DISCRETIONARY DISTRIBUTIONS: OLD RULES, NEW PERSPECTIVES

LESLIE KIEFER AMANN
Chief Fiduciary Officer
Sr. Vice President
Sentinel Trust Company LBA
Houston, Texas
713.529.3729
lamann@sentineltrust.com

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Austin

Leslie Kiefer Amann
Sentinel Trust Company
Senior Vice President/Chief Fiduciary Officer
713.630.9614
lamann@sentineltrust.com

Publications/Presentations

- Discretionary Distributions, State Bar of Texas Advanced Estate Planning & Probate Course 2014; Texas Bankers Association Graduate Trust School 2001 - 2014; South Texas College of Law Wills & Probate Institute 2013; El Paso Estate Planning Council 2010; Corpus Christi Estate Planning Council 2012; San Antonio Estate Planning Council 2012; Houston Bar Association Trust & Estate Section 2012; Arkansas Bankers Association 2012.
- Discretionary Distributions, Old Rules – New Perspectives, *Texas Tech Univ. Law School - Estate Planning & Community Property Law Journal*, Volume 6, Book 2, 2014.
- Discretionary Distributions – Say What You Mean and Mean What you Say, State Bar of Texas Estate Planning & Probate Drafting Course 2014; Attorneys in Tax & Probate 2015.
- Personal Trust Administration from the Corporate Trustee Perspective, Texas State Bar Annual Advanced Estate Planning & Probate Course, 2003; Midland Business & Estate Planning Council 2004; Corpus Christi Estate Planning Council 2004; San Antonio Estate Planning Council 2005; Fort Worth Estate Planning Council 2006; Texas Bankers Association Trust School 1999-2014.
- The Uniform Principal and Income and Uniform Prudent Investor Acts and the Power to Adjust, Houston Bar Association Wills & Probate Institute Advanced Course 2004; Corpus Christi Estate Planning Council 2005; El Paso Society of CPAs 2005; Houston Estate and Financial Forum 2006; San Antonio Estate Planning Council 2007; Midland Estate Planning Council 2007.
- Getting Documents From Financial Institutions - Where to Find the Texas Statutory Requirements and How to Use Them (With Some Helpful Tips and Forms), University of Houston Law Center Advanced Civil Discovery Seminar – Dallas/Houston 2005.
- Fiduciary Law, American Bankers Association National Graduate Trust School 2005-2006.
- Criteria for Selecting a Fiduciary, Texas Society of CPAs, Advanced Estate Planning Conference 2002; South Texas College of Law Trust & Probate Institute 2012.
- Fiduciary Responsibility, National Trust Closely Held Business Association 2001.
- Property Law for Fiduciaries, Texas Bankers Association Graduate Trust School 2007-2014; paper reprinted in the *Journal of the NAEPC* 2008.

Professional Affiliations/ Accomplishments

- Adjunct Professor, University of Houston Law Center, 1988-2000; Adjunct Professor Award, University of Houston Law Center, 1999.

- Board Service – Texas Bankers Association Wealth Management and Trust Division, Chairman 2010-2012, and Education, Investment, and Governmental Relations Committees; Houston Estate & Financial Forum Board of Directors; Houston Bar Association Probate, Trust & Estate Law Section Executive Council; Houston Business & Estate Planning Council, President 2007-2008; University of Houston Law Center Alumni Board 2001-2011; University of St. Thomas Planned Giving Advisory Board 2006 - 2012.

Education

- University of Houston Law Center, JD 1987; Texas State University, B.M. Ed. 1976.

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The "discretion" exercised by a trustee includes all aspects of administration but making payments out of the trust – the discretionary distribution – often seems to be the greatest challenge. This material was originally created to be used at the Texas Bankers Association Annual Graduate Trust School. Over a period of nearly 15 years, it has been gradually expanded to include illustrations and materials from other states; however, the primary focus remains the information needed to make excellent fiduciary decisions and draft clear fiduciary instructions under Texas law.

Many of the citations will be of Texas law; however, some principles are universally applied and regarding those, the paper will draw on the case law of other states and sources. But it is critically important that a trustee check the specific state law that applies to the trust being administered before making any decision.

I. A TRUST IS A RELATIONSHIP

In any relationship, a healthy understanding between the parties as to what each expects of the other is important. In a trust, the expectations and parameters of the relationship are defined by three primary sources:

a) The instrument creating the relationship;
b) Statutes that apply to the relationship (Estates, Trust, or Guardianship Code);
c) The "common law" of fiduciary duty to the extent it has not been superseded by the instrument creating the relationship or a governing statute.

Administrators rely on this order of priority to make virtually all decisions - looking to the terms of the instrument first, then to the statute and finally to common law. The terms of the document control unless to do so would be against public policy; the best expressions of public policy are the declarations of the legislature found in the statutes.

On the surface, administering a trust seems easy enough; after all, a trust comes with written instructions. But in order to provide the best possible service to beneficiaries, trustees should understand not just what to do but why.

The trustee should never forget that there is a mandate in the Texas Trust Code requiring the trustee to administer a trust according to its terms and in *good faith:*

> TEX. PROP. CODE §113.051 GENERAL DUTY
>
> The trustee shall administer the trust *in good faith* according to its terms and this subtitle. In the absence of any contrary terms in the trust instrument or contrary provisions of this subtitle, in administering the trust the trustee shall perform all of the duties imposed on trustees by the common law.

A fiduciary acts in good faith when he believes his defense is viable and reasonable in light of existing law. *Lee v. Lee*, 47 S.W.3d 767, 795 (Tex. App.-Houston [14th Dist.] 2001, pet denied). Bad faith, in a trustee relationship means to "act knowingly or intentionally adverse to the interest of the trust beneficiaries". *Interfirst Bank Dallas N.A. v. Risser*, 739 S.W.2d 882, 898 (Tex. App.-Texarkana 1987, no writ) disapproved on other grounds, *Texas Commerce Bank v. Grizzle*, 96 S.W.3d 240, 249 (Tex. 2002). In every decision the trustee must consider the mandate that he act in good faith and in the best interest of the beneficiaries.

Over the last century, the National College of Commissioners on Uniform State Laws have promulgated a number of "default" trust statutes. Some of these are familiar such as the Uniform Principal and Income and Prudent Investor Acts. Others are less well known but may be applicable in many states, such as the Uniform Trust Code, the Uniform Institutional Investors Act, Uniform Power of Attorney Act, Uniform Securities Act and a host of others. And there are other helpful sources of which trustees should be aware despite the fact that they are not binding authority. Those include the Restatements of Trust; various Uniform Codes and their Commentary; and various treatises.[1]

Among the Uniform statutes, there are a handful that have been adopted in Texas as default and mandatory provisions. *Mandatory provisions* are sections of the Trust Code that affect administration and <u>cannot be overridden</u> by a trust document; a list of items where the legislature has dictated that it would be against public policy to allow the trust document to supersede the statute. *Default provisions* are those that prevail when the document is silent or vague on a particular matter. While the rule is to look to the instrument first, the prudent fiduciary must be aware of the *mandatory* rules – those few items where the statute prevails even when the document recites something else. Most of these items are set out in TEX. PROP. CODE §111.0035 DEFAULT &

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[1] *See for example,* William F. Fratcher, *Scott on Trusts* (4th ed 1988); George Gleason Bogert & George Taylor Bogert, *The Law of Trusts and Trustees* (6th ed. 2006).

MANDATORY RULES; CONFLICT BETWEEN TERMS & STATUTE. Only one section directly impacts distribution (the terms of a trust may not limit any common-law duty to keep a beneficiary of an irrevocable trust who is 25 years or older informed) but administrators should be aware of all the provisions of this statute.

II. DEFINING THE TERMS

In any distribution decision, a threshold question will be whether the trustee has discretion to make the decision at all. There are many trusts that contain mandatory distribution provisions. These may involve certain acts of discretion as to timing or calculation of "net income" (discussed later herein) but the decision as to *whether* to distribute is not the trustee's to make in a trust with a mandatory distribution standard. Where the standard for distribution in the document gives discretion to the trustee, the first thing the trustee must determine is how much discretion is granted and what kind of standard for exercising that discretion is imposed. Distribution standards fall into three categories:

A. The Support Trust

A true support trust directs the trustee to pay only for the health, education, maintenance or support (often abbreviated as HEMS) of the beneficiary. In other words, the beneficiary may compel the trustee to make distributions in accordance with a specific standard that is generally referred to as an "ascertainable standard". Ascertainable means specific enough to be objectively applied. Typically, a support standard will include HEMS or something similar and may require that the trustee consider the standard of living that the beneficiary enjoys at a prescribed period of time.

B. The Discretionary Trust

A true discretionary trust provides that the trustee shall distribute income and principal only in an amount that the trustee in its sole discretion sees fit to pay. In other words, the trustee is authorized to make distributions in its sole discretion, which are not subject to any objective standard. The beneficiary may not compel a distribution; instead, distributions are in the *sole discretion* of the trustee. This is a "non-objective standard" because it is not specific enough to be objectively applied. Income that the trustee does not elect to distribute to the beneficiary typically is accumulated and thus the exercise of discretion may result in its being paid to another class of persons (remaindermen).

C. The Hybrid

The personal trust that is most common is a hybrid of the two wherein the trustee is charged with sole discretion over income and principal as the trustee deems appropriate and requiring that in making that determination, the trustee consider what is necessary for the support of the beneficiary. Regrettably, there is little case law providing interpretive assistance. The prudent trustee is charged with reviewing each request to determine if it may fall within the scope of the standard of that particular instrument and under the circumstances presented.

III. DISTRIBUTIONS PURSUANT TO GRANTOR'S INTENT

The duty of the trustee is to reasonably exercise discretion and act to accomplish the purposes of the trust according to the grantor's intent - within the mandates of public policy and subject to judicial review. A trustee's exercise of discretion has long been held to be subject to judicial review. *State v. Rubion*, 308 S.W.2d 4, 9 (Tex. 1957). (Avoiding a situation that requires judicial review, that is avoiding litigation, is preferable.) Many of the early cases arise from suits brought by the trustee seeking a construction from the court of a will or trust instrument. This is not the usual posture of the cases being handed down today. Today, most cases appearing in the literature are suits brought against the trustee for breach of duty. And in general, whether the action is initiated by the trustee or the beneficiary, courts do not like to be burdened with the trustee's job. *Coffee v. William Marsh Rice University*, 408 S.W.2d 269, 284 (Tex. Civ. App. – Houston 1966, writ ref'd n.r.e.). "This Court cannot substitute its discretion for that of the Trustees, and can interfere with their exercise of discretionary powers only in case of fraud, misconduct, or clear abuse of discretion." It is worth noting, however, that in this case, the court did ultimately hold that the trustees were free to disregard a provision of the trust providing that the university was to benefit the "white residents of Houston" and found that because conditions had changed significantly since the creation of the trust, the trustees were free to disregard the particular provision applicable to race in order to accomplish the overall intent of the settlor. This case is a perfect example of a change in public policy that impacted a change in administration.

Despite the reluctance of courts in general to substitute their discretion for that of a trustee, a trustee faced with a significant or difficult decision regarding a distribution (particularly one that may have impact on more than one class of beneficiary) may still want to consider seeking a determination of the court. Most financial institutions will have a carefully crafted policy and procedure for the decision to seek a judicial interpretation because the decision to request an official construction is itself an exercise of discretion.

A trustee must be careful not to assume it has discretion to make any particular decision. An important first step is to read the document to determine the intent of the grantor and that the decision is a power of the trustee under that particular instrument. *Keisling v. Landrum*, 218 S.W.3d 737, 741 (Tex. App. – Fort Worth 2007, pet. denied) citing *Corpus Christi Nat'l Bank v. Gerdes*, 551 S.W.2d 521, 523 (Tex. Civ. App.-Corpus Christi 1977, writ ref'd n.r.e.); *Eckels v. Davis*, 111 S.W.3d 687, 694 (Tex. App.- Fort Worth 2003, pet. denied).

A. Reading the Document

Professional trustees know that they must read the instrument carefully even when certain that it is unambiguous and that they recall perfectly what it says. Every trustee should make a practice of reviewing the relevant portion of the document each time he or she makes a distribution and the whole document at least once a year (a good time is during the annual review). If there is extrinsic evidence in the file that clarifies the grantor's intent or relevant circumstances, review that as well. (As noted below, such extrinsic material may not be binding on the trustee but prudence and ignorance of purpose do not co-exist.)

Sometimes the basic information has to be "gathered". Memos to the file from a previous trustee or administrator, letters from the grantor or written modifications to the document may be critical in interpreting a document. It is often appropriate to review the circumstances of the grantor at the time the instrument was executed and in testamentary trusts, the circumstances existing at the time of the testator's death. *First Nat. Bank of Beaumont v. Howard*, 229 S.W.2d 781, 783-785 (Tex. 1950); *McReary v. Robinson*, 59 S.W. 536, 537 (Tex. 1900). You are looking for express instructions in the document from the settlor or a direct statement of the purpose of the trust. There may be clues to infer the purpose from the structure of the trust; there may be an expression of preference between current and future beneficiaries. The rules of construction of wills and trusts are well settled. *Hurley v. Moody Nat'l Bank of Galveston*, 98 S.W.3d 307, 310 (Tex.App.-Houston [1st Dist.] 2003, no pet.). Some of the basic rules of construction that have evolved to help interpret the discretionary distribution clause (or any part) of a trust agreement:

1) Every trust is different; the trustee must determine and implement the goals of the grantor from the content of the document. The cardinal principle to be observed in construing a trust instrument is to ascertain the settlor's intent with the view of effectuating it. *Coffee*, 408 S.W.2d at 273 citing *Parrish v. Mills*, 101 Tex. 276, 106 S.W. 882; *Keisling v. Landrum*, 218 S.W.3d 737 (Tex. App. – Fort Worth 2007, pet. denied). You must read the whole instrument carefully.
2) Intent must be drawn from the instrument. *In re Estate of Dillard*, 98 S.W.3d 386, 391 (Tex. App. – Amarillo 2003, pet. denied); *Huffman v. Huffman*, 339 S.W.2d 885, 888 (Tex. 1960). Clear your mind of what you think the document says or want it to say and read what it actually says.
3) You cannot "correct" the work of a testator, grantor, or of the drafting attorney. The purpose of requiring a will to be in writing is to enable the testator to place it beyond the power of others, after he is dead, to change or add to his will or to show that he intended something he did not. If possible, the court should construe the instrument to give effect to all provisions so that no provision is rendered meaningless. *Myrick v. Moody*, 802 S.W.2d 735, 738 (Tex.App.-Houston [14th Dist.] 1990, writ denied). If the language of a trust is unambiguous and expresses the intent of the settlor, it is unnecessary to construe the instrument because it speaks for itself. *Hurley*, 98 S.W.3d at 310, citing *Jewett v. Capital Nat'l Bank*, 618 S.W.2d 109, 112 (Tex.Civ.App. – Waco 1981, writ ref'd n.r.e.).
4) This is not math. You can't add or subtract to what appears in the instrument. If it is not ambiguous, a court will admit no other evidence for its interpretation. *Corpus Christi Nat'l Bank v. Gerdes*, 551 S.W.2d 521, 523 (Tex.Civ.App.-Corpus Christi 1977). However, for trustees it is often appropriate to consider outside circumstances. And, if a document is truly unclear, "extrinsic" evidence may be considered by a court to determine what the testator meant by a particular word or phrase. In *Reilly v. Huff*, 335 S.W.2d 275, 279 (Tex. Civ. App. – San Antonio 1960, no writ), the court accepted evidence that the testator was a person of solid business experience and that the instrument was drafted by his attorney to determine that "descendant" should be read in the legal sense.
5) There is no reason to be afraid of your dictionary – use it.[2]

[2] By way of example, the trust instrument states: "In connection with the management of said trusts…I give unto said Trustee all powers of Trustees set forth in the statutes

6) An expression of specific intent controls over an expression of general intent; if two expressions of specific intent are in conflict, choose the one that least conflicts with the general intent.
7) "May" means maybe – use discretion. "Shall" means mandatory – *just do it*. *Keisling*, 218 S.W.3d at 742; *Roberts v. Squyres*, 4 S.W.3d 485, 489 (Tex. App. – Beaumont 1999 pet. denied). And with apologies to *Nike.*
8) Be certain you know what rules may apply that may not appear in the document and in Texas, **exculpatory clauses may not have any effect at all.** (Note that TEX. PROP. CODE §111.0035 states that the terms of a trust prevail over any provision of the Trust Code except that they may not limit the applicability of §114.007. Section 114.007 states that any term of a trust relieving a trustee of liability for breach of the trust is unenforceable to the extent it excuses a breach in bad faith, an intentional breach, one made with reckless indifference to the beneficiary, if the trustee derives any profit from the breach or if the exculpatory clause was inserted in the document as a result of abuse of a fiduciary or confidential relationship with the settlor.)

Certain legal presumptions may be of use. These presumptions apply only if there is no specific contradiction of them found in the document:

- By leaving a will or trust the testator did not intend for property to revert to his estate or pass in intestacy.
- By leaving a will or trust the testator intended to confer some benefit on the beneficiary.
- Children are favored over grandchildren, descendants are favored over collateral relatives, who are favored over strangers.
- The testator intended that the estate vest as early as possible.
- All persons in a given class and all classes of beneficiaries are treated equally.
- Every word a testator or grantor uses is important. Nothing is there for no reason.
- The testator intended the law in effect at that time should apply.

For most decisions, the trustee will not find a "bright line". In *Re Will of Flyer* the Court held that "although the decisions in this area of the law place emphasis on the precise verbiage found in the provision creating the trust, close analysis reveals that they take into consideration more than such verbiage alone … we educe [the testator's] design not only from the language employed but from a sympathetic reading of the will as an entirety and in view of all the facts and circumstances under which such provisions were framed." *In Re Will of Flyer,* 245 N.E.2d 718 (1969). If you are working with a document that has been created, modified or reformed by a court, read the order establishing the trust and the agreement itself as carefully as you would any other trust document – even if you think you know what it says.

As an example, for trusts created under Section 142 the statute mandates a "health, education, maintenance and support" distribution standard. TEX. PROP. CODE §142.005. But it is not unusual for the attorneys involved in the creation of a court trust to depart from the terms of the statute and for a judge to approve a trust containing such a departure. Technically, a departure from the statutory language of Section 142 is an abuse of discretion. *Aguilar v. Garcia* states that the "clear language of the statute requires that the trustee have sole discretion to determine what is in the best interest of the beneficiary and make distributions for the health, education, maintenance or support of the beneficiary." The *Aguilar* court said it is mandatory to follow the statutory language. *Aguilar v. Honorable Carolyn Garcia***,** 880 S.W.2d 279 (Tex. App.-Houston [14th Dist.] 1994, no writ).

This statute was amended again in 2007 to make it clear that the only acceptable reason for a court to depart from this distribution standard is to qualify the beneficiary for government benefits as in a supplemental needs trust. Nevertheless, there are many court trusts that specifically mandate items such as the purchase of a residence or a fixed amount for support.

B. Mathematical Calculations vs. Fiduciary Decisions

Some trusts call for distribution by virtue of a formula; the trustee may not be distributing under a

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and to…make *advancements* to or for the benefit of said trust estates unto the beneficiaries thereof for such purposes as said Trustee may deem desirable or proper…and charge against the interest of said beneficiary to whom such *advances* are made…." However, the instrument also stated in another place in the document: "Except as noted elsewhere herein, the trustee shall not borrow nor lend." Trustee consulted Webster's Dictionary regarding the meaning of the word "advance" which includes: (1) to bring or move forward; (2) to accelerate the growth or progress of; (3) to raise to a higher rank and (4) *to supply or furnish in expectation of repayment.* Do not be afraid of the dictionary.

traditional discretionary standard. A charitable remainder unitrust for example, may simply require the trustee to exercise discretion in the choice of investments and apply a formula to determine how much to distribute. In some cases the amount of such a distribution is fixed but the trustee is required to exercise discretion in the choice of the charity that will receive the distribution. This still requires a careful reading of the instrument and file to determine what charitable purposes the grantor/testator intended to accomplish. In some trusts requiring the mandatory distribution of income, the trustee is required to exercise discretion in the decision whether to use the adjustment power (discussed below). In each instance, however, determining the intent of the grantor is important.

IV. DETERMINE PRIMARY PURPOSE OF THE TRUST

Individual personal trusts generally have no mandated statutory language; accordingly, the variance between trusts is nearly unlimited. One of the first things a trustee should do in interpreting a personal trust is to review it to determine its purpose. There are several reasons that people establish discretionary trusts. Trusts may be for tax planning; to facilitate the orderly transfer of wealth in accordance with specific wishes; to protect the assets of someone unable to protect themselves; or to accommodate for parental deficiency or exercise control from the grave. (This last is not a realistic goal but is occasionally a factor in the decision to establish a trust.)

When a trust is established for federal tax purposes, it must comply with the Internal Revenue Code's "ascertainable standard". If a power to invade the principal of a trust is limited by an ascertainable standard, then it generally is not includable in the beneficiary's federal gross estate. Some of the language scrutinized by the courts in cases determining whether a power is appropriately limited for tax purposes is helpful when considering distributions. The *Restatement (Third) Trusts* Section 50 contains an extensive discussion of this precedent. But despite the broad interpretation of state courts in considering what is appropriate to distribute under an "accustomed standard of living" trust, the prudent personal trustee should also be aware of the tax ramifications of such a standard.

The power to invade corpus to continue an accustomed standard of living has been held to be outside the ascertainable standard in some cases, even if limited somewhat. In personal trust, the issue is not how the trustee spends the money but how the trustee *could* spend the money. The Treasury states that "[a] power to use property to enable the donee to continue an accustomed mode of living, without further limitation, although predictable and measurable on the basis of past expenses, does not come within the ascertainable standard prescribed in §2041(b)(1)(A) of the Code since the standard of living may include customary travel, entertainment, luxury items, or other expenditure not required for meeting the donee's needs for health, education or support." REV. RUL. 77-60, 1977-1 C.B. 282. The Treasury Regulations define a general power of appointment by saying what it is not:

> "A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent shall not be deemed a general power of appointment." TREAS. REG. §20.2041-1. (Emphasis added.)

Upon that framework, certain Treasury Regulations build a standard that includes:

a) Support in reasonable comfort
b) Maintenance in health and reasonable comfort
c) Education, including college and professional education
d) Medical, dental, hospital, nursing expenses and expenses of invalidism. TREAS. REG. §20.2041-1 (C)(2).

In *Estate of Vissering v. Commissioner*, 990 F.2d 578 (10th Cir. 1993), an estate challenged the tax court's decision surrounding the word "comfort". After contentious litigation, it was generally established that the term "comfort" does not make the standard unascertainable if the beneficiary already leads a lifestyle that is at least "reasonably comfortable". This, of course, is a circular argument as it refers back to a previous standard of living.

It is important to note that the power to use property for "happiness" is deemed to be outside of the ascertainable standard. Apparently, reasonable comfort is "ascertainable" but happiness is not.[3]

Tax cases provide some guidance but the better guideposts for the prudent trustee are found in the body of common law dealing with personal trust. In looking at personal trusts, the standard may be a clue to the purpose of the trust. If a beneficiary has a power, as co-trustee or otherwise, to make a distribution to himself or for his benefit, but that power is limited by an ascertainable standard, then the

[3] "Happiness" being unascertainable is a subject for a different kind of seminar.

trust property will probably not be includable in the beneficiary's gross estate for tax purposes and tax planning may be the primary purpose of the grantor in establishing the trust. But if the power is too broad to be considered ascertainable (for example, the right to distribute money for "happiness") then the assets fall back into the taxable estate of the beneficiary and it can be assumed that the grantor simply wished to provide for the beneficiary. Because they are less common, trustees occasionally forget that not every trust is designed to effect tax savings.

And occasionally a trust intended to be for tax planning misses the mark, so in Texas, "saving" language is found in TEX. PROP. CODE §113.029. DISCRETIONARY POWERS; TAX SAVINGS. (a) Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of terms such as "absolute," "sole," or "uncontrolled," the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

(b) Subject to Subsection (d), and unless the terms of the trust expressly indicate that a requirement provided by this subsection does not apply:

> (1) a person, other than a settlor, who is a beneficiary and trustee of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee's personal benefit may exercise the power only in accordance with an ascertainable standard relating to the trustee's individual health, education, support, or maintenance within the meaning of Section 2041(b)(1)(A) or 2514(c)(1), Internal Revenue Code of 1986; and

* * *

(d) Subsection (b) does not apply to:

a) a power held by the settlor's spouse who is the trustee of a trust for which a marital deduction, as defined by Section 2056(b)(5) or 2523(e), Internal Revenue Code of 1986, was previously allowed;
b) any trust during any period that the trust may be revoked or amended by its settlor; or
c) a trust if contributions to the trust qualify for the annual exclusion under Section 2503(c), Internal Revenue Code of 1986.

A. Consider Circumstances Such as Standard of Living

Many testamentary trusts incorporate the desire of the testator to provide support to a loved one "in the manner to which she was accustomed at my death" creating more precedent on standard of living than nearly any other issue facing trustees. Even in trusts where the previous standard of living of the beneficiary is not an issue, the "appropriate" standard usually is.

To administer a trust with a "standard of living" clause, a trustee should investigate and document. This might be as simple as visiting the beneficiary and following up on distributions for major expenses, vacations, and education. Or it may require research to determine the grantor's standard of living a generation or more ago. Many factors are considered relevant by the courts in various circumstances: type and size of dwellings, type and expense of educational institutions attended, wardrobe, domestic help employed, number and price of automobiles, membership in recreational facilities, vacations and everyday activities. *In re Golodetz*, 118 N.Y.S.2d 707, 712-713 (N.Y. Sur. Ct. 1952). These should be monitored and recorded by the trustee and considered in making maintenance and support distribution decisions. The trustee must determine the amount sufficient for the "suitable" support and maintenance of the beneficiary. *In re Rockefeller*, 260 N.Y.S.2d 111, 114 (N.Y. Sur. Ct. 1965).

B. Consider Other Sources of Support

There is also some precedent available to guide the trustee regarding the obligation to consider other sources of income available to the beneficiary when making maintenance and support decisions. Cases arising from situations where the instrument does not address whether the trustee should consider outside resources of the beneficiary are largely testamentary and vary in outcome. In various jurisdictions, the default approach falls into three broad categories:

1) the testator intended that the trust be an absolute gift of support and the trustee should not look outside the trust to determine the beneficiary's other means;
2) the trustee must consider other means but the beneficiary is not required to exhaust them; and
3) the beneficiary must rely completely on his own resources for support unless they prove inadequate.

Often, the grantor specifies what the trustee should consider regarding outside support. But when it is not specified in the instrument, Texas law follows the moderate path assuming the beneficiary's other means of support should be considered but the beneficiary is not required to exhaust outside resources.

In Texas and a majority of states, the view is that there is no reasonable ground to exclude information regarding other means in considering distributions for support. The most important factor to be considered in these jurisdictions is the ultimate intent of the testator or grantor - generally presumed to be support as necessary. The rationale is that to determine what amount of support is *necessary*, the trustee must consider the beneficiary's circumstances and determine *need*. *First Nat. Bank of Beaumont v Howard*, 229 S.W.2d 781, 786 (Tex. 1950). In *Howard*, the Court held that the requirement that the trustee consider income "from any source" included the family. It held that the trustee must consider all income "enjoyed by the beneficiaries from any and all sources, all income enjoyed by their husbands from whatever source so long as it is available for the support of the beneficiaries and their sons" and income received by the sons. *Howard*, 229 S.W.2d at 786.

As noted, this is not the prevailing view everywhere. *In re Demitz*, 208 A.2d 280 (Pa. 1965); *see also* Jonathan M. Purver, Annotation, *Propriety of Considering Beneficiary's Other Means Under Trust Provision Authorizing Invasion of Principal for Beneficiary's Support*, 41 A.L.R.3d 255, 266 and cases cited therein.

In some cases of doubt, courts have suggested the trustee should err on the side of the 'primary' beneficiary. *Munsey v. Laconia Home for the Aged*, 164 A.2d 557, 559 (N.H. 1960). This, of course, presumes that one class of beneficiary is of "primary" importance. Most trusts don't have a 'primary' beneficiary. In fact, as noted below, in most cases the trustee has the same duty to all classes of beneficiary. This may create a conflict between the needs of the current income beneficiary and those of future income or principal beneficiaries. (As discussed below, this conflict is what led to the creation of the Power to Adjust.)

V. CONSIDER THE DUTY OF LOYALTY (IF IT IS EASY, YOU AREN'T DOING IT RIGHT)

The "Trustee's Power to Adjust" found in §116.005 of the Texas Property Code addresses the tension created by the duty of impartiality and the duty to give due regard to the interests of both income and remainder beneficiaries. In making investment allocation decisions, the statute instructs the trustee to act first according to the instrument and then according to the Act. If that result does not allow the fiduciary to comply effectively with the duty of impartiality, the trustee may "adjust" between principal and income. In order to fully understand the mechanism, it is helpful to understand how that tension arises in the first place.

The duty of loyalty may be the most important aspect of the fiduciary relationship; it demands a trustee put aside the most human of instincts – "self-interest." At all times, the trustee must put the interests of the beneficiaries above those of himself or of anyone else. And, as spelled out in unmistakable terms in the Texas statute at §117.007, a trustee must manage the trust solely in the interest of **all** the beneficiaries. This is frequently the most difficult aspect of a trustee's administrative duties. Drafters should recognize that this objectivity is slightly easier for a professional trustee than for a member of the family or close friend. But beware of any trustee who claims that this part of the job is easy. To view each situation objectively is more difficult than it sounds, particularly when the trustee is confronted with a duty of "perfect loyalty" to two or more beneficiaries of different interests. This is the case in most personal trusts.

The current statute does not distinguish between classes of beneficiary. (Nor did the previous statute.) Section 111.004(2) defines a "beneficiary" as a person for whose benefit property is held in trust, regardless of the nature of the interest. "Interest" is separately defined as including "any interest, whether legal or equitable or both, present or future, vested or contingent, defeasible or indefeasible." TEX. PROP. CODE §111.004(6). Later, §116.002(2) specifies that the term "beneficiary" in a trust includes "an income beneficiary and a remainder beneficiary". *Nothing in either section of the statute suggests favoring one class of beneficiary over another.*

A. Does the Document Reflect a Preference for a Class of Beneficiary?

Unless a document specifically directs the trustee to favor one class of beneficiary over another, accommodating competing interests within the bounds of the duty of loyalty is a challenge. If the trust instrument does provide an articulated standard for unequal treatment between classes, and the terms of the instrument are followed, the trustee should be comfortable with disparate treatment. Drafters should remember that if the grantor wants to favor one class over another, the document must say so.

There are, certainly, many examples of documents that present clear and easily interpreted preferences for either the income or remainder beneficiary. And some settlors provide a clear mandate or a purpose statement. An example of such a clear and unmistakable mandate would be: "trustee shall distribute income and principal as necessary for the health, support, maintenance and comfort of my spouse without regard for the rights of the remainder beneficiaries, even to the complete dissipation of the trust assets..."

In many cases, however, the articulated standard is not sufficiently clear. If the document is silent or unclear, the trustee turns to the standards in the statutes – which as noted above, provide for the administration of the trust with the same regard for the interests of income and remainder beneficiaries. The Texas UPIAs mandate consideration of the total investment strategy stressing results in the short term for the current income beneficiary and long-term for the future classes of beneficiaries. TEX. PROP. CODE §§116 and 117. (Despite the use of the word "uniform" in the titles of these Texas acts, they depart somewhat from the text propounded by the National Conference of Commissioners on Uniform State Laws.)

B. When the Document Says Distribute All Income

There are three things the trustee must look for in making a determination as to when to use the Adjustment Power.[4] These three requirements for use are:

1) the trustee invests and manages trust assets as a prudent investor,
2) the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income and
3) the trustee determines that making an adjustment is the only way to be "fair and reasonable to all of the beneficiaries except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries."

Uniform Principal and Income Act of Texas (Comment – Section 104) (1997).

In simple terms, §116.005 (the adjustment power) authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. When the distribution standard states "distribute all income", what was previously a matter of discretion only as it related to investment decisions now requires a separate exercise of discretion to determine the appropriate amount of the distribution as well.

Some trustees assume that you almost never need to utilize the power. But every trustee has an affirmative duty to administer every trust. TEX. PROP. CODE §113.051. And, part of that duty is to consider whether the Adjustment Power will apply to a particular trust. Therefore, every irrevocable trust must be reviewed at least once to determine if the power should be used going forward. Many trusts will require annual review. This analysis may be boiled down to three basic questions:

C. Is the Adjustment Power Available?

Whether the Adjustment Power is available is a two-part test. First, the trustee must determine if the Principal and Income Act is the governing law of the trust. Second, the trustee must be certain the document does not specifically prohibit use of the adjustment power. Even if the Principal and Income Act applies to the trust, the document may contain specific language prohibiting its application; if so, that specific language will govern the trust. TEX. PROP. CODE §116.004(a)(1). The trust may have special circumstances which prohibit the use of the adjustment power. For example, even when the Principal and Income Act applies to a trust, the adjustment power will <u>not</u> be available if any of the following is true:

1) Language in the trust instrument prohibits investing assets as a prudent investor. Example: "I prohibit the Trustee from ever investing in equities" or "Trustee shall only invest in those instruments backed by the full faith and credit of the United States government" or "trustee may not sell the interest in [insert large concentration of stock here]." (In Texas, this is usually XOM.)
2) The trust describes the amount that shall/may be distributed by referring to a specific amount, and does not refer to the income of the trust. For example: "Distribute $1,500 per month to each beneficiary," or "Distribute 3% of the market value on March 1st."
3) If a trust's distribution provision is a single discretionary standard that applies to *both* income *and* principal, the adjustment power does not apply but it is important that the standards be identical. Beneficiaries with access to both principal and income, but under different circumstances may be eligible for adjustment. Example: "Distribute all income and principal only in the event of an emergency."

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[4] The provision describing those three items is found in TEX. PROP. CODE §116.005. TRUSTEES POWER TO ADJUST

(a). A Trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 116.004(a), that the trustee is unable to comply with Section 116.004(b). The power to adjust conferred by this subsection includes the power to allocate all or part of a capital gain to trust income.

4) A non-independent co-trustee is required by the document to participate in the adjustment power decision because no related party, subordinate party, or beneficiary may participate in the decision. If such a co-trustee is required to participate, the adjustment power may not be used. But if the non-independent co-trustee's participation in every decision is not required, then the non-independent co-trustee may be able to decline to participate allowing the power to adjust to be used. TEX. PROP. CODE §116.005(d) and (e) [5]
5) The trust has charitable and non-charitable beneficiaries and is taking a charitable set aside for capital gains. These are non-qualified trusts funded prior to the 1969 tax law, which created qualified Charitable Remainder Trusts. These pre-1969 split interest trusts have both individual and charitable interests, with the net income being remitted to the income beneficiaries or sometimes shared with a non-profit organization. The power of adjustment does not apply to trusts where a charitable set-aside deduction is being taken.

Engaging in this analysis, the trustee first determines if the UPIA governs the trust and whether the adjustment power is available. If the governing law does not include the UPIA, or if any of the above listed circumstances exist, then the Trustee's analysis is complete and the power is *not* available. All that remains for a trustee to do is to make certain that analysis is documented in the file and coded to the trust accounting system.

If the use of the Adjustment Power is truly prohibited by the terms of the irrevocable document - that single review is enough. If the prohibition of use of the power is due to circumstances (such as identity of a co-trustee), a trustee should have a mechanism to trigger a new review when circumstances change. This can be a tickler in trust accounting software or may be done in conjunction with annual review.

If Available, Should an Adjustment Be Made to Income This Year?

If the Principal and Income Act is the governing law of a trust, and under the current circumstances of the trust the adjustment power is available, then the trustee is faced with whether to make an adjustment. Even in a case where the adjustment power is available to the Trustee, the circumstances and liquidity needs of the income beneficiary, the circumstances of the remainder beneficiaries, the size of the trust, the current asset allocation, the income being produced now, and other factors will all influence the trustee's decision as to whether and how to exercise the power.

The application of the prudent investor rule is fundamental to the adjustment power. The trustee cannot exercise the adjustment power unless the prudent investor rule is in use for the trust. And, if the trustee applies the prudent investor standard and decides that the investment objectives of the trust can be met by an asset allocation that produces enough traditional income to provide the income beneficiary with the level of benefit he is entitled to under the trust, then no adjustment needs to be made. (Just because you can, doesn't mean you should.) However, if the trustee applies the prudent investor standard and the investment strategy results in traditional income that does not provide the income beneficiary with the appropriate benefit, then the trustee may make the adjustment.

D. What Issues Should the Trustee Consider?

Making this analysis is a valuable opportunity for the trustee to make a wholesale review of all of the circumstances of the trust. Many corporate trustees have committed these questions to a form to be completed by a trust officer and submitted to a trust committee to aid in the decision. The form used is not important; but undertaking a diligent investigation <u>is</u> important. Questions include:

- What are the purpose of the trust and the primary intent of the grantor? What is the expected duration of the trust?
- What are the ages and any special circumstances of the beneficiaries?
- What are the liquidity needs? Reviewing past expenditures is important, but the trustee should also consider the foreseeable future – including education, health, age of retirement, and other assets that may be coming to the beneficiaries.
- Does the document allow a trustee to invade principal? Does the document allow accumulation of income?

[5] Uniform Principal and Income Act, Section 104 (1997); the Texas Act was amended to repeal the section that specifically limited an adjustment that diminishes the income interest in a trust requiring all income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment. Presumably, this was in response to IRS adoption of the Section 643 regulations.

- How are the assets invested, including non-financial assets of the trust such as oil & gas, timber, rental property, closely held businesses?
- How will the other provisions of the Principal and Income Act affect the net amount allocated to income from oil & gas, timber, and fees?
- What effect would an adjustment to income have on the tax situation of the trust and the beneficiaries? (Remember - **trust accounting and tax accounting -** not the same thing! Funds that the trustee distributes as income may or may not be treated that way for tax purposes.)

E. If an Adjustment is Made this Year, How Much Should it Be?

After considering the factors discussed above, the trustee must exercise discretion to decide whether to adjust between principal and income. An adjustment amount will likely differ for various trusts administered by a trustee, and should be re-examined every year. A primary concern for the trustee will be the historical returns on the investments in this trust. After consideration of the actual returns and the appropriate beneficial enjoyment, if there is a difference between those amounts, an adjustment may be made between principal and income.[6]

For example, consider a hypothetical **$2 million** trust invested in various asset classes with five year average returns as set out in the Addendum. In Chart A we see that during this period of strong equity market performance (January 1, 2003 through December 31, 2007), by allocating less of the portfolio to traditional fixed income assets, the traditional income (shaded gray on the chart) decreased but the total return is increased. In order to be fair to both classes of beneficiary (and assuming that it represents an appropriate level of beneficial enjoyment), adjustment considerations might be as follows:

1) Prior to UPIA – traditional income is $69,500;
2) After UPIA when account is invested for total return – traditional income is $64,500;
3) Adjustment in this year should be <u>no more than</u> $5,000.

When fees are taken in accordance with the statute, for example a fee of 1% or $20,000 taken 50/50 from income and principal, the pre-adjustment income to be distributed would be $59,500. Making the same adjustment calculation ($5,000) but having rebalanced the account for total return, the actual amount to distribute would still be $59,500 but the amount undistributed for the principal beneficiaries has increased.

Assuming that the trustee elected to include the entire difference as the adjustment amount and distributed $59,500, this would result in an annual distribution of 3.475% of the $2 million FMV trust. Take the fee into account and the percentage received by the beneficiary is just under 3%. Trustees who assure beneficiaries that they can rely on "a flat 4%" should be worried - this may not be sustainable. For this reason, in those states where the statute supports a "unitrust" type calculation, trustees should recalculate annually to be sure it is a sustainable percentage and should communicate carefully with beneficiaries. In those situations precluding recalculation, the percentage should be chosen very carefully.

Varying the five year period used (perhaps something like January 1, 2008 to December 31, 2012, can produce somewhat different results. In the second illustration (Chart B) we see the impact of having allocated less of the portfolio to traditional fixed income assets at a time when equities were experiencing lackluster performance has no real impact on the overall performance of the portfolio but may require that the Trustee consider an adjustment running the other way. Or, in order to be fair to both classes of beneficiary (and assuming that it represents an appropriate level of beneficial enjoyment) the trustee may prefer to utilize only the traditional income calculation that year.

Many trustees review only three to five years of historical information – but **longer is much better**. For example, consider the hypothetical **$2 million** trust invested in various asset classes with twenty-five year average returns as set out in Chart C. The best way to obtain truly fair results is to utilize a longer view – 10, 20 or even 30 years – because long term data provides a greater smoothing effect on the calculations. For this purpose, a "market cycle" is clearly something longer than five years. And it is important to utilize the actual historical data for the individual trust. A large trust utilizing multiple asset classes and including alternative investments will look very different than the simple allocation presented in these examples.

Of course, in reality, the actual market value of the trust will vary. In that event, if the trustee is using a unitrust type calculation it is, of course, applied to the reduced number. For example, if the value of the trust is down 15% resulting in a total market value of

[6] Above all, remember that Section 116.005 "does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolios total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule." [Uniform Act Comment to Section 116.005].

$1.7 million and the 3% number from our first calculation is applied, the resulting distribution would be $51,000. If the trust value is up 15% then the 3% unitrust calculation would apply to $2.3 million and the resulting 3% distribution to the income beneficiary would be $69,000.

It is important to note that there is no single solution. Each set of circumstances must be considered and addressed by a prudent trustee. However, there is a constant formula for avoiding mistakes – that the trustee establishes prudent policies, follow those policies scrupulously, obtain thoughtful advice and document the process in every case.

In a corporate trust department, the procedure described above is usually accomplished by the completion of various forms to gather information specific to the particular account, calculations (some institutions have devised software to perform these), a recommendation by the trust officer, and review and approval by a trust committee. For an individual trustee, even one who may be a sophisticated investor, performing the review and making an appropriate decision may be daunting. For that reason there are a growing number of professional fiduciaries and institutions who provide "agent for fiduciary" services and will do the research and make recommendations to the trustee. On very large trusts containing multiple asset classes such as hedge funds, private equity, or oil and gas, even a professional trustee may choose to retain a consulting expert for adjustment power calculations.

F. When Not to Exercise

The Act provides several limitations on the power to adjust a trust as noted above. They are mainly designed to preserve tax benefits that may have been important to the purpose for creating the trust, to prevent other adverse tax consequences, and to remove the potential for conflict of interest by denying the power to adjust to any beneficiary.

VI. THE SPENDTHRIFT CLAUSE

The interaction of a spendthrift clause and the distribution standard frequently raise difficult issues for the trustee. There is little Texas precedent on this issue. But consider *NationsBank of Virginia v. Grandy*, 450 S.E.2d 140 (Va. 1994), wherein the court held that despite unfettered discretion to invade principal, trustees properly refused to invade corpus to pay a beneficiary's debts where beneficiary had substantial assets outside the trust sufficient to pay.

Contrast that with *In re Family Trust of Windus,* an Iowa case wherein the court held that an invasion of principal to pay credit card debt in excess of $60,000 was permissible under the support standard. *In re Family Trust of Windus*, 2008 WL 3916438 (Iowa Ct. App. 2008). And see, *In re Estate of Morgridge*, 2007 WL 1874332 (Cal. Ct. App. 2007), wherein the court held that invasion of principal to pay a $71,000 credit card debt was not within the "support standard".

Trustee should be familiar with the terms of the statute regarding when a spendthrift trust is created in the relevant state. In Texas, §112.035 clarifies that a settlor is not considered a beneficiary of a trust solely because a trustee who is not the settlor is authorized to pay taxes for the settlor.

Trustees should remember the spendthrift protection terminates with the trust. *Faulkner v. Bost*, 137 S.W.3d 254, 260-61 (Tex. App. – Tyler 2004, no pet.). Once in the hands of the beneficiary, funds are fair game for creditors. See discussion below regarding an exception to the spendthrift rule for child support. *First City Nat'l Bank v Phelan,* 718 S.W.2d 402, 406 (Tex. App. – Beaumont 1986, writ ref'd n.r.e.). This is the law in most states including Texas. TEX. FAM. CODE §151.001.

VII. COMMUNICATE WITH THE BENEFICIARY.

The trustee has a duty to be informed of circumstances affecting the trust; therefore, the trustee ought to be in frequent communication with the beneficiaries about individual circumstances and the administration of the trust in general. Administrative decisions regarding the availability and application of the Adjustment Power are key issues and the communication with the beneficiaries should be accurate, complete, timely, and in writing.

Many states that have adopted the Uniform Principal and Income Act have also adopted a provision which requires the trustee to give notice to the beneficiaries of the proposed adjustment and then provides for a limited time in which to object. Texas decided not to include such a provision because statute and common law already provide adequate notice protection for beneficiaries.

Despite the fact that there is no separate statutory mandate, trustees should educate beneficiaries about this tool and its application to their trust. Beneficiaries should receive information about the process the trustee used to make these discretionary decisions (and indeed all discretionary decisions) in language that is as non-technical as possible, given the technical nature of the subject. And trustees should encourage questions and discussion so that beneficiaries understand the terms and administration of their trust and should document the decision making process.

A. Keep Every Scrap of Paper (or Digital Data)

Documenting discretionary action is important and should include payment of expenses, distributions to beneficiaries, and decisions regarding investments or the use of the adjustment power. "If a dispute between the beneficiary and trustee requires a determination of reasonableness, the proof required will be that which would be required to make the same determination by decree." *In re Martin's Will*, 199 N.E. 491, 495 (N.Y. App. Div. 1936).

In other words, file documentation may become courtroom evidence. By way of example, if a beneficiary submits his grade report to demonstrate an aptitude for art and then requests a distribution for a semester in France to study painting, treat that grade report as if it were worth a few months in Europe. It might be if there is future litigation surrounding the decision to distribute.

VIII. WHAT TO PAY?

At first blush, the issue of what to distribute in a trust seems easy. Health, education, maintenance and support are all words with a common, ordinary meaning; however, circumstances affect their interpretation. The trustee must determine whether the primary purpose of a trust is support now, conservation of assets for the future, or both – keeping in mind that not every trust is intended to last for generations. The variety of expenses to consider seems infinite; there is little guidance in case law because suit is rarely instituted to force or protest distribution for a single item. Some items can easily fit into more than one classification. Some commonly considered items are discussed herein.

A. Health

The term "health" typically includes many distributions that would also be permissible under a support standard alone. In Texas, a recent amendment to §142.005 (b) (2) specifies that a … "trustee may conclusively presume that medicine or treatments approved by a licensed physician are appropriate for the health of the beneficiary". This section was added because trustees administering court created trusts found the variety of requests for distributions related to "health" to be daunting. Difficult decisions related to "health" may involve alternative treatments such as acupuncture or homeopathic remedies and elective medical procedures such as plastic surgery, laser eye surgery, cosmetic dentistry, non-diagnostic full body scans, unprescribed lab tests (such as tests for STDs), tattoo removal, and concierge medicine. Some of the obvious (and more traditional) requests that fall under the category of health include:

- Health, dental, life, and long-term care insurance premiums
- Uninsured doctor, hospital and lab costs
- Home health care[7]
- Physical therapy
- Psychiatric treatment or psychological counseling
- Mental health and mental retardation services
- Occupational therapy
- Medical expenses of beneficiary's children where duty to support exists
- Dental and orthodontia expenses
- Medical supplies, equipment, and batteries
- Pharmaceuticals
- Medically prescribed therapeutic items such as pools, horses, or home gym equipment
- Hospital beds and specially designed furniture for the handicapped
- Eye care, eyeglasses and contact lenses
- Linens and special clothing requirements
- Handicap transport vans and lift equipment
- Ramp construction, adaptation of doors and remodeling to accommodate handicaps
- Installation of safety equipment such as handrails
- Specialized cleaning to eliminate allergens

B. Education

Without limiting or expanding provisions present in the trust document, education is usually considered to include room and board, tuition, fees, books, and other costs of higher education and/or technical training. *Restatement (Third) of Trusts* §50 cmt d(3) (2003). As such, education would appear to be easy to define but there are many cases demonstrating ambivalence in the courts. Although the restatement appears to include all these categories as "education" there are some contrary decisions for review. See, *Southern Bank & Trust Co. v. Brown*, 246 S.E. 2d 598, 603 (S.C. 1978) wherein the court found that "education" did not include post-graduate studies but was limited to education up to and including a bachelor's degree. See also, *Epstein v. Kuvin*, 95 A.2d 753 (N.J. Super Ct. App. Div. 1953) which held that the term "college education" did not include medical school and *Steeves v. Berit*, 832 N.E.2d 1146, 1152 (Mass. App. Ct. 2005) adopting a similar definition of "college" in the context of a divorce case. Finally, in the case of *Lanston v. Children's Hospital*, 148 F.2d 689 (D.C.Cir. 1945) the court found that it was within a trustee's discretion to refuse to fund the further education of a beneficiary who was 42 years old, well educated and had a "large income".

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[7] See *In re Stonecipher*, 849 N.E.2d 1191, (Ind. App 2006), wherein the court found that it was not an abuse of the trustee's discretion to refuse to invade trust principal for in-home nursing care for the present beneficiary given the consideration of her income from other sources, the remaindermen beneficiaries, and extensive gifting some of which was made from personal funds.

Common requests classified by corporate trustees as "education" would include but not be limited to the following:

- Tuition for college, trade school, vocational training, or graduate school
- Tuition including private schools for all ages including elementary and secondary education
- Study skills classes and tutoring
- Speech and/or reading therapy
- Room and board at school
- Summer school and summer activities
- After school programs and extended day care
- Costs of travel to and from school
- Sports activities and lessons
- Computer purchase, maintenance and repair
- Graduation costs, proms, class rings
- Music lessons and instrument purchase and repair
- Books and school supplies
- Uniforms and school clothes

C. Maintenance and Support

The terms "maintenance" and "support" are now generally considered to be synonymous and may be deemed an expression of purpose as much as a distribution standard. "Support" has been interpreted very broadly in many sources. The *Restatement (Third) Trusts* Section 50, Comment d(2) (2003) provides a non-exclusive list of examples including "regular mortgage payments, property taxes, suitable health insurance or care, existing programs of life and property insurance, and continuation of accustomed patterns of vacation and of charitable and family giving." And as noted above, courts have held that the "needs of a married man include not only needs personal to him, but also the needs of his family living with him and entitled to his support." *Robison v. Elston Bank & Trust Co.*, 48 N.E.2d 181, 189 (Ind. App. 1943). In fact, when the distribution standard includes these terms, a trustee's discretion is no longer considered "unbridled". *First Nat'l Bank of Beaumont v. Howard*, 229 S.W.2d 781, 785 (Tex. 1950); *In re Estate of Dillard*, 98 S.W.3d 386, 395 Tex. App. – Amarillo 2003, pet. denied). In general terms, "maintenance and support" refers to living expenses such as:

- Rent or mortgage payments and utilities
- Property taxes, insurance, maintenance and repairs (on property held outside the trust)[8]
- Auto purchase, repair, and insurance
- Childcare services
- Funeral costs
- Legal fees (for items such as divorce, adoption, or criminal defense)
- Estate planning, tax, and accounting advice
- Tax preparation and payment
- One time requests for vacations, birthdays, Christmas, emergencies, etc.

This list was compiled over a relatively short time frame in conjunction with requests made in trusts that almost exclusively contained a plain HEMS standard. It is not meant to be exhaustive. Some of these items may seem frivolous for small trusts which provide further support for the rule that individual circumstances must be considered. But under all circumstances, "support" probably means more than the bare necessities. *Hartford-Connecticut Trust Co. v. Eaton*, 36 F.2d 710 (2d Cir. 1929).

D. Consider Any Others Obligated to Support the Beneficiary

The existence of a trust generally does not abrogate the duty of any other person obligated to support the beneficiary. (This principle may be applied to the beneficiary himself. In a situation where maintenance and support may deplete the corpus of the trust, and the grantor has not favored the current beneficiary over the remaindermen, trustee for an able-bodied but lazy beneficiary may have to encourage that beneficiary to help himself. Many grantors even include language to make that clear to the trustee.) There are numerous factors to consider in situations where others may be obligated to support a beneficiary. These are raised most often in court created trusts although they certainly may be an issue in any type of personal trust. Such considerations include:

1) the ability of a parent or parents to support a beneficiary under a disability, educate the beneficiary, meet emergencies or provide necessary training for life;
2) the age, mental and physical condition of the beneficiary and if incapacitated the likely duration of the incapacity; and
3) the likelihood of the beneficiary to have continuing medical needs or be able to obtain insurance and to support himself. All states also have law regarding duty between spouses.

Beneficiaries and their family members may find the questions a trustee must ask in order to properly consider these items intrusive; some refuse to respond. But the trustee is charged with determining whether

8 Real estate held **inside** the trust will require that taxes, insurance and maintenance be included as expenses of the trust rather than discretionary distributions.

the parent is satisfying his or her duty to support a child or whether the need for maintenance and support really exists so the information is necessary. Most people would rather answer specific questions or prepare financial statements than provide tax returns and tax returns often do not provide a clear picture of financial resources. Notwithstanding their limited value, some corporate trustees still require beneficiaries to provide them.

Importantly, as noted above, a court ordered child support obligation will "trump" even a trust containing a spendthrift clause. TEX. FAM. CODE § 154.5 allows the attachment of a parent's trust assets as follows:

a) The court may order the trustees of a spendthrift or other trust to make disbursements for the support of a child to the extent the trustees are required to make payments to a beneficiary who is required to make child support payments as provided in this chapter.

b) If disbursement of the assets of the trust is discretionary, the court may order child support payments from the income of the trust but not from the principal.

Finally, it is an unfortunate fact of modern society that substance abuse is found at every level of affluence; it is occasionally addressed in trust documents. A standard of living clause may lock the trustee into maintaining a beneficiary in a comfortable style while he spends the trust assets on drugs or alcohol. The problem became so prevalent that the American College of Trust and Estate Counsel (ACTEC) asked its fellows to suggest language to address it in documents. The recommendation included a provision for drug screening of all beneficiaries, whether or not the trustee suspects the use of drugs. This provides some protection for the trustee against claims of abuse of discretion but presents additional problems and expense. The recommendation included assertion by the grantor that by "making distributions to a beneficiary contingent on passing a drug test," the Grantor is "promoting the health and well-being of the beneficiary." ACTEC suggested that the instrument specify the frequency and timing of such tests and address consent as a requirement for receipt of funds. Despite the resources expended on this project at the time, the language was not widely adopted. This author has seen only a few such documents actually funded and is not aware of any courts having been asked to interpret such a clause.

IX. WHO TO PAY

It is axiomatic that distributions must be made to or for the benefit of the beneficiary. Usually, determining the identity of the beneficiaries is a relatively easy trustee duty. In interpreting a testamentary instrument, a question may arise as to whether the term "issue" refers to all descendants of the grantor/testator or just children. Drafters continue to use a variety of terms despite the fact that the Texas statute does not adequately define many of them. Many states define these terms more specifically.

For example, in **Pennsylvania** the statute specifies: **Meaning of "heirs" and "next of kin," etc.; time of ascertaining class.--**A devise or bequest of real or personal estate, whether directly or in trust, to the testator's or another designated person's "heirs" or "next of kin" or "relatives" or "family" or to "the persons thereunto entitled under the intestate laws" or to persons described by words of similar import, shall mean those persons, including the spouse, who would take under the intestate laws if the testator or other designated person were to die intestate at the time when such class is to be ascertained, a resident of the Commonwealth, and owning the estate so devised or bequeathed: Provided, however, that the share of a spouse, other than the spouse of the testator, shall not include the allowance under the intestate laws. The time when such class is to be ascertained shall be the time when the devise or bequest is to take effect in enjoyment. 20 Pa. C.S. s2514.

In **Michigan** the statute provides a statutory will form mandating the use of the term "descendants" and then defines it in the statute by stating: (b) "Descendants" means your children, grandchildren, and their descendants. Estates and Protected Individuals Code Act 386 of 1998, Article 700.2519, Section 3.4 (b).

Under **Florida** law, "lineal descendant**"** or **"**descendant" is defined to mean "a person in any generational level down the applicable individual's descending line." It includes children, grandchildren, or more remote descendants but excludes collateral heirs. § 731.201(9), Fla. Stat. (2007).

The **California** Statute states: "Descendants" mean children, grandchildren, and their lineal descendants of all generations, with the relationship of parent and child at each generation being determined as provided in Section 21115. A reference to "descendants" in the plural includes a single descendant where the context so requires. CA Probate Code Section 6205.

In **Missouri** under Section 472-010(2) "Child" includes an adopted child and a child born out of wedlock, but does not include a grandchild or other more remote descendants; (14) "Heirs" means those persons, including the surviving spouse, who are entitled under the statutes of intestate succession to the real and personal property of a decedent on his death intestate; … (16) "Issue" of a person, when used to refer to persons who take by intestate succession, Includes adopted children and all lawful lineal descendants, except those who are the lineal descendants of living lineal descendants of the intestate;

And see **Oklahoma** §60-175.3. "Relative" means a spouse, ancestor, descendant, brother, or sister, by blood or adoption.

The **Texas** Code contains a definition of “relative” that is “a spouse, or whether by blood or adoption, an ancestor, descendant, brother, sister or spouse of any of them.” TEXAS PROP. CODE §111.004 (13).

For an interesting discussion of the use of the word “descendants” in a Texas trust that includes a discussion of the history of trust and estate statutes and the Texas Family law, see *In re Ellison Grandchildren Trust*, 261 S.W.3d 111 (Tex. App. – San Antonio 2008, pet. denied).

Some courts have construed the terms “issue” and “descendants” interchangeably. *Guilliams v. Koonsman*, 279 S.W.2d 579, 583 (Tex. 1955). Generally, Texas case law holds that the word “issue” includes all descendants unless there is something specific in the instrument to suggest a narrower interpretation. *Atkinson v. Kettler*, 372 S.W.2d 704, 711-12 (Tex. Civ. App. – Dallas 1963), *rev’d on other grounds*, 383 S.W.2d 557 (Tex. 1964).

Once the appropriate beneficiary has been determined, and if circumstances require, payments may be made for the benefit of rather than directly to the beneficiary. Many trusts contain a “facility of payment” clause and Texas statute specifically allows payments for the beneficiary instead of to him or her:

> TEX. PROP. CODE §113.021. DISTRIBUTION TO MINOR OR INCAPACITATED BENEFICIARY.
>
> (a) A trustee may make a distribution required or permitted to be made to any beneficiary in any of the following ways when the beneficiary is a minor or a person who in the judgment of the trustee is incapacitated by reason of legal incapacity or physical or mental illness or infirmity:
>
> a) to the beneficiary directly;
> b) to the guardian of the beneficiary's person or estate;
> c) by utilizing the distribution, without the interposition of a guardian, for the health, support, maintenance, or education of the beneficiary;
> d) to a custodian for the minor beneficiary under the Texas Uniform Transfers to Minors Act (Chapter 141) or a uniform gifts or transfers to minors act of another state;
> e) by reimbursing the person who is actually taking care of the beneficiary, even though the person is not the legal guardian, for expenditures made by the person for the benefit of the beneficiary; or
> f) by managing the distribution as a separate fund on the beneficiary's behalf, subject to the beneficiary's continuing right to withdraw the distribution.
>
> (b) The written receipts of persons receiving distributions under Subsection (a) of this section are full and complete acquittances to the trustee.

The statutes are also clear for court trusts.

> TEX. EST. CODE §1301.102 OPTIONAL TERMS
>
> (a) A management trust created for a ward or incapacitated person may provide that the trustee make a distribution, payment, use or application of trust funds for the health, education, maintenance, or support of the person for whom the trust is created or of another person whom the person for whom the trust is created is legally obligated to support:
>
> ***
>
> (2) to:
>
> A) the ward’s guardian;
> B) a person who has physical custody of the person for whom the trust is created or of another person whom the person for whom the trust was created is legally obligated to support; or
> C) a person providing a good or service to the person for whom the trust was created or to another person whom the person for whom the trust was created is legally obligated to support.

> TEX. PROP. CODE §142.005. TRUST FOR PROPERTY
>
> (c) A trust established under this section may provide that: ***

(2) distributions, payments, uses, and applications of all trust funds may be made to the legal or natural guardian of the beneficiary or to the person having custody of the beneficiary or may be made directly to or expended for the benefit, support or maintenance of the beneficiary without the intervention of any legal guardian or other legal representative of the beneficiary. Texas trust law clearly contemplates distributions to a parent, guardian or caregiver.

As noted above, all distributions should be carefully documented. Policy for distributions to parents or caregivers should include faithful documentation of the purpose of each reimbursement (including receipts or copies of cancelled checks). Periodic maintenance and support distributions should be supported by documentation of a request and need. Such information should be gathered periodically – at least annually is preferred. This might include financial information for someone else (not the beneficiary) if that person retains a duty to support the beneficiary. The determination as to when a parent's duty to support a child has ended requires that the trustee look to the Texas Family Code. Currently it requires support to age 18 or graduation from high school for a child who is not disabled. The parent of a child suffering a disability may be required by law to support that child indefinitely:

TEX. FAMILY CODE §154.001 SUPPORT OF CHILD.

(a) The court may order either or both parents to support a child in the manner specified by the order: ***
if the child is disabled as defined in this chapter, for an indefinite period.

TEXAS FAMILY CODE §151.001(b), reads as follows:

> The duty of a parent to support his or her child exists while the child is an unemancipated minor and continues as long as the child is fully enrolled in a secondary school in a program leading toward a high school diploma and complies with attendance requirements described by Section 154.002(a) (2).

Accordingly, despite the common misconception among lay persons, it is important to be aware that child support does not necessarily end at age eighteen.

For incapacitated adults similar documentation of expenses should be accumulated and the prudent trustee may prefer to make distributions directly to providers to avoid casting a guardian of the person or a caregiver in the role of a financial fiduciary. Situations where an extremely low-income household may be caring for a beneficiary with a substantial sum in trust (as is often the case in a court created trust) may require special attention to detail. In a supplemental needs trust, distributions directly to the beneficiary are not advisable even if they are not for prohibited items. Refer frequently to the instrument and should questions arise, do careful research or seek the advice of a specialist.

Beneficiaries should be treated differently upon reaching age 18. At that time, assuming the beneficiary is not mentally incompetent, distributions should not be made without the beneficiary's knowledge and statements should be directed to him or her unless the trust specifically addresses this issue. Many parents are shocked to discover that their child must be informed at 18 (or 25) years of age and may request that their child not even be told about the trust. **This is not acceptable in Texas.** Disclosure is mandatory except in very narrow circumstances. Having been amended several times, the current version, effective upon the Governor's signature on June 17, 2007, reads as follows:

§111.0035 (c) The terms of a trust may not limit any common-law duty to keep a beneficiary of an irrevocable trust who is 25 years of age or older informed at any time during which the beneficiary:

1) is entitled or permitted to receive distributions from the trust; or
2) would receive a distribution from the trust if terminated.

(TEX. PROP. Code §113.060 (effective 01/01/06 and repealed as of June 17, 2007) imposed a standard that a "trustee shall keep the beneficiaries of the trust *reasonably* informed." Questions regarding what is reasonable and whether this applied to unvested or contingent remaindermen had trustees (individual and professional) scurrying for counsel. The current statute, while less harsh in its requirements, clearly precludes a testator or grantor from mandating non-disclosure for any beneficiary 25 or older but leaves some room for interpretation regarding what amount of disclosure is necessary to keep a beneficiary informed.)

In light of the terms of the current statute, trustees and parents should plan for full communication to begin at age 18 unless the document mandates that it may be avoided to age 25. Thereafter, even if the document purports to allow continued secrecy, the statute is clear that the trustee is required to keep the beneficiary fully informed.

X. WHEN TO PAY? PROMPTLY.

A trustee may not unreasonably delay the exercise of discretion. While the court will not direct how the trustee exercises its discretion (with respect to selecting charitable entities to receive distributions), it does have the power to order a "recusant or unreasonably dilatory trustee" to make a decision. If the trustee refuses, it may be removed and a successor appointed. *Boyd v. Frost National Bank*, 196 S.W.2d 497 (Tex. 1946).

One advantage of a professional trustee is that decisions can be made consistently and objectively and investment choices can be more diverse. However, when assets are invested in a more diverse portfolio, the trustee must be sure that liquidity does not become an issue. Liquidity should be the trustee's problem – not the beneficiary's. With the use of modern technology, trades may now settle in a matter of hours. Many institutions now use mutual funds, but restrictions on trading common trust funds are still relevant. Many alternative investments, however, are very illiquid – requiring in some instances, a year or more to opt out. The trustee should take care to maintain sufficient liquid assets in an account to cover the beneficiary's routine needs, fees and expenses of trust, and the occasional "emergency". Beneficiaries who need an appropriate distribution are generally not sympathetic to trade date or lock up requirements the trustee has imposed upon them.

If the distribution standard in a trust includes a requirement of necessity, delay is particularly difficult to justify. After all, if the trustee has made a determination that need exists in order to support the distribution in the first place; it is reasonable to assume the beneficiary "needs" the money **now.**

The timing of distributions is also affected by other considerations. It is important to remember that income not distributed may usually be reinvested. But principal and income investments should not be co-mingled in some circumstances. Many settlors intend by the establishment of the trust to preserve the assets as the separate property of their child. Upon the failure of a marriage, the issue becomes whether undistributed income has been "acquired" by the spouse during the marriage. The determination may be clouded in cases where the instrument provides that undistributed income "shall become principal".

Helpfully, in most cases where the distribution of income is solely within the discretion of the trustee, the courts have held that the beneficiary did not acquire the property and the trust is not subject to division on divorce. *Buckler v. Buckler*, 424 S.W.2d 514 (Tex. Civ. App. - Fort Worth 1968, writ dism'd). Undistributed income earned by a decedent's estate of which a spouse is a beneficiary was held to have not been acquired by that spouse. *In re Burns*, 573 S.W.2d 555, 557-58 (Tex. Civ. App. - Texarkana 1978, writ dism'd). The court reasoned that there was no constructive receipt of the income, as the beneficiary had no present or past right to require its distribution. The trustee may elect to distribute undistributed income periodically to avoid commingling. Generally, in Texas, if the beneficiary receives discretionary income distributions from the trust during the marriage, those funds will be community property. *Ridgell v. Ridgell*, 960 S.W.2d 144, 148 (Tex. App. - Corpus Christi 1997, no pet.).

The issue is somewhat easier in the case of a grantor trust. Undistributed income in a self-settled trust established prior to the marriage, will remain separate property. *Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App. - Fort Worth 1996, writ den'd). After a marriage, absent any fraud on the community, a spouse may create a trust from separate property, and so long as the income remains undistributed through the marriage and there is no right to compel distribution, the income is not acquired during marriage and remains separate trust property. *Lipsey v. Lipsey*, 983 S.W.2d 345, 351 (Tex. App. – Fort Worth 1998, no pet.). This makes a trust an effective planning tool for the protection of separate property and is another example of why the precise wording of the distribution standard is important.

When the trustee makes the decision **not** to pay a requested distribution, it is important to document the reasons for declining, and thereafter to convey the decision to the appropriate parties quickly.

XI. SPECIAL CONSIDERATIONS FOR INDIVIDUAL TRUSTEES (AND CO-TRUSTEES)-DISTRIBUTIONS TO SELF

There are compelling reasons for an attorney or accountant to avoid serving as a trustee - particularly if he or she also performs professional services for the trust. As noted, the duty of loyalty requires the trustee to forego any personal interest and any opportunities for gain with respect to property subject to the fiduciary relationship and to act completely in the interest of the beneficiaries. *Interfirst Bank of Dallas v. Risser*, 739 S.W.2d 882, 898 (Tex. App. – Texarkana 1987). This duty of fidelity forbids the trustee from placing himself in a situation where there is or could be a conflict between self-interest and the duty to the beneficiaries. *Risser*, 739 S.W2d at 899, *citing*, *Slay v. Burnett Trust*, 143 Tex. 621, 187 S.W.2d 377 (1945). This is the case even if a client receives disclosure and agrees to exculpatory provisions. Generally, an instrument cannot authorize self-dealing. *Langford v. Shamburger*, 417 S.W.2d 438 (Tex. Civ. App. – Fort Worth 1967, writ ref'd n.r.e.).

Similarly, an individual trustee who, in his discretion were to distribute attorney or accounting fees to himself or his firm that were unreasonable, might be held liable in tort. *Weatherly v. Martin*, 754 S.W.2d 790, 794 (Tex. App. – Amarillo 1988, writ denied); *King v. Acker*, 725 S.W.2d 750, 754 (Tex. App. – Houston [1st Dist.] 1987, no writ). The trustee is entitled to **reasonable** fees from the funds of the trust. Determination of what is reasonable in Texas requires the consideration of a number of factors such as amount and character of the trust property, character of the trustee's services, degree of difficulty and what is customary in the community. TEX. PROP. CODE §114.061. Assume that it would be unreasonable for a trustee to engage himself for professional services and charge both trustee and attorney or accounting fees. Even if the professional is **merely a co-trustee**, this raises questions of self-dealing.

One of the most notable Texas cases on breach of fiduciary duty may be the decision in *Burrow v. Arce*, 997 S.W.2d 229 (Tex. 1999), in which compensation was the issue. Although this case did not involve a traditional trustee, an attorney was found to have had a fiduciary duty to his personal injury clients whose funds he held in constructive trust. Even though the court found the beneficiaries of the constructive trust (the plaintiffs) had not suffered monetary damages as a result of the breach, the court required the return of all fees (an amount in excess of $60 million) upon a finding of a breach of the duty of loyalty. The Court stated, that to limit forfeiture of compensation to instances in which the principal sustains actual damages would conflict with the justification for the rule. It is the trustee's disloyalty, not any resulting harm that violates the fiduciary relationship and thus impairs the basis for compensation.

The assessment of fees seems to be the most frequently cited cause of a breach of the duty of loyalty. Since trust fees are typically based on market value, items held in trust which are not of an easily ascertainable market value (alternatives, real estate, oil and gas, timber, etc.) can create conflict between the trustee who may be motivated to show an increase in value and the beneficiary who may be pre-disposed to keeping the market value low for tax and fee purposes. Such assets should be evaluated annually and reappraised every three years at a minimum. If a trustee elects not to spend money for a certified appraisal, appropriate disclosure should be made to the beneficiaries regarding what method is used to determine value.

A trustee should remember to make capacity clear when signing a contract or purchase request whether for purchase of a valuation, delegation of investment authority, to hire a caregiver or any act on behalf of the trust. A trustee may be personally liable on a contract if he fails to stipulate to the contrary (indicate capacity as the trustee) when signing a contract. *Nacol v. McNutt*, 797 S.W.2d 153 (Tex. App. – Houston [14th Dist.] 1990, writ denied).

XII. COUNSEL FOR THE FIDUCIARY-DISTRIBUTIONS TO COUNSEL

If you are a trustee obtaining advice to make a discretionary decision (or for any purpose in your capacity as trustee), an issue may arise as to whom the attorney represents and whether he has a duty to the beneficiary. The Texas Trust Code provides that a trustee may employ attorneys … reasonably necessary in the administration of the trust estate. TEX. PROP. CODE §113.018. Case law in Texas holds that the trustee who retains counsel to represent the fiduciary in connection with administrative decisions in a trust or estate is the client. The client is not the trust, *Thompson v. Vinson & Elkins*, 859 S.W.2d 617, 623 (Tex. App. – Houston [1st Dist.] 1993, writ denied); or the beneficiaries. *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996). Communications between the trustee and the attorney hired to provide legal services to the trust are protected by the attorney-client privilege so that a trustee can obtain the best possible legal guidance. Without such protection, trustees might be inclined to forsake legal advice, thus adversely affecting the trust. *Huie*, 922 S.W.2d at 924. Or they might feel compelled to blindly follow counsel's advice ignoring their own judgment and experience. *In re Prudence-Bonds Corp.*, 76 F.Supp. 643,647 (E.D.N.Y. 1948). Such protection does not, however, abrogate a trustee's duty to make disclosure regarding the distribution of funds from a trust. The beneficiaries should be informed that a lawyer has been retained by the trustee and that the fiduciary is the lawyer's client – not the beneficiaries. It should be clear that while the fiduciary and the lawyer will, from time-to-time, provide information to the beneficiaries regarding the fiduciary estate, the lawyer does not represent them. MODEL RULES OF PROFESSIONAL CONDUCT § 1.2, Commentary (adopted Texas January 1, 1990).

In Texas today, the trustee is entitled to assert the attorney-client privilege. *Huie*, 922 S.W.2d at 923. However, in other jurisdictions, the privilege has been held not to attach when a trustee seeks legal advice concerning a matter impacting the interests of the beneficiary. This view, that counsel retained by a fiduciary is working in tandem with the fiduciary for the benefit of the beneficiaries and has the discretion to reveal privileged communications to the beneficiaries if necessary to protect the trust estate is widely held in many states in the U.S. and under English common law. Indeed, usually "a fiduciary has a duty of disclosure to the beneficiaries…and cannot subordinate the interests of the beneficiaries, directly affected by the advice sought to his own private interests under the guise of privilege." *Hoopes v. Carota,* 531 N.Y.S.2d 407 (App. Div. 1988), *aff'd mem.*, 543 N.E.2d 73 (1989).

When making a distribution to counsel, the best practice is to engage counsel free of any conflict of interest, and to document the engagement and payments carefully remembering that the privilege may not apply. *Huie v. DeShazo,* is not an absolute guarantee that a trustee's claim of privilege will be upheld. There are exceptions to Evidence Rule 503 including any claim wherein the trustee has failed to make appropriate disclosures to the beneficiary. *Montgomery v. Kennedy,* 669 S.W.2d 309 (Tex. 1984).

A. Terminating Distributions

A common time for a dispute to arise between the beneficiaries and the trustee is upon termination of the trust. Terminating events may be a specified birthday; the death of a beneficiary or an individual who was a measuring life; the depletion of the trust assets to an uneconomic size; or the completion of the purpose of the trust, such as the graduation from college of the beneficiary of an education trust. A trustee can anticipate some events and ensure files are tidy and documentation is gathered in advance but there are some events that cannot be anticipated. Good documentation habits ensure a trust file is ready for a terminating event and distribution of the corpus at any time.

There is Texas statute that impacts the determination that a trust is uneconomic:

> TEX. PROP. CODE §112.059. TERMINATION OF UNECONOMIC TRUST.
>
> (a) After notice to beneficiaries who are distributees or permissible distributees of trust income or principal or who would be distributees or permissible distributees if the interests of the distributees or the trust were to terminate and no powers of appointment were exercised, the trustee of a trust consisting of trust property having a total value of less than $50,000 may terminate the trust if the trustee concludes after considering the purpose of the trust and the nature of the trust assets that the value of the trust property is insufficient to justify the continued cost of administration.
> (b) On termination of a trust under this section, the trustee shall distribute the trust property in a manner consistent with the purposes of the trust.
> (c) A trustee may not exercise a power described by Subsection (a) if the trustee's possession of the power would cause the assets of the trust to be included in the trustee's estate for federal estate tax purposes…

It is obvious that any decision to terminate a trust under the uneconomic provisions of the statute should be preceded by communication with and full disclosure to the beneficiaries. The statute is relatively new (2007) and the author is unaware of any Texas cases deriving from either a refusal to terminate an account that is smaller than the threshold amount set out in the statute or an attempt to terminate an account that is larger for uneconomic reasons.

XIII. CONCLUSION

The distribution decisions associated with personal trust are more art than science. Experience and judgment matter. And often, as the adage goes, the most valuable experiences arise out of an exercise of bad judgment. In some cases, a mistake can result in a very painful lesson for a trustee. To be a good trustee requires education, skill, attention to detail, the ability to plan carefully and execute meticulously, patience, judgment and a little luck.

A. Top Ten Rules for Making Distributions

In the words of the esteemed Judge Learned Hand:

> "The Law ought not make trusteeship so hazardous that responsible individuals and corporations will shy away from it."

Dabney v. Chase National Bank of New York, 196 F.2d 668 (2nd Cir. 1952). Concerns about litigation tend to increase the cost of fiduciary services and decrease the number of trustees willing to serve. On the other hand, the most important aspect of the fundamental trust relationship is protection of rights of the beneficiaries. A breach of the trust must be met with a punishment severe enough to provide the necessary protection for those rights. In consideration of that, here are some general guidelines to apply in making discretionary decisions related to a trust - a summary of the "dos and don'ts" that might help your trustee client avoid the punishment.

1) Do not rely on your memory or that of a previous trustee. Re-read the instrument frequently. Check past distribution records and keep personal information on beneficiaries (marriages, children, serious illnesses) up to date.
2) Know the trust's situs and governing law and stay current on the law of that

jurisdiction. Remember that changes in the mandatory and default statutes may significantly impact the interpretation of a document.

3) Assume any exculpatory language in the trust will not be construed in your favor. *Interfirst Bank v. Risser*, 739 S.W.2d 882 (Tex. Civ. App. – Texarkana 1987, no writ).
4) Act quickly. Make decisions and distributions promptly. Do not let the failure to decide become the decision.
5) Executing transactions and efficient operations should not be the beneficiary's problem. Maintain sufficient liquid assets to cover routine needs. Insure all trust accounting and asset entries are accurate.
6) Document everything you do. Convey decisions promptly and document your reasons. When you make a decision *not* to pay a request, it is just as important to document. Keep excellent records religiously.
7) Communicate with the beneficiaries. Educate them regarding the terms of the trust. If you are a professional trustee, follow your institution's policy and procedures manuals, operating guides or whatever documents are provided. If you are an individual trustee, establish clear policies and procedures to facilitate communication with the beneficiaries and make those policies clear to them.
8) Make your capacity clear when signing a contract, purchase request or anything on behalf of the trust. A trustee may be personally liable on a contract if he fails to stipulate to the contrary when signing. *Nacol v. McNutt*, 797 S.W.2d 153 (Tex. App. – Houston [14^{th} Dist.] 1990, writ denied).
9) If you need help, seek independent counsel who is free of any conflict of interest. Document the relationship and remember that the attorney client privilege may not apply in every case.
10) The rules are not the same for every trust; exercise of discretion requires review of individual circumstances. Each trust instrument and individual beneficiary will be different. Embrace that and go with it!

ADDENDUM

Portfolio Totals $2 million

Chart A

Five years spanning January 1, 2003 through December 31, 2007 (includes 2003 when the S&P 500 returned 28.7%)

Asset Type	**Average return 5 years**	**Previous Allocation**	**Annual Return Income/Gain**	**Allocated for Total Return**	**Expected Annual Return**
Cash	4%	5%	$ 4,000	5%	$ 4,000
US Bonds/Fixed Income	4.5%	55%	$ 49,500	45%	$ 40,500
US Equities Yield	2% div	40%	$ 16,000	50%	$ 20,000
US Equities Gain	13% gain		$104,000		$130,000
Total Return		100%	$173,500	100%	$194,500
Traditional income			$ 69,500		$ 64,500

Charts are for illustration and discussion purposes only; they are NOT recommendations of asset allocations, representations of actual past results, or predictions regarding future returns. Historic rates of return are based on standard indices and rounded for ease of demonstration.

Chart B

Five years spanning January 1, 2008 through December 31, 2012 (includes 2008 when the S&P 500 fell 37%)

Asset Type	**Average return 5 years**	**Previous Allocation**	**Annual Return Income/Gain**	**Allocated for Total Return**	**Expected Annual Return**
Cash	1%	5%	$ 1,000	5%	$ 1,000
US Bonds/Fixed Income	6%	55%	$ 66,000	45%	$ 54,000
US Equities Yield	2% div	40%	$ 16,000	50%	$ 20,000
US Equities Gain	4% gain		$ 32,000		$ 40,000
Total Return		100%	$115,000	100%	$ 115,000
Traditional Income			$ 83,000		$ 75,000

Charts are for illustration and discussion purposes only; they are NOT recommendations of asset allocations, representations of actual past results, or predictions regarding future returns. Historic rates of return are based on standard indices and rounded for ease of demonstration.

Chart C

Twenty-five years spanning January 1, 1989 through December 31, 2013)

Asset Type	Average return 5 years	Previous Allocation	Annual Return Income/Gain	Allocated for Total Return	Expect l Annual Return
Cash	4%	5%	$ 4,000	5%	$ 4,000
US Bonds/Fixed Income	7%	55%	$ 77,000	45%	$ 63,000
US Equities Yield	2% div	40%	$ 16,000	50%	$ 20,000
US Equities Gain	12% gain		$ 96,000		$120,000
Total Return		100%	$193,000	100%	$207,000
Traditional Income			$ 97,000		$ 87,000

Charts are for illustration and discussion purposes only; they are NOT recommendations of asset allocations, representations of actual past results, or predictions regarding future returns. Historic rates of return are based on standard indices and rounded for ease of demonstration.