

# **Fixing or Killing Off Broken Trusts**

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**40<sup>th</sup> Annual Advanced Estate Planning and Probate Course  
San Antonio, Texas  
June 22-24, 2016**

*Revised June 2, 2016*



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“Protecting the Surviving Spouse and Protecting Yourself After *Belt v. Oppenheimer*,” State Bar of Texas Advanced Estate Planning and Probate Law Course (2006), updated on [texasprobate.com](http://texasprobate.com).

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“The New Guardianship Rules Regarding Inventories, Monthly Allowances and Investments,” State Bar of Texas Guardianship Law Course (2004).

“Top Ten Brilliance and Blunders: A View from the Webmaster,” State Bar of Texas Annual Advanced Estate Planning and Probate Course (2002).

“Modifying and Terminating Irrevocable Trusts,” State Bar of Texas Advanced Estate Planning and Probate Law Course (1999), updated on [texasprobate.com](http://texasprobate.com).

“Court-Created Trusts in Texas,” State Bar of Texas Advanced Drafting: Estate Planning and Probate Law Course (1995), updated on [texasprobate.com](http://texasprobate.com).

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# Fixing or Killing Off Broken Trusts<sup>1</sup>

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## 1. Introduction

One of the ironies of the enactment of the generation-skipping transfer tax (“GST”) in 1986 is that a statute designed to curb using trusts for multigenerational planning actually encouraged multigenerational planning. By taxing generation-skipping transfers to the extent they exceeded the lifetime GST exemption amount, estate planners found a new basis for trust planning: if the government is going to allow generation-skipping planning up to the exemption amount, then families ought to take advantage of it.

For this and other reasons, the use of trusts having long terms has increased dramatically. As these trusts mature, families and estate planners are discovering that the trust terms used at the time the trust was created often fail to address the family’s needs and fail to meet the industry standard of trusts today. This paper calls these “broken trusts.”<sup>2</sup>

Not coincidentally, as the practice of using long-term trusts has grown, there has been a movement toward finding ways to change or terminate broken trusts. This movement is happening on four fronts:

1. Drafters are including provisions in new trust documents which permit adjustment of trust terms in the future.
2. Statutes are being amended to liberalize modification or termination of trusts.
3. The legal academic community and the courts have moved the needle in the direction of deviating from the settlor’s literal terms in appropriate cases.



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<sup>2</sup> These trusts may have been expertly and correctly drafted. They may have accurately represented the settlors’ intentions at the time they were signed. They are called “broken” in this paper because they have that attribute to the persons desiring to change or terminate them.

4. Attorneys working on broken trusts are becoming craftier at using the available tools to fix or terminate them.

This paper mentions strategies which drafters may use to build flexibility into new trust documents. It then takes a close look at the evolving law of judicially modifying and terminating irrevocable trusts. Finally, it discusses the tools – some old, some new – in the attorney’s toolbox to fix or terminate broken trusts without going to court, including decanting (as currently exists in Texas and as might exist in the future) and combining trusts.

## **2. Drafting with the Future in Mind**

This paper mostly focuses on fixing or terminating existing broken trusts. Still, it is worth noting some of the things drafters of trusts can do to make it easier to adjust to future events. While these strategies build in flexibility, some of them may be inappropriate in specific cases. Still, it is the author’s opinion that the default approach of the drafter should be to provide flexibility and not be restrictive.

### *2.1. Provide Broad Trustee Discretion and Powers*

By far, the best way to provide flexibility in the future is to grant the trustee broad discretion – or, at least, broad discretion to the extent permitted by tax law – and to give the trustee broad powers. A settlor creating a trust which may last 10+ years (especially a multigenerational trust) cannot anticipate all of the circumstances which may arise. If the settlor restricts the trustee as to investments or distributions, modification is much more likely to be necessary. Of course, this approach makes selection of the trustee critical and it will not work in all situations. There may be factors which make wide discretion inappropriate.

Consider the following approaches:

- Use a broad discretionary distribution standard if an ascertainable standard is not required for tax purposes.
  - Precatory advice about details of distribution decisions is preferable to mandatory instructions and helps overcome a corporate trustee’s reluctance to be left with broad discretion.
  - A savings provision may be used to convert the trust to an ascertainable standard trust if a beneficiary becomes trustee. Also, Section 113.029(b) of the Texas Trust Code may convert the trust to an ascertainable standard trust if a beneficiary becomes a trustee.
- Use a simple “health, education, maintenance and support” standard if an ascertainable standard is required.



- Precatory advice about details of distribution decisions is preferable to mandatory instructions or modifications to the standard.
  - *Permit* the trustee to consider factors such as other resources or standard of living; do not *require* them to be considered.
  - Do not require exhaustion of the marital trust before making principal distributions from the bypass trust, especially now that basis adjustment may be more important than estate tax savings.
- Expand default trust code powers rather than contracting them, and make sure boilerplate trustee powers do not limit default powers.

## 2.2. *Include Robust Successor Trustee Provisions*

Using long-term trusts makes it more likely that the original trustee will be unable to serve until trust termination. Even if a corporate trustee is used, it often is necessary or appropriate to change corporate trustees or change from a corporate trustee to an individual trustee.

Section 113.083(a) of the Texas Trust Code provides that, on the death, resignation, incapacity, or removal of a sole or surviving trustee, a successor trustee shall be selected according to the method, if any, prescribed in the trust instrument. If a successor cannot be selected under the method prescribed in the trust instrument, a court appoints a successor trustee. Unless the family situation is extremely dysfunctional or a trust is a court-created trust, the drafter should take steps to make it unnecessary to go to court to appoint a successor trustee.

Consider using one or more of the following methods to select new trustees:

- Include a lengthy list of successor trustees.
- Give individual trustees the power to appoint their successors and to designate who should succeed them in the event of their death, resignation or incapacity, and consider giving the trustee's designation precedence over the list of successors named in the trust instrument.
- Give a third party such as a trust protector or trustee appointer the power to appoint successor trustees and to designate who should succeed as trustee in the event of the death, resignation or incapacity of the then-serving trustee, and consider giving the third party's designation precedence over the list of successors named in the trust instrument.
- Allow an individual beneficiary with capacity to remove and replace a corporate trustee with another corporate trustee, and consider allowing the parent or guardian of a minor or incapacitated beneficiary to hold this power on the beneficiary's behalf.

- Define a mechanism for determining when the requirement of a corporate trustee ends and an individual trustee is permitted.

### 2.3. *Permit Change of Situs*

Often problems may be solved if the trust can be made subject to another state's laws.

### 2.4. *Include a Decanting Provision*

Rather than relying on the Texas decanting statute, include an express provision allowing the trustee to transfer part or all of the trust property to another trust. An express provision is not subject to the strict Texas rules.<sup>3</sup> Care must be taken to avoid tax problems, however. This may be addressed by using an independent trustee, a special trustee with limited powers, an independent trust protector with the power to direct the trustee to decant, and by including a savings provision.

### 2.5. *Creative Use of Trust Protectors*

The growing use of trust protectors provides significant flexibility to address future problems. Care must be taken to avoid tax problems, however. The trust either needs to have an independent trust protector or it needs to have a mechanism for appointing an independent or special trust protector.

In *appropriate* cases, a trust protector may be given the power to:

- Change trustees.
- Change the distribution standard within parameters set by the settlor in the trust instrument (for example, using a trust protector to turn special needs trust provisions on and off.)
- Change or redefine beneficiaries.
- Direct the trustee to change the situs of the trust.
- Direct the trustee to decant.
- Amend the trust to achieve the settlor's tax objectives.
- Make substantive amendments to the trust.
- Terminate a trust early.

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<sup>3</sup> See "Decanting" below.

- Grant a general or special power of appointment.

#### 2.6. *Use Liberal Trust Division and Combination Provisions*

The Texas division and combination of trusts statute<sup>4</sup> is an extremely useful and often overlooked way to fix administrative provisions in a broken trust. However, statutory division or combination cannot “impair the rights of any beneficiary or adversely affect achievement of the purposes of” the original trust or trusts. This makes it unusable, for example, to divide a pot trust for three children into separate trusts for each child or to merge a trust without a power of appointment into one with a power of appointment.

The terms of the trust instrument may be drafted to expand the default rule about division and combination of trusts. Consider permitting divisions and combinations one or more of these situations:

- Dividing a pot trust into separate trusts.
- Dividing a trust to prevent a GST inclusion ratio of between zero and one.
- Merging a trust subject only to Texas law into a trust which permits a change of situs.

#### 2.7. *Use Care About Including Remote Charitable Beneficiaries*

Despite the drafter’s best efforts, if a trust lasts long enough, it is likely to end up involved in a judicial proceeding. Estate planning clients should be warned about possible charity and attorney general involvement in will construction and trust modification proceedings.<sup>5</sup> If the decision to include the charity as a last resort beneficiary is just an afterthought, clients may wish to consider another way to handle the problem.

If a client has strong philanthropic feelings, by all means charitable gifts should be included in the estate planning documents. In that case, consider making the gifts to the charities separate from the family gifts. In other words, do not make the charity a beneficiary of the general family trust — make an outright bequest to the charity or make the gift to the charity in a separate trust.<sup>6</sup> By using this approach, the charity and the attorney general may not be a necessary party to suits involving the family trust.

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<sup>4</sup> Tex. Trust Code §112.057.

<sup>5</sup> See “Charity/Attorney General Involvement” below.

<sup>6</sup> Obviously, split interest gifts such as charitable remainder unitrusts have to have both charitable and noncharitable beneficiaries.

Trust instruments making charitable gifts should be drafted to avoid the need for attorney general involvement if the named charity ceases to exist. This provision should permit the trustee to select a substitute charity nonjudicially and without notice to or approval of the attorney general.

### 3. Judicially Modifying and Terminating Irrevocable Trusts

Trusts, being creatures of equity, are subject to the equitable powers of the courts even when they are irrevocable and unamendable by their own terms. This section of the paper discusses the law regarding modifying and terminating trusts and the methods available for such action. It then examines some of the practical problems attorneys face when seeking to modify or terminate a trust, including the problems typically faced by the trustee, the income beneficiary and the remainder beneficiary.

#### 3.1. *Common Law*

Prior to the enactment of the Texas Trust Code in 1983, there was no specific statutory authorization for modifying or terminating trusts outside of the trusts' terms. The only statutory authority in the Texas Trust Act (predecessor to the Code) was Section 46(c):<sup>7</sup>

Nothing contained in this Section of this Act shall be construed as restricting the power of a court of competent jurisdiction to permit and authorize the trustee to deviate and vary from the terms of any will, agreement, or other trust instrument relating to the acquisition, investment, reinvestment, exchange, retention, sale, supervision or management of trust property.

That oblique reference is consistent with the common law doctrine of deviation. It was this doctrine which gave courts the authority to modify or terminate trusts other than in accordance with their terms prior to the adoption of the Texas Trust Code. This doctrine was expressed by the Dallas Court of Civil Appeals in *Amalgamated Transit Union, Local Division 1338 v. Dallas Public Transit Board* as follows:

A court of equity is possessed of authority to apply the rule or doctrine of deviation implicit in the law of trusts. Thus a court of equity will order a deviation from the terms of the trust if it appears to the court *that compliance with the terms of the trust is impossible, illegal, impractical or inexpedient, or that owing to circumstances not known to the settlor and not anticipated by him, compliance would defeat or substantially impair the accomplishment of the purpose of the trust.* [citation omitted]

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<sup>7</sup> V. A. T. S. art. 7425b-46 C, repealed effective January 1, 1984.

In ordering a deviation a court of equity is merely exercising its general power over the administration of trust; it is an essential element of equity jurisdiction.<sup>8</sup>

If this part of the *Amalgamated Transit Union* opinion has a certain ring to it, it is because the same language was codified into Section 112.054 of the Texas Trust Code in 1984, discussed below.

Are there limits on the court's equitable powers to deviate from the trust instrument? Bogert and Bogert, in their treatise on trusts and trustees, draw a distinction between the dispositive provisions and the administrative provisions of a trust. While the court clearly has the power to deviate from the administrative provisions of the trust instrument in order to give full effect to the dispositive or beneficial provisions, it must proceed more carefully when deviating from the dispositive or beneficial scheme.<sup>9</sup> This does not mean that a court has no power to alter the settlor's dispositive scheme, rather it means the court must exercise more care. Examples in Bogert where the dispositive scheme may be altered are cases where a statute (such as Tex. Trust Code §112.054, discussed below) supports the court action or cases where the parties to litigation enter into a compromise agreement altering trust terms which the court finds to be fair and reasonable.<sup>10</sup>

Some Texas courts were reluctant to apply these equitable principles (or at least to extend them to their possible ends) prior to the adoption of the Texas Trust Code. For example, in *Frost National Bank of San Antonio v. Newton*,<sup>11</sup> the Texas Supreme Court held that a trust could not be terminated on the basis that its principal purposes had been satisfied because the court could not substitute its judgment for the settlor in determining which purposes she considered "principal" and which were merely "incidental."<sup>12</sup>

Because of this inconsistency and because of the uncertainty surrounding application of these equitable principles, Section 112.054 was a welcome addition to Texas's statutes in 1984.

The principles permitting modification or termination of trusts were significantly broadened by the 2005 amendments to Section 112.054, discussed below. The author sees this as part of a general trend toward greater and greater power of courts to tinker with irrevocable trusts. The

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<sup>8</sup> *Amalgamated Transit Union, Local Division 1338 v. Dallas Public Transit Board*, 430 S. W. 2d 107, 117 (Tex. Civ. App. — Dallas 1968, writ ref'd), cert. denied, 396 U. S. 838 (1969) [emphasis added]. See also Restatement (Second) of Law of Trusts, 2nd Edition, §167, and Restatement (Third) of Law of Trusts §66.

<sup>9</sup> See Bogert, *Trusts and Trustees* (2nd Ed. Rev.), §561.

<sup>10</sup> See Bogert, *Trusts and Trustees* (2nd Ed. Rev.), §994.

<sup>11</sup> 554 S. W. 2d 149 (Tex. 1977).

<sup>12</sup> 554 S. W. 2d at 154.

increased flexibility of trust administration (of which the Uniform Prudent Investor Act and the Uniform Principal and Income Act, enacted in Texas in 2003, are examples) increases the need for (and, in more and more cases, the willingness of) courts to place themselves in the settlor's shoes in dealing with changing circumstances.

Because of this trend, the common law rules regarding trust modification and termination remain important. Section 111.005 of the Texas Trust Code provides that common law rules will prevail except as the Trust Code changes such rules. Thus, even after the enactment of the Trust Code, Section 112.054 may not be the exclusive basis for modifying or terminating a trust. In an appropriate case, a court of competent jurisdiction could modify or terminate a trust for other reasons or on another basis using its general equity powers.

### 3.2. *Tex. Trust Code §112.054*

The enactment of Section 112.054 of the Texas Trust Code in 1984 not only solidified the power of courts to modify or terminate trusts, it also provided a framework for such proceedings. It was based on the doctrine of deviation as stated in Section 167 of the Restatement of the Law of Trusts, Second Edition, and in the *Amalgamated Transit Union* opinion.<sup>13</sup>

In 2005, legislation sponsored by the Real Estate, Probate and Trust Law Section of the State Bar of Texas sought to pick out the best parts of the Uniform Trust Code (which was not adopted as a whole in Texas) for addition to the Texas Trust Code. Most of the trust modification and termination provisions of the Uniform Trust Code were imported into Section 112.054.

Here is what the author said about the 2005 changes in that session's legislative update:<sup>14</sup>

The changes to Section 112.054 are based on Sections 410, 411, 412 and 416 of the Uniform Trust Code. They represent a significant modernization of the statute regarding judicial modification or termination of irrevocable trusts.

Under prior law, it was necessary to prove either (1) that the purposes of the trust had been fulfilled or become impossible or illegal to fulfill or (2) that, because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the purposes of the trust. This standard was a codification of the pre-Trust Code common law modification standard expressed in *Amalgamated Transit Union, Local Division 1338 v. Dallas Public Transit Board*, 430 S.W. 2d 107, 117 (Tex. Civ. App. — Dallas 1968, writ ref'd), cert. denied, 396 U. S. 838 (1969).

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<sup>13</sup> 430 S. W. 2d 107, 117 (Tex. Civ. App. — Dallas 1968, writ ref'd), cert. denied, 396 U. S. 838 (1969). *See also* Guide to the Texas Trust Code, 3rd Edition (1996), p.10.

<sup>14</sup> O'Connor's Probate Code *plus* (2005-2006), p. xviii and [texasprobate.com](http://texasprobate.com).

The 2005 changes preserve the first of the two bases for modifying or terminating a trust – that the purposes have been fulfilled or become impossible or illegal to fulfill – but it liberalizes the second basis and adds three new bases for modifying or terminating a trust:

In cases of circumstances not anticipated by the settlor, rather than having to prove that compliance with the terms would defeat or substantially impair the accomplishment of the purposes of the trust, Subsection (a)(2) now provides that one must prove merely that the modification or termination “will further the purposes of the trust.” This is a much easier standard to meet and is much more logical.

Subsection (a)(3) permits “administrative, nondispositive” provisions of the trust to be modified if “necessary or appropriate to prevent waste or avoid impairment of the trust's administration.” No inquiry into the settlor's knowledge or intent is required.

Subsection (a)(4) permits modifications or terminations if necessary to achieve the settlor's tax objectives, so long as the action is “not contrary to” the settlor's intentions. These changes may be given retroactive effect. Whether or not these modifications – especially retroactive modifications – will be successful for tax purposes is uncertain. According to the official comments of the National Conference of Commissioners on Uniform State Laws to Section 416 of the Uniform Trust Code:

Whether a modification made by the court under this section will be recognized under federal tax law is a matter of federal law. Absent specific statutory or regulatory authority, binding recognition is normally given only to modifications made prior to the taxing event, for example, the death of the testator or settlor in the case of the federal estate tax. *See* Rev. Rul. 73-142, 1973-1 C.B. 405. Among the specific modifications authorized by the Internal Revenue Code or Service include the revision of split-interest trusts to qualify for the charitable deduction, modification of a trust for a noncitizen spouse to become eligible as a qualified domestic trust, and the splitting of a trust to utilize better the exemption from generation-skipping tax.

Subsection (a)(5) permits the trust to be terminated if its continued existence is not necessary to achieve any material purpose of the trust or for the trust to be modified in any manner which is “not inconsistent with a material purpose of the trust.” However, Subsection (a)(5) changes are permitted only if all beneficiaries agree. Virtual representation concepts may be used in obtaining beneficiary consent pursuant to Subsection (d).

The 2005 changes are a clear expansion of the bases for judicial modification or termination of irrevocable trusts and make it easier to meet the statutory standard. Texas courts have stated that the 2005 changes "liberalized the rules governing modification and termination of trusts."<sup>15</sup> The 2005 changes permit modifications "that enhance the attainment of the settlor's trust purposes."<sup>16</sup>

The 2005 changes to Section 112.054 apply to trusts existing on January 1, 2006, as well as to trusts created on or after January 1, 2006. With respect to trusts already in existence on that date, the 2005 changes "apply only to an act or omission relating to the trust that occurs on or after January 1, 2006."<sup>17</sup>

Since this statute forms the basis for virtually all suits to modify or terminate a trust in Texas, this paper will examine each of its elements in detail.

### 3.2.1. *Trustee or Beneficiary May Bring Suit*

Section 112.054(a) provides that a trustee or a beneficiary may petition the court. A "beneficiary" is a person "for whose benefit property is held in trust, regardless of the nature of the interest." Tex. Trust Code §111.004(2). Thus, any beneficiary — income, remainder, contingent remainder — has standing to bring a modification or termination suit under Section 112.054.

Section 112.054 does not authorize a *settlor* to bring a suit. A settlor may be an "interested person" for purposes of Section 115.011 (the "parties" section) and by such section be authorized to initiate a proceeding under Section 115.001 (the jurisdiction section). *See* Tex. Trust Code §§ 111.004(7), 115.001 and 115.011(a).<sup>18</sup> It is unclear, however, if this general authority to commence an action regarding a trust would be sufficient for a settlor to survive a standing challenge if the settlor sought to initiate a Section 112.054 action.

In *In re Willa Peters Hubberd Testamentary Trust*,<sup>19</sup> pursuant to a mediated settlement agreement, a court-appointed mediator filed a petition to modify a trust under Section 112.054. A party objected, since the mediator was neither a trustee nor a beneficiary. The appellate court

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<sup>15</sup> *In re Willa Peters Hubberd Testamentary Trust*, 432 S. W. 3d 358, 365 (Tex. App. – San Antonio 2014).

<sup>16</sup> *In re White Intervivos Trusts*, 248 S. W. 3d 340, 342 (Tex. App. – San Antonio 2007 no pet.), quoting Stanley M. Johanson, Johanson's Texas Probate Code Ann., Texas Property Code § 112.054, commentary (2007 ed.).

<sup>17</sup> HB 1190, Section 31, 79<sup>th</sup> Texas Legislature (2005).

<sup>18</sup> Section 115.001 of the Texas Trust Code does not contain the "trustee or beneficiary" limitation. It may be possible for an interested person who is not a trustee or beneficiary to bring what amounts to a modification or termination action under the broad provisions of Section 115.001 without relying on Section 112.054. *See* "Who May Initiate Suit" below.

<sup>19</sup> 432 S. W. 3d 358 (Tex. App. – San Antonio 2014).



found that the mediator had standing to bring the action because the mediator was “an attorney who was authorized to represent the beneficiaries and the trustee in filing the petition.”<sup>20</sup> Therefore, while it is preferable to have the trustee or a beneficiary directly bring the action, the door is open for someone "representing" the trustee or the beneficiary to bring the action.

3.2.2. *Actions the Court is Authorized to Take*

Section 112.054 is entitled “Judicial Modification or Termination of Trusts.” Nonetheless, it authorizes the court to do more than modify or terminate a trust. Under Section 112.054(a), the court is authorized to:

- Change the trustee;
- Modify the terms of the trust;<sup>21</sup>
- Direct or permit the trustee to do acts that are not authorized or that are forbidden by the terms of the trust;
- Prohibit the trustee from performing acts required by the terms of the trust; or
- Terminate the trust in whole or in part.

One can imagine the meeting of the committee which drafted the Trust Code when this list was developed — a bunch of trust lawyers thinking of all of the things they had ever tried to do and been frustrated in doing. The list is fairly all-encompassing, but it is interesting to compare it with the list of things a court is authorized to do under the “jurisdiction” section of the code (Section 115.001). The following chart compares the two lists:

<i>Section 112.054(a)</i>	<i>Section 115.001(a)</i>
Change the trustee	(3) Appoint or remove a trustee

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<sup>20</sup> 432 S. W. 3d at 363.

<sup>21</sup> A possible legislative change in 2017 is to permit the court to “modify or reform” the trust terms. See “Possible 2017 Legislation” below.

<i>Section 112.054(a)</i>	<i>Section 115.001(a)</i>
Modify the terms of the trust	<p>(4) Determine the powers, responsibilities, duties, and liability of a trustee</p> <p>(6) Make determinations of fact affecting the administration, distribution, or duration of a trust</p> <p>(7) determine a question arising in the administration or distribution of a trust</p> <p>(8) relieve a trustee from any or all of the duties, limitations, and restrictions otherwise existing under the terms of the trust instrument or the Trust Code</p>
Direct or permit the trustee to do acts that are not authorized or that are forbidden by the terms of the trust	<p>(4) Determine the powers, responsibilities, duties, and liability of a trustee</p> <p>(6) Make determinations of fact affecting the administration, distribution, or duration of a trust</p> <p>(7) determine a question arising in the administration or distribution of a trust</p>
Prohibit the trustee from performing acts required by the terms of the trust	<p>(4) Determine the powers, responsibilities, duties, and liability of a trustee</p> <p>(6) Make determinations of fact affecting the administration, distribution, or duration of a trust</p> <p>(7) determine a question arising in the administration or distribution of a trust</p> <p>(8) relieve a trustee from any or all of the duties, limitations, and restrictions otherwise existing under the terms of the trust instrument or the Trust Code</p>

<i>Section 112.054(a)</i>	<i>Section 115.001(a)</i>
Terminate the trust in whole or in part	4) Determine the powers, responsibilities, duties, and liability of a trustee  (6) Make determinations of fact affecting the administration, distribution, or duration of a trust  (7) determine a question arising in the administration or distribution of a trust  (8) relieve a trustee from any or all of the duties, limitations, and restrictions otherwise existing under the terms of the trust instrument or the Trust Code
[No corresponding action]	(1) Construe a trust instrument  (2) Determine the law applicable to a trust instrument  (5) Ascertain beneficiaries  (9) Require an accounting by a trustee, review trustee fees, and settle interim or final accounts  (10) Surcharge a trustee

Section 115.001 was amended in 2007: (1) to give district courts (and statutory probate courts) jurisdiction “over all proceedings by or against a trustee” as well as over all proceedings on the laundry list. (Subsection (a)); and (2) to provide that the laundry list in Subsection (a) is not exhaustive. (Subsection (a-1)).

Though entitled “Jurisdiction,” Section 115.001 is more than a jurisdiction section — it is the substantive basis for causes of action. For example, Section 115.001(a) is the only authority in the Trust Code for a judicial settlement of interim or final accounts. Because of this, and because of the general equitable powers of the courts with respect to trusts, it is a good idea to plead both Section 112.054 and Section 115.001 as bases for modifying or terminating a trust. Then, if the proof does not exactly match the specific categories expressed in Section 112.054, general equitable principles and Section 115.001 can be relied upon.

### 3.2.3. Findings Required

#### A. Prior to 2005 Changes

Prior to the 2005 changes, the court could take these wonderful actions under Section 112.054 if it found that one of the two following conditions had occurred: (1) the purposes of the trust have

been fulfilled or have become illegal or impossible to fulfill; or (2) because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of the purposes of the trust.

These findings were virtually identical to those applicable under the common law doctrine of deviation.<sup>22</sup>

Of these two grounds for action, unknown or changed circumstances was by far the most common basis under the prior law. It provided more flexibility. Nonetheless, it set a high standard – no change was possible absent a showing that following the trust instrument as written would “defeat or substantially impair” accomplishment of the “purposes” of the trust.

#### B. *Findings Required Under Current Statute*

The new statute keeps the first ground, reduces the level of proof required for the second ground and adds three new grounds for modifying or terminating a trust. A trust may be modified or terminated, etc., if: (2005 changes shown)

(1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; [∅]

(2) because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;

(3) modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration;

(4) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or

(5) subject to Subsection (d):

(A) continuance of the trust is not necessary to achieve any material purpose of the trust; or

(B) the order is not inconsistent with a material purpose of the trust [compliance with the terms of the trust would defeat or substantially impair the accomplishment of the purposes of the trust].

Following is a discussion of each of these bases for modifying or terminating a trust:

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<sup>22</sup> See *Amalgamated Transit Union, Local Division 1338 v. Dallas Public Transit Board*, 430 S. W. 2d 107, 117 (Tex. Civ. App. — Dallas 1968, writ ref'd), cert. denied, 396 U. S. 838 (1969) (quoted above).

1. *Impossible to Fulfill Purposes*

The first possible finding probably is the least common. One may take the position that the purposes of a trust for a minor have been fulfilled if the beneficiary has attained a level of age and maturity where the trust is no longer necessary. Also, one can imagine certain fact patterns where the trust, when drafted, called for the trustee to take certain legal actions (for example, actions based on race or ethnicity) which, through the passage of time and changes in the law, now are illegal. For the most part, however, this will not be the basis for modifying or terminating most trusts.

2. *Unknown or Unanticipated Circumstances*

The 2005 changes to this standard make it much easier to meet. Instead of having to show that the unknown or unanticipated circumstances would mean that complying with the unmodified trust would “*defeat or substantially impair* the accomplishment of the purposes of the trust,” the applicant need only show that, because of the changed circumstances, modifying or terminating the trust “*will further* the purposes of the trust.”

However, despite the fact that courts have recognized the 2005 changes as liberalizing the trust modification and termination rules, one Texas court has narrowly read Section 112.054(a)(2), making it more difficult than it should be to modify or terminate a trust under this provision. In *In re Willa Peters Hubberd Testamentary Trust*,<sup>23</sup> the Court focused its attention on the “purposes of the trust.” It cited *Frost National Bank of San Antonio v. Newton*<sup>24</sup> – a case decided under the prior, stricter statute – in concluding that the trust had two purposes – to distribute all of the income to two beneficiaries and to provide for the health, support, education and maintenance of those beneficiaries and more remote beneficiaries.<sup>25</sup> The *Hubberd* court could have taken a much broader view of the purposes of the trust – to support and benefit the beneficiaries – but it took this narrower view. It found that the court could modify the trust to require a beneficiary to maintain insurance as a condition to receiving distributions because maintaining insurance would further the trust purpose of to provide for the health and support of the beneficiaries, but it found that requiring insurance premiums to be paid from trust income would not further the purpose of distributing the “entire net income” of the trust to certain beneficiaries.<sup>26</sup> Since the court found two purposes of the trust, it followed the 1977 *Newton*

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<sup>23</sup> 432 S. W. 3d 358 (Tex. App. – San Antonio 2014).

<sup>24</sup> 554 S. W. 2d 149 (Tex. 1977).

<sup>25</sup> 432 S. W. 3d at 367.

<sup>26</sup> 432 S. W. 3d at 367.

decision in determining that it could not elevate one purpose (providing for health and support) over the other (paying all income), and prohibited the modification.<sup>27</sup>

In the author's opinion, the *Hubberd* court's view is much too narrow. By providing for distribution of all income and for distributions for health, education, maintenance and support, the settlor's primary purpose clearly is supporting and caring for those beneficiaries, so if the court finds a better way to do it that the settlor could not have anticipated, the court should have the authority to do so under Section 112.054(a)(2) – to further the purposes of the trust.

### 3. *Administrative, Nondispositive Provisions*

Perhaps the most significant change in 2005 was to permit “administrative, nondispositive” provisions to be modified upon a showing that the change is “necessary or appropriate to prevent waste or avoid impairment of the trust’s administration.” Note that this finding is not based on the apparent or supposed intention of the settlor. Rather, it focuses on the efficient administration of the trust regardless of the intent of the settlor.

What is an administrative, nondispositive provision? The author believes this includes most investment restrictions (for example, “don’t sell Blackacre,” “invest only in New York Stock Exchange stocks,” etc.), choice of law provisions and provisions affecting administration and management powers. With respect to provisions requiring the retention of specific assets, one might argue that the provision is “dispositive” and, therefore, not subject to change under Section 1123.054(a)(3), if the purpose of the restriction was to assure that the specific asset passed to the remainder beneficiaries. However, in most cases, this is a convenient way for a trustee to seek to free itself of restrictions which make it difficult or impossible to comply with the new prudent investor standard.

Other administrative, nondispositive changes are changing the manner of selecting new trustees, changing the required qualifications of trustees (for example, eliminating the requirement of a corporate trustee) and changing the governing law of the trust to another state.

### 4. *Necessary to Achieve Tax Objectives*

Section 112.054(a)(4) permits retroactive modification of provisions if necessary or appropriate to achieve the settlor’s tax objectives in a way which is not contrary to the settlor’s intentions. The retroactive feature is welcome but may not be binding on the IRS. A nonstatutory reformation action still may be the best way to fix a scrivener’s error causing a tax problem (e.g., a crummey power that does not work).<sup>28</sup>

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<sup>27</sup> 432 S. W. 3d at 367.

<sup>28</sup> See “*Reformation and Recission*” below.

## 5. *Modification or Termination with Beneficiary Consent*

Section 112.054(a)(5) permits termination of a trust upon a finding that “continuance of the trust is not necessary to achieve any material purpose of the trust” if, but only if, all beneficiaries agree. Similarly, the subsection permits modification of a trust if the change “is not inconsistent with a material purpose of the trust” if, but only if, all beneficiaries agree. Consent of minor, incapacitated, unborn or unascertained beneficiaries may be obtained using virtual representation concepts or by appointment of a guardian ad litem. Tex. Trust Code Sec. 112.054(d).

## 6. *Possible 2017 Legislation*

Early drafts of the 2017 REPTL legislative package contain these changes to Section 112.054(a):

a. New subsection (a)(6) would be added to permit a court to enter an order if it “is necessary to correct a scrivener’s error in the governing document, even if unambiguous, to conform the terms to the settlor’s intent.” Subsection (e) would require proof of the settlor’s intent in scrivener’s error cases by clear and convincing evidence. Corresponding changes to the section title (“Judicial, Modification, Reformation or Termination of Trusts”) and to the preamble to subsection (a) (permitting the terms of the trust to be “modified or reformed”). This is consistent with the will reformation statute enacted in 2015. *See* Tex. Est. Code §§255.451-255.455. The 2005 changes to the Texas Trust Code left out Section 415 of the Uniform Trust Code – “Reformation to Correct Mistakes” – which means that reformations currently are subject to common law.<sup>29</sup> The UTC section is broader than the REPTL proposal, which is limited to reformation to correct a scrivener’s error.

b. Subsection (a)(4) would be amended to permit the court to act if “necessary or appropriate to ... qualify a distribute for governmental benefits” if the action is not contrary to the settlor’s intentions.

If enacted, these provisions will take effect September 1, 2017.

### 3.2.4. *Conforming to the Intent of the Settlor*

Tex. Trust Code §112.054(b) directs the court to exercise its discretion “to order a modification or termination” under Section 112.054(a) “in the manner that conforms as nearly as possible to the *probable* intention of the settlor.” The word “probable” was added to Subsection (b) by the 2005 changes. Obviously, if the modification is needed because of a circumstance truly unanticipated by the settlor, it is hard to prove what the settlor intended with respect to that circumstance. Lowering the standard to the “probable” intention makes it easier to meet.

Two things about this requirement are important to note:

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<sup>29</sup> *See* “Reformation and Rescission” below.

First, it applies only to “modification or termination orders.” Does this mean that it does not apply to the other actions permitted by Section 112.054(a), such as changing trustees, ordering the trustee to do something prohibited by the trust instrument or prohibiting the trustee from doing something required by the trust instrument? One can argue that the intentions of the settlor are less important to these actions permitted by Section 112.054(a), so the drafters of the legislation intended to make this requirement applicable only to modifications or terminations. After all, changing trustees or directing or prohibiting an action specifically addressed in the trust instrument necessarily requires the court to go against the stated intention of the settlor. On the other hand, it seems possible that “modification or termination” was just a shorthand way of saying the five actions permitted under Section 112.054(a), and the intention of the settlor is important with respect to all such actions.

Second, while this requires the court to conform “as nearly as possible” with the settlor’s probable intention, implicit in Section 112.054 is the concept that *some* departure from the settlor’s probable intention is permitted, if not required. It makes no sense to have a statute on modifying or terminating trusts if the court cannot veer away from the settlor’s intention at least to some degree.

A case decided on the law that existed prior to 2005, *Conte v. Ditta*<sup>30</sup> used this provision to limit the scope of a trial court's modification of a trust. The trust instrument provided that a beneficiary (who also was the trustee) had the power to appoint a successor trustee, and if that beneficiary could not do it, the adult beneficiaries (including the beneficiary/trustee) had the power. The trial court removed the beneficiary/trustee. The court also modified the trust to provide that the court, not the trustee/beneficiary and not the adult beneficiaries, had the power to appoint the successor trustee. The court believed that it would be "impractical, inexpedient and would substantially impair the accomplishment of the purposes of the trust" to permit the beneficiary/trustee or the adult beneficiaries to appoint the successor. The appellate court agreed that the trust terms should be modified to prohibit the removed trustee from appointing her successor, but it said the trial court failed to make the modified terms conform as nearly as possible to the to the intention of the settlor by giving itself the power to appoint a successor trustee. The settlor had expressed a clear intention that the beneficiaries should be allowed to name a successor, so the modification needed to conform as nearly as possible to this intention.<sup>31</sup>

### 3.2.5. *Spendthrift Clauses are a Factor But Not an Impediment*

Section 112.054(b) provides in part:

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<sup>30</sup> 312 S. W. 3d 951 (Tex. App. – Houston (1st Dist.) 2010).

<sup>31</sup> 312 S. W. 3d at 960.



The court shall consider spendthrift provisions as a factor in making its decision whether to modify or terminate, but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust.

Most irrevocable trusts include spendthrift provisions — provisions which prohibit a beneficiary from anticipating his or her receipt of trust property and which prohibit a beneficiary's creditors from attaching the beneficiary's interest in the trust. These provisions are at least some indication that the settlor did not want the beneficiaries to have the power to deal with and/or receive the trust property prior to the time for distribution under the trust instrument. Thus, absent some mention of the effect of a spendthrift clause in a modification or termination statute, a court might find that the inclusion of a spendthrift provision by itself is a sufficient reason not to modify or terminate a trust if the effect of the modification or termination would be to accelerate the receipt of trust property by one or more beneficiaries.

Of course, in most cases spendthrift clauses are included as part of the administrative provisions of a trust, rather than as an integral part of the trust's dispositive provisions. When administrative provisions conflict with the dispositive or beneficial provisions, in general the administrative provision must yield.<sup>32</sup>

Section 112.054(b) wisely provides that the court should consider the spendthrift provision as a factor, but that the inclusion of the spendthrift provision is not an automatic bar to modification or termination. In some cases, the court's consideration of the spendthrift provision may lead it to conclude that acceleration of distributions to beneficiaries runs counter to the settlor's primary intent and would necessarily frustrate the settlor's purposes in setting up the trust. In other cases, the court may conclude that the spendthrift provision was included for prophylactic creditor protection or for other, relatively insignificant reasons, so the spendthrift provisions should not impede the modification or termination for other, more pressing reasons.

Note that the provision regarding spendthrift trusts in Section 112.054(b) speaks in terms of the court's discretion to "modify or terminate" a trust, not its discretion regarding changing trustees, ordering the trustee to do something prohibited by the trust instrument or prohibiting the trustee from doing something required by the trust instrument — the other actions permitted under Section 112.054(a).

### 3.2.6. *No Justiciable Controversy Required*

Proceedings under Tex. Trust Code §112.054 do not require a justiciable controversy.<sup>33</sup> Therefore, a modification or termination suit is not subject to attack merely because there is no actual controversy before the court.

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<sup>32</sup> See Bogert, *Trusts and Trustees* (2nd Ed. Rev.), §561.

<sup>33</sup> *Gregory v. MBank Corpus Christi, N.A.*, 716 S.W.2d 662 (Tex. App.--Corpus Christi 1986, no writ).

### 3.3. *Reformation and Recission*

Reformation suits<sup>34</sup> are kin to modification and termination suits, but the basis for the suit is different. Reformation suits are based on mistakes of fact at the inception of the trust, not deviation from the trust terms due to changed circumstances. If, due to a mistake in the drafting of the trust instrument, the instrument does not contain the terms of the trust as intended by the settlor and trustee, the settlor or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms which were actually agreed upon.<sup>35</sup>

Reformation based on mistake must be based on a mistake of fact, not a mistake of law.<sup>36</sup> However, while the general rule is well settled that a court will not relieve against a mistake of law, it is also generally held that such rule is confined to mistake of the general rules of law, and has no application to the mistake of persons as to their own private legal rights and interests, so that, if parties contract under a mutual mistake and misapprehension as to such rights, the result is that the agreement is liable to be set aside as having proceeded upon a common mistake.<sup>37</sup> In *Furnace v. Furnace*, for example, the parties were mistaken as to what effect a sale would have on their interests in a trust. Dicta in the opinion indicates that this was a mistake of fact, not of law, even though legal interpretations of instruments were involved. (Despite the dicta, the court of appeals in *Furnace* found that the parties waived this issue by failing to submit it at trial.)

A recent trend in cases is to permit reformation of the trust to achieve the clearly expressed intent to save transfer taxes even though the instrument would otherwise fail to achieve that intent. For example, if the settlor's intent to save generation-skipping taxes is clearly stated in the trust instrument, the dispositive provisions of the trust may be reformed where necessary to effectuate such intent.<sup>38</sup> However, in one case applying Texas law, reformation was denied where the alleged mistake as to tax consequences was not the overriding reason for the trust. In *duPont v. Southern National Bank of Houston*,<sup>39</sup> the court found that there was insufficient evidence that the settlor would not have created the trust but for his alleged mistake as to tax consequences.

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<sup>34</sup> Texas has not adopted a provision based on Section 415 of the Uniform Trust Code, which permits a court to reform the terms of a trust to conform with the settlor's intention if both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement. Case law in Texas supports reformation, so a similar remedy is available in Texas without express statutory authority. See "*Possible 2017 Legislation*" above about possible 2017 legislation to address reformation due to a scrivener's error.

<sup>35</sup> Bogert, *Trusts and Trustees* (2nd Ed. Rev.), §991.

<sup>36</sup> *Community Mut. Ins. Co. v. Owen*, 804 S.W.2d 602 (Tex. App.-Houston (1st Dist.) 1991, writ denied).

<sup>37</sup> *Furnace v. Furnace*, 783 S.W.2d 682, 686 (Tex. App.-Houston (14th Dist.) 1989, writ dismissed w.o.j).

<sup>38</sup> *Loeser v. Talbot*, 589 N. E. 2d 301, 412 Mass. 361 (1992).

<sup>39</sup> 575 F. Supp. 849 (S. D. Texas 1983), affirmed in part, vacated in part, on other issues 771 F. 2d 849 (5th Cir. 1985), cert. denied 475 U. S. 1085 (1986).

The court apparently believed that the primary purpose of the trust was to keep property from his wife, not tax savings.<sup>40</sup>

Tex. Trust Code §112.036 expressly permits reformation of a trust which would otherwise violate the rule against perpetuities.

If a settlor never intended to create a trust, then rescission is the proper remedy. In *Wils v. Robinson*,<sup>41</sup> the court of appeals found that Section 112.054(a)(2) was not a basis for terminating a trust which the settlor said he never intended to create; rather, rescission was the proper remedy, based on mistake, fraud, duress or undue influence.<sup>42</sup> Despite the result in *Wils*, the prudent course is to plead and attempt to prove modification and termination under Section 112.054 as an alternative theory when rescission is a possible theory.

### 3.4. *Jurisdiction*

#### 3.4.1. *District Court and Statutory Probate Court*

A district court and a statutory probate court have jurisdiction over trust matters.<sup>43</sup> A suit to modify or terminate a trust safely may be brought in a district court or a statutory probate court.

#### 3.4.2. *County Court at Law*

A statutory county court other than a statutory probate court (a “county court at law”) has the jurisdiction over a matter involving “the interpretation and administration of a testamentary trust if the will creating the trust has been admitted to probate in the court” and “the interpretation and administration of an inter vivos trust created by a decedent whose will has been admitted to probate in the court.”<sup>44</sup>

It would be great if Section 31.002(b) addressed jurisdiction in broader terms or contained a laundry list of matters over which county courts at law had trust jurisdiction.<sup>45</sup> It does not,

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<sup>40</sup> Section 112.054(a)(4), which permits modification of a trust if “necessary or appropriate to achieve the settlor’s tax objectives,” is another basis for addressing this issue. See “*Necessary to Achieve Tax Objectives*” above. See also “*Possible 2017 Legislation*” above.

<sup>41</sup> 934 S.W.2d 774 (Tex. App.-- Houston. (14th Dist.) 1996, writ granted), judgment vacated without reaching merits 938 S.W.2d 717 (Tex. 1997).

<sup>42</sup> 934 S. W. 2d at 779.

<sup>43</sup> Tex. Trust Code §115.001; Tex. Est. Code §§31.002, 32.006 and 32.007.

<sup>44</sup> Tex. Est. Code §31.002(b).

<sup>45</sup> See, for example, Tex. Trust Code §115.001.

however, so until there is an appellate case on the point, a practitioner is stuck interpreting this language. A county court at law did not have jurisdiction over trusts prior to 2011. When Section 4B of the Texas Probate Code (the predecessor of Section 31.002 of the Estates Code) was enacted in that year, the clear intention was to avoid the need for two proceedings – a probate proceeding in the county court at law and a trust proceeding in the district court – when an issue involving a trust arose during the probate administration. Since one of the most common issues to arise is the need to modify a trust, the author thinks this change was intended to include modifications and terminations of trusts. At many levels, the termination or modification of a trust involves the “administration” of that trust. Still, the statute is not as clear as it could be.

Under Section 31.002(b), the county court at law has jurisdiction over a testamentary trust if the will creating the trust was probated in that court and over an inter vivos trust if the settlor’s will was probated in that court, regardless of how long after the probate proceeding the suit involving the trust is commenced.

### 3.4.3. *Court-Created Trusts*

The court creating a guardianship management trust under Chapter 1301 of the Estates Code retains the jurisdiction to modify or terminate that trust even if it is not a statutory probate court or a county court at law.<sup>46</sup> Similarly, the court which creates a trust under Section 142.005 of the Property Code retains jurisdiction to modify or terminate that trust.<sup>47</sup>

### 3.5. *Venue*

Venue of a trust action is based on Section 115.002 of the Trust Code.

If there is a single, noncorporate trustee, venue is proper in the county where the trustee resides or has resided at any time during the four-year period preceding the date the action is filed. Venue also is proper in the county where the situs of administration is maintained or has been maintained at any time during the four-year period preceding the date the action is filed.

If there are multiple noncorporate trustees, venue is proper in a county where any of the trustees resides or has resided in the last four years, as well as in the county where the situs of administration is maintained or has been maintained in the last four years. If the multiple trustees maintain a principal office in Texas, venue also is proper where the trustees maintain the principal office.

If there are one or more corporate trustees, venue is proper where the situs of administration is maintained or has been maintained at any time during the four-year period preceding the date the

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<sup>46</sup> Tex. Est. Code §1301.201.

<sup>47</sup> Tex. Prop. Code §142.005(d).

action is filed. Venue also is proper where any corporate trustee maintains its principal office in Texas.

Notwithstanding these provisions, if the settlor is deceased and the administration of his or her estate is pending in Texas, “an action involving the interpretation and administration of” an inter vivos trust or testamentary trust created by the settlor may be brought in the county in which the administration of the settlor’s estate is pending.

Keep in mind that, while jurisdiction is a mandatory requirement, venue is permissive. A judgment in a court without jurisdiction is void or voidable, but a judgment in a court with jurisdiction but without proper venue is valid and enforceable. Therefore, it is possible to file a friendly suit (or an unfriendly suit, for that matter, so long as no one objects to venue) in a county where venue is improper if that location is more convenient for the parties.

### 3.6. *Parties to Termination/Modification Suit*

#### 3.6.1. *Who May Initiate Suit*

As noted above, Section 112.054(a) of the Trust Code provides that a trustee or a beneficiary may commence an action under that section, while Section 115.011(a) provides that any “interested person” may commence an action under Section 115.001, the general jurisdictional statute. This inconsistency makes it unclear whether an “interested person” who is not a trustee or beneficiary (for example, the settlor) can initiate a modification or termination suit.

The definition of “interested person” in Section 111.004(7) was amended in 1995 in response to at least one case at the trial court level in which the court determined that a beneficiary was not an “interested person” and, therefore, could not initiate an action under Section 115.001. That should not be a problem with an action under Section 112.054, since that section specifically authorizes a beneficiary to bring the action. Nonetheless, the 1995 amendment to Section 111.004(7) makes it clear that, while a trustee or a beneficiary always is an “interested person,” whether a person other than a trustee or a beneficiary is an “interested person” for purposes of bringing a trust code action “may vary from time to time and must be determined according to the particular purposes of and matter involved in any proceeding.” Among those persons who have been found to not be “interested persons” were a father of minor beneficiaries seeking to compel an accounting or remove a trustee,<sup>48</sup> and the settlor’s wife, who was not a trustee, was not a beneficiary, did not stand to inherit any trust assets, and had no community property interest in corpus or undistributed income of trust.<sup>49</sup>

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<sup>48</sup> *Davis v. Davis*, 734 S. W. 2d 707 (Tex. App. — Houston (1st Dist) 1987, writ ref’d, n. r. e.).

<sup>49</sup> *Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App. -- Fort Worth 1996, writ denied).

### 3.6.2. *Necessary and Proper Parties*

Often the most difficult problem facing an attorney seeking to judicially modify or terminate a trust is determining which parties are necessary parties and which are merely proper parties. The vast majority of trusts have potential contingent beneficiaries who are unknown, undeterminable or suffering a legal disability such as minority. If these persons are necessary parties, then a guardian ad litem usually will be necessary to fully resolve the proceeding. If, on the other hand, these persons merely are proper parties, it may be unnecessary to have an ad litem.

The Trust Code attempts to bring some clarity to the issue of necessary versus proper parties. Tex. Trust Code §115.011(b) starts out by stating plainly that contingent beneficiaries designated as a class are not necessary parties. It then provides that the only necessary parties are:

- (1) A beneficiary of the trust on whose act or obligation the action is predicated;
- (2) A beneficiary of the trust designated by name, other than a beneficiary whose interest has been distributed, extinguished, terminated, or paid;
- (3) A person who is actually receiving distributions from the trust estate at the time the action is filed; and
- (4) The trustee, if a trustee is serving at the time the action is filed.

In the case of a charitable trust, §115.001(c) provides that the attorney general shall be given notice of any proceeding as provided in Chapter 123 of the Property Code. That chapter gives the attorney general the opportunity to intervene if he sees fit.

A beneficiary who first raises the modification or termination issue with the trustee (the instigator, so to speak) probably is a necessary party under subparagraph (1) of Section 115.011(b).

Subsections (1) and (2) were amended in 2001 to make clear that they apply only to beneficiaries *of the trust*, not beneficiaries of other gifts or trusts under the will or trust instrument. The 2011 amendment also excluded as necessary parties any beneficiary whose interest has been fully distributed or paid. Thus, the trustee can avoid having a nuisance beneficiary in the lawsuit if the trustee is able to fully distribute his or her interest.

What does “*actually* receiving distributions . . . at the time the action is filed” mean? It cannot be limited to beneficiaries actually receiving distributions at the instant the lawsuit is filed, for this would usually yield no necessary parties. At the other extreme, it apparently does not mean persons to whom distributions are possible at the time the suit is filed — for example, descendants of the primary beneficiary in cases where the trustee holds a spray power. The more probable middle ground includes each person who has received distributions from the trust and

whose basis for receiving those distributions has not terminated. Avoiding unnecessary “necessary” parties is a good reason to avoid routinely including spray powers in bypass trusts.<sup>50</sup>

### 3.6.3. *Virtual Representation and Related Issues*

Sometimes it is impossible to get all beneficiaries before the court due to the status of some of the beneficiaries. Beneficiaries who are minors, incapacitated, unborn or unascertained cannot themselves participate in a judicial modification or termination proceeding. Trustees and other persons interested in the trust understandably are reluctant to take actions involving the trust which do not bind these other beneficiaries.

Of course, one alternative is to have a guardian of the estate or a guardian ad litem appointed for such persons. Tex. Trust Code §115.014(a) authorizes the court to appoint one or more guardians ad litem if the court determines that the representation of those persons’ interests otherwise would be inadequate. Tex. Trust Code §115.013(c)(2)(A) provides that, to the extent there is no conflict of interest between the guardian ad litem and the persons represented, an order binding the guardian ad litem binds the “ward.”

In 2005, Subsection (c) was added to Section 115.014 of the Trust Code, permitting a guardian ad litem to “consider general benefit accruing to the living members of a person’s family” in deciding how to act. This makes it easier to obtain guardian ad litem approval to a modification that provides no direct benefit to minor or unascertained beneficiaries but which benefits the family (and, presumably, the minor or unascertained members of the family) generally.

There is another way to bind minors, unborn and unascertained beneficiaries in some cases – virtual representation. The doctrine of virtual representation exists at common law independent of statute.<sup>51</sup> In addition, the doctrine has been codified in Section 115.012(c) of the Trust Code.<sup>52</sup>

Under Section 115.013(c), if there is no conflict of interest and no guardian of the estate or guardian ad litem has been appointed, a parent may represent his minor child as guardian ad litem or as next friend. Also, an unborn or unascertained person who is not otherwise represented is bound by an order to the extent his interest is adequately represented by another party having a substantially identical interest in the proceeding.

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<sup>50</sup> For others, see the author’s paper “Protecting the Surviving Spouse and Protecting Yourself After *Belt v. Oppenheimer*” on [texasprobate.com](http://texasprobate.com).

<sup>51</sup> See, for example, *Mason v. Mason*, 366 S.W.2d 552 (Tex. 1963); *Starcrest Trust v. Berry*, 926 S.W.2d 343 (Tex. App. --Austin, 1996); *Hedley Feedlot, Inc. v. Weatherly Trust*, 855 S.W.2d 826 (Tex. App.--Amarillo 1993, no writ); and *Citizens State Bank v. Bowles*, 663 S.W.2d 845 (Tex. App.--Houston [14th Dist.] 1983, writ dism'd).

<sup>52</sup> See also Tex. Trust Code §114.032 and “*The Nonjudicial Virtual Representation Statute*” below.

While this statutory statement of virtual representation is limited to parents acting for their minor children and other beneficiaries acting for unborn or unascertained persons, the cases applying the common law virtual representation doctrine do not appear to limit virtual representation to minors and unborn persons.<sup>53</sup> Also, *Mason v. Mason*<sup>54</sup> makes clear that the common law doctrine of virtual representation is not limited to beneficiaries representing other beneficiaries. In *Mason*, it was the trustee who was found to have virtually represented the beneficiaries in a suit challenging the validity of the trust.

Normally, only parties may appeal a judgment. An exception exists for persons represented in a case by virtual representation. Even though they are not actually joined in a proceeding and made an actual party, they probably have the right to appeal the judgment — they may be bound by the judgment when it becomes final, but they have an independent right to appeal it before it becomes final.<sup>55</sup> This right of appeal should be factored into the parties' decision about when it is appropriate to make distributions following a judicial modification or termination — better to wait until the judgment becomes final and binding on virtually represented parties before doling out the money.

If a beneficiary is not a necessary party under Section 115.011, and if he or she is not represented in the proceeding by a guardian, a guardian ad litem or by virtual representation, that beneficiary is not bound by the judgment.

#### 3.6.4. *Analysis of Necessary Parties, Virtual Representation, and Ad Litem Requirements in Modification and Termination Proceedings*

The virtual representation statute (Section 115.013(c)) and the necessary parties statute (Section 115.011) provide a safe harbor in most cases where trust modification or termination is sought — if all of the necessary parties described in Section 115.011 can be served or otherwise brought into the suit, if all minors can be represented by their parents without a conflict of interest, and if the interests of all unborn or unascertained persons are adequately represented by another party having a substantially identical interest, then a guardian ad litem generally can be avoided and the parties can have a moderate level of comfort that the modification or termination order will be binding on all beneficiaries. If some or all of these requirements cannot be met, then one or more ad litem probably are necessary under Section 115.014.

It is useful to examine these factors in the following hypothetical:

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<sup>53</sup> See, e.g., *Mason v. Mason*, 366 S.W.2d 552 (Tex. 1963).

<sup>54</sup> 366 S.W.2d 552 (Tex. 1963).

<sup>55</sup> See *American Physicians Insurance Exchange v. Cardenas*, 717 S. W. 2d 707 (Tex. App. -- San Antonio 1986, writ ref'd, n. r. e.); *Grohn v. Marquardt*, 487 S.W.2d 214 (Tex. Civ. App.--San Antonio 1972, writ ref'd n.r.e.).



### Virtual Representation Hypothetical

Assume Settlor S creates an irrevocable trust with T as trustee, income to I for life, remainder to R on the death of I, or to R's descendants per stirpes if R predeceases I. None of R's descendants are adults.

**Example 1:** Assume I and R are adults with capacity. T wishes to modify the trust to invest in equities. (S required the investment in FDIC-insured accounts only, but T believes S could not have anticipated the circumstances now presented, with low interest rates on accounts and high return on equities.)

T and I are necessary parties. R is not a necessary party (unless R is the beneficiary “on whose act or obligation the action is predicated”), but R will not be bound by the judgment unless R is made a party or is virtually represented. Therefore, R must be made a party. R can virtually represent his minor children (there's no conflict of interest, since R's interest is identical to those of his children on this issue), and R can virtually represent unborn and unascertained persons (he can adequately represent their interest, and they have a substantially identical interest with R).

**Example 2:** Assume I is an adult with capacity, while R is I's minor child. T wishes to modify the trust to invest in equities.

T and I are necessary parties. R is not a necessary party (unless R is the beneficiary “on whose act or obligation the action is predicated”), but R will not be bound by the judgment unless R is made a party or is virtually represented. I cannot virtually represent R, however, since there is a conflict of interest. (Investment in equities affects the income interest and the remainder interest differently.) Also, I's interest is not substantially identical to that of R's descendants, so I cannot virtually represent those unborn or unascertained persons. A guardian ad litem is needed for R, R's descendants and unborn and unascertained persons, but only one ad litem ought to be needed, since the interests of R, R's descendants and unborn and unascertained persons are identical.

**Example 3:** Assume I and R are adults with capacity. I wants to terminate the trust early and have all of the trust property distributed to I. R is willing to agree, and T is willing to permit the termination if a court orders it.

T and I are necessary parties. R is not a necessary party (unless R is the beneficiary “on whose act or obligation the action is predicated”), but R will not be bound by the judgment unless R is made a party or is virtually represented. Therefore, R must be made a party. In theory, at least, R can virtually represent his minor children, since there's no conflict of interest and since R's interests are identical to those of his children on this issue. Similarly, in theory, at least, R can virtually represent unborn and unascertained persons (he can adequately represent their interest, and they have a substantially identical interest with R). In reality, however, it is not clear that virtual representation would bind R's descendants, since R is basically giving up the store — yes, his interests are identical, but he's doing nothing to protect those interests. The minute the termination is approved, his interests and those of his descendants go away. A guardian ad litem may be needed. The guardian ad litem may determine that, notwithstanding that R's descendants get nothing directly from this plan, it nevertheless may be beneficial to R's descendants because there will be less money eaten up in trust fees and R's descendants may eventually get something.

### Virtual Representation Hypothetical

Assume Settlor S creates an irrevocable trust with T as trustee, income to I for life, remainder to R on the death of I, or to R's descendants per stirpes if R predeceases I. None of R's descendants are adults.

**Example 4:** Assume I and R are adults with capacity. I wants to terminate the trust early and have part of the trust property distributed to I and part of the trust property distributed to R. R is willing to agree, and T is willing to permit the termination if a court orders it.

T and I are necessary parties. R is not a necessary party (unless R is the beneficiary "on whose act or obligation the action is predicated"), but R will not be bound by the judgment unless R is made a party or is virtually represented. Therefore, R must be made a party. R cannot virtually represent his minor children or other descendants, since there's a conflict of interest -- under the plan, R gets part of the trust property and R's descendants do not. A guardian ad litem is needed. The guardian ad litem may determine that, notwithstanding that R's descendants get nothing directly from this plan, it nevertheless may be beneficial to R's descendants because there will be less money eaten up in trust fees and R's descendants may eventually get something.

**Example 5:** Assume I and R are adults with capacity. I wants to terminate the trust early and have part of the trust property distributed to I and part of the trust property distributed to R. R is willing to agree, but T is unwilling to consent. T will agree to have the trust modified so that noncorporate trustees are permitted and I becomes the trustee. I and R agree to proceed with this modification rather than the modification.

T and I are necessary parties. R is not a necessary party (unless R is the beneficiary "on whose act or obligation the action is predicated"), but R will not be bound by the judgment unless R is made a party or is virtually represented. Therefore, R must be made a party. R can virtually represent his minor children (there's no conflict of interest, since R's interest is identical to those of his children on the modification issue), and R can virtually represent unborn and unascertained persons (he can adequately represent their interest, and they have a substantially identical interest with R on the modification issue).

**Example 6:** Assume I and R are adults with capacity. T, I and R agree to have the trust modified so that noncorporate trustees are permitted and I becomes the trustee. Shortly after the judicial modification, I, as trustee, distributes all of the trust property to I and R.

T and I are necessary parties. R is not a necessary party (unless R is the beneficiary "on whose act or obligation the action is predicated"), but R will not be bound by the judgment unless R is made a party or is virtually represented. Therefore, R must be made a party. If the post-modification distributions were not prearranged, R presumably can virtually represent his minor children (there's no conflict of interest, since R's interest is identical to those of his children on the modification issue), and R can virtually represent unborn and unascertained persons (he can adequately represent their interest, and they have a substantially identical interest with R on the modification issue). However, the deal looks fishy, and R's descendants might have a basis to complain about I's and R's actions upon attaining majority.

## 4. Nonjudicial Modification or Termination

In many cases, it may not be necessary to resort to a judicial proceeding to modify or terminate a trust.<sup>56</sup>

### 4.1. *Actions Permitted by the Trust Instrument*

Clearly, the best way to modify or terminate a trust nonjudicially is to do so in accordance with the trust instrument. Therefore, the drafter of the trust instrument can do a lot to make life easier — or harder — for trustees or beneficiaries who later want to modify or terminate the trust.

Many trusts include provisions which expressly permit the trustee or others to modify or terminate the trust in certain circumstances. Some modification or termination provisions are quite broad, but care must be taken not to give the person holding the power to modify or terminate a general power of appointment for federal gift and estate tax purposes. See “Drafting with the Future in Mind” above for a tips on including provisions promoting flexibility.

Even if the trust instrument does not include an express modification or termination provision, the trustee may be able to terminate a trust by distributing the remaining assets pursuant to a facility of payment provision. Tex. Trust Code §113.021 provides a rudimentary facility of payment provision for trusts with no broader express provision. It permits the trustee to make a distribution required or permitted to be made to a minor or incapacitated beneficiary in one of several ways, including to a custodian under the Uniform Transfers to Minors Act. Of course, a well-drafted trust usually has a much broader facility of payment provision which, for example, may not be limited to minors or incapacitated persons. These provisions can provide the means for getting property out of a cumbersome, expensive trust into a form that is more beneficial to the beneficiary.

### 4.2. *Termination and Modification Permitted by Statute*

Even if the trust instrument contains no provision authorizing modification or termination of the trust, the Trust Code may contain a provision that makes it possible to accomplish the same purpose.

#### 4.2.1. *Revocation by Settlor*

Unlike most states, in Texas a trust is revocable by the settlor unless it is irrevocable by the express terms of the instrument.<sup>57</sup> The trust instrument should be examined for an express irrevocability clause. If the trust is revocable, then of course the settlor can terminate it and

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<sup>56</sup> Of course, the trustee may wish to get the court’s blessing to the modification or termination in some cases even if there is a nonjudicial basis for modification or termination.

<sup>57</sup> Tex. Trust Code §112.051.

modify it at will, provided that the settlor cannot enlarge the trustee's duties without the trustee's consent.<sup>58</sup>

#### 4.2.2. *Termination by Occurrence of Event*

Although it almost goes without saying, a trust terminates if by its terms the trust is to continue only until the expiration of a certain period or until the happening of a certain event and the period of time has elapsed or the event has occurred.<sup>59</sup>

#### 4.2.3. *Merger*

Tex. Trust Code §112.034 is a codification of the doctrine of merger. It provides that a settlor does not create a trust if he retains both legal title and all equitable interests or if he transfers both legal title and all equitable interests to the same person. Also, Section 112.034 provides that a trust terminates if the legal title to the trust property and all equitable interests (other than a settlor's beneficial interest protected under a spendthrift trust) in the trust become united in one person. This doctrine rarely applies with most modern trusts (or attempts at trust) since there usually is one or more remainder beneficiaries other than the settlor.

#### 4.2.4. *Division and Combination of Trusts*

Section 112.057 of the Trust Code permits the trustee to divide a trust into two or more separate trusts or combine two or more trusts into a single trust without a judicial proceeding "if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes" of the original trust or trusts. Combining two trusts under Section 112.057 can be superior to decanting under the Texas decanting statutes.<sup>60</sup>

#### 4.2.5. *Decanting*

In 2013, the legislature added Subchapter D to Chapter 112 of the Trust Code, entitled "Distribution of Trust Principal in Further Trust." These 17 sections bring decanting to Texas for trusts with no express decanting provision. Decanting permits the trustee of a trust to transfer ("decant") the property from that trust to another trust under certain circumstances. While this is not a modification of the transferring trust, as a practical matter the terms of the transferring trust are modified to match the terms of the receiving trust, since the receiving trust's instrument will thereafter govern the trust.

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<sup>58</sup> Tex. Trust Code §112.051.

<sup>59</sup> Tex. Trust Code §112.052.

<sup>60</sup> (Tex. Trust Code §§ 112.071-112.087).

The Texas statute contains many limitations on the power to decant. Like most of the Trust Code, the decanting statutes establish default rules. A settlor may include specific decanting provisions in the trust instrument which control over the statutory provisions.

Under the current Texas statute, it is virtually impossible to use decanting to change dispositive provisions of a trust unless the trustee has full discretion. “Full discretion” means the power to distribute principal to or for the benefit of one or more of the beneficiaries “that is not limited or modified by the terms of the trust in any way, including by restrictions that limit distributions to purposes such as the best interests, welfare, or happiness of the beneficiaries.”<sup>61</sup> All other trusts are “limited discretion” trusts. Decanting by a trustee of a limited discretion trust requires the receiving trust to have the same current beneficiaries, the same remainder beneficiaries, the same distribution language and the same power of appointment terms.<sup>62</sup> Since very few trusts have *no* limitations or modifications of discretion, most are considered limited discretion trusts, and the changes possible through decanting are limited to administrative provisions.<sup>63</sup> Another impediment to using the current Texas decanting statute is that it prohibits the trustee from using the power to “materially impair the rights of any beneficiary of the trust,” whether or not the trust is a full discretion or limited discretion trust.<sup>64</sup>

Still, often the administrative provisions are the ones that need fixing, and decanting under the Texas statute is a viable option.

There are several restrictions and requirements for decanting under the Texas statute. For a full discussion of decanting, including current Texas requirements, *see* Melissa Willms, “Decanting Trusts: Irrevocable Not Unchangeable,” 20<sup>th</sup> Annual Advanced Estate Planning Strategies Course (2014).

Early drafts of REPTL’s 2017 legislative package include changes to the Texas decanting statutes that may make them more usable. The definitions of “full discretion” and “limited discretion” trusts in Section 112.071 would change so that limited discretion means a mandatory distribution power in which a trustee has no discretion or a power to distribute principal that is limited by an ascertainable standard, and full discretion means a power to distribute principal that is not limited by an ascertainable standard. Also, the prohibition that a decanting cannot

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<sup>61</sup> Tex. Trust Code §112.071(5).

<sup>62</sup> Tex. Trust Code §112.073.

<sup>63</sup> A possible strategy for limited discretion trusts is a twist on the venerable Texas “two-step:” Step 1: The trustee of the Texas trust decants to a second trust which is identical except that it is subject to the laws of a state with a more liberal decanting statute. Step 2: The trustee of the second trust makes a more substantive decanting under the laws of that state. This approach poses a risk for the Texas trustee, however, since the trustee of the Texas trust is required to exercise the decanting power “in good faith, in accordance with the terms and purposes of the trust, and in the interests of the beneficiaries.” Tex. Trust Code §112.073(f).

<sup>64</sup> Tex. Trust Code §112.085(2).

“materially impair” the rights of any beneficiary would be deleted from Section 112.085. If enacted, these provisions will take effect September 1, 2017.

#### 4.2.6. *Disclaimers*

The Texas Uniform Disclaimer of Property Interests Act<sup>65</sup> permits trust beneficiaries to disclaim beneficial interests and permits trustees to disclaim property which otherwise would pass into a trust. Under the act, a disclaimer must occur prior to acceptance of the property or interest, but there is no time limit for the disclaimer. In the appropriate case, a disclaimer by the trustee or a trust beneficiary could have the effect of preventing a trust from being created.

#### 4.2.7. *Amendment of Charitable Trusts*

Section 112.055 of the Trust Code provides for certain tax-oriented provisions to be included in a trust instrument governing private foundations and certain split-interest trusts by operation of law, while Section 112.056 permits the settlor of a trust and the trustee of a trust to consent to such amendments nonjudicially.

#### 4.3. *Termination by Agreement of Settlor and Beneficiaries*

Although the beneficiaries of a spendthrift trust may not alienate or encumber their interest in the trust property, a spendthrift trust may be modified or terminated by the consent of all the parties to it. If a settlor of a trust is alive and all of the beneficiaries of an irrevocable spendthrift trust consent (and there being no incapacity to consent by any of the parties), the settlor and all of the beneficiaries may consent to a modification or termination of the trust.<sup>66</sup> Texas case law appears to make no provision that the trustee consent or even be a party to the agreement to modify or terminate a spendthrift trust.

There are two serious practical impediments to terminating a trust by agreement of the settlor and all beneficiaries. First, the settlor often is dead, rendering this method ineffective. Second, the concept of virtual representation available in judicial proceedings to modify or terminate trusts is not available when terminating a trust by agreement, and in the vast majority of cases there are minor or contingent beneficiaries who cannot enter into the agreement.

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<sup>65</sup> Chapter 240 of the Texas Property Code. For a detailed discussion of this 2015 act, see Karisch, Featherston and Jonas, “Disclaimers under the New Texas Uniform Disclaimer of Property Interests Act,” 39<sup>th</sup> Annual Advanced Estate Planning and Probate Course (2015), updated at [texasprobate.com](http://texasprobate.com).

<sup>66</sup> *Musick v. Reynolds*, 798 S.W.2d 626 (Tex. App.--Eastland 1990, no writ); *Becknal v. Atwood*, 518 S.W.2d 593 (Tex. Civ. App.--Amarillo 1975, no writ); and *Sayers v. Baker*, 171 S.W.2d 547 (Tex. Civ. App.--Eastland 1943, no writ).

4.4. *The Nonjudicial Virtual Representation Statute*

In 1999, Section 114.032 was added to the Texas Trust Code, to read as follows:

Sec. 114.032. LIABILITY FOR WRITTEN AGREEMENTS. (a)

A written agreement between a trustee and a beneficiary, including a release, consent, or other agreement relating to a trustee's duty, power, responsibility, restriction, or liability, is final and binding on the beneficiary and any person represented by a beneficiary as provided by this section if:

- (1) the instrument is signed by the beneficiary;
- (2) the beneficiary has legal capacity to sign the instrument; and
- (3) the beneficiary has full knowledge of the circumstances surrounding the agreement.

(b) A written agreement signed by a beneficiary who has the power to revoke the trust or the power to appoint, including the power to appoint through a power of amendment, the income or principal of the trust to or for the benefit of the beneficiary, the beneficiary's creditors, the beneficiary's estate, or the creditors of the beneficiary's estate is final and binding on any person who takes under the power of appointment or who takes in default if the power of appointment is not executed.

(c) A written instrument is final and binding on a beneficiary who is a minor if:

- (1) the minor's parent, including a parent who is also a trust beneficiary, signs the instrument on behalf of the minor;
- (2) no conflict of interest exists; and
- (3) no guardian, including a guardian ad litem, has been appointed to act on behalf of the minor.

(d) A written instrument is final and binding on an unborn or unascertained beneficiary if a beneficiary who has an interest substantially identical to the interest of the unborn or unascertained beneficiary signs the instrument. For purposes of this subsection, an unborn or unascertained beneficiary has a substantially identical interest only with a trust beneficiary from whom the unborn or unascertained beneficiary descends.

(e) This section does not apply to a written instrument that modifies or terminates a trust in whole or in part unless the instrument is otherwise permitted by law.

Subsection (e) of the new statute seemingly shuts the door on using it for trust modifications and terminations. However, one person's "modification" is another person's "agreement relating to a trustee's duty, power, responsibility, restriction, or liability."

The drafters of Section 114.032 apparently intended it to be useful in obtaining releases of the trustee which are binding on minors and unborn persons, and subparagraph (e) seems to present no impediment to that. For example, if the trustee discovers that it made a mistake, it can make a full disclosure of the mistake, offer some sort of restitution to the trust, and get a release from the current beneficiaries. This statute would make that agreement binding on minors and unborn persons in many cases, since their interests would be "substantially identical" to their parents or other beneficiary.

## **5. Selected Problem Areas in Trust Modification and Termination**

### *5.1. Tax Issues Affecting Trust Modifications, Combinations and Decanting*

This paper looks at the state law issues surrounding trust modifications and termination, not the tax issues. There are potential tax implications to trust modifications, combination and decanting. The growth of decanting has caused a new focus on the tax implications of changing trust terms. Since 2011, the IRS has had a no-ruling policy with respect to certain issues relating to decanting arrangements, including whether decanting results in a taxable gift.<sup>67</sup> Rulings are possible if the decanting results only in administrative-type changes where there is no change in beneficial interests or the perpetuities period. While the rise in decanting is what is motivating the IRS to take a closer look at these issues, the issues are the same whether the trust change is achieved through decanting, judicial modification, nonjudicial modification or trust combination.

Melissa Willms's paper "Decanting Trusts: Irrevocable Not Unchangeable," 20<sup>th</sup> Annual Advanced Estate Planning Strategies Course (2014), includes an excellent discussion of tax issues involved with decanting or modifying trusts. The author thanks Melissa for discussing these issues with him.

### *5.1. Does a Trustee Have a Duty to Seek Trust Modification or Termination?*

Does a trustee have a duty to petition the court to modify or terminate a trust if that action is necessary to prevent waste or avoid impairment of the trust's administration? Restatement (Third) of Trusts §66 (2003) provides:

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<sup>67</sup> See Rev. Proc. 2015-3, §5.01(20), 2015-1 I.R.B. 129.



(1) The court may modify an administrative or distributive provision of a trust, or direct or permit the trustee to deviate from an administrative or distributive provision, if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust.

(2) If a trustee knows or should know of circumstances that justify judicial action under Subsection (1) *with respect to an administrative provision*, and of the *potential of those circumstances to cause substantial harm to the trust or its beneficiaries*, the trustee has a duty to petition the court for appropriate modification of or deviation from the terms of the trust.

[Emphasis added]

The comments to this section of the restatement provides that this duty of the trustee “ordinarily does not apply to the initiation of proceedings for modification of or deviation from *distributive* provisions of a trust.” But the comment continues: “[I]f the trustee is *actually* aware that a purpose of the settlor would be jeopardized by adhering to existing provisions governing distribution when judicial action under Subsection (1) would be justified, the trustee has a duty to petition the court for instructions or for appropriate deviation or modification.”

An example of a situation in which Subsection (2) – imposing the duty in a case where the trustee knows or should know of the potential of circumstances to cause substantial harm to the trust or its beneficiaries – may apply is where the trust terms prohibit the sale of an asset which is likely to decline in value significantly if the trust continues to hold it. In such a case, the trustee may have a duty to seek court relief from the terms of the trust requiring the trustee to hold the asset.

It is common for a trust beneficiary to be denied eligibility for government benefits because the trust has a “health, education, maintenance and support” distribution standard. The restatement comments suggest that the trustee of such a trust may have a duty to seek instructions or modification of the trust terms to make the trust a special needs trust, allowing the trust beneficiary to qualify for benefits.

## 5.2. *Charitable Beneficiaries*

### 5.2.1. *The Uniform Prudent Management of Institutional Funds Act*

The Uniform Prudent Management of Institutional Funds Act (“UPMIFA”) may affect a court’s ability to modify or terminate a trust with charitable beneficiaries. The Texas version of UPMIFA is found in Chapter 163 of the Property Code.

UPMIFA sets different investment standards and different income allocation rules for funds held by an institution. The definition of “institution” in the act includes “a person, other than an individual, organized and operated exclusively for charitable purposes” and “a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated.” Tex.

Prop. Code §163.003(4). An “institutional fund” is a fund held by an institution exclusively for charitable purposes. Tex. Prop. Code §163.003(5).

The problem arises with Section 163.011, which reads: “Subtitle B, Chapter 9 (the Texas Trust Code), does not apply to any institutional fund subject to this chapter.”

It makes sense for the UPMIFA’s investment standards and income allocation rules (not the Trust Code’s rules) to apply to a trust which has exclusively charitable beneficiaries or a trust which started with noncharitable and charitable beneficiaries. What does not make sense is for UPMIFA to make the entire Trust Code inapplicable to these trusts. By making the entire Trust Code inapplicable, UPMIFA may make modifications and terminations under Section 112.054 unavailable. Representatives of the charitable trusts section of the Attorney General’s office and REPTL have discussed the possibility of amending Section 163.011 so that only Chapter 116 (the Uniform Principal and Income Act) and Chapter 117 (the Uniform Prudent Investor Act) do not apply to charitable trusts which are subject to UPMIFA. That would satisfy the purposes of UPMIFA while also providing a framework for trust administration, including judicial modifications and terminations.

The legislature probably will fix this problem in 2017. Until then, when reforming, modifying or terminating a trust which might be subject to UPMIFA, it is necessary to plead for common law and equitable remedies in addition to citing Section 112.054. The common law and equitable remedies not found in the Trust Code continue to apply.

### 5.2.2. *Charity/Attorney General Involvement*

As in most states, in Texas the attorney general is authorized to protect the public’s interest in charities. There are obvious, valid reasons for this. One of the ways in which the attorney general gets involved in litigation involving charities is found in Chapter 123 of the Texas Property Code. While that chapter is entitled “Attorney General Participation in Proceedings Involving Charitable Trusts,” the definitions of “charitable trust,” “charitable entity” and “proceeding involving a charitable trust” in Section 123.001 give it broad applicability. This paper discusses charitable trusts in the traditional, trust law sense – an express trust with one or more charitable beneficiaries.

In most actions involving a charitable trust, the proceeding will affect the interest of the charity as beneficiary, and therefore the charity must be made a party. Additionally, the party initiating any proceeding involving a charitable trust is required to give notice to the attorney general by sending the attorney general, by registered or certified mail, a copy of the petition or other instrument initiating the proceeding involving a charitable trust within 30 days of the filing of such petition or other instrument, but no less than 25 days prior to a hearing in such a proceeding.<sup>68</sup> The attorney general is a proper party and may intervene in a proceeding involving

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<sup>68</sup> Tex. Prop. Code §123.003(a).

a charitable trust at any time. Additionally, the attorney general may enter into a compromise, settlement agreement, contract or judgment relating to a proceeding involving a charitable trust.<sup>69</sup>

While the folks at the charitable trusts section are no doubt just doing their jobs, they can throw a monkey wrench into what is otherwise a fairly straightforward solution to problems involving a trust. When trying to terminate or modify a trust with a remote contingent charitable beneficiary, the attorney general's involvement may impede the ability of the family to come to a fair solution. Charities themselves do not usually take positions which are adverse to those taken by family members. Often the charities have worked closely with the family and are comfortable with the proposed solution. However, because of the nature of the task undertaken by the attorney general — protecting the theoretical interests of the general public — the attorney general often is forced to end up on the opposite side of everyone else at the negotiating table. It is critical to give the required notice under Tex. Prop. Code §123.003 in a timely manner and to cooperate as much as possible with the attorney general's representative. It also is a good idea to establish contact with the charity first to have a good relationship established before the attorney general's office looks at the file. If the assistant attorney general sees that the charity is actively involved in the proceeding, he or she may be more likely to pass on the opportunity to become involved in the proceeding.

### 5.2.3. *Cy Pres*

Generally speaking, the cy pres doctrine is a rule for the construction of instruments in equity by which the intention of the party is carried out as near as may be when it would be impossible or illegal to give it literal effect. More commonly, it is the equitable power which enables the court to carry out a testamentary or inter vivos trust established for a particular charitable purpose if the testator/settlor has expressed general charitable intent but for some reason his purpose cannot be accomplished in the manner specified in the will or trust instrument.

Previously a judicial proceeding with attorney general involvement was the only way to get a new charitable beneficiary if the one in the trust instrument failed and the trust instrument was silent as to its replacement. For trusts created on or after August 30, 1999, Section 113.026 provides a means for the settlor or trustee to nonjudicially select a new charity to replace the failed charity when the trust instrument is silent. The attorney general still gets notice, and the charity selected still has to fall within the cy pres doctrine. However, if the attorney general chooses not to intervene, the replacement of the failed charity may occur nonjudicially.<sup>70</sup>

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<sup>69</sup> Tex. Prop. Code §123.002.

<sup>70</sup> Section 113.026 represented a compromise between the proponent of the bill, who wanted broader substitution powers (outside the cy pres doctrine if the settlor was alive and wished to designate a charity which did not have a same or similar purpose) and less attorney general involvement, and the attorney general's office, which wanted the cy pres doctrine to apply in all cases. One unfortunate aspect of the compromise is that the new law only applies to trusts created on or after August 30, 1999. One quirk of the statute is that the attorney general can be held

### 5.3. *Does a Trustee Have a Duty to Seek Trust Modification or Termination?*

Does a trustee have a duty to petition the court to modify or terminate a trust if that action is necessary to prevent waste or avoid impairment of the trust's administration? Restatement (Third) of Trusts §66 (2003) provides:

(1) The court may modify an administrative or distributive provision of a trust, or direct or permit the trustee to deviate from an administrative or distributive provision, if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust.

(2) If a trustee knows or should know of circumstances that justify judicial action under Subsection (1) *with respect to an administrative provision*, and of the *potential of those circumstances to cause substantial harm to the trust or its beneficiaries*, the trustee has a duty to petition the court for appropriate modification of or deviation from the terms of the trust.

[Emphasis added]

The comments to this section of the restatement provides that this duty of the trustee “ordinarily does not apply to the initiation of proceedings for modification of or deviation from *distributive* provisions of a trust.” But the comment continues: “[I]f the trustee is *actually* aware that a purpose of the settlor would be jeopardized by adhering to existing provisions governing distribution when judicial action under Subsection (1) would be justified, the trustee has a duty to petition the court for instructions or for appropriate deviation or modification.”

An example of a situation in which Subsection (2) – imposing the duty in a case where the trustee knows or should know of the potential of circumstances to cause substantial harm to the trust or its beneficiaries – may apply is where the trust terms prohibit the sale of an asset which is likely to decline in value significantly if the trust continues to hold it. In such a case, the trustee may have a duty to seek court relief from the terms of the trust requiring the trustee to hold the asset.

It is common for a trust beneficiary to be denied eligibility for government benefits because the trust has a “health, education, maintenance and support” distribution standard. The restatement comments suggest that the trustee of such a trust may have a duty to seek instructions or modification of the trust terms to make the trust a special needs trust, allowing the trust beneficiary to qualify for benefits.

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responsible for all court costs of the parties involved if the court determines that the attorney general acted unreasonably in seeking judicial review of the appointment of the replacement charitable beneficiary.

#### 5.4. *Problems Unique to the Trustee*

When a modification or termination action is contemplated, the trustee usually faces unique problems and issues. The trustee often finds itself reluctant to modify or terminate while the beneficiaries are enthusiastic about the action, or the trustee may see an immediate need to modify the trust, but the beneficiaries are not so excited about the prospect of reviewing all this legal mumbo-jumbo.

Here are suggestions for trustees when modification or termination is considered:

- Retain outside counsel in all but the most routine and small cases. Under *Huie v. DeShazo*,<sup>71</sup> a trustee's consultations with its attorneys are protected by the attorney-client privilege. The trustee can get (hopefully) good, independent advice and protect its communications about the propriety of terminating or modifying the trust and the problems which may be experienced with beneficiaries.
- Make a full and reasonable disclosure of all material facts, including all material nonstandard transactions. Only by doing so can the trustee have any hope of making an agreement with beneficiaries binding and enforceable.<sup>72</sup>
- If possible, merely agree not to oppose the modification or termination rather than actively seeking, supporting or agreeing to the termination or modification. The trustee has a common law duty to defend the trust, and it is preferable to let the beneficiaries push for the termination of the trust rather than having the trustee out on the front lines. Obviously, this ignores the real world to a certain degree — there are going to be many times when the trustee has to take the lead in a modification or termination, and such action often is entirely accurate. Also, in some cases the trustee may have a duty to seek modification or termination of the trust.<sup>73</sup>
- Make sure the necessary parties are joined, and make sure the parties being virtually represented fall comfortably within the virtual representation statute or doctrine. If there's any doubt, recommend to the court that a guardian ad litem be appointed.
- Remember that trustees not only have a duty to act reasonably when they exercise discretion, they also have a duty to decide whether or not to exercise discretion given to them by the trust instrument. Failure to exercise discretion when it is given (for example, failure to exercise discretion to terminate a small trust using the nonjudicial termination

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<sup>71</sup> 922 S. W. 2d 920 (Tex. 1996).

<sup>72</sup> See *Montgomery v. Kennedy*, 669 S. W. 2d 309, 313 (Tex. 1984); Tex. Trust Code §§114.003 and 114.032.

<sup>73</sup> See “Does a Trustee Have a Duty to Seek Trust Modification or Termination?” above.

power given the trustee in the trust instrument) can be as much of a breach as exercising the discretion wrongfully or improperly. Document the trust records not only if the trustee chooses to exercise discretion, but also when the trustee chooses not to exercise discretion. For example, a notation may be “considered terminating trust under small trust provision, but decided that the purposes of the trust continue to be served at this time, so termination is inappropriate.”

- While this should go without saying and does not have particularly to do with trust modification or termination suits, remember to treat all beneficiaries with courtesy and respect, and remember that the trustee’s internal email probably is discoverable if it exists.
- If the trust is terminated, delay the actual distribution of trust property until the judgment is final. Remember that parties who were virtually represented in the proceeding may have an independent right to appeal the judgment.

## **6. Conclusion**

Modifying or terminating trusts is something most attorneys face at some point in their practices. The author hopes this outline will be a ready resource for those occasions, with both legal and practical advice.