determination of qualified beneficiaries is made, Sarah’s husband Henry is alive as are their two children, Mary and Elizabeth, and their grandson Edward, who is the child of Elizabeth.

The qualified beneficiaries of this trust are :

A) *Henry* because he is a distributee of the trust income;

B) *Mary* and *Elizabeth*, because they would be the distributees of the income if Henry's interest were to terminate, but the trust would stay in effect; and

C) *Edward*, because he is the only living grandchild at this point in time and thus he would take the principal were Henry and Mary and Elizabeth to die and the trust to terminate.

When an irrevocable trust is created or when a revocable trust becomes irrevocable, the trustee is required to inform the qualified beneficiaries of the existence of the trust. (UTC 813).

In some states, this duty applies only to beneficiaries who are age 25 or older.

F. Requirement of a TRUSTEE who has ACTIVE DUTIES to perform

1. Who may serve as Trustee?

a. A trustee may be an individual or an entity.

i. Many states have specific rules that dictate what entities may act as fiduciaries in that state.

ii. An individual trustee must be of age (18 in most states) and have the legal capacity to transfer property.

b. A trustee must ACCEPT the office. In other words, a person cannot be forced to act as trustee against his or her or its will.

i. The settlor may specify in the trust the method of acceptance of the trusteeship.

ii. In the event there is no method spelled out in the trust or if the expressed method is not the exclusive one, the acceptance may be accomplished if the designated trustee: a) accepts delivery of the trust property; b) starts exercising the powers or performing the duties of the trustee; or c) in some other way indicates acceptance of the trusteeship. (UTC 701(a)(1)).

iii. A named trustee who wishes to reject the trusteeship should do so via a clear communication at the earliest possible time.

G. Requirement of TRUST PROPERTY

1. Generally, a trust is not established until there is property transferred to the trust (sometimes called the trust "res"). This property is the corpus, the principal, the subject matter of the trust. There must be a specific, identifiable and

separable *property interest* to which the trustee's duties relate. *If there is no trust property, there is no trust.*

2. Trust property need not be *tangible* but it must be a true property interest:

Wilson owes Frederick \$10,000. Frederick, in writing, says, "I hereby declare myself the trustee of the debt that Wilson owes me. I hold the debt in trust for the benefit of my daughter Christine."

Choses in action and accounts receivable are "interests in property," even though they are intangible.

The term "property" is defined broadly in the UTC to include "anything that may be the subject of ownership" and includes property interests whether real or personal, legal or equitable. (UTC 103(12)).

3. Monica writes a trust instrument naming Peoples Bank as trustee and providing that the income is to be distributed to Monica's spouse during his life, the remainder to their children. Monica does not transfer any assets into the trust but she names the trustee as beneficiary under several of her life insurance policies. Has a valid trust been created?

H. DISCRETIONARY TRUSTS AND SPENDTHRIFT TRUSTS

These types of trusts are used (among other reasons) to protect a beneficiary's interest from the beneficiary's creditors as well as from the beneficiary's own spendthrift habits.

1. Adam Hanson transfers \$750,000 to a trust "to use the income to support myself and my spouse Ava (in equal shares) during our lives, remainder to our children."

Adam names the National Bank of Eden as the trustee.

a. Suppose that Ava, who is gainfully employed as a lawyer earning \$200,000 per year, demands payment of her share of the income interest - must the trustee pay?

b. Suppose Ava wants to assign or sell her income interest - may she do so?

c. Suppose, instead of selling her interest, Ava runs up a huge credit card bill. What are the rights of the department store to satisfy the claim out of the trust?

i. Why would the credit card company want to seek payment directly from the trust?

d. Suppose instead that the trustee's instructions were "to pay the income quarterly to myself and my spouse and also to use whatever portion of the principal the trustee deems appropriate in the trustee's sole discretion"?

ii) Ava runs up a huge bill at the jewelry store buying diamonds for herself and her family. The bill far exceeds Ava's share of the income interest. What are the rights of the jewelry store to satisfy the claim out of the trust principal?

e. One more variation on the trust language: the trustee's instructions were "to pay the income quarterly to myself and my spouse and also to use whatever portion of the principal the trustee deems appropriate for the support of myself and my spouse"?

f. The UTC abandoned the “evasive distinction” between a discretionary trust and a support trust.

UTC 504: A creditor (with one exception described below) cannot reach a beneficiary’s interest in a discretionary trust, whether the trust is completely discretionary or the trustee’s discretion is tied to some standard.

2. Suppose that Adam sets up an irrevocable trust, instructing the trustee "to use the income for the support of myself, my son Seth, and my son Kane during our lives, remainder to my daughter Elba and her issue." The trust also contains the following clause:

No interest of any beneficiary herein shall be assignable by such beneficiary nor shall it be subject to the claims of the beneficiary's creditors.

a. Seth would like to sell his income interest - may he do so?

b. Suppose that Seth is divorced and has fallen behind on his child support payments. May his children reach his interest in the trust to satisfy this claim?

c. "Exception creditors":

i. spouse or children to satisfy a court order for support or maintenance;

ii. a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust.

iii. the state or federal government to the extent state or federal law allows.

3. Suppose that Adam sets aside property in a trust to be used for his own benefit and adds a spendthrift clause to the trust? (UTC 505)

i. If the trust is *revocable* and Adam is still *alive*, the settlor's creditors can reach the trust property, regardless of whether there is a spendthrift provision and regardless of whether the beneficiaries are the settlor or third parties.

Similar rules apply to someone who has a power to withdraw property from the trust.

ii. If the trust is *irrevocable* and Adam is still *alive*, the settlor's creditor may reach the maximum amount that could be distributed to the settlor. (If payments from the trust are completely *discretionary*, the trust assets are not "available" to the settlor and thus cannot be reached by the settlor's creditors.)

iii. If the trust was *revocable* and Adam has *died*, the settlor's creditors can reach the trust property to the extent that the probate estate is insufficient to pay the claims.

iv. If the trust was *irrevocable* and Adam has *died*, ... the UTC is silent as to this situation. Theoretically, the trust assets would not be available to the settlor's creditors.

III. TRUST ADMINISTRATION

A. Appointment and Resignation of Trustee

1. Usually, the trust instrument names the trustee or grants the power to someone else to appoint the trustee. Any vacancy in a trustee position will be filled according to the provisions of the trust instrument or by the court in a manner that is consistent with the settlor's intent.

2. Cotrustees

a. A settlor may choose to name two or more cotrustees to serve simultaneously.

b. If there are three or more cotrustees, they may act by majority rule.

i. A cotrustee who disagrees with a proposed action may refuse to participate or participate but file a written dissent.

c. All co-trustees are expected to participate in the management of the trust unless certain functions have been delegated to only one of them.

3. Vacancy in the Trusteeship

a. If a vacancy occurs in the trusteeship, the vacancy will be filled in the manner prescribed in the trust instrument. If the instrument is silent, the court will fill the vacancy. If there is a cotrustee remaining, the cotrustee may continue to administer the trust without the naming of a successor cotrustee.

b. UTC 704 provides the following priority for filling the vacancy: the successor trustee designated in the trust instrument; a person selected unanimously by the qualified beneficiaries (without the need for court approval); or a person appointed by the court.

c. Under UTC 705, a trustee who wishes to resign should give written notice to the settlor (if living), all qualified beneficiaries, and any cotrustees. Alternatively, the trustee may seek court permission to resign.

d. Under UTC 706, a trustee may be removed by the settlor or by the court. The trustee may be removed by the court for a “serious breach of trust” or if the qualified beneficiaries unanimously request removal or if fewer than all the qualified beneficiaries request due to a substantial change in circumstances.

4. Trustee Compensation

a. A trustee is entitled to the compensation set forth in the trust instrument or, if there is no compensation schedule in the instrument, to “reasonable compensation.” (UTC 708).

i. The trustee is also entitled to reimbursement for reasonable expenses paid on behalf of the trust. (UTC 709).

B. Trustee Duties

a. Article 8 of the UTC enumerates the trustee’s duties, which include the duty to:

- administer the trust in good faith in accordance with its terms and in the interests of the beneficiaries;

- to be loyal -- that is, administer the trust solely in the interest of the beneficiaries;

- to administer the trust impartially;

- to administer the trust prudently;
- to control and protect trust property;
- to keep records and accounts; and
- to keep the beneficiaries reasonably informed.

C. Investments

1. Standard of Care: “Prudent Investor” Rule

Standard that would be observed by a prudent investor, considering the purposes, terms, distribution requirements, and other circumstances of the trust.

The trustee must use reasonable care, skill and caution.

If the trustee has any *special skills or expertise* or is named as trustee on the basis of representation of such skills or expertise, the trustee is under a duty to use those skills.

2. When judging a trustee's investment decisions, the court will look at the performance of the entire portfolio rather than the performance of any single investment.

When making investment decisions, the trustee may consider:

- a) the general economic conditions;
- b) the possible effect of inflation or deflation;
- c) the expected tax consequences of investment decisions or strategies;
- d) the role that each investment or course of action plays within the overall trust portfolio;
- e) the expected total return of the account;
- f) the other resources of the beneficiaries;
- g) the needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- h) an asset's special relationship or value, if any, to the purposes of the trust or to one or more of the beneficiaries.

3. Trustee's general duties as to investment of trust property:

- a. duty not to speculate (use "reasonable care, skill & caution");
- b. duty to maintain marketability;

- c. duty to keep trust productive;
- d. duty to diversify;
- e. duty not to delegate investment decisions without careful selection and oversight of agent;
- f. duty not to commingle; and
- g. duty of impartiality: trustee must balance the interests of the income and remainder beneficiaries