

Change-Up to Fix-Up: Settling and Fixing Trust Disputes and Problems by Modification and Reformation

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UNIFORMITY?



Heart of America =

**Arkansas, Iowa, Kansas, Nebraska,
Missouri & Oklahoma**

- **Uniform Trust Code (“UTC”)**
- **Uniform Probate Code (“UPC”)**



UNIFORM TRUST CODE (“UTC”)

- **Completed in 2000; amended most recently in 2010**
- **33 jurisdictions have adopted versions of the UTC (including Arkansas, Kansas, Nebraska and Missouri; not Oklahoma or Iowa)**
- **Includes innovative provisions**

MODIFICATION (UTC §411)



- **Noncharitable irrevocable trust may be modified or terminated with consent of beneficiaries, upon court approval**
- **Without court approval if settlor is living and also consents**
- **If settlor not living (or does not participate), modification or termination cannot be inconsistent with a material purpose of the trust**

UNANTICIPATED CIRCUMSTANCES (UTC §412)



- **Circumstances not anticipated by settlor**
- **Trust may be modified or terminated to further the purpose of the trust or because existing terms are impractical**
- **Must be in accordance with settlor's "probable intention"**

REFORM TO CORRECT MISTAKES (UTC §415)



- **Court can reform a trust “even if unambiguous” if settlor’s intent and the terms were affected by a mistake of fact or law**
- **Clear and convincing evidence**
- **Retroactive?**

ACHIEVE SETTLOR'S TAX OBJECTIVES

(UTC §416)



- **Court can modify trust to achieve settlor's tax objectives**
- **Modification cannot be “contrary to the settlor's probable intention”**
- **Can be retroactive**

OTHER UTC PROVISIONS



- **Uneconomic Trusts (§414)**
- **Division (§417)**
- **Combination (§418)**
- **Cy Pres (§413)**

UNIFORM PROBATE CODE



- **Completed 1956; most recently amended in 2010**
- **17 states have adopted some version of the UPC in substantial form, including Nebraska, but almost all states have adopted portions of the UPC**

DECANTING

- **29 states (including Missouri)**
- **First trust, second trust**
- **Different states have different standards**
- **Can draft decanting language into the document (even if not in a decanting state)**

WHY MODIFY / DECANT / TERMINATE A TRUST?



- **Facelift**
- **Divide / combine**
- **Uneconomic (small trusts)**
- **Also... maybe to change situs**

WHY MODIFY / DECANT / TERMINATE A TRUST?



- **Resolve Litigation**
- **Unanticipated circumstances**
- **Fix (reform) mistakes & clarify ambiguities**
- **Accomplish Settlor's tax objectives**

CONSIDERATIONS



- **Court approval needed?**
- **Desirable?**
- **Who needs to participate?**
- ***Who should* participate?**

CONSIDERATIONS (cont.)



- **Virtual Representation**
 - **Applicable?**
 - **Considerations?**
 - **Guardian ad litem?**

CONSIDERATIONS (cont.)



- **Tax Considerations**
 - **Gift?**
 - **GST? Grandfathered?**
 - **Income?**
 - **“Do No Harm”**

SCENARIO 1: TRUSTEE SURCHARGE



- **Settlor creates dynasty trust years ago for descendants naming Anybank sole trustee**
- **No trustee succession provision**

SCENARIO 1: TRUSTEE SURCHARGE (cont.)



- **Beneficiaries upset by Anybank's administration (trustee fees, investments, general administrative concerns)**
- **Beneficiaries compel Anybank to account and they file objections**

SCENARIO 1: TRUSTEE SURCHARGE (cont.)



- **Beneficiaries want Anybank out and want family as successor trustees**
- **Expensive, lengthy litigation?**
- **Removal?**

SCENARIO 1: TRUSTEE SURCHARGE (cont.)



- **UTC §706 (removal)**
 - **Serious breach of trust?**
 - **Unfitness, unwillingness or persistent failure of trustee to administer trust effectively?**
 - **Substantial change of circumstances?**
 - **Removal requested by qualified beneficiaries (if adopted; Arkansas and Nebraska have adopted)**

SCENARIO 1: TRUSTEE SURCHARGE (cont.)



- **Settlement?**
- **Convince Anybank to resign in exchange for withdrawing (or reducing) surcharge claim?**
- **If Anybank resigns, modify to allow qualified beneficiaries to appoint successor trustee pursuant to UTC §704.**
- **Who signs settlement agreement?**

SCENARIO 1: TRUSTEE SURCHARGE (cont.)

- **Modification of trust terms pursuant to UTC §411?**
 - **“Modernize” trustee provisions to add provisions permitting appointment of successor trustees and co-trustees, and removal of trustee**
 - **Material purpose for corporate to serve?**
 - **Family members as co-trustees?**

SCENARIO 1: TRUSTEE SURCHARGE (cont.)



- **Who signs modification / settlement agreement?**
- **Estate, GST, income tax considerations?**

SCENARIO 2: DIVISION



- **Settlor creates trust for two children, Sam and Dana**
- **Dana has three children, and Sam has none (and likely never will)**
- **Trust distributes income per stirpes; no principal distribution**
- **Trust terminates upon death of Sam and Dana; at termination, principal per stirpes to Settlor's descendants**
- **UTC State governs validity, construction and administration**

SCENARIO 2: DIVISION (cont.)



- **Sam needs income and wants investments in tax free muni bonds**
- **Dana has no need for income and wants the trust to invest in equities**
- **Solution? Divide the trust!**
- **Long-recognized in states to address different needs, investment approaches and family circumstances**

SCENARIO 2: DIVISION (cont.)



- **Then-serving trustees and adult beneficiaries signed NJSA dividing the trust**
- **Parties did not modify terms for distribution upon termination (i.e., per stirpes to Settlor's descendants)**
- **What's the problem?**

SCENARIO 2: DIVISION (cont.)



- **After division, Sam becomes a surprise father at age 50 to Ellie**
- **Dana's trust grows much larger than Sam's**
 - **Started 50%/50%**
 - **Decades later, Dana's trust is 80% of the combined value, and Sam's trust is 20% of the combined value**
- **Dana dies, and Sam is on his death bed. Ellie is 25.**
- **Ellie questions what happens at termination (do the trusts recombine because termination provision was not modified?)**

SCENARIO 2: DIVISION (cont.)



- **What should have been done?**
 - **At division, trust should have been modified provisions at termination**
 - **Each divided trust to be distributed to the descendants of the child for whom the trust was created**
 - **Cross-remainders if a family line dies out**

SCENARIO 2: DIVISION (cont.)



- **What can be done now?**
- **NJSA**
 - **Beneficiaries (including Ellie) and trustees modify each divided trust to distribute assets to the child's descendants at termination (with cross remainders)**
 - **Why would Ellie agree?**
 - **Gift, estate, GST tax considerations?**



SCENARIO 2: DIVISION (cont.)



- **Court petition to modify trust?**
 - Ellie would receive notice, which likely will cause expensive litigation
- **Decant trusts into new trusts?**
 - Ellie would not need to approve decanting, but she could object
 - Would decanting violate duties of loyalty and impartiality? Breach?
- **Gift, estate and GST tax considerations?**

SCENARIO 3: SUBSTANCE ABUSE

- Decedent dies, leaving GST exempt trust for son, a successful lawyer in his 40s
- Mandatory income distributions
- Principal available for support
- 5X5
- Law governed by UTC state that also has a Delaware/Missouri-style decanting statute (if power to invade principal, assets can be distributed to new trusts with new terms)

SCENARIO 3: SUBSTANCE ABUSE (cont.)



- **Son was hiding severe drug problem**
- **Trustee concerned for son and believes decedent would have made the trust completely discretionary with no 5X5 *had he known***

SCENARIO 3: SUBSTANCE ABUSE (cont.)



- **NJSA**
 - **Would son agree?**
 - **Is modification inconsistent with a material purpose?**
 - **Can son be virtual representative?**
Conflicts of interest?

SCENARIO 3: SUBSTANCE ABUSE (cont.)



- **Court Petition**
- **UTC §411 (modification by consent)**
 - **Who signs?**
 - **Son won't consent, he could object, leading to litigation**
 - **Material purpose considerations?**

SCENARIO 3: SUBSTANCE ABUSE (cont.)



- **UTC §412 (unanticipated circumstances)**
 - No material purpose test (“probable intent”)
 - Son’s consent is not required, but he could object
 - GST tax considerations from shifting assets to lower generations

SCENARIO 3: SUBSTANCE ABUSE (cont.)



- **UTC §415 (reformation to correct mistakes)**
 - Decedent mistakenly thought son did not have a drug problem
 - No material purpose test
 - Son's consent is not required (but he could object)
 - GST tax considerations

SCENARIO 3: SUBSTANCE ABUSE (cont.)



- **Decanting**
 - Decant into new trust with discretionary terms
 - Son’s approval is not required, but depending on the state (Missouri) notice must be given
 - Once son finds out, could seek to block the decanting or surcharge the trustees
 - Trustee’s duties of loyalty to the son and other beneficiaries
 - GST tax considerations (do grandfathered GST “decanting” regulations apply?)

SCENARIO 4: STEP-UP

- **Decedent dies years ago, leaving trust for daughter**
- **Upon termination, trust will be distributed to daughter's descendants**
- **UTC state governs laws concerning validity, construction and administration**

SCENARIO 4: STEP-UP (cont.)



- Value of the trust is \$1,000,000
- Trust consists of highly-appreciated, low basis stock
- Daughter's estate is valued at approximately \$3,000,000
- Beneficiaries are concerned about low basis and want step up at daughter's death

SCENARIO 4: STEP-UP (cont.)



- **Termination Option**

- **Assets become included in the daughter's estate (if she owns them at death), achieving step-up**
- **State estate/inheritance tax?**
- **Assets subject to claims of creditors**
- **Assets could be diverted away from the family**
- **Who can serve as virtual representative?**
- **What if daughter is a spendthrift?**
- **Gift tax considerations (by daughter's descendants)?**

SCENARIO 4: STEP-UP (cont.)



- **UTC §411 (termination by consent)**
 - Is termination inconsistent with a material purpose?
- **UTC §414 (termination of uneconomic trusts)**
 - Trust can be terminated if value of trust property is insufficient to justify cost of administration
 - Is \$1,000,000 with one current beneficiary considered uneconomical?

SCENARIO 4: STEP-UP (cont.)



- **UTC §412 (unanticipated circumstances) and UTC §416 (achieve settlor's tax objectives)**
 - **Need to establish trust was created primarily to protect against estate / GST taxes**
 - **Need to establish that settlor did not anticipate the changing tax laws (especially high exemption amounts)**

SCENARIO 4: STEP-UP (cont.)



- **Modification / add general power of appointment**
 - **Assets would be included in daughter's estate, achieving a step-up in basis (state tax considerations)**
 - **No diversion from the intended beneficiaries *unless daughter has creditors and exercises power in favor of creditors***
 - **If daughter is a spendthrift?**
 - **Who can serve as virtual representative?**
 - **Gift / GST tax considerations?**

SCENARIO 4: STEP-UP (cont.)



- **UTC §411 (modification by consent)**
 - **Material purpose?**
- **UTC §412 (unanticipated circumstances) and UTC §416 (achieve settlor's tax objectives)**
 - **Establish that trust was created primarily to protect against estate / GST taxes**
 - **Establish that settlor did not anticipate the changing tax laws (especially high exemption amounts)**



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