



Fixing the Sideways Trust After it becomes Irrevocable

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to the
Northeastern Michigan Estate Planning Council
February 25, 2021

I. Introduction

It happens to every trust lawyer. A client brings in an irrevocable trust that just does not work the way it supposed to. The only person with the power to amend the trust is dead, incapacitated without an agent or other fiduciary empowered to make changes to the trust, or has voluntarily given up the power to amend the instrument and now suffers from settlor's remorse. The client asks the lawyer to rewrite the broken trust. Simple enough, right? The lawyer explains to the client what "irrevocable" means. So what next?

There are a number of tools available in the Michigan Trust Code to fix the irrevocable trust that has gone sideways. Not all tools are available in all cases, however, and in some cases the beneficiaries and trustee are simply stuck with a trust that they would all rather see terminated. Following is a discussion of the various tools available to fix the "sideways" trust.

The trust can be "sideways" in such a way that it is obvious to all parties that it is broken. All parties may agree that the trust contains a clerical error, for example. All parties may agree that the unintended effect of trust language is the overpayment of taxes, although the Internal Revenue Service may be unmoved by the beneficiaries' plight. Other "brokenness" is more subtle. The trust may appear unambiguous and otherwise free of error on its face, but the terms may have led to continued disputes between the trustee and beneficiaries, which could be corrected by an agreed upon modification. Some trusts may have worked perfectly in the time

they were drafted, but the world itself, being anything but irrevocable, has changed in such a way that the beneficiaries are negatively affected. Some solutions to a broken trust are obvious to all, but others are hard reached only after hours of mediation or protracted litigation.

Many of these problems can be avoided by artful drafting. The drafter has many tools in her tool belt to build flexibility into a trust that were not available to the drafters of even one generation ago. The assumption here is that it is too late for solving these problems through flexible drafting because the settlor is either unavailable to amend the trust, due to death or incapacity, or the trust is irrevocable by its terms. Here are a couple drafting options to consider:

Give the Trustee or a Trust Director the Power to Amend or Consent to a Modification by Agreement. One drafting option to consider is giving the trustee or a trust director the power to amend the trust even after the trust becomes irrevocable. It is not uncommon, however, for the trustee to use one of the options below to fix a trust, even if granted the unilateral power to amend in the instrument, simply to protect herself or himself from being questioned later or to seek the “blessing” of the probate court. As is discussed below, it is also wise to consider giving a trust director the power to agree to a modification of the trust, as it is typically required to avoid the probate court’s involvement.

Give the Settlor’s Agent, Conservator, or Guardian of the Estate the Power to Amend the Trust on his or her Behalf. It is also wise to consider, where appropriate, giving the settlor’s conservator, guardian of the estate, or agent under a durable power of attorney the power to amend a trust. Such power should also be included in the terms of the durable power of attorney and even in the Letters of Conservatorship or Guardianship.

II. The Various Ways Irrevocable Trusts go “Sideways”

A. Ambiguity

A trust can easily become unworkable when trust terms are ambiguous, either on their face or where there is a latent ambiguity given the circumstances. “The trustee shall distribute my Buick to my daughter, Susan” may appear perfectly unambiguous, but it will lead to head scratching by the trustee if the settlor left two Buicks in the driveway at her death.

B. Clerical Errors

The smallest clerical error in an instrument can cause the largest of problems. Some clerical errors create ambiguities and some just cause confusion. A classic example is the percentage gifts in a residue clause that do not add up to 100 percent. Sometimes there are cross references to section headings that are incorrect. Sometimes it appears that the wrong name was included. Sometimes it is obvious what the drafter intended to do, other times it is not.

C. The Trust is Uneconomical to Administer

It is not uncommon for the annual cost to administer a small trust to exceed the income it generates in a year, causing the principal to become depleted over time.

D. The Trust has Become Disputed

The best of trusts are disputed. Often it makes sense for the trustee and beneficiaries to agree to a change in the terms of a trust instrument, even terms that were well-intended and well-drafted, to settle a controversy that has arisen between them.

E. The Trust Purposes are Illegal or Against Public Policy

As society changes, so do social taboos, laws, and public policy. While still illegal under federal law, marijuana production and distribution is now legal and big business in Michigan. Same sex marriage, recently unknown in the United States, is now legal in all fifty states and protected by the United States Constitution. Racist language in deeds and estate planning documents was once common and enforceable, but is now both void as against public policy and violates both federal and state civil rights law.

F. The Trust does not Work as Intended Because Circumstances Have Changed

As circumstances change over time even the most reasonable of trust terms can present difficulty. Beneficiaries are living longer. Few estates are exposed to Federal Estate Tax liability. Interest rates remain historically low. Fewer communities are served by local banks with local trust departments. All of these trends have affected the way trusts operate, especially those intended to last for many years.

III. Nonjudicial Tools Available to Fix the “Sideways” Trust

A. Decanting

Decanting is a relatively new tool in Michigan to fix the “sideways” trust. Stated simply, trust decanting involves distributing assets from one trust to another, like wine is poured from one bottle to another to remove the sediment that has collected in the old bottle. Trusts can be decanted under common law, as now codified in the Michigan Trust Code, or under new statutory authority in the MTC. Not all trustees, however, have the power to decant. That power is largely a function of the degree of discretion granted to the trustee in the instrument. James Spica, the drafter of Michigan’s trust decanting legislation, has written excellent resources for the Institute for Continuing Legal Education on trust decanting. When available, trust decanting permits the use of a totally new instrument, as opposed to merely fixing the existing problematic language in the old instrument. For that reason, it is often the most desirable option when it is available.

B. Consolidation or Division of Trusts

The Michigan Trust Code permits a trustee, upon notice to qualified trust beneficiaries and holders of powers of appointment, to “divide trust property into 2 or more separate portions or trusts” or “consolidate 2 or more trusts and administer them as 1” if the resulting trust or trusts “have substantially identical terms and conditions or if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.” MCL 700.7417.

Consolidation can be used creatively in certain limited circumstances. A new trust can be created with “substantially identical terms and conditions” as the original trust, without the offending language necessitating the change, assuming, of course, that language is not “substantial,” and the two can be consolidated together under the new and improved terms, so long as the result “does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.” The result is essentially a de facto decanting.

C. Nonjudicial Settlement Agreement

Michigan law has long permitted beneficiaries to enter into settlement agreements involving trusts. The first statutory authority was known as the Dodge Act, so named because it was passed in response to trust litigation involving the family of the automaker brothers. The nonjudicial settlement agreement provision of the MTC is found in MCL 700.7111, which was based largely on Uniform Trust Code Section 111. A nonjudicial settlement agreement may address, among other things not relevant to this discussion, “The interpretation or construction of the terms of the trust.” MCL 700.7111(3)(a). Very importantly, however, MTC 700.7111 provides that, “A nonjudicial settlement shall not be used to accomplish the termination or modification of the trust.” The Reporter’s Comment to MCL 700.7111 speaks to the difference between “reformation, interpretation, and construction” of a trust, which can be addressed in a nonjudicial settlement agreement, and “modification,” which can only be accomplished by agreement under MCL 700.7411(1)(b).

D. Modification by Agreement

An irrevocable trust can be modified by agreement in very limited circumstances. An irrevocable trust can be modified by agreement “on the consent of the qualified trust beneficiaries and a person or committee that is given the power under the terms of the trust to grant, veto, or withhold approval of . . . modification of the trust.” MCL 700.7411(1)(b). The Reporter’s Comment to MCL 700.7411 make it clear that the approval of “a person or committee that is given the power under terms of the trust to grant, veto, or withhold approval of . . . modification of the trust” is a necessary condition. If there is no such person or committee the trust may not be modified by agreement. Only trusts created after the effective date of the MTC (April 1, 2010) may be modified by agreement. MCL 700.7411(2).

IV. Judicial Tools Available to Fix the “Sideways” Trust

A. Interpretation

Probate courts are granted the power to interpret the terms of a trust in the MTC, which grants the probate court exclusive subject matter jurisdiction to “Determine a question that arises in the administration or distribution of a trust, including a question of construction of a . . . trust” and to “Instruct a trustee and determine relative to a trustee the existence or nonexistence of an immunity, power, privilege, duty, or right.” MCL 700.1302(b)(v) and (vi)

B. Reformation

The Michigan Trust Code and case law both permit a probate court to “reform the terms of a trust, even if unambiguous, to confirm the terms of to the settlor’s intention if it is proved by clear and convincing evidence that both the settlor’s intent and the terms of the trust were affected by mistake of fact or law, whether in expression or inducement.” MCL 700.7415. The Reporter’s Comment to MCL 700.7411 and MCL 700.7415, speak to the difference between reformation and interpretation, discussed above.

C. Modification of a Noncharitable Trust by Court Order with Agreement

The probate court may modify a noncharitable irrevocable trust with the consent of the trustee and the qualified trust beneficiaries. Importantly, the court must also “conclude that the modification . . . of the trust is consistent with the material purposes of the trust or that continuance of the trust is not necessary to achieve any material purpose of the trust.” MCL 700.7211 (1)(a). Notice must be provided to the “settlor, the settlor’s representative if the petitioner has a reasonable basis to believe the settlor is an incapacitated individual, the trust director, if any, a powerholder [granted the power under the terms of the trust to grant, veto, or withhold approval of . . . modification of the trust), if any, the trustee, and any other person named in the trust to receive notice of such a proceeding.” MCL 700.7411(3).

D. Modification of a Noncharitable Trust by Court Order without Agreement

The probate may modify the administrative terms of a noncharitable trust without the consent of the trustee and qualified trust beneficiaries, but only after notice is given as described above, and only if “continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust’s administration.” MCL 700.7412(1). The probate court may modify the administrative or dispositive terms of a trust without the consent of the trustee and qualified beneficiaries, but only after notice is given as described above, “because of circumstances not anticipated by the settlor, modification . . . will further the settlor’s stated purpose or, if there is no stated purpose, the settlor’s probably intention.” MCL 700.7412(2).

E. Modification or Termination of a Charitable Trust by Court Order (Cy Pres)

The MTC provides the probate court with statutory authority, long conferred by case law, under the doctrine known as Cy Pres, to modify or terminate a charitable trust “if a particular charitable purpose becomes unlawful, impracticable, or impossible to achieve, no alternative taker is named or provided for, and the court finds the settlor had a general, rather than a specific, charitable intent: [and that] (a) The trust does not fail, in whole or in part. [and] (b) The trust property does not revert to the settlor or the settlor’s successor in interest.” MCL 700.7403(1).

V. Terminating the Irrevocable Trust

A. Termination by Operation of Law

A trust terminates by operation of law “to the extent the trust is revoked or expires pursuant to its terms, no purpose of the trust remains to be achieved, or the purposes of the trust have become impossible to achieve.” MCL 700.7410(1). While not required, a trustee or beneficiary of a

noncharitable trust, or a person with the power to enforce the terms of a charitable trust pursuant to the terms of MCL 700.7405, may commence a proceeding to confirm the termination of the trust. MCL 700.7410(2). The probate court's finding that the terms of a trust are "unlawful or contrary to public policy" is required before a trustee can terminate the trust. MCL 700.7410(1).

B. Termination by Trustee of an Uneconomic Trust

A trustee may terminate a trust "consisting of trust property having a total value less than \$50,000 (as adjusted for inflation, currently \$80,000)" after giving 63-days of notice to qualified trust beneficiaries and, if the trust is a charitable trust, the attorney general.

C. Termination by Agreement without Seeking Court Approval

The requirements for termination by agreement are identical to the requirements for modification of a noncharitable trust by agreement discussed above. MCL 700.7411(1)(b).

D. Termination by Agreement with Court Approval

The requirements for termination by agreement with court approval are identical to the requirements for modification of a noncharitable trust by the court discussed above. MCL 700.7411(1)(a).

E. Termination by Court Order without Agreement

The requirements for termination by the probate court without the agreement of the trustee and qualified trust beneficiaries are identical to the requirements for modification of a noncharitable trust by the court without the agreement of the trustee and qualified trust beneficiaries discussed above. MCL 700.7412(b).