But What's an Ascertainable Standard? Clarifying HEMS distribution standards and other fiduciary considerations for trustees

INDEPENDENT TRUSTEE ALLIANCE CONFERENCE

MAY 13, 2021

CHRISTIAN S. KELSO, *Dallas*
Farrow-Gillespie Heath Witter LLP

Christian S. Kelso
Partner

Christian S. Kelso practices in the areas of estate planning, wealth preservation and transfer, probate, tax and transactional corporate law. His primary focus is finding practical, cost-effective solutions for families and businesses to avoid costly, and often heartbreaking disputes in both the courtroom and the living room. Mr. Kelso is a counselor who is dedicated to making the law work for his clients and helping them understand how best to address the legal issues they face.

Mr. Kelso's estate planning and wealth preservation practice involves both large and small estates and is premised on the notion that the size of a client's estate should not be relevant to the amount of compassion and dedication each deserves. Whether the situation merely calls for a simple Will or complex trusts, Mr. Kelso works closely with his clients to craft solutions that best achieve their goals, both legal and personal.

Where probate of an estate is required, Mr. Kelso provides assistance and advice which is focused on minimizing litigation and intra-family disputes. When proper planning is in place and other circumstances allow, this process can be straightforward and simple, particularly for clients who have the right counselor by their side to guide them through the legal formalities. Other situations, however, can be more complicated. The death of a loved one can often set an entire family at odds as emotions and forgotten tensions well up. In situations like this, Mr. Kelso is able to draw on both his personal and professional experience to ease family tensions and deploy appropriate legal strategies so that clients can move on with their lives.

Mr. Kelso's transactional corporate practice is focused on avoiding legal problems before they materialize. He helps businesses develop solutions that mitigate risk, both in the form of legal exposure and tax. Employing a full-time, in-house attorney can be expensive, but every business faces situations which are best addressed with the counsel of a trusted advisor. Mr. Kelso fills this roll by acting as general counsel on an as-needed basis and assisting with all manner of issues.

Christian S. Kelso is a native Dallasite, having attended St. Mark's School of Texas for twelve years before moving on to the University of Texas at Austin. Mr. Kelso came back to Dallas for both his J.D. and LL.M. (Taxation) degrees, which he received from Southern Methodist University. Mr. Kelso is an active member of the community in North Texas, both legal and otherwise, and sits on charitable boards and other governing bodies. He speaks German fluently and lives in Dallas with his wife and two children.

TABLE OF CONTENTS

I. Acknowledgments: Before beginning, I would like to recognize just a few of the many people who were instrumental in helping me research and compile this paper. Much credit on the research side goes to Mary C. Burdette whose previous work for the State Bar of Texas served as both an inspiration and a model for this paper. Also, Chris Klemme of Happy State Bank, was far more helpful than he knows. Credit for editing goes to Joanne Nakos, of my previous firm, Malouf Nakos Jackson & Swinson, P.C., as well as to my wife, Bethany. Of course, my wife also gets credit for tolerating all my late nights and weekends at the office. I could never have done this alone. Thanks to all!

II. Introduction and Background. Many of us who grew up in the 1980's and 1990's spent countless hours watching (and rewatching) the action/science fiction film *Predator*, starring, among others, Arnold Schwarzenegger, Jessie Ventura and Carl Weathers. In the movie, an alien roams the jungles of Central America, hunting humans for sport. The technologically advanced alien is equipped with a cloaking device that bends visual light such that the alien is rendered invisible to the human eye…almost.

An abstract legal contrivance, the ascertainable trust distribution standard is much like the Predator's cloaking device. Although it renders the Predator hard to see clearly, you know he is there because you feel his effect. Those of us who work regularly with trusts talk about ascertainable standards all the time, but this is mostly at the theoretical level. When we try to dig more deeply or ask real-world questions, it quickly becomes apparent that most of us only have a general understanding of how the ascertainable standard actually functions in real life. In our day-to-day lives, we tend to skim over the topic, telling our clients that the terms of their trusts include magic words from the tax code which will allow for maximum flexibility without inflicting an adverse tax consequence. And yet, when the client, now acting as trustee of his or her trust, reaches out to ask if he or she is authorized to make a particular distribution, we scratch our head, wondering why there is no case law on point. And thus we learn that, as with the Predator, if you fail to give it respect, you will be sorry.

So, what is the big deal about ascertainable standards? The very term "ascertainable" implies something that is definitive, quantifiable and discoverable. Meriam-Webster defines the verb "ascertain" as meaning "to make certain, exact, or precise" or "to find out or learn with certainty." And yet, the actual meaning of the most common ascertainable standards in American trust law remain amorphous, undefined and poorly understood, even by most practitioners.

Originally, this paper was intended to be an examination of relevant case law which would shed light on distribution standards and enable the reader to better understand the limits of their meaning. It was intended to provide a list of permissible and impermissible distributions from a trust with standard language making it subject to one or more ascertainable standards. Exhaustive research, however, has proved this a futile task for two reasons. First, the economics of American jurisprudence make it unlikely that many such cases will ever be reported. A beneficiary may get upset when his trustee will "only" buy him a Buick for his support and maintenance, rather than the Cadillac he wants. But is the beneficiary really going to sue the trustee to get the Cadillac? Even if the beneficiary wins, his or her trust will likely pay the trustee's legal expenses, which will no doubt be substantially more than the cost of any car. Also, if the beneficiary does complain, is his or her case likely to get to the point where it will become legal precedent? In all likelihood, the parties will settle out of court. Thus, the case will likely go unreported and therefore unavailable as legal precedent for future disputes.

Second, the high number of variables surrounding any particular trust distribution make every situation as unique as a snowflake. Put simply, when a trustee is acting properly, there are so many factors that go into his or her decision to distribute (or not distribute) that no two instances will ever be the same. Therefore, the few reported cases that do exist can only be illustrative, not determinative, with regard to any future case.

In light of these difficulties, the focus of this paper has shifted somewhat from its original intent. Rather than provide definitive lists of what a trustee can and cannot do, it will provide guidelines for trustees (and the people who advise them). Although this may only be a second-best option for a trustee who merely seeks a bright line test, it is hoped that this guidance will nonetheless put him or her at ease with regard to some admittedly tough questions. In particular, this paper will seek to enlighten individual trustees who may not have the legal resources of their corporate brethren. They, and those who advise them, are encouraged to turn to this resource for guidance, both when establishing a trust and also when considering a particularly tough distribution.

Like Blain in Predator, most of us "ain't got time to bleed." Whether that means overspending on legal fees, wasting one's own time, or simply avoiding a lawsuit altogether, I hope that the following guidelines will make the trustee's life just a little bit better.

III. General Information. Although the information in this section may seem simplistic for some, experience has taught that many trustees, including lay people and trustees with significant legal training, simply do not fully grasp the underlying concepts that govern their fiduciary role. For a layperson especially, ideas such as splitting equitable and legal title to property can be particularly vexing. Also, even in the rare instances where counsel has been given, trustees may not internalize all the salient points. There is simply too much for most people to take in at once. Therefore, it is a good idea to go over the basics on a regular basis so that the trustee understands the big picture and how they fit into it.

A. Fiduciary Duty in General. First things first. All trustees must, at a minimum, understand that fiduciary duties are the highest duties known to the law. *Nathan v Hudson*, 376 S.W.2d 856, 860-61 (Tex. App.—Dallas 1964, writ ref'd n.r.e.). The law in Texas holds trustees to a "very high and very strict standard of conduct which equity demands." *Slay v. Burnett's Trust*, 187 S.W.2d 377, 387-88 (Tex. 1945). The very act of accepting the position of Trustee carries with it an acceptance of this high standard. *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (Tex. 1938). *See also Geeslin v. McElhenney*, 788 S.W.2d 683, 685 (Tex. App.—Austin 1990, no writ). An intelligible and eloquent summary of a fiduciary's duty was put forth by Justice Cardozo in the case of *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545-46 (1928) as follows:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A [fiduciary] is held to something stricter than the morals of the marketplace. Not honesty alone, but the

punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

The law recognizes other elevated duties which one person might owe to another. Most notably these include the duties a person might owe to a spouse or child. And yet, the highest of all is the fiduciary duty. This may seem counterintuitive, but the reality is that a natural compulsion binds us all to our spouses and children, at least most of the time! But there is no similar bond between the trustee and the beneficiary. Further, the temptations facing fiduciaries are generally high because fiduciaries tend to control significant assets, which might easily be misappropriated or squandered on risky misadventures. For these reasons, and probably also because a fiduciary may be paid for his or her service, the law points a finger at the fiduciary and says, "You better act straight…OR ELSE!" Those who counsel individual trustees are well-advised to make sure our trustee clients keep this notion foremost in their thoughts.

B. Sources of Law. One of the more vexing problems confronting trustees is the plethora of sources from which they might draw conclusions or look to for guidance. Those without legal training might know no better than to go to their favorite internet search engine. We lawyers understand how much damage this might cause, so, in order of their respective authority, the following sources of law are described briefly below.

<u>1. The Texas Trust Code</u>. The Texas Trust Code (the "**TTC**" or simply the "**Trust Code**") is contained within the Texas Property Code (the "**TPC**"), specifically, Subtitle B of Title 9 of the TPC (e.g. §§ 111.001 et seq.). The Trust Code contains most (but not all) of the relevant statutory provisions relevant to the day-to-day activities of trustees. Most of the Trust Code provisions are default provisions which may be overridden in a trust instrument. In practice, many of the statutory provisions, which are designed to be especially conservative, are, in fact, overridden by standard provisions in trust instruments to more effectively achieve the goals behind the trusts they govern. This makes sense when one considers the practical implications of trust drafting. A "simple" trust (in the literal sense, and not as that term is generally understood for tax purposes) which fails to consider all the possible contingencies should be construed in such a manner which is most favorable to the beneficiary. In contrast, where a settlor makes the effort to think through and document his or her intent with regard to more unlikely scenarios, the law should (and generally does) generally seek to enforce and fulfill such intent.

But not all of the Trust Code's provisions are default rules. No matter what a settlor may intend, some rules may not be contravened. Often, a settlor may wish to protect a trustee in such a way which the law deems inappropriate. Thus, to preserve the core duties owed by any trustee, as fiduciary, certain requirements must remain unalterable. To this end, TTC § 111.0035 provides as follows:

> (a) Except as provided by the terms of a trust and Subsection (b), this subtitle governs:
>
> (1) the duties and powers of a trustee;
>
> (2) relations among trustees; and

(3) the rights and interests of a beneficiary.

(b) The terms of a trust prevail over any provision of this subtitle, except that the terms of a trust may not limit:

(1) the requirements imposed under Section 112.031;

(2) the applicability of Section 114.007 to an exculpation term of a trust;

(3) the periods of limitation for commencing a judicial proceeding regarding a trust;

(4) a trustee's duty:

(A) with regard to an irrevocable trust, to respond to a demand for accounting made under Section 113.151 if the demand is from a beneficiary who, at the time of the demand:

(i) is entitled or permitted to receive distributions from the trust; or

(ii) would receive a distribution from the trust if the trust terminated at the time of the demand; and

(B) to act in good faith and in accordance with the purposes of the trust;

(5) the power of a court, in the interest of justice, to take action or exercise jurisdiction, including the power to:

(A) modify, reform or terminate a trust or take other action under Section 112.054;

(B) remove a trustee under Section 113.082;

(C) exercise jurisdiction under Section 115.001;

(D) require, dispense with, modify, or terminate a trustee's bond; or

(E) adjust, deny, or order disgorgement of a trustee's compensation if the trustee commits a breach of trust; or

(F) make an award of costs and attorney’s fees under Section 114.064; or

(6) the applicability of Section 112.038.

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

(1) is entitled or permitted to receive distributions from the trust; or

(2) would receive a distribution from the trust if the trust were terminated.

2. Common Law. Where the Trust Code is silent (and therefore by implication, where a given trust instrument is also silent), the next source of authority is the common law. Trust Code § 113.051 provides that "[i]n the absence of any contrary terms in the trust instrument or contrary provisions of [the TTC], in administering the trust, the trustee shall perform all of the duties imposed on trustees by the common law." Note that the TPC also contains similar language at § 111.005.

Attorneys will, of course, be familiar with the rules governing the authoritative value of the common law of various jurisdictions, but they should remember that the lay people they counsel may not. Also, given the small number of cases on point, practitioners may be forced to look to extra-jurisdictional authority when seeking guidance for, or, God forbid, defending a given position. Furthermore, practitioners in Texas should note the wide variation in rules adopted by the various jurisdictions. Where they wish to rely on (or distinguish) extra-jurisdictional precedent, they would be well-advised to examine the other rules applicable in such jurisdiction and compare them to those applicable in Texas. In other words, if you think a certain rule should be adopted in Texas, you are more likely to win your argument if the rule comes from a state with other rules that are similar to ours and not from one with a long list of very different rules.

3. Federal Law. While federal law technically supersedes state law, it is less important to our present purposes because, as is well established, property law is generally considered the purview of the individual states and this paper generally concerns itself with property law. That said, certain federal law concepts and principles, particularly as contained within the Internal Revenue Code of 1986, as amended (the "**IRC**"), are nonetheless important. For example (and as will be described in more detail below), the ascertainable standard is itself a federal, tax law concept. See, e.g., IRC §§ 2041 and 2514, along with their related Regulations.

4. Secondary Sources. Although not precedential, an array of secondary sources is both available and frequently relied on by practitioners. While there are many treatises, hornbooks, supplements, outlines, websites and other sources available, the most important secondary sources are the Restatements of Trusts and the Uniform Trust Code.

The Restatement (Third) of Trusts was promulgated in 2003 and followed the Restatement (Second) of Trusts, which dates to 1959. Texas has not adopted either of these Restatements, but they are nonetheless valuable to practitioners here. Importantly, many portions of the Restatements are in direct conflict with the Trust Code, so caution is advised when relying on the terms of either. Where a conflict does exist, the statutory provision controls. TTC § 112.035 (regarding spendthrift trusts) is one example of such a conflict.

That said, Texas courts have cited the Restatement (Second) of Trusts numerous times but, according to at least one study, citations of the more recent iteration are far fewer in number. See Burdette, Mary C., *What Every Trustee Should Know*, 2014 (Prepared for the State Bar of Texas 25th Annual Estate Planning and Probate Course), at p. 2.

Similarly, Texas has not adopted the Uniform Trust Code (the "**UTC**") and legislative history indicates that certain of its provisions were specifically rejected in the TTC. Again, however, where there is no conflict with authoritative law, the UTC can be very helpful.

C. Defining the Problem (The Distribution Standard Spectrum). Another over-arching concept which is germane to the principle topic at hand is what one might think of as a spectrum of available distribution standards. Just as light exists on a spectrum ranging from infrared to ultra violet, with visible light making up only a small section in-between, so too may we view the distribution standards from which a grantor might choose for (or which the law might impose on) a given trustee. Thus, even if we cannot quantify the particular standard mandated by a given trust instrument, we can at least ordinate the standards such that we know what each is not, which, if not illustrative, is at least instructive.

The spectrum of trust distributions standards necessarily must stretch from the level of uncontrolled or unfettered distributions to the level of required or mandatory distributions. In other words, outside of certain unwaivable constraints, as described below, a given trustee's power must fit into one of three categories: With regard to any particular distribution, he or she may (i) have complete discretion, (ii) be required to make the distribution, or (iii) something in-between.

Ascertainable standards lie in-between the mandatory and unfettered standards. Typically, they permit distributions for a beneficiary's health, education, maintenance, or support ("**HEMS**"). The beneficiary of a trust with this language may, so the theory goes, compel the trustee to make distributions in accordance with a specific standard and prevent the trustee from making distributions which are outside of the standard. Think about this for a second because, in theory, it is a profound notion but in practice, it is not particularly easy to implement.

Additionally, some trusts contain "unascertainable" distribution standards. These, however, should be the same as unfettered trustee discretion because a court cannot interpret them sufficiently to compel (or forbid) a distribution. Of course, this may or may not be the fact in practice, but that is the theory.

This stands to reason because the function of an ascertainable standard is to provide a beneficiary, whether present or contingent, with a legally enforceable interest in trust property that a court can determine, and on which it might ultimately rule. At the same time, however, the standard must also provide the trustee with enough discretion so that he or she can evaluate future facts and circumstances, which are unknown at the time the trust instrument is created, but which must be addressed in order to achieve the goals of the settlor.

D. Meaning and Purpose. The concept of the ascertainable standard stems from a tax law problem. If a trustee of a given trust is also its beneficiary and he or she may indiscriminately make distributions to him- or herself, then the IRC will treat the beneficiary as having a general power of appointment over trust property, which, in turn, would make all of the trust's assets includible in his or her estate. However, a primary purpose of many trusts is keeping assets out of their beneficiaries' estates. Therefore, the IRC has set out the ascertainable standard as a safe harbor within which a trustee/beneficiary may take refuge and avoid inclusion for estate tax purposes. As stated in Treas. Reg. § 20.2041-1(c)(2):

> A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of [IRC §] 2041(b)(1)(A), not a general power of appointment.

On the settlor's side, several court cases and IRS rulings have held that, if the settlor is the trustee or controls the trustee of a trust, then the trustee's possession of a power to make distributions to, or for the benefit of, a beneficiary of the trust, if limited by an ascertainable standard relating to the beneficiary's health, education, support, or maintenance, will not cause the trust property to be included in the gross estate of the settlor/trustee for federal estate tax purposes under the IRC. *Estate of Budd,* 49 T.C. 468 (1968) acq. 1973-2 C.B. 1; *Estate of Frew,* 8 T.C. 1240 (1947); Rev. Rul. 73-143, 1973-1 C.B. 407; PLRs 200213013, 200123034, 200011055, 200011054, 199903025 and 9527025.

In addition, Treas. Reg. § 20.2041-1(c)(2) sets forth a number of different powers that are limited by an ascertainable standard; such powers include, but are not limited to, the following:

(1) [S]upport in reasonable comfort;

(2) [M]aintenance in health and reasonable comfort;

(3) [E]ducation, including college and professional education; and

(4) [M]edical, dental, hospital and nursing expenses and expenses of invalidism.

See also, Estate of Vissering v. Comm'r, 990 F.2d 578, 581–82 (10th Cir. 1993) (explaining that the term "comfort" does not make the standard unascertainable, so long as the beneficiary already leads a lifestyle that is at least reasonably comfortable—this, of course, appears to circle back to a previous standard of living).

Also, the lapse or other release or exercise of such a power limited by such an ascertainable standard will not be a taxable gift for federal gift tax purposes by the beneficiary which held the power. IRC § 2514(c)(1); Treas. Reg. § 25.2514-1(c)(2).

Similarly, where a trust beneficiary holds a fiduciary power during his or her lifetime to make distributions to or for the benefit of another beneficiary of the same trust, and the power is limited by an ascertainable standard relating to the other beneficiary's health, education, support, or maintenance, he or she will not be deemed to have made a taxable gift for federal gift tax purposes upon exercising (or failing to exercise) such power. Treas. Reg. § 25.2511-1(g)(2). But, this same regulation states that "if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or non-exercise of a power," then the power is not considered to be limited by the requisite standard.

Even if such a power is subject to an ascertainable standard, property distributable to a person for whom the beneficiary/trustee has a legal obligation to support could be included in the beneficiary/trustee's gross estate for federal estate tax purposes, unless the trustee is prohibited from making any distributions to a beneficiary that would satisfy the trustee's individual legal obligation to support such beneficiary. Treas. Reg. § 20.2041-1(c)(1). In other words, if a trust is set up for a minor beneficiary and that beneficiary's parent is named as trustee of that trust (i.e. as a grandparent might do), then special language is required to prevent the parent/child from spending trust funds to fulfill his or her legal duty as parent of the beneficiary for the benefit of the beneficiary/grandchild.

Furthermore, the prevalence of HEMS standards has prompted the states to draft clarifying legislation for local, non-tax purposes. For example, if a beneficiary of a trust, as trustee or otherwise, holds a power to make distributions to himself (or for his benefit), an issue can arise regarding the ability of the beneficiary's creditors to satisfy claims against the beneficiary from the beneficiary's interest in the trust. When, however, the trust has a spendthrift provision and the beneficiary's power is limited by an ascertainable standard relating to the beneficiary's health, education, support, and/or maintenance, a creditor in Texas generally cannot attach the beneficiary's interest on the basis that the beneficiary holds a distribution right or power. TTC § 112.035. Also, TTC § 113.029(b) provides:

> Subject to Subsection (d), and unless the terms of the trust expressly indicate that a requirement provided by this subsection does not apply:
>
> (1) a person, other than a settlor, who is a beneficiary and trustee, trustee affiliate, or discretionary power holder of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee's, the trustee affiliate's, or the discretionary power holder's personal benefit may exercise the power only in accordance with an ascertainable standard relating to the trustee's, the trustee affiliate's, or the discretionary power holder's individual health, education, support, or maintenance within the meaning of Section 2041(b)(1)(A) or 2514(c)(1), Internal Revenue Code of 1986; and
>
> (2) a trustee may not exercise a power to make discretionary distributions to satisfy a legal obligation of support that the trustee personally owes another person.

Note, however, that TTC § 113.029(b) does not apply to:

> (1) a power held by the settlor's spouse who is the trustee of a trust for which a marital deduction, as defined by Section 2056(b)(5) or 2523(e), Internal Revenue Code of 1986, was previously allowed;
>
> (2) any trust during any period that the trust may be revoked or amended by its settlor; or
>
> (3) a trust if contributions to the trust qualify for the annual exclusion under Section 2503(c), Internal Revenue Code of 1986. Id.

Also, TTC § 112.035(d) was added to confirm that a settlor will not be considered a beneficiary solely because the trustee of an intentionally defective grantor trust can pay or reimburse income taxes. Tex. HB 564, 80th Leg. R.S. (2007).

IV. Intent: The Prime Directive. The terms of a trust, as set forth in the governing instrument, generally govern its administration.

A. Grantor May Generally Set Out Trust Provisions. It is well settled in Texas that the first principle of trust construction is to honor the intent of the grantor. To determine the intent of the grantor, a court looks primarily to the text of the written instrument establishing the trust. *Nowlin v. First National Bank*, 908 S.W.2d 283, 286 (Tex. App.—Houston 1995). *See also Beaty v. Bales*, 677 S.W.2d 750, 754 (Tex. App.—San Antonio 1984) ("... the trustee's powers are conferred by the instrument and neither the court nor the trustee can add or take away such power. The trust is entitled to that construction which the maker intended."); *Stewart v. Selder*, 473 S.W.2d 3 (Tex. 1971) (a court interprets a trust in order to determine the settlor's intent); *Bleiden v. Greenspan*, 742 S.W.2d 93, 96 (Tex. Ct. App.—Beaumont 1987) (citations omitted), rev'd on other grounds, 751 S.W.2d 858 (1988) ("[I]t is well settled and elementary that the supreme goal of construing a trust instrument or a testamentary instrument, is to determine the intent of the [trustor, testator, or settlor].")

Every trust is different, however, and a well-crafted instrument will allow the trustee to determine the settlor's goals from the content of the trust document. *Keisling v. Landrum*, 218 S.W.3d 737, 741 (Tex App.—Fort Worth 2007, pet. denied); *Coffee v. William Marsh Rice University*, 408 S.W.2d at 273 (Tex. Civ. App.—Houston 1966, writ ref'd n.r.e.) ("The cardinal principle to be observed in construing a trust instrument is to ascertain the settlor's intent with the view of effectuating it."). This underscores the notion that there is no bright-line test when it comes to the properness of any single distribution.

The Trust Code also sets out this same rule in numerous provisions. TTC § 111.002 ("If the terms of this subtitle and the terms of a trust conflict, the terms of the trust control ...."); TTC § 113.001 ("A power given to a trustee [under the Trust Code] does not apply to a trust to the extent that the instrument creating the trust ... conflicts with or limits the power."); TTC § 113.051 ("The trustee shall administer the trust according to its terms and this subtitle. In the absence of any contrary terms in the trust instrument or contrary provisions of this subtitle, in administering the trust, the trustee shall perform all of the duties imposed on trustees by the common law.").

B. Non-waivable Provisions. The forgoing notwithstanding, it is worth noting that the Texas Trust Code does set out certain provision which may not be waived. See TTC § 111.0035. Generally, these provisions are maintained for public policy reasons which are thought to trump the general belief that a grantor should be able to impose whatever provisions he or she wants on whoever is willing to accept a given trusteeship. Thus, for example, a grantor may not compel a trustee to commit an illegal act. TTC § 112.031. Nor may a trust instrument relieve a trustee from certain breaches of trust. TTC § 114.007.

The reach of these provisions limiting a grantor's freedom should not be given short shrift. Some grantors often wish to limit trustees' liability. This is most obvious in instances where a grantor intends to be trustee of a given trust. In this instance, planning attorneys are well-advised to remind their clients that they can't have their cake and eat it too. If the client wants to establish a trust, for example to benefit a child or grandchild, and also act as trustee, the client needs to understand that he or she will be beholden to that child or grandchild in a fiduciary capacity. There are no takebacks!

On the other hand, the non-waivable provisions are also included to prevent large, corporate trust companies from exerting their will on individual grantors. Imagine, for example, what would happen if trust companies, simply and as a matter of course, refused to accept trusteeships unless all fiduciary liability was waived. Needless to say, this would be disastrous because it would completely destroy the entire trust relationship between grantor, beneficiary, and trustee. And yet imagining a world where such requirements were commonplace is not particularly difficult.

With these circumstances in mind, it is easy to understand the need to balance the interests of grantor, trustee and beneficiary. While the grantor's intent is given the greatest deference, certain circumstances warrant deference to the beneficiary.

V. **<u>Specific Distribution Standards and their meaning.</u>** Although the possibilities are literally limitless, a handful of distribution standards are used rather commonly. These fit neatly across the distribution standard spectrum described above and will be addressed below in order of increasing restriction.

A. Absolute, Uncontrolled or Unfettered Trustee Discretion. There are many instances where a trustee may properly be given authority to administer trust assets and make distributions with complete discretion. This may be styled in terms of "absolute," "uncontrolled," "sole" or "unfettered," discretion, but at least for purposes of this paper, all such terms shall be considered synonymous. In particular, where the trustee of the trust at issue, broad discretion may be handed over without concern. Alternatively, where the need for flexibility is at a premium and both tax and creditor protection concerns are low, unfettered trustee discretion may be appropriate even where the trustee is also the primary beneficiary.

On its face, allowing a trustee to make distributions in his or her absolute discretion seems simple. Such a trustee should be authorized to properly make distributions whenever and however he or she deems appropriate. But all is not as it seems. A fundamental and non-waivable aspect of every trust is that the trustee must be trusted to manage, use and distribute the trust's assets for the benefit of the trust's beneficiaries. Thus, at some point, a court must be able to step in and declare the actions of a trustee as being improper. This imperative applies even where the grantor intends to confer uncontrolled discretion on the trustee. Thus, where a grantor truly wishes to remove restrictions, he or she should consider an outright gift.

All trustees must make discretionary decisions, including decisions regarding distributions, investments, principal and income allocations, and expenditures, just to name a few. A trustee must exercise a discretionary power "reasonably" and in the best interests of the beneficiaries. *See Sassen v. Tanglegrove Townhouse Condo. Assoc.*, 877 S.W.2d 489 (Tex. App.—Texarkana 1994, writ denied). This includes the trustee making informed decisions based primarily on the terms of the trust and in a manner that carries out the grantor's intent. Unless the trust instrument is ambiguous, the grantor's intent must be determined solely by its terms. Thus, in legal lingo, we say that the grantor's intent should be determined from contents found within the "four corners" of the document.

Under TTC § 113.051, "[t]he trustee shall administer the trust in good faith according to its terms and this subtitle." Similarly, TTC § 111.0035 (b)(4)(B) states that "[t]he terms of a trust prevail over any provision of this subtitle, except that the terms of a trust may not limit…a trustee's duty…to act in good faith and in accordance with the purpose of the trust." The difference in these two provisions is subtle but profound, so trustees are well-advised to pay close attention to their specific meaning. The first, which is theoretically waivable, references good faith according to the trust instrument's *terms*. On the other hand, the latter, non-waivable, statute references good faith in accordance with the *purpose of the trust*. Standard rules of statutory construction mandate a presumption that this distinction is both purposeful and meaningful. In drafting § 111.0035 (which only happened in 2005) the legislature could have simply referenced § 113.051 as it did with several other non-waivable provisions. Instead, § 111.0035 adopts slightly different language which is, at least presumably, more onerous on trustees. In other words, the legislative intent clearly indicates that, at the end of the day, trustees are actually supposed to act in a fiduciary capacity. In other words, one cannot hold and benefit from the title of trustee and at the same time be free of the burdens and responsibilities that go along with a fiduciary position.

The above rules beg the question: When does a trustee act (or fail to act) in good faith? Fortunately for trustees, this particular standard is not especially high. A fiduciary acts in good faith when he believes his defense is viable and reasonable in light of existing law. *Lee v. Lee*, 47 S.W.3d 767, 795 (Tex. App.—Houston 2001, pet. denied). Note that this rule does not require the trustee to believe his or her defense to be absolute or even likely to win. It merely has to be viable and reasonable. In contrast, bad faith is "acting knowingly or intentionally adverse to the interest of the trust beneficiaries." *Interfirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 897 (Tex. App.—Texarkana 1987, no writ). A key aspect of American jurisprudence is that good faith and bad faith are both mutually exclusive and comprehensive. In other words, every action is either taken in good faith or in bad faith. There are no actions with are taken in neither good faith nor bad faith and there are no actions which are taken in both good faith and bad faith.

The fact that trustees are necessarily subject to non-waivable duties means that there really is no "absolute discretion." Regardless of the language used in a trust instrument, a trustee's exercise of discretion in the performance of his or her duties is always subject to review by Texas courts under an "abuse of discretion" standard. *Corpus Christi Bank and Trust v. Roberts*, 597 S.W.2d 752, 754 (Tex. 1980). For purposes of this paper, however, future references to a trustee's absolute discretion shall be understood to include the caveat that such power is slightly less than absolute.

The fact that trustees are saddled with certain non-waivable duties, however, does not mean that a beneficiary of a discretionary trust can compel the trustee to make trust distributions. *See Burns v. Miller, Hiersche, Martens & Hayward, P.C.*, 948 S.W.2d 317 (Tex. App.—Dallas, 1997, writ denied); and Bogert on Trusts § 228. *See also Ridgell v. Ridgell*, 960 S.W.2d 144 (Tex. App.—Corpus Christi 1997, writ denied). Rather, such a beneficiary must show that the trustee failed to act properly. Given the right facts and circumstances, a beneficiary may be able to convince a court that a trustee's refusal to exercise a pure discretionary distribution power is so unreasonable as to constitute a breach of trust or to justify removal.

On the other hand, courts do not like to be burdened with the trustee's job. See *Coffee v. William Marsh Rice Univ*., 408 S.W.2d 269, 284 (Tex. Civ. App.—Houston 1966, writ ref'd n.r.e.) ("This Court cannot substitute its discretion for that of the Trustees, and can interfere with their exercise of discretionary powers only in case of fraud, misconduct, or clear abuse of discretion.").

Section 116.006 of the Texas Uniform Principal and Income Act ("**UPIA**") provides that a court may not question a trustee's exercise or non-exercise of the power to adjust between principle and income unless the court determines that the decision was an abuse of the trustee's discretion. If a court determines that a trustee has abused its discretion, the court may place the income and remainder beneficiaries in the positions that they would have occupied if the discretion had not been abused. If the trustee reasonably believes that one or more beneficiaries will object to the exercise of a discretionary power, he or she may petition the court to determine whether the proposed discretionary act will result in an abuse of the his or her discretion. *Id*.

B. Unascertainable Standards. Rather than provide a trustee with unfettered discretion, a grantor may prefer to use other, unascertainable standards by which distributions can be made. A distribution standard will typically be considered unascertainable when there is no objective manner by which to determine whether a given distribution (requested or made) fits within the distribution standard of the instrument.

Unascertainable standards may be used when the settlor is less concerned about maintaining the trust principal for the remainder beneficiaries or when he or she wants the trustee to have more flexibility in making distributions. While their specific efficacy may be difficult or impossible for a court to determine per se, they nonetheless provide guidance in the form of expressing grantor intent. Consider, for example, a hypothetical situation where a trust instrument directs a trustee to make distributions for the beneficiary's "comfort" (which, as described below, is well-recognized as an unascertainable distribution standard) and the trustee denies the beneficiary's requests for a given distribution. In theory at least, a court should not be able to compel the distribution under these facts alone. However, if the beneficiary produces, an email wherein the trustee states his intent to make the beneficiary uncomfortable (for example, to encourage certain behavior), then, again in theory, the trustee is acting in bad faith and contrary to the intent of the trust, which he may not do.

Unascertainable distributions standards are also employed sometimes to achieve certain tax consequences. In particular, where it is beneficial to include a trust's corpus in a beneficiary's estate (for example, to achieve a step up in basis) this may be an option. Similarly, certain trusts, such a revocable living trusts, are simply not designed to provide tax benefits or creditor protection, so the limitations associated with ascertainable distribution standards bring no benefit to the beneficiary. But extreme caution is recommended before including such language in a trust instrument. Not only may there be other, unintended consequences, to using such language, but different provisions may also achieve the positive tax result without harmful side effects. Due to the potential tax and creditor protection implications, these unascertainable standards should be used with caution and only with the advice of a well-versed attorney.

There is no clear definition of an unascertainable standard. Nor is there an exclusive list of terms create one. Certain terms, however, are generally understood to be so indefinite that they do imply an unascertainable distribution standard. These include terms like "comfort," "happiness," "benefit" and "welfare." *See* Treas. Reg. § 20.2041-1(c)(2) ("A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard."); *See also* Treas. Reg. § 1.674(b)-1(b)(5)(i) (a power to distribute corpus for pleasure, desire, or happiness of beneficiary is not limited by a reasonably definite standard).

This is perhaps one of the most frustrating aspects of all trust law in the United States. After all, what actual difference is there (at least in practice) between allowing a trustee to make distributions for the beneficiaries' "welfare and benefit" versus their "maintenance and support?" What makes the former pair unascertainable and the latter ascertainable? Stated another way, are "maintenance and support" really that much more ascertainable than "welfare and benefit?"

<u>1. Comfort.</u> A distribution standard that includes "comfort" as a basis has generally been held to create an unascertainable standard. Reg. § 20.2041- 1(c)(2); *First Virginia Bank v. United States,*

490 F.2d 532 (4th Cir. 1974) ("In the absence of [state] law limiting [a beneficiary's] power to consume the proceeds from the sale of the stock to an ascertainable standard relating to her health, support, or maintenance, the value of the stock must be included in her gross estate. While the power to consume need not be limited to the bare necessities of life, the Regulations specifically state: A power to use the property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard."); but *see Estate of Strauss,* T.C. Memo 1995-248 (court held under Illinois law, "comfort" is ascertainable standard); *Pyle v. United States*, 766 F.2d 1141 (7th Cir. 1985) (government argued comfort ascertainable under state law); *Rock Island Bank & Trust Co. V. Rhoads,* 187 N.E. 139 (Ill. 1933) (comfort ascertainable under Illinois law as it refers to maintaining someone in station of life to which that person is accustomed and because station in life is known, standard is measured and hence ascertainable.)

In Texas, comfort is not limited by state law in a manner that would allow it to be considered an ascertainable standard. *See Lehman v. United States,* 448 F.2d 1318, (5th Cir. 1971). In *Lehman*, the court considered a Texas Will providing that the wife could "in the exercise of her own discretion,… consume for her own use, benefit, comfort, support, and maintenance, all or any part of the corpus of [the testator's] estate or proceeds thereof whenever she, in her own discretion, deems the income, rents, and revenues thereof insufficient for her support, maintenance, comfort, and welfare." *Id.* In that case the Fifth Circuit noted that "the critical fact is that, regardless of the name attached to it, [the wife's] interest was obviously coupled with plenary authority to convey, encumber or consume the property, and Texas courts have consistently accorded full force and effect to similar testamentary provisions." *Id (citing Messer v. Johnson,* 422 S.W.2d 908, 912 (Tex. 1968); *Commercial Bank, Unincorporated of Mason v. Satterwhite,* 413 S.W.2d 905, 909 (Tex. 1967); *Murphy v. Slaton,* 273 S.W.2d 588(Tex. 1954); *Nye v. Bradford,* 193 S.W.2d 165, 167 (Tex. 1946), *Edds v. Mitchell,* 184 S.W.2d 823, 825 (Texas 1945); *McMurray v. Stanley,* 6 S.W. 412, 415 (Tex. 1887)). Therefore, based on Texas law, the court held the inclusion of the word comfort resulted in the wife possessing an "unrestricted and discretionary right - at least in the absence of evidence of action fraud - to consume the property, governed only by her own personal assessment of her own personal need." *See Id.*

<u>2. Welfare.</u> A distribution standard that includes "welfare" has also been found to create an unascertainable standard. *See* Reg. '20.2041-1(c)(2); *First Virginia Bank v. United States,* 490 F.2d 532 (4th Cir. 1974) ("In the absence of [state] law limiting [a beneficiary's] power to consume the proceeds from the sale of the stock to an ascertainable standard relating to her health, support, or maintenance, the value of the stock must be included in her gross estate. While the power to consume need not be limited to the bare necessities of life, the Regulations specifically state: "A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard.").

<u>3. Happiness, Benefit, Best Interest.</u> While the words "happiness" and "benefit" are described in Treas. Reg. § 20.2041- 1(c)(2) as unascertainable standards, the Restatement (Third) of Trusts § 50, Comment d(3) (2003) provides just a little more insight:

> Although one effect of authorizing distributions for the "benefit," "best interests," or "welfare" of a beneficiary is to suggest a support standard, these terms tend also to authorize discretionary expenditures that fall beyond the usual scope of a purely

> support-related standard. For example, a "benefit" standard might make it reasonable for a trustee to make substantial distributions to provide a beneficiary with capital needed to start a business. … Terms of this type, however, lack the objective quality of a term such as "support." Thus, they may not facilitate a beneficiary's efforts to obtain judicial intervention to compel distributions by the trustee. On the other hand, the presence of less objective terminology in a discretionary standard may diminish the relevance of the beneficiary's other resources, except a parent's obligation to support a minor beneficiary.
>
> The terms of a discretionary standard occasionally include stronger language, such as the word "happiness." Such language suggests an intention that the trustee's judgment be exercised generously and without relatively objective limitation. Although "happiness" alone expresses no objective minimum of entitlements (which to some extent may nevertheless be readily implied), the primary effect of such a term is to immunize from challenge by remainder beneficiaries almost any reasonably affordable distributions. This, however, does not mean that the trustee cannot properly resist any reasonable request by the beneficiary, because the decision remains one within the fiduciary discretion of the trustee.

C. Ascertainable Standards. HEMS standards are not the only ascertainable standards. Any standard which a court can interpret sufficiently to compel a distribution will qualify, at least for tax purposes. HEMS standards are typically viewed as being at the outer boundary of permissible discretion, so any language which further limits a trustee's discretion will only serve to make a given standard "more ascertainable," for lack of a better term. Sometimes, HEMS language is specifically reigned in, as when a trust provides for medical care only in emergency situations. Other times, completely different language might be used. Consider for example a trust in which the trustee is directed to provide all the money or other assets reasonably necessary to fund the beneficiary's hobby of collecting and painting fine art. This is clearly an ascertainable standard because, if a distribution is made for some other purpose (for example, the beneficiary's health insurance) then a remainder beneficiary can sue the trustee for abuse of discretion.

Still, HEMS standards remain customary, and practitioners are advised against deviating from this language without special consideration. Where circumstances do, in fact, warrant extra language (as they often do), explicitly stating that any such additional language is intended as a further limitation may help to avoid unintended legal conclusions.

<u>1. Support & Maintenance.</u> The terms "support" and "maintenance" are generally considered to be similar. In fact, under the Restatement, these terms are considered synonymous. Restatement (Third) of Trusts § 50 Comment d (2003).

When the distribution standard includes the terms support and maintenance, a trustee's discretion is not unbridled discretion. See *State v. Rubion*, 308 S.W.2d 4 (Tex. 1957) (citing *First National Bank of Beaumont v. Howard*, 229 S.W.2d 781, 785 (Tex. 1950)); *Anderson v. Menefee*, 174 S.W. 904 (Tex. Civ. App.—Fort Worth, writ refused, writ ref'd); *William F. Frathcer*, Scott on Trusts, Vol. 2, § 187, p. 986. Rather, the trustee's discretion must be "reasonably exercised to accomplish the purposes of the trust according to the settlor's intention and his exercise thereof is subject to judicial review and control." *Kelly v. Womack*, 268 S.W.2d 903, 907 (Tex. 1954); *Powell v. Parks*, 86 S.W.2d 725 (Tex. 1935); *Davis v. Davis*, 44 S.W.2d 447 (Tex. Civ. App.—Texarkana 1931, no writ).

The Restatement provides a nonexclusive list of example expenditures which fall within the support and maintenance standard. These include, but are not limited to: "regular mortgage payments, property taxes, suitable health insurance or care, existing programs of life and property insurance, and continuation of accustomed patterns of vacation and of charitable and family giving." Restatement (Third) of Trusts § 50 comment d(3) (2003). In addition, courts have held that "[t]he needs of a married man include not only needs personal to him, but also the needs of his family living with him and entitled to his support." *Robison v. Elston Bank & Trust Co.,* 48 N.E.2d 181, 189 (Ind. App. 1943).

See Appendix "A" for a chart of other possible expenditures that may be covered under a support and maintenance standard. These examples are not meant to be exhaustive. Some of these items may seem frivolous, particularly for small trusts, but this is just further support for the rule that individual circumstances must be considered at all times. Under all circumstances, however, support probably means more than the bare necessities. *Hartford-Conn. Trust Co. v. Eaton,* 36 F.2d 710 (2d Cir. 1929).

The Texas Supreme Court in *Rubion* recognized a number of factors that should be considered by a trustee exercising its discretion in a "support" or "maintenance" trust. *Rubion*, at 10. They include: (i) the size of the trust estate; (ii) the beneficiary's age, life expectancy and condition of life; (iii) the beneficiary's present and future needs; (iv) the other resources available to the beneficiary's individual wealth; and (v) the beneficiary's present and future health, both mental and physical.

See also In re Gruber's Will, 122 N.Y.S.2d 654, 657 (N.Y. Sur. 1953) (age and condition of beneficiary, amount of trust fund, and other factors); *Hanford v. Clancy*, 183 A. 271, 272 (N.H. 1936) (size of fund, present situation of beneficiary, present and future needs, other resources, and future emergencies); *Falsey's Estate, Sur.*, 56 N.Y.S.2d 556, 563 (N.Y. Sur. 1945) (age of beneficiary, physical and mental health of beneficiary, size of trust compared to beneficiary's life expectancy).

Support has also been held to include the educational expenses of the beneficiary's dependents. See *First National Bank of Beaumont v. Howard*, 229 S.W.2d 781 (Tex. 1950). In that case, the Texas Supreme Court held that the fact that the settlor had paid for his daughters' college education indicated that he considered the expense of a college education for a dependent a "necessary" expenditure. *Id*.

The changes in a beneficiary's standard of living or the value of trust assets can impact the level of support that is proper. Restatement (Third) of Trusts § 50 Comment d(2) (2003). Thus, if a beneficiary's standard of living increases (for example, due to external factors not involving the trust) or if the trust's assets appreciate in value, then more liberal distributions should be permissible. *Id*. Presumably, the converse would also be true, so trustees should be careful.

Carrying on business as usual or doing something a particular way because it has always been done that way before may lead a trustee to some peril.

The present and future needs of the beneficiary are to be considered by the trustee. But when the trust is potentially insufficient to provide for both needs, the trustee is faced with a difficult decision. Unfortunately, the few courts that have addressed this issue have not held consistently. For example, compare the decision of *State v. Rubion*, 308 S.W.2d at 4, with *Penix v. First National Bank of Paris,* 260 S.W.2d 63 (Tex. Civ. App.—Texarkana, writ ref'd).

In *Rubion*, the Texas Supreme Court ruled that the trustee had abused his discretion by refusing to invade the principal of the trust to make payments for the beneficiary's care while she was in a state mental hospital. *Rubion*, at 8. The trustee argued that he was within his discretion to withhold payments of principal because the corpus of the trust should be preserved for her support if she were ever discharged from the hospital, and further, that if the trust corpus were used to pay all of her medical care it would completely destroy the trust. *Id.* Disagreeing, the court held the trustee abused his discretion by withholding the entire principal and the trustee should have determined what amount could have been distributed while still preserving the long-term health of the trust. *Id*. at 9. Again, this underscores the trustee's duty to assess the situation before responding appropriately and with flexibility.

In *Penix*, the appellate court ruled that a trustee was within its discretion to withhold principal *as well as income*, in order to meet the future needs of the beneficiary. *Penix*, at 67. There, the trustee argued successfully that, since the beneficiary was only nine years old, the income produced from the trust was well in excess of what was needed for her current support, and that any excess above the beneficiary's current needs should be held in reserve for emergencies. *Id.* at 64-65. The court found that the trustee was within its discretion, relying heavily on the language granting the trustee the power to carry out the terms of the trust "free from any supervision by the probate or other courts." The court discounted any significance of the word "shall" within the grant. *Id*.

While the results in each case were different from the respective trustee's perspectives, *Penix* and *Rubion* adhere to the same rule. When exercising discretion in a support trust, a trustee should consider both the present and future needs of the beneficiary, as well as other relevant facts and circumstances.

<u>2. Education.</u> Without limiting or expanding provisions, education is considered to include living expenses, tuition, fees, books and other cost of higher education and/or technical training. *See* Restatement (Third) of Trusts § 50 Comment d(3) (2003). As such, education would appear to be easy to define; however, there are many cases demonstrating ambivalence in the courts. A list of common requests classified by corporate trustees and others as fitting within an "education" standard is provided in Appendix "A".

Of course, there are some conflicting decisions for review. See *S. Bank & Trust Co. v. Brown*, 246 S.E.2d 598, 603 (S.C. 1978), finding that education did not include post-graduate studies but was limited to education up to and including a bachelor's degree. *See also*, *Lanston v. Children's Hosp.*, 148 F.2d 689 (2d Cir. 1945), finding that it was within a trustee's discretion to refuse to fund the further education of a beneficiary who was forty-two years old, well-educated and had a "large income." And *see*, *Steeves v. Berit*, 832 N.E.2d 1146, 1152 (Mass. App. Ct. 2005), *abrogated by Halpern v. Rabb*, 914 N.E.2d 110 (2007), adopting a similar definition of "college" in the context of a divorce case; and *Epstein v. Kuvin*, 95 A.2d 753, 754 (N.J. Super. Ct. App. Div. 1953), holding that the term "college education" did not include medical school.

3. Health. The term health typically includes distributions for health as would be implied from a support standard alone. *See* Restatement (Third) of Trusts § 50 comment d(3) (2003).

Currently, the Texas Property Code specifies that a "trustee may *conclusively* presume that medicine or treatments approved by a licensed physician are appropriate for the health of the beneficiary." TPC § 142.005(b)(2) emphasis added. The legislature added this section because trustees administering judicially created trusts found the variety of health-related requests to be daunting. See Tex. H.B. 564, 80th Leg., R.S. (2007) (enrolled version). Difficult decisions for distributions related to health may involve alternative treatments, such as acupuncture or homeopathic remedies, as well as elective medical procedures such as plastic surgery, laser eye surgery, cosmetic dentistry, non-diagnostic full body scans, over the counter lab tests (such as tests for sexually transmitted diseases), tattoo removal, and concierge medicine. Some examples are included in Appendix "A".

In drafting a distribution to cover health, attorneys may want to consider *In re Stonecipher*, 849 N.E.2d 1191, 1197 (Ind. Ct. App. 2006), where the court found that it was not an abuse of the trustee's discretion to refuse to invade trust principal for in-home nursing care for the present beneficiary, given the consideration of her income from other sources, the remainder beneficiaries, and extensive gifting, some of which was made from personal funds.

While it is unusual for a settlor to specify or preclude certain distributions related to healthcare in the terms of a document there are nonetheless some interesting examples. A grantor's desire to exercise control from the grave and micromanage the determination of an appropriate distribution for health is an interesting exception. Some grantors may wish to limit health distributions to situations that do not result from "self-inflicted" problems, as might be caused by substance abuse or risky behavior (See Appendix "B"). Additionally, a grantor may wish to limit all distributions to emergency situations of some sort in order to encourage some behavior or other result. For example, trust funds might be distributable to a grantor's children for emergency health purposes only at any time in which they are married and without a marital property agreement in place. The same trust might further provide that the children may receive full HEMS distributions once their respective spouses have signed the property agreement.

4. General Considerations for HEMS Standards. In certain circumstances, it can be easy to confuse ascertainable standards with unascertainable standards. Typically, one "bad" word will spoil the bunch, which is to say providing for a beneficiary's "health, support and comfort" causes the trust to be subject to an unascertainable distribution standard. In theory, this is because the addition of "comfort" expands the standard beyond the point at which it is ascertainable. However, "support in reasonable comfort" is still considered ascertainable, as is "maintenance in health and reasonable comfort." Treas. Reg. § 20.2041-1(c)(2). Thus, while adding one wrong word will generally taint an otherwise ascertainable standard and render it unascertainable, there are instances where the opposite is true. In practice, however, the prudent drafted should always avoid any verbiage which

might bring the standard into doubt. There is simply nothing to gain by adding such superfluous language.

Furthermore, the examples above leave much to chance where a trustee is in the position of contemplating a potential distribution. For example, what if a beneficiary requests a distribution to pay for yoga classes arguing that they promote the beneficiary's health? Is this what the grantor intended, or did they intend more traditional medicine? Is a course in preparation of reaching the next level in scientology properly payable as education for the beneficiary? What about changes over time? Bloodletting and lobotomies may have once been accepted forms of mainstream medical treatment, but most would say that they are not anymore.

Trustees may find limited comfort in the fact that some distributions may fit into multiple categories. For example, a trustee may not agree that a yoga class is appropriate for a beneficiary's health, but might nonetheless make a distribution by determining that the class is educational.

Still, this problem underscores how drafters should, where possible, provide clarification as to the intent of each grantor. Sadly, drafting attorneys almost never bother to delve into their clients' intent in this regard and many beneficiaries have suffered for it. Unfortunately for them, the law generally denies recompense on the theory that, because those beneficiaries are not themselves clients, they lack the requisite privity to assert any cause of action against the attorneys. Thus, at least for the foreseeable future, trustees must be prepared to deal with minimally descriptive trust documents.

D. Mandatory Distributions. A mandatory distribution requires the distribution of income and/or principal in a manner that does not require the exercise of a trustee's discretion. The most common mandatory distribution requires the distribution of all the trust's income. Qualified terminable interest property ("**QTIP**") trusts are just one example of the kind of trust with a mandatory distribution. IRC § 2056(b)(7) mandates that QTIP trusts distribute income at least annually in order to qualify for the estate tax marital deduction.

As with completely discretionary distribution standards, one might think that a mandatory distribution standard involves little intellectual machination, but that is not always the case. A mandatory trust distribution must be triggered by some event or set of facts because, absent the trigger, the beneficiary's gift would simply be outright (i.e. not in trust). Sometimes these triggers are easy to determine and sometimes they are more difficult.

Consider, for example a trust which allows distributions upon the beneficiary's attainment of, say, thirty years of age. There, the trigger is the beneficiary's thirtieth birthday. This should generally be straightforward, but what if the beneficiary's birthday is not known or in dispute? People lie about their birthdays for a myriad of reasons. If records conflict, problems will ensue for a trustee faced with this distribution requirement. On the other hand, what if the beneficiary is disabled? In that case, an exception will typically allow the trustee to continue holding the trust assets for so long as the incapacity continues. But a corporate trustee who is out of regular contact with the beneficiary may not realize that the beneficiary is incapacitated. This might be the case, for example, if the beneficiary only contacts his or her trust officer in the mornings when he or she is sober.

On the other hand, consider the QTIP trust which requires annual income distribution. What is income and how is it determined? As it happens, this is a more complicated question than most might think. TTC § 116.002(4) defines trust income as "money or property that a fiduciary receives as a current return from a principal asset." Trust income differs from both financial accounting income and taxable income. Unlike financial income and taxable income, which may be based on accrual principles, trust income generally is computed on a cash basis. Also, the UPIA applies in determining trust income. Not only does the UPIA provide rules for allocating between income and principal, it also authorizes a trustee to adjust between the two when certain conditions are met. TTC § 116.005. Thus, the seemingly simple task of distributing income to a beneficiary entails far more than one might initially think.

VI. Modifying Language. In addition to the terms described above, trust instruments typically include modifying language which impacts how distributions are to be made. These complicate the problem of interpreting trust language.

In many ways, these modifiers are like the wheels on the Enigma machines which the Germans developed to scramble messages for coded radio communication in World War II. The Enigma machine looked and functioned much like a typewriter, except that inside, it had several disks with complex circuitry. As an uncoded message was entered by the operator, the disks would rotate, thereby changing the internal circuitry and randomizing the code. As each letter of the original message was entered, the changing circuitry would indicate a seemingly random letter for coded transmission. In other words, "a" might be coded as "f" in one instance and then "g" the next. As the Germans added more disks to the machine, the possible letter combinations increased exponentially, making the code that much more difficult to break.

Modifiers such as those discussed below act like extra wheels in the Enigma machine. That is to say, changing the modifiers can lead to different, and seemingly maddening, results with regard to the same external facts and distribution language. Even if a trustee can "decode" the concepts of health, education, maintenance and support, the modifiers can cause him or her to abide by separate and functionally different rules for each set of modifiers.

It is worth noting that this modifier concept alone makes it very difficult to find case law on point for a given scenario because it creates too many permutations. Even in the unlikely event that a case is on point with regard to external facts and the distribution standard at issue, a single, seemingly innocuous, modifier can completely alter the result, rendering the case distinguishable as president.

Still, some guidance is available and the following are some (but certainly not all) such modifiers that trustees should consider:

A. "Shall" v. "May". The term "may" implies discretion. *See* Texas Government Code § 311.016. If a trustee *may* make distributions for HEMS, he or she may, for example, determine that a beneficiary needs a distribution for a mortgage payment and still determine properly that the distribution should be withheld. On the other hand, the term "shall" means that something is mandatory. *Keisling v. Landrum*, 218 S.W.3d 737, 742 n.3 (Tex. App.—Fort Worth

2007, pet. denied); *Roberts v. Squyres*, 4 S.W.3d 485, 489 (Tex. App.—Beaumont 1999, pet. denied). If the same trustee *shall* make distributions for HEMS, the distributions becomes compulsory and enforceable upon his or her determination that the beneficiary needs it for the mortgage payment, assuming, of course, that the trust instrument does not somehow provide otherwise. In practical terms, however compelling a distribution in such a situation is difficult for a beneficiary because of the challenge presented by proving the trustee's determination. But trustees do sometimes leave evidence of their findings. For example, an individual trustee may have discussed their determination with a friend, spouse or family member of the beneficiary. Likewise, a corporate trustee may make such determinations by committee, for which there are discoverable meeting notes.

On a more theoretical front, a "may" modifier effectively creates an upper limit to permissible distributions. A trustee who *may* make distributions for HEMS, might never make any distribution at all. On the other hand, a "shall" modifier triggers every distribution that falls within the standard. Because it therefore makes the related distribution standard more ascertainable, a "shall" standard is preferred when tax is a prime consideration. Similarly, a "may" modifier subjects a trustee to attack on multiple fronts, creating a catch-22. In the above example involving the trustee who may make a distribution to cover the beneficiary's mortgage payment, if the trustee makes the distribution, the beneficiary will be satisfied (at least in theory), but the remainder beneficiaries are likely to complain. On the other hand, if the trustee withholds the distribution, the beneficiary will complain but the remainder beneficiaries will be satisfied (again, at least in theory).

B. Accustomed Standard of Living. Trust instruments frequently direct trustees to allow beneficiaries to maintain their particular standard of living. The standard of living of the beneficiary is usually determined as of the time of the grantor's death or when the trust became irrevocable. The implication that support is to be interpreted at that time is in keeping with interpreting the trust according to the settlor's intent. Even without specific language, a distribution for support is to be made according to the beneficiary's station in life. Restatement (Third) of Trusts § 50 Comment d(2) (2003). However, whether this accustomed style is expressed or implied, a lower level of distributions may be justifiable if the trust estate is modest relative to the probable future needs of the beneficiary. *Id*. *See also*, *Estate of Miller*, 230 Cal.App.2d 888, 41 Cal. Rptr. 410 (1964), appeal after remand 259 Cal.App.2d 536, 66 Cal. Rptr. 756 (1968) (the trustee is to maintain the beneficiary "in the social and economic position in which the latter had been living at the time of the creation of the trust, and give him the comforts and necessities to which he had become accustomed and not merely ... the bare necessities of life.") A pair of New Hampshire cases treated references to such words as "needs," "necessities," and "necessary" as the substantial equivalent of support in the beneficiary's accustomed manner, rather than being limited to what is essential; *Amoskeag Trust Co. v. Wentworth*, 99 N.H. 346, 111 A.2d 198 (1955), and *Orr v. Moses*, 94 N.H. 309, 52 A.2d 128 (1947). Compare *Huntington National Bank v. Aladdin Crippled Children's Hosp. Ass'n*, 108 Ohio App. 234, 157 N.E.2d 138 (1959); and *Wright v. Trust Company Bank of Nw. Ga*., 260 Ga. 414, 396 S.E.2d 213 (1990).

C. Other Sources of Support. When making discretionary distributions, a trustee may or may not be obligated to consider the beneficiary's other resources. If the settlor has provided guidance in this area, the settlor's intent will control. Also, all rules are tempered by the grantor's intent as reflected in the overall purpose of the trust. *See* Restatement (Third) of Trusts § 50 Comment e (2003).

If the trust document is silent, a trustee should generally consider other resources but he or she may have some discretion in determining the impact of the resources on the distributions to be made from the trust. *Id*. The consideration of other resources, however, involves balancing of the intent of the grantor regarding the treatment of the beneficiary and the other purposes of the trust. For example, even if a trust instrument directs that trust assets are to be distributed liberally, withholding distributions may be appropriate where the beneficiary is facing creditor problems and the intent behind the trust was protecting him or her from creditors. Conversely, where distributions are only to be made sparingly, a trustee might still properly distribute trust income to a married beneficiary if applicable community property laws would cause that income to taint otherwise separate trust corpus and render it subject to attack in the event of divorce.

The Restatement, however, sets out the following two qualifications to the general rules:

> One qualification is that, if the discretionary power is one to invade principal for (or to distribute additional income to) a beneficiary who is entitled to all or a specific part of the trust income, or to an annuity or unitrust amount, the trustee must take the mandatory distributions into account before making additional payments under the discretionary power. Where a beneficiary is entitled to payments from another trust created by the same settlor (e.g., nonmarital and marital deduction trusts for a surviving spouse), or as a part of coordinated estate planning with another (such as the settlor's spouse), required distributions from the other trust—and the purposes of both trusts—are to be taken into account by the trustee in deciding whether, in what amounts, and from which trust(s) discretionary payments are to be made.
>
> Another qualification is that, to the extent and for as long as the discretionary interest is intended to provide for the support, education, or health care of a beneficiary ... for periods during which a beneficiary probably was not expected to be self-supporting, the usual inference is that the trustee is not to deny or reduce payments for these purposes because of a beneficiary's personal resources.

References to 'other resources' and similar terms are normally understood to include the beneficiary's other income, but not principal available to the beneficiary. See *Keisling v. Landrum*, 218 S.W.3d 737 (Tex. App.—Fort Worth 2007, pet. denied). In the *Keisling* decision, the appellate court held that a beneficiary was not required to exhaust all her assets, other than a house and car, in order to receive distributions from a trust that required ("shall") the trustee to distribute trust income when the beneficiary's "own income and other financial resources from sources other than this trust [were] not sufficient" to maintain her standard of living. See Id. at 740. In reaching its decision, the appellate court found that "other financial resources" were limited to "income and other periodic receipts, such as pension and other annuity payments and court-ordered support payments." *Id*. at 743 citing Restatement (Third) of Trusts § 50 Comment e(2) (2003).

The forgoing notwithstanding, the principal of the beneficiary may yet be relevant, depending on the terms and purpose of the trust. Once again, the determination of what resources to consider includes (i) the settlor's relationships both to the current beneficiary and the remainder beneficiaries, (ii) the liquidity of the beneficiary's assets, and (iii) the purposes of the trust, both tax and non-tax. *Id*.

D. Support v. Supplement? Another particularly vexing problem for a trustee is determining whether a given grantor intended to support a beneficiary or merely supplement their lifestyle. As discussed in more detail below, trust language will sometimes restrict distributions for "nonproductive" beneficiaries (or even prohibit them altogether). Also, a trustee who is affirmatively directed to take other sources of support into consideration is likely to have intended that the trust at issue merely supplement where needed rather than being used as the beneficiary's primary source of support. Although rules of construction mandate a presumption that both the grantor and his or her drafting attorney were both familiar with and understood the terms of the trust instrument at execution, from a practical standpoint, seasoned practitioners have come to know that this is seldom the case.

The problems are that (i) people's opinions differ significantly in this regard and (ii) slightly different standards can result in completely opposite results for various beneficiaries. For example, a testator may create a trust for his children and further issue with the intent of preserving assets in the family for as long as possible, providing supplemental support as needed and as available. But another testator might establish a very similar trust with the intent that the children enjoy the benefits thereof, even if that means the grandchildren do not eventually inherit. And yet, these two, very different clients, might have used the same Will form from a single attorney. In the latter example, it may be the testator's intent that his children provide for further descendants through their own estate planning. Experience has shown that clients really do "fall all over the map" in this regard, so it is extremely difficult for trustees to decipher intent from the four corners of an instrument, particularly in the modern world of endless boilerplate language.

From a drafting perspective, it may behoove a grantor to specify how distributions are to be made by using language such as "generously" or "adequately." Such language can be used in conjunction with a HEMS or other ascertainable standard without negatively impacting the tax result. See. Restatement (Third) of Trusts § 50 Comment d(3) (2003) ("On the other hand, stronger language, such as "generous" support, may permit and encourage the trustee to allow, and may even require, some reasonable enhancement of the beneficiary's lifestyle; but it falls short of a "happiness" standard…in that the benefits still must normally be support-related.")

E. Legal Duty to Support. Many trust instruments will contain a prohibition on a trustee acting in such a manner as to relieve themselves of a legal duty under applicable law. Such language, which is sometimes referred to as an "Upjohn" clause after the case of *Upjohn v. U.S.* (30 A.F.T.R. 2d. 72-5918 (W.D. Mich 1972)), is most often, but not always, intended to prohibit a trustee from using trust assets to pay for anything which he or she is obligated to provide to his or her child as a matter of law and regardless of the trust.

Under Texas law, a parent has a legal obligation to support his or her minor children. This includes the duty to provide a child with clothing, food, shelter, and medical and dental care. *See* Texas

Family Code § 151.001; *See also Daniels v. Allen,* 811 S.W.2d 278 (Tex. Civ. App.—Tyler 1991, no writ) *overruled on other grounds, Tucker v. Thomas*, 419 S.W.3d 292, 299 (Tex.2013) (parent has obligation to support his minor children and provide necessities). A parent's obligation of support exists without the need for a court order. *See In Interest of A.D.E.,* 880 S.W.2d 241 (Tex. Civ. App.—Corpus Christi 1994, no writ) (father has duty to support child, even when not ordered by trial court to make payments of support); *Boriack v. Boriack,* 541 S.W.2d 237 (Tex. Civ. App.—Corpus Christi 1976, dism'd) (mother, as well as a father, has duty to support her minor children).

The prohibitive language of an Upjohn clause typically comes into play in one of two scenarios: Either a grandparent has established a trust for the benefit of a minor grandchild and named the intervening child as trustee, or a spouse has established a trust for the benefit of a minor child and named the other spouse as trustee. In either case, the trustee is the parent of the beneficiary and owes the beneficiary a legal duty of support because the beneficiary is a minor.

To be certain, however, the prohibition is not limited to situations where the trustee is also the parent of a minor beneficiary. The legal duty might arise if the trustee is also the guardian of an adult, but otherwise incapacitated beneficiary. Spouses also have support obligations to each other which can come into play. In Texas " Each spouse has the duty to support the other spouse and [a] spouse who fails to discharge the duty of support is liable to any person who provides necessaries to the spouse to whom support is owed." Texas Family Code § 2.501(a) & (b). In any event, the duty referenced in an Upjohn clause has nothing to do with the trustee/beneficiary relationship, so it may be better to say that the prohibition is invoked where an individual who happens to be trustee of a given trust also owes a legal duty of support to the individual who happens to be a beneficiary of the trust.

Conversely, if the beneficiary is not a minor or the spouse of the trustee and no other relationship exists to create a legal duty of support, the prohibition will not apply. Thus, corporate and unrelated trustees need not concern themselves with this particular legal landmine. In fact, many trust instruments provide for the appointment of a "special trustee" who is free from this constraint (and often others as well). Typically, these special trustees can be appointed on a temporary basis in order to do something which the existing trustee is prohibited from doing, such a make a support distribution. However, care must be taken when drafting language for the appointment of a special trustee. Without certain protections, the special trustee might be determined to be merely an agent of the existing trustee or the entire arrangement may be interpreted as a sham, either of which will likely lead to adverse consequences.

The legal duties prohibition is meant as a cure to two tax problems. First, if a grantor creates a trust for the benefit of a minor child or a dependent spouse, any income of the trust distributed for the support of the minor child or dependent spouse is treated as taxable income to the parent/spouse. Treas. Reg. § 1.677(b)-1. Furthermore, § 2036 of the IRC may cause inclusion of the entire corpus of a given trust in the estate of its trustee if that trustee has the power to discharge a legal obligation. Importantly, the trustee does not have to actually discharge his or her obligation. The mere power to do so is enough to cause inclusion. *Estate of Prudowsky v. Comm'r*, 55 T.C. 890 (1971); *Estate of Pardee v. Comm'r*, 49 T.C. 140 (1967). This is why some affirmative mechanism is needed to deny the trustee such power. In fact, some states have gone so far as to codify the prohibition. See North Carolina Uniform Trust Code § 36C-8-814(b)(3).

Legal support prohibitions are often contained in the boilerplate of a trust instrument which individual trustees are unlikely to bother reading and less likely to understand. Catching a trustee off-guard in this situation can be all too easy and seasoned practitioners therefore know to discuss such provisions with their clients in terms that are relevant to a given scenario. Litigators who specialize in trust administration issues also know to look for these clauses and point out violations when doing so might further a client's case. If a trustee makes even a small distribution in violation of an Upjohn clause, he or she has violated his or her fiduciary duty and may be subject to reprimand, in the form of repayment or removal from the trusteeship. This underscores the point that trustees, and in particular individual trustees, should maintain a close relationship with their attorneys and other professional advisors.

Fortunately for trustees, the legal obligations referenced by an Upjohn clause are typically very narrow. Nonetheless, they raise some interesting issues. Understanding where to draw the line between what is and what is not permitted can be a daunting task. For example, a parent must provide a child with food clothing and shelter, but this obviously does not mean steak dinners, designer labels and a swanky uptown apartment with servants and a view. The trustee must determine where to draw the line and he or she is well-advised to seek legal counsel when doing so.

Although the distributions prohibited by an Upjohn clause are narrow in scope, there is very little legal precedent for determining exactly what is prohibited and what is not. Just as with the questions trustees face regarding HEMS distributions themselves, reported cases are rare, and those that get reported will generally be distinguishable because of underlying differences in relevant facts, so the best course of action is to proceed conservatively and with an abundance of caution. For example, many individual trustees who are prohibited from discharging a legal duty of support will want to use their children's or spouses' trust assets to support their family lifestyle, which is often luxurious. Families who set up such trusts tend to have expensive tastes and their lifestyle generally exceeds by far their base line duty of support.

In the absence of legal precedent to the contrary, more conservative guidelines are advisable. Thus, where an Upjohn clause applies, the following expenditures are best avoided:

- Rent or any similar payments
- Home improvements or decor
- Homeowner's or renter's insurance
- Basic utilities for the home
- Property taxes
- Clothing
- Health insurance
- Non-elective healthcare
- General dentistry
- Dentures
- Optometry

- Prescription glasses
- Food

On the other hand, there a number of expenses which do not fall within support obligation, so trust assets should be properly expendable on the following:

- Cell phones
- Pets
- TV, cable or satellite service
- Internet service
- Personal accessories
- Automobiles
- Auto insurance
- Private school education (because public school education is provided free of charge by the state)
- Extracurricular activities
- Trips and vacations
- Elective health care
- Orthodontics

VII. <u>Other Considerations.</u> In addition to a trust's terms and applicable law governing trust administration in general, trustees frequently face external factors worth consideration. A few (but, again, not all) are discussed below.

A. Determining a Beneficiary's Needs. A threshold issue for any independent trustee will be to determine whether a given beneficiary, in fact, needs a contemplated distribution. Does the necessity for such a determination mean that the trustee must (or may) require access to bank accounts, tax returns and other personal information? Generally, the answer is no, but there are exceptions. The key to this question is reasonableness. According to the Restatement (Third) of Trusts § 50 Comment e(1) (2003):

> The trustee has a duty to act in a reasonable manner in attempting to ascertain the beneficiary's needs and, under the usual rule of construction, other resources that may be appropriately and reasonably available for purposes relevant to the discretionary power. The trustee generally may rely on the beneficiary's representations and on readily available, minimally intrusive information requested of the beneficiary. This reliance is inappropriate, however, when the trustee has reason to suspect that the information thus supplied is inaccurate or incomplete.

Thus, a trustee must obtain reliable information from a beneficiary in order to make informed, reasonable distribution decisions. The trustee should solicit information from the beneficiary regarding his or her financial needs, wants, resources, and standard of living. Appropriate documentation will vary from case to case, but generally will include items such as:

- Income and cash flow information
- Financial statements
- All trust instruments under which the beneficiary has a right to receive or request a distribution
- Income tax returns
- Tuition statements or estimates and agreements relating to the beneficiary's education;
- Receipts or invoices as to any amounts to be reimbursed
- Information regarding the beneficiary's employment status and efforts to obtain employment
- Status of the beneficiary's housing, transportation and any other relevant information regarding support
- Status of the beneficiary's medical insurance and anticipated health care needs
- Debts of the beneficiary and status of any litigation related thereto
- Standing with regard to taxes, particularly where the beneficiary owes back taxes or penalties
- Notification of any significant changes in any beneficiary's housing, education, development or medical needs
- History of assistance **previously supplied by the grantor to the beneficiary**

Admittedly, information gathering in this regard may be more art than science. Some trustees desire to obtain extensive information from the beneficiary to "paper" their file, however, this can lead to feelings of ill-will and invasion of privacy by the beneficiary. Other trustees go to the opposite extreme and request no information. This can lead to claims of breach of fiduciary duty against the trustee by other beneficiaries who may eventually request that the trustee justify his or her prior distributions.

Furthermore, a trustee should be prepared to do more than simply approve or deny a distribution request. Communicating with a beneficiary about the merits of his or her request (as well as the requests of other beneficiaries) may avoid future problems. If, for example, a distribution can only be made by liquidating assets and triggering a severely adverse tax consequence, the better trustee will be happy to take as much time as may be needed to explain to the beneficiary why the distribution would do more harm than good.

B. Multiple Beneficiaries. Trusts will almost always have more than one beneficiary and the trustee is always tasked with the duty of balancing their various rights. A trust instrument that categorizes certain persons as "primary" or otherwise preferred beneficiaries is easier for the trustee to administer, and so-called "pot trusts" (i.e. trusts with more than one current beneficiary) make the trustee's work more difficult.

However, when no such intent is expressly provided in the trust instrument or implied by its terms, it cannot be otherwise inferred, and the Trust Code provides that a trustee must act impartially as to all beneficiaries. Specifically, TTC § 116.005(b) provides as follows:

> In exercising the power to adjust under Section 116.005(a) or a discretionary power of administration regarding a matter within the scope of this chapter, whether

> granted by the terms of a trust, a will, or this chapter, a fiduciary shall administer a trust or estate *impartially*, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this chapter is presumed to be fair and reasonable to all of the beneficiaries. (Emphasis added).

In addition, TTC § 117.008 provides:

> If a trust has two or more beneficiaries, the trustee shall act *impartially* in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. (Emphasis added).

Note that the Restatement suggests inferences with regard to prioritizing multiple beneficiaries. These inferences are generally in conflict with the statutes cited above, so the statutes should control whenever Texas law is to be applied. However, situations might arise where ambiguity in the trust document make the Restatement relevant, despite Texas law.

Another problem exists where a beneficiary has minor children. As discussed above, parents are legally obliged to provide their children with certain basic necessities like food, clothing, housing and medical care. *See* Texas Family Code § 151.001. This duty of support (now owed by the beneficiary, rather than the trustee, as discussed above) must be considered when making distributions from a trust. See *Gray v. Bush*, 430 S.W.2d 258 (Tex. Civ. App.—Fort Worth 1968, ref. n.r.e.) (in the absence of financial necessity to do so, mother was not authorized to invade funds provided by trust that was separate estate of children and was created for purpose of prescribed support payments).

Unfortunately, no Texas decision has provided clear guidance as to the extent to which a trustee must consider a parent/beneficiary's obligation of support. But, the decision in *Deweese v. Crawford* provides some guidance in this area. 520 S.W.2d 522 (Tex. App.—Houston [14th Dist.] 1975, writ ref'd n.r.e.) *overruled on other grounds by, Cherne Indus., Inc. v. Magallanes*, 763 S.W.2d 768 (Tex. 1989). In *Deweese*, the court considered a demand by the parents of minor children on a third party to distribute social security benefits the third party was receiving as "trustee" for the minor children. The court noted that the parents are principally responsible for the minor children's support and maintenance. Therefore, only when it was shown that the parents were unable to meet their obligation to properly support and maintain the children was the trustee required to distribute funds for their benefit. Until the parents established they were unable to provide the requisite support, the court held that the trustee could appropriately choose to accumulate the benefits.

In reaching its decision, the *Deweese* court noted that issues regarding distributions of social security benefits are governed by federal law. Therefore, while it is not certain that the court's decision would have been the same if the case involved a traditional trust instead of a trust created to administer federal benefits, the analysis and results should be the same. Furthermore, the decision in *Deweese* is consistent with Texas courts historical hesitancy to interfere with the reasonable exercise of a trustee's discretion.

Not surprisingly, however, beneficiaries will often seek or use distributions to support their family. This raises the issue of whether a trustee may take into account the needs of a beneficiary's family, or his or her obligation of support when making distributions.

Regardless of the grantor's intent, however, a trustee of a support or discretionary trust may be required to make distributions for support of a beneficiary's child when the beneficiary has been ordered to make child support payments. The extent of the payments depends on how much discretion the trustee has over making distributions.

A trustee subject to a HEMS distribution standard may be required to make distributions for the support of the beneficiary's child. *See* Texas Family Code § 154.005 ("The court may order the trustees of a spendthrift or other trust to make disbursements for the support of a child to the extent the trustees are required to make payments to a beneficiary who is required to make child support payments as provided by this chapter."). A trustee of a purely discretionary trust may only be ordered to make child support payments for the benefit of the child from income but not principal. *See* Id. ("If disbursement of the assets of the trust is discretionary, the court may order child support payments from the income of the trust but not from the principal.")

A condition precedent to such an obligation, however, is that the beneficiary has been ordered to pay child support. *See Kolpack v. Torres*, 829 S.W.2d 913 (Tex. Civ. App.—Corpus Christi 1992, writ denied); *See also Matter of Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.—Texarkana 1976, no writ) (trial court, instead of ordering trustees to pay to wife a certain sum per month for benefit of child, should have first ordered trust beneficiary parent to make child support payment or payments, after which it could have then ordered trustees to make disbursements for support of child). In *Kolpack*, the appellate court held that a trial court could not obligate a trustee of a discretionary trust to make disbursement of trust income directly to a beneficiary's child until it first imposed that obligation on the parent. *Kolpack,* at 916.

C. Encouraging or Discouraging Behavior: The "Dead Hand". Although somewhat less common than in years past, the occasional grantor still intends to encourage behavior they view as "good" and discourage what they consider to be "bad" behavior. This concept has come to be known as the "Dead Hand" principle because it is as if a testator's or grantor's cold, dead hand reaches out of the grave to "guide" the behavior of another person, typically a young descendent who may subscribe to somewhat more modern moral standards.

The Dead Hand principle, raises significant issues because, on the one hand, grantor intent is to be respected. See Restatement (Third) of Property: Wills and Other Donative Transfers (2003) at § 10.1 (The Donor's intention is given effect to the maximum extent allowed by law). After all, transferred property, whether at death or before, initially belongs to the donor and he or she is generally free to do with it whatever he or she wants.

And yet, on the other, so too must we respect a beneficiary's freedom to choose his or her own path in life. Therefore, certain rules of law override grantor intent. These typically relate to matters such as spousal rights, creditor's rights, unreasonable restraints on alienation, the promotion of divorce, restrictions involving categories of people such as race or sex (and now probably also sexual orientation), and the promotion of illegal activity.

Indeed, this topic has been long-debated. In his 1880 book, *The Dead Hand,* Arthur Hobhouse included the following:

> "A clear; obvious, natural line is drawn for us between those persons and events which the Settlor knows and sees, and those which he cannot know and see. Within the former province we may push his natural affections and his capacity of judgment to make better dispositions than any external Law is likely to make for him. Within the latter, natural affection does not extend, and the wisest judgment is constantly baffled by the course of events... What I consider to be not conjectural, but proved by experience in all human affairs, is, that people are the best judges of their own concerns; or if they are not, that it is better for them, on moral grounds, that they should manage their own concerns for themselves, and that it cannot be wrong continually to claim this liberty for every Generation of mortal men." Hobhouse, Arthur, *The Dead Hand*, 188, 183-185 (1880).

In practice, language forbidding distributions to beneficiaries who fail drug or alcohol tests are generally acceptable, as are requirements that beneficiaries make themselves somehow productive in society. Similarly, conditional payments for things like higher education are almost always perfectly valid.

Perhaps unsurprisingly, the case law in this particular area—that is, the place where disputes seem most precipitous—seems to center around personal relationships. For example, language discouraging a beneficiary from marrying someone of a particular race is verboten! Additionally, terms that encourage divorce are typically considered to be against public policy, particularly in conservative states such as Texas. *Southwestern Bell Tel. Co. v. Gravitt*, 551 S.W.2d 421 (Tex. Civ. App.—San Antonio 1976, writ denied).

Sometimes, however, a seemingly impermissible requirement will nonetheless be permitted if the proper intent can be found. As Professor Gerry Beyer put it:

> As a general rule, conditions that a beneficiary must be divorced to receive a benefit have been found to be contrary to public policy. Courts, recognizing the importance of the family unit in an organized, harmonious society, seek to protect the familial bond from injurious outside influences. In Texas, however, a provision requiring divorce as a precursor to receipt of a benefit was upheld where the testator's dominant motive was to provide support for the beneficiary if the beneficiary became divorced or widowed. When deviating from the norm, it is necessary that proper intent, i.e., the intent to provide support if the beneficiary loses the support of a spouse, be shown and that the provision be drafted carefully to demonstrate this good intent. 9 Texas Practice Series § 21.4 (3d Ed.), citing *Hunt v. Carroll*, 157 S.W.2d 429 (Tex. Civ. App.—Beaumont 1941, writ ref'd).

A particularly interesting case was that of *Shapira v. Union National Bank*. In Shapira, a testator made a large bequest to his son on the condition that the son marry "a Jewish girl whose parents were both Jewish" within seven years of the testator's death. 39 Ohio Misc. 28, 315 N.E.2d 825. Of course, the son failed to meet the condition, so he brought suit to have it invalidated. The primary issues of the case were whether the condition was (i) against public policy and (ii) reasonable at to the son. Perhaps surprisingly, the court in that case upheld the condition, finding that it was neither against public policy nor unreasonable. The court noted an overwhelming majority of case law supporting such bequests and was unwilling to change the law. It noted that the bequest did not prohibit the son's marriage. That would have been against public policy. Rather, said the court, the condition sought to promote Jewishness and, much to the son's dismay, allowable. *Id.*

In practice, one wonders if the rule in Shapira would stand (or should) today. Modern thinking might tend to view the condition of marrying someone within a given religion as being an unreasonable incursion on one's religious and marital freedom. Additionally, the case raises practical issues. For example, how should one administering the estate of Dr. Shapira determine whether or not a person was really Jewish? What if they were a convert or a member of Jews for Jesus?

Additionally, the Dead Hand principle poses the significant practical problem. Long-term trusts require flexibility to function over time and the Dead Hand necessarily limits flexibility. The world changes after we die and the future is unpredictable. What happens when a trust, which was meant to promote healthy living, conditions distributions on a school-age beneficiary's consumption of a Dr. Pepper every day at 10am, 2pm, and 4pm and then the beneficiary's school, now aware of the mal-effects of their consumption, bans sodas on school grounds? Conversely, a trust may properly discourage the unhealthy habit of smoking cigarettes, but what happens when the beneficiary takes up e-cigarettes?

The long and short is that Dead Hand provisions cause problems all around. For the trustee stuck with conditional distributions, advice and counsel should be sought whenever a distribution is contemplated, particularly where personal matters are at issue. Similarly, drafters must take extreme care in drafting Dead Hand provisions. First, they must be carefully crafted so as to be enforceable in any event. Second, they must straddle a middle ground of flexibility and rigidity because being too far on either side of the spectrum will thwart the grantor's intent. If the provision is too flexible, it will have no teeth and if it is too rigid, the beneficiary may be able to work around it.

D. Taxes. Traditionally, taxes have been a significant (if not the primary) motivating force behind estate planning as an industry. Therefore,

> It is normally appropriate, and often necessary, for a trustee to take tax considerations into account in determining what discretionary distributions to make ... An often more troublesome question is whether distributions can properly be made purely for tax reasons to selected beneficiaries under a flexible power ... An appropriate answer may require careful consideration of the other resources of the various beneficiaries, as well as their income-tax and estate-tax positions, the tax

circumstances of the trust, and the underlying purposes of the settlor. Restatement (Third) of Trusts, Comment e(5) (2003).

Note that this language comes from 2003, when tax rules were very different than they are now. With the applicable exclusion amount now over $20 million for a married couple, transfer tax (i.e. estate, gift and generation-skipping transfer tax) is far less of a concern, and capital gains tax is an increasing problem. Under traditional estate planning techniques (i.e. those from 2012 and before), married couples would seek to gain an estate tax advantage by implementing a "credit shelter" or "bypass" trust as part of their estate plan. Such a trust was generally available for a surviving spouse, but, because it would not be counted as part of his or her gross estate for transfer tax purposes, its assets would not receive a step up in basis under IRC § 1014. Thus, taxpayers were encouraged to endure the expense of capital gains tax (really, it was their children who endured it) in order to lessen their exposure to the more expensive estate tax. Although this made sense in a world where the applicable exclusion amount was $1 million, or $2 million or even $3.5 million, the current exclusion exceeds the value of all but a small percentage of estates in America. Therefore, traditional planning may subject a taxpayer to capital gains tax even though no estate tax would apply, and many trusts which were primarily designed to lessen the amount of overall tax borne by their respective families are now likely to cause increased taxation.

The trustee's fiduciary duty in this respect remains unclear, but it underlies the point that he or she should, in any event, take into consideration the tax impact that distributions from a particular trust will have. Whereas this had been relatively easy when estate tax was such an overwhelming concern, the best approach now appears to be more holistic and therefore complicated.

Another example might be where trusts are created for children and grandchildren, some of which are grandfathered or otherwise exempt from generation-skipping taxes and others of which are not. The trustee in this situation should obviously strive to make distributions to the children's generation (as well as distributions to the grandchildren for tuition or medical expenses that will also be protected from those taxes) from the non-exempt trust, while preserving the exempt trust (where possible) for the grandchildren and younger beneficiaries. Likewise, a trustee should generally make distributions to a surviving spouse from a marital trust that will be included in the spouse's estate, before making distributions to the spouse from a bypass or credit shelter trust.

Thus, once again, trustees are well-advised to seek out professionals who know and understand these rules.

VIII. <u>Best Practices; A Conclusion of Sorts.</u> So, where does all of this leave us? Well, just as Dutch, Dillon, Blaine and the rest could not see the Predator, so too does the ascertainable standard remain elusive to trustees and their advisors. But the cloaking device should be a little less hazy by now. At the very least, we should now be able to discern a few general rules to avoid suffering at the hands of "*el cazador trofeo de los hombres*" (the demon who makes trophies of men).

A. Be Flexible. Flexibility is a hallmark of the American trust. It is at once the trust's greatest asset and its greatest hindrance. Beneficiaries have problems that they want solved and they may not realize that a particular solution might come in any form other than a check.

Particularly where there are various, competing interests to consider, the trustee should consider alternate avenues of satisfying a beneficiary's need as expressed by a distribution request.

Loans are a fine example of this principle. A trustee may consider loaning funds to a beneficiary for certain purposes instead of making a distribution. In a multiple beneficiary or "pot" trust this is sometimes seen as a way to satisfy a beneficiary's needs, without giving one beneficiary "too much" of the trust estate. For a trust that will divide into shares at some date (i.e., at a surviving spouse's death, or when the youngest child reaches a certain age), it is sometimes intended that the loan will simply be offset against the beneficiary's ultimate share. Yet, if funds are needed to serve more pressing needs of another beneficiary, the loan may be called in by the trustee.

Still, the trustee should not throw caution to the wind when making loans to beneficiaries. As a threshold matter, the trustee must first determine whether the trust instrument permits loans to beneficiaries, and if permitted, the trustee should determine whether interest must be charged to the beneficiary. If permitted, the trustee should evaluate the security for the loan and the beneficiary's ability to repay the loan. Too often decisions to loan funds to beneficiaries in fact become decisions to make a distribution, because the beneficiary is unwilling or unable to repay the loan. The trustee who loans trust funds to a beneficiary must be prepared to deal with default, if it occurs. All loans should be properly evidenced by a note, with any appropriate security agreements executed as well.

To the extent permitted, interest-free loans may create a balance between a secondary or tertiary beneficiary's desire to enjoy the trust's benefits while protecting the superseding interest of a primary beneficiary. If an interest-free loan is made, however, the trustee should note that the forgone interest is itself a distribution from the trust. On the other hand, interest that is paid by the beneficiary will be taxable to the trust as ordinary income.

Other ideas for flexibility might include buying property instead of making distributions for its rental, or vice versa. For example, if a beneficiary needs housing for college, the trustee may consider buying a condo or house in which the beneficiary can live. This might generate rental income for the trust as well as capital gain as the property increases in value.

On the other hand, if a beneficiary prefers to drive a new car every few years, it may make more economic sense for the trust to lease a vehicle (or distribute cash to the beneficiary so he or she can make lease payments). Of course, this will involve an analysis of the trust's terms and economic status, but even if trust assets are such that it can easily afford to buy a new car every couple of years, the trustee should not frivolously agree to an uneconomical arrangement.

B. Establish a Process and Follow it. Finally, as stated above, the exercise of discretion, whether absolute or under an ascertainable standard, involves reasonableness on the part of the trustee, but reasonableness is itself amorphous. Clearly, though, a trustee cannot act reasonably if the trustee does not act at all. Therefore, almost any procedure for evaluating distributions will be better than none. A trustee that establishes a process for determining which distributions are to be made is less subject to challenge than a trustee distributing far less or far more with no process in place. Trustees that can present a well thought out and reasonable decision-making process are often victorious, even if their decisions appear to contradict the language of a trust (*Penix v. First National Bank of Paris*, 260 S.W.2d at 63), or the clear intent of the grantor, (*Coffee v. Rice*, 408 S.W.2d 269 (Tex. Civ. App.—Houston 1966, writ ref'd n.r.e.)). The trustee should maintain contemporaneously prepared documents identifying all information considered, copies of documents considered, and other steps involved in the investigation conducted by the trustee in making the decision.

It is an abuse of discretion for a trustee to fail to exercise judgment at all, no matter how broad the standard. Scott on Trusts § 187.3. The trustee's discretion must be "reasonably exercised to accomplish the purposes of the trust according to the settlor's intention and his exercise thereof is subject to judicial review and control." *Id. at* §§ 187.1-3; *Kelly v. Womack*, 268 S.W.2d 903, 907 (Tex. 1954); *Powell v. Parks*, 86 S.W.2d 725 (Tex. 1935); *Davis v. Davis*, 44 S.W.2d 447 (Tex. Civ. App.—Texarkana 1931, no writ).

The importance of reading and re-reading the trust instrument with regard to distributions cannot be overstated. The trust instrument should be read before the trustee agrees to serve, and also at each yearly review. In addition, the trustee should review the distribution provisions of the trust at any time a distribution request is being evaluated. The trustee should not only review the portion of the trust which actually grants the distribution powers, but should also review the entire trust instrument for other statements and clauses (i.e. modifiers) which indicate the settlor's intent with regard to distributions and the relative priority or preference to be given to different beneficiaries.

When reviewing the merits of a given distribution request, a trustee may wish to note (and record) some or all of the following:

- Specifics of the beneficiary's request, including amount, purpose and method of the distribution (i.e. direct payment to third party, cash distribution to beneficiary, loan, etc.)
- Date the distribution is needed
- Other distributions to all beneficiaries to date
- Financial situation of all beneficiaries
- Alternatives to the requested distribution
- Anticipated distributions to all beneficiaries
- Description of distribution standard, including any modifiers, and reasons why the distribution would fit within such standard (or not)
- Description of beneficiary's lifestyle or standard of living
- Whether the distribution is requested from income or principal
- Tax impact to the primary beneficiary
- Tax impact to the trust and other beneficiaries
- Other assets and sources of income available to the beneficiary
- Beneficiary's obligations to family and/or obligations of family to the beneficiary
- Any other relevant factors

C. Maintain Open Lines of Communication. Once the trustee has made his or her review, the decision should be communicated to the beneficiary promptly and in writing. Furthermore, the trustee should be willing to discuss the decision with the beneficiary in depth, upon request.

At the end of the most litigators will agree that the best way to keep a trust case out of court is to keep beneficiaries informed about the trust's administration. To be sure, this is not a foolproof or perfect strategy and privacy remains a definite concern. But the fact remains that, rightly or wrongly, beneficiaries have credibility issues with both individual and corporate trustees. Sometimes these issues are related to family dynamics where jealousies and other emotions get in the way. Beneficiaries may also feel that trustees are greedy and self-interested. Also, the inescapable nature of the trustee-beneficiary relationship can be uncomfortable for beneficiaries because they feel beholden to their trustees and are uncomfortable asking for distributions. Finally, beneficiaries who suffer from such things as substance abuse, diminished capacity or other mental problems are often paranoid. Thus, communicating with beneficiaries, particularly before they can become disgruntled, can go a long way to show good faith on the part of the trustee and therefore alleviate tensions inherent to their position.

An ancillary benefit of a trustee's willingness to communicate openly with beneficiaries is that it forces the trustee to both develop and maintain effective administrative procedures and also to keep thorough records. A trustee simply cannot communicate effectively with a beneficiary without having the right information readily available and that information cannot be maintained without effective procedures.

In our Predator analogy, a trustee's willingness to deliver information to a beneficiary is like a special ops team member's willingness to put down his weapon. The Predator does not hunt unarmed humans because it is not sporting. But psychologically speaking, those who, literally or figuratively, draw their guns too quickly tend to regret it.

Of course, not every beneficiary can be pacified. Thus, information becomes the weapon of choice. Trustees who must fight with beneficiaries will generally find the courts much more accommodating when they can show good processes and thorough recordkeeping. Remember, the beneficiary's case will be just as hard to prove as the trustee's. But by keeping better records, the trustee can show how and why decisions were made. Thus, even if a particular court disagrees with a particular decision, its ability to find that decision unreasonable will be significantly curtailed.

Now, let's "get to the choppa!"

Appendix A

The following is a list, derived from various sources of some expenditures which might be properly payable under a HEMS standard. It is not intended to be exhaustive, nor should it be read to imply that every item will always be appropriate in every case.

Health	Education	Maintenance & Support
Emergency & regular medical treatment	Grammar, secondary and high school tuition	Mortgage payments & down payment on a home
Routine healthcare examinations	Medical school, law school, or other professional school	Continuation of accustomed patterns of vacation
Health, Dental or Vision Insurance	College in Europe as part of a study abroad program	Property/casualty/liability insurance for home, auto, etc.
Unconventional medical treatment	Costs for long-term studies or "career students"	Support for beneficiary engaged in charitable endeavors
Extended vacations to relieve tension and stress	Support of beneficiary while in school	Continuation of family gifting
Rehab for physical problem or addiction	Support of beneficiary between semesters	Life insurance
Health-related home renovations	Graduate & post graduate school tuition and expenses	Charitable gifting
Specialized cleaning services to remove allergens	Extracurricular activity fees, expenses & paraphernalia	Rent payments
Cosmetic surgery	Tutoring; speech or reading therapy	Automobiles
Home health care	Graduation costs, proms & class rings	Property taxes
Gym, Spa or Golf memberships	Books, computers, supplies, etc.	Home repair & maintenance
Dental & orthodontics	Study abroad	Support of family members
Golf club memberships	Technical school training	Assistance starting a business
Psychiatric treatment	Career training	Legal fees
Eye care	Day care	
Handicap transport	Uniforms & school clothes	
Lasik surgery	Room & board	

<u>Appendix B</u>

The following are examples of language which may be useful for drafters in the situations indicated, whether as a form language or for perspective. No comment is intended with regard to the legal merit, or practical effect or overall desirability of any specific example.

<u>a. Encouraging employment:</u>

(a) It is the Grantor's overriding intent in establishing the trusts hereunder to benefit his descendants, supplement their earnings and enhance their standard of living, but only if and to the extent that such descendants remain productive members of society and continue to be gainfully employed on a full-time basis. Full-time employment will require, at a minimum, working forty (40) hours per week, whether on a self-employed basis or for a third-party employer. It shall also be considered full-time employment if a Beneficiary is a full-time stay-at-home parent raising minor children who have been born or adopted into a lawful marriage of the Beneficiary, so long as the Beneficiary's spouse has full-time employment outside the home. The trust distributions provided for hereafter in subsection (b) shall be suspended at all times that the Beneficiary is not gainfully employed on a full-time basis, as determined by the Trustee in the Trustee's sole discretion, unless such Beneficiary has a medical condition or disability that makes such employment unrealistic or impossible; provided that, the Trustee may rely upon the determination of the Trust Committee established under subsection x.x in a situation where the medical condition or employment status of a Beneficiary is not entirely clear. Once the Beneficiary regains full-time employment, trust distributions under subsection x.x shall not resume until the Beneficiary has maintained such employment for twelve (12) consecutive months. In the event that a child of the Grantor is a single parent as the result of divorce, death of a spouse, or a single parent adoption or use of assisted reproduction techniques, the Trust Committee shall determine whether the employment requirements of this subsection (a) shall be waived to allow such single-parent Beneficiary to be a stay-at-home parent and still receive the distributions authorized below in subsection (b).

(b) With regard to each trust administered under this Article with respect to which the Beneficiary is under the age of fifty (50) years, the Trustee may distribute to each Beneficiary, if the Trustee, in the Trustee's sole discretion, determines it to be in the Beneficiary's best interests, any amount not exceeding the lesser of (i) twice the annual earned income of the Beneficiary, or the Beneficiary's spouse in the event that the Beneficiary is a stay-at-home parent (as reflected on the Beneficiary's Federal income tax return for the prior year) or (ii) the annual annuity amount defined below. Any distributions under this subsection shall be made in quarterly installments at the end of each calendar quarter. The annuity amount as to each trust is an amount equal to five percent (5%) of the average of the net fair market values of such trust as of the end of the prior two calendar years (except as provided in Subsection (c) below for the first four years of the trust).

b. Posthumous continuation of support and encouragement:

I have always encouraged my children to build useful and fulfilling lives. I have provided the means to allow them to choose a career, business or profession about which they may be passionate and to pursue whatever education is required to excel in their chosen field. It is my intent that my trustee, in his discretion, will use these funds to provide health, education, maintenance and support as reasonable and necessary to continue to encourage them to pursue these goals and support them in these endeavors as I have done up until the time of my death. Accordingly, to the extent that funds are available and the trustee, in his discretion deems it prudent, I encourage my trustee to consider requests for the purchase of a residence, to facilitate the start of a business or enter a profession, to obtain additional education or for travel in a manner that expands the knowledge, creativity and sophistication of my children in order that they may continue to do meaningful work for profit or charity.

c. Describing factors that may be important and encouraging productive behavior:

In an effort to provide the Trustee with guidance in making distributions under the standards provided in subsection X above, the Trustee may consider such circumstances and factors as the Trustee believes are relevant, including but not limited to the following: (a) the other income and assets known to the Trustee to be available to the distributee, and the advisability of supplementing such income or assets, (b) the tax consequences of any such distribution, (c) the character and habits of the distributee, including the diligence, progress and aptitude of the distributee in acquiring an education and advancing his or her career goals, the ability of the distributee to handle money usefully and prudently, and to assume the responsibilities of adult life and self-support, (d) the extent to which any such distribution could contribute to the development of negative attitudes in the distributee, such as entitlement, complacency or narcissism, (e) external factors and circumstances which may threaten the distributee's financial security or progress toward financial maturity and independence, and (f) the distributee's cultivation of a life plan and goals which are both challenging and realistic in terms of intellectual prowess, emotional maturity, and career and/or family development.

d. Discouraging bad behavior:

My Trustee shall NOT distribute any trust income or principal to my son for his emergency or serious medical needs if he has employer medical benefits or if such needs arise from his participating in risky or irresponsible activity, as determined in the sole discretion of my Trustee, which determination shall be binding on all parties. For purposes of this Will, "risky or irresponsible activity" shall include but shall not be limited to drunken driving, illicit drug use, unprotected sex, and any illegal actions.

e. Describing education:

"Education" as used herein shall include the best education a beneficiary is capable of absorbing, such as study at private schools and colleges, and graduate studies, if such beneficiary desires to pursue such studies

f. Encouraging employment and payment of insurance

(a) If the Grantor's son is employed on a full-time basis (35 or more hours per week), the Trustee shall distribute to the Grantor's son monthly (for each month that the Grantor's son is employed on a full-time basis) an amount equal to ten percent (10%) of the annual compensation of the Grantor's son from the calendar year immediately preceding the year in which such distributions are to be made (as determined by reference to the Form W-2, Form 1099-Misc or similar form received by the Grantor's son for such year); provided, however, that the 10% distribution rate shall be increased by the inflation rate for the calendar year immediately preceding the year in which such distributions are to be made, as determined by the Consumer Price Index;

(b) If the Grantor's son is not working at all (as an employee or independent contractor), the Trustee shall distribute to the Grantor's son seventy-five dollars ($75) per day for a period lasting no longer than six (6) consecutive months; provided, however, that such distributions shall not begin until the unemployment benefits to which the Grantor's son expire; provided, further, that the $75 per day distribution rate shall be increased for inflation, as determined by the Consumer Price Index, using the year of execution of this Will as the base year;

(c) If the Grantor's son is below the age of sixty-five (65) years, the Trustee shall pay on behalf of the Grantor's son the premiums on a disability insurance policy with the Grantor's son named as the insured and beneficiary and with the maximum benefit level available elected;

(d) The Trustee shall pay on behalf of the Grantor's son the premiums on an insurance policy covering the personal items (including expensive computers and electronics) of the Grantor's son (kept inside his apartment, home or other domicile) to protect against damage/loss due to theft, fire and similar hazards; provided, however, to allow the Trustee to purchase the appropriate amount of insurance coverage, the Grantor's son must provide annually to the Trustee a complete inventory of his possessions, supported by pictures; provided, further, that if the Grantor's son fails to provide the required inventory and supporting pictures, the Trustee shall not purchase such insurance; (e) If the Grantor's son owns his own home, the Trustee shall pay on behalf of the Grantor's son the premiums on a homeowner's insurance policy with terms and coverage standard at that time;

(f) If the Grantor's son and his spouse are both unemployed or if neither the employer of the Grantor's son nor the employer of the spouse of the Grantor's son pays for his health insurance premiums, then the Trustee shall pay on behalf of the Grantor's son the premiums on a secondary health insurance policy (with a $5,000 deductible, indexed for inflation) for the Grantor's son with terms and coverage standard at that time; provided, however, that the Grantor's son shall be responsible for premium payments on any primary health insurance policy;

(g) The Trustee shall pay on behalf of the Grantor's son any medical expenses incurred by the Grantor's son (only after attaining the age of sixty years) that are not covered by his health insurance policy, Medicare, Medicaid, social security or any other similar benefit plans;

(h) If the Grantor's son has biological or adopted children, then the Trustee shall purchase and pay the premiums on a term life policy insuring the life of the Grantor's son with the trust named as beneficiary; provided, however, that the Trustee, with the assistance of a professional financial advisor, shall determine the appropriate amount of life insurance to cover the future health, support, maintenance and education of such children;

(i) The Trustee shall pay on behalf of or reimburse the Grantor's son for educational expenses only under the following guidelines: If the expenses relate to the current occupation of the Grantor's son, then the Trustee shall cover such expenses only if the employer of the Grantor's son refuses to cover such expenses; or If the expenses are unrelated to the current occupation of the Grantor's son, then the Trustee shall reimburse the Grantor's son for such expenses only after the Grantor's son provides proof of a passing grade, graduation or a certificate of passing.

<u>g. Discouraging drug use:</u>

If my Trustee reasonably believes that a beneficiary is abusing drugs or alcohol and that the resources of the Trust, if distributed, would facilitate continued abuse, my Trustee may establish a discretionary trust with all or any portion of the share which would otherwise be distributed to a beneficiary. For the purposes of this section, the term "drugs" would include legal and illegal substances, whether or not prescribed by a physician, upon which the beneficiary has become dependent and/or uses regularly to his/her detriment. In establishing such discretionary trust, the Trustee may select a trustee, co-trustee and/or successor trustees, and shall include all provisions determined to be reasonable and necessary by the Trustee after consultation with a qualified attorney. It is my intent that any discretionary trust established pursuant to this provision be drafted and managed so as to (1) prevent the resources in the Trust from being used to purchase drugs or alcohol in situations where the purchase of same would work a detriment to the beneficiary, as perceived by the Trustee, (2) provide a platform from which the trustee could implement treatment for the beneficiary, and (3) prevent the resources in the Trust from enabling a beneficiary to continue a self-destructive lifestyle as a result of his/her drug and/or alcohol use and/ or dependency. Trustee may demand, and the appointed Trustees of the discretionary trust established in accordance with this paragraph may demand, that a beneficiary participate in testing to determine if drug and alcohol use is occurring, demand a beneficiary participate in drug or alcohol counseling or rehabilitation, and charge the beneficiary's share for all costs incurred in such testing and treatment. The remainder beneficiaries of any discretionary trust established pursuant to this provision shall be the descendants of the lifetime beneficiary, by right of representation, or if none, the estate of said beneficiary.

h. Encouraging drug rehab:

John Doe Trust. The gift to the trustee of the John Doe Trust (the "John Doe Trust") shall constitute the initial trust estate of a trust for the benefit of John, subject to the following conditions:

Distributions for John. No distributions shall be made to John or on behalf of John, other than payment for the treatment described below, unless and until (i) John has attended "Survivors' Week" at the Happy Hills Rehabilitation Clinic, located at 123 ABC St., Shangri-La, or its successor institution or organization; provided however, if either Survivors' Week or Happy Hills is not then in existence, the trustee, in the trustee's discretion, may require John to attend a similar program from a similar institution as a condition precedent to the termination of this trust; and (ii) John has received two hundred fifty (250) hours of psychotherapy from a therapist licensed and trained in compulsive and addictive disorders and specializing in childhood trauma, family of origin issues, and abuse recovery. The Survivors' Week and psychotherapy requirements shall be collectively referred to herein as the "Treatment." The trustee shall pay for the Treatment by making payments directly to the psychotherapist or Happy Hills (or its successor institution or organization or such similar institution, as the case may be, if a successor or similar institution is providing the Treatment). No distributions shall be made directly to John during the term of this trust. Termination. The trust shall terminate upon the first to occur of (i) John's completion of the Treatment; (ii) John's failure to complete the Treatment within six (6) years from the date of my death, or (iii) John's death. Upon termination as a result of John's completing the Treatment, the trust estate shall be distributed to John, subject to the Contingent Trust provisions.

Upon termination as a result of John's failure to complete the Treatment within six (6) years of my date of death, or as a result of John's death prior to the date which is six (6) years after my date of death, the trust estate shall be distributed as follows: If any of my grandchildren or the descendants of any of my grandchildren are then living, to the trustee of the Descendants Trusts created herein. If none of my grandchildren or the descendants of any of my grandchildren are then living, to the University of Nevada at Las Vegas.
Statement of Trust Purposes. My primary concern in establishing this trust is for the benefit of John if John agrees to follow the Treatment described above. The trust shall be managed accordingly

<u>i. Factors to consider; Encouraging productivity:</u>

In making any discretionary distributions to a descendant of mine from any trust under this Article, the trustee of such trust shall have discretion to consider all relevant facts and circumstances, including the nature and size of the trust estate, tax aspects, the maturity of such descendant, and the particular situation of such descendant in his or her personal life. In exercising this discretion, the trustee shall consider my desire that such descendant seek to develop his or her talents and abilities through personal effort and become financially responsible and a credit to our family and the community. The trust estate shall be used only to help support a constructive life of good character and responsibility on the part of each beneficiary of such trust. My trustee shall make distributions in such a manner as to encourage each to reach his or her potential and to lead a productive and self-sufficient life.

<u>j. Encouraging productivity:</u>

It is the intention of the Settlor, that no such payment of income to such child shall be made if, in the judgment of the Independent Trustee, the ambition or incentive of such child to provide for such child's own support would be retarded or destroyed thereby; provided, however, that the fact that a beneficiary hereunder has become successful by such beneficiary's own endeavors, shall not cause the Independent Trustee to withhold any such payment from that beneficiary.