

EXCERPT FROM PRIMER ON AMERICAN TRUST LAW

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Sources

What follows is a summary of American trust law, which was originally drawn from the common law case tradition. The principal source to which the American courts have turned to discover the law of trusts is the Restatement of Trusts, a work published by the American Law Institute which is an attempt to fully state this judge-made law. With the gradual enactment by the states of the Uniform Trust Code, a model statute completed in 2000, this reliance on the common law tradition will decline. But with respect to most of the topics addressed in this primer, the Uniform Trust Code merely codifies and does not change the common law. When researching American trust law, reference to the Restatement and published court cases is still quite relevant.

Introduction to Trusts

What is an express trust? An express trust is an extremely flexible method of disposing of property and providing for the changing needs of persons who are to benefit from that property. In essence, the legal and equitable interests in the property are split, with the legal ownership being held by one or more trustees and the equitable ownership (the beneficial use) of the property being held by one or more beneficiaries. The trustee of the property has a fiduciary duty to hold the property and act for the benefit of the beneficiaries.

An express trust is created pursuant to express written document or oral declaration, as opposed to certain other kinds of trusts which are remedial devices created by process of law. Those other kinds of trusts are described in Part 2. Unless specifically noted, this discussion of trusts centers only on express trusts.

What are the essential elements of a trust? There must be a creator, or settlor, who expresses an intent to create a trust. There must be trust property, or res. And there must be one or more beneficiaries. No trust will fail for want of a trustee--the court will appoint one--but it will fail if it lacks an identifiable beneficiary. Although trusts are usually created with documentation, a written trust document is not required. An oral declaration of a trust will suffice except where the Statute of Frauds requires a writing or the trust is to be created under a will. A trust may be created by a settlor without notice to or acceptance by a beneficiary.

What makes a trust so flexible?

1) Trusts are very useful estate planning tools because the settlor can provide for ongoing oversight of the gift. Discretion--or flexibility in administration--can be given to the trustees in order to provide for changing needs of the beneficiaries or for unforeseen circumstances that affect the trust property.

2) Trusts may be created with minimal funding, adding additional funding at a later date; almost any property may be placed in trust and may be divided into present and future beneficial interests.

3) Trusts may be created in a will as a testamentary trust, or alternatively they may be created by the settlor during his or her lifetime as an inter vivos trust. Thus, a trust is not merely a post-death tool but may be currently useful to its creator.

4) Trusts may be either revocable or irrevocable. Revocable (living) trusts, which the settlor has the right to modify or terminate, have become a popular strategy for passing property at death without going through probate, or court administration.

How did the concept of trusts come into the American legal system? The system appears to have originated from a desire to make gifts to medieval church orders in England which were prohibited by their vows from owning property. A legal gift was therefore made to certain responsible persons, who were mandated to hold the property to the use of the friars. This was in most cases an unenforceable system, although the ecclesiastical courts eventually did try to take jurisdiction. Uses became more popular in England when the Statute of Uses was passed in 1535. King Henry VIII was actually trying to abolish uses by enacting the statute, which turned equitable uses into legal interests and extinguished the interests of the parties to whom the property was legally conveyed. However, there were many loopholes in the operation of the statute, the most notable of these being that the Statute of Uses did not execute active trusts. That meant that if the "trustee" had an active duty --to determine and distribute income, to collect rents, to do anything other than just hold the property and perform ministerial duties--the use could not be extinguished and would be enforced by the courts.

The concept of trusts has been adopted in U.S. states as part of the common law. Despite the fact that the Statute of Uses, itself, was abolished in England in 1925, trusts have proven to be such an effective strategy for disposition of property that the concept remains.

Other Types of Trusts

What is a constructive trust? A constructive trust is imposed by a court in order to prevent the unjust enrichment of one who wrongfully acquires property, e.g. where an inheritance is obtained through fraud. It is a judicial remedy and involves no act by the true owner of the property. The wrongful holder of the property is deemed to hold the equitable interest in trust for the true owner (or successors in interest). Upon the court's imposition of the constructive trust, the wrongful holder is automatically divested of legal title. Title will then vest in the true owner or successor. The wrongful holder is also liable for any profit made during the period of wrongful holding.

What is a resulting trust? A resulting trust arises in situations where the settlor fails to dispose of all the equitable interest in property. The inference is then that the settlor intends the equitable interest to revert back to her rather than to other transferees. If all other interests in the trust have expired, the trustee of a resulting trust, like the trustee of a passive express trust, has a duty to transfer the trust property or reversionary interest in the trust property back to the settlor. A resulting

trust also arises when an express trust is invalid in whole or part; the trustee to whom the property was transferred holds it in a resulting trust for the settlor.

What is an honorary trust? An honorary trust is a trust for a specific noncharitable purpose without any ascertainable human beneficiaries, such as to provide care for a designated animal or for the care and upkeep of cemetery or other burial property. An honorary trust traditionally has been unenforceable because there is no human beneficiary; but under the Uniform Trust Code and other statutes in a number of states such trusts can be enforced by the court or by a person appointed in the trust document or by the court.

Trust Creation

What are the methods for creating a trust? There are five basic methods for creating an express trust:

- A testamentary trust may be created through the will of a property owner.
- A trust may be created through an inter vivos transfer by a property owner to another person as trustee for one or more beneficiaries.
- A trust may be created, absent an actual transfer, by a declaration by a property owner that the owner holds that property as trustee for one or more beneficiaries.
- A trust may be created by the exercise of a power of appointment by appointing property to a person as trustee for one or more persons who are permissible objects of the power.
- A trust may be created by a promise that creates enforceable rights in a person to later receive property as trustee.

What level of capacity does the settlor need in order to create a trust? The answer to this question differs based on the type of trust being created.

- To create a testamentary trust (either by transfer or declaration), the settlor must have the capacity to devise the property. Generally, that involves the ability to understand the natural objects of testator's bounty and the nature and extent of testator's property, as well as the ability to understand and make decisions about the disposition of that property. That the testator thereafter becomes incapacitated and lacks capacity at her death, when the trust becomes effective, is immaterial.

- To create an irrevocable inter vivos trust (either by transfer or declaration), the settlor must have the capacity to make an outright gift. This is generally considered a slightly higher standard than testamentary capacity and requires an understanding of the effect of the transfer on the donor and donor's dependents.

- To create a revocable inter vivos trust, there is a split of authority on the level of capacity needed. One approach follows the law of wills, on the theory that these trusts are used primarily as will substitutes. The second view is that the capacity level should be that of an irrevocable trust because these trusts, unlike wills, are used to manage property during the settlor's lifetime.

- To create a trust by exercise of a power of appointment, the settlor must have the level of capacity needed for an outright transfer of a like type. A person may exercise a testamentary power only if that person (donee of the current power) has testamentary capacity. A donee of a power may

appoint to another to hold as a trustee of a revocable trust only if the donee has testamentary or gift-making capacity, whichever is the standard in that jurisdiction. And a donee of a power may create an irrevocable trust only if the donee has the capacity to transfer like property outright as a gift or, if more appropriate, through commercial or contractual disposition.

Persons who do not have legal capacity to transfer property - minors and incompetent adults - may make a transfer in trust, but the transfer is voidable. The settlor may ratify the transfer upon (re)attaining capacity or, after the settlor's death, the transfer may be ratified by those to whom the property would pass if the transfer were voided. In some states it is possible for an incapacitated person's guardian, conservator, or holder of a durable power of attorney to create a trust on behalf of an incapacitated person.

Must the settlor intend to create a trust? Yes and no. The settlor must intend to create a trust relationship, but it is not necessary for the settlor to use the term "trust" or "trustee" or to understand the legal requirements. (And using the correct terms without intending to create a trust relationship does not create a trust.) The settlor's intent must be communicated--it cannot be a secret, undisclosed intent--but that communication may be generic and need not be directed specifically at the trustee or beneficiaries. Failure to notify the involved parties concerning the creation of an inter vivos trust, however, may in some cases be seen as evidence that the property owner did not have a current intent to create a trust. There must be an intent to create a present trust, that is, it cannot be an intent to create a trust some time in the future. Precatory language, expressing the donor's suggested use or disposition of property, is not sufficient to create a trust. Whether the donor intended to impose legal obligations on the transferee or merely wanted to express a moral duty or nonbinding wish is often a matter for judicial interpretation.

Must the settlor receive consideration for the creation of a trust? No, this is not a contractual arrangement. Trusts may be created gratuitously--it is not a bargained-for exchange. However, a promise to create a trust may be part of a contractual agreement and may be enforced pursuant to contract law.

What kind of property may be transferred in trust? Any legally cognizable interest in any real or personal property, tangible or intangible, may be transferred in trust. This includes not only money--as little as one cent--or a piece of land in fee simple, but also contingent remainders and other future interests, stocks, choses in action, mineral rights, leaseholds, life insurance policies and insurance beneficiary designations, etc. However, specific property must be identified. It is not sufficient to gratuitously agree to make a gift without indicating the source and setting it aside. The requirement of an identifiable res creates a fiduciary duty as to that property, meaning it cannot be commingled or used as the trustee's own.

Who may be the beneficiaries of a trust? Any person (i.e., legal person, including corporate entities) or class of persons may be the beneficiaries of a trust, provided that they are sufficiently ascertainable that they may go into court and enforce the trustee's obligations. The beneficiaries do not have to be currently identified, so long as they are identifiable within the period

of the rule against perpetuities. In fact, they may be as yet unborn so long as they are ascertainable through a class or other designation. For example, a trust for the members of the Midwest University's graduating class of 2020 would be acceptable because the beneficiaries will be ascertainable even though the members of the class have not yet been admitted to the university. Until they are identified, the court can appoint someone to represent their interests.

The trustee may, other things being equal, be a beneficiary of the trust; but a trustee may not be the sole beneficiary of the trust, as there would then be no independent party to enforce the settlor's terms. The legal and equitable interests therefore would merge in the beneficiary to constitute an outright gift.

Who may serve as trustee? Individuals and corporate trust entities may serve as trustee, either singly or jointly. The trustee should be capable of performing the duties of a trustee. In some cases it may be that appointment of more than one trustee is optimal. For example, if there is a large estate to be administered, it may be advantageous to have a professional trust department as trustee; but if, in addition, the trustee is given discretion as to how to distribute assets, then a relative or someone else who is familiar with the beneficiaries should perhaps also serve as co-trustee. A trustee need not be omnipotent, but has the authority to delegate some functions (e.g., accounting, property management) to qualified others. To plan for the resignation or death of a trustee, including instances where the settlor serves as trustee, it is to the settlor's advantage to name a successor trustee. However, no trust will fail for lack of a trustee; the court has the authority to appoint trustees if there is an otherwise valid trust.

Is there a valid trust if the trustee has no active duty to perform? No. This gets back to the issue of active versus passive trusts raised by the Statute of Uses. The trustee must have more than mere ministerial duties to perform or the trust will be invalidated in favor of outright gift to the beneficiaries. Ministerial duties include the mandatory distribution of income with no discretion as to the amount distributed to each of the beneficiaries. If the trustee is merely collecting the income and passing it on to the beneficiaries, it is a passive duty. However, any obligation to manage the money by collecting rents, investing the principal, insuring the property, etc., and any grant of discretion to the trustee as to the amount or timing of distributions would be considered active duties and would validate the trust.

Is there a valid trust if the settlor fails to fully set forth the terms of the trust in a written document? If the trust is created during lifetime, the answer is yes. Unless the Statute of Frauds requires that the trust be in writing, an inter vivos trust may be created by an oral declaration. If the trust is created by will, however, the failure to set forth fully the terms of the trust in the will may mean that the trust is "secret" or "semisecret." If the testator clearly intends to and does create a trust relationship but fails to set forth in the will the purpose and beneficiaries to whom the equitable interest belongs, a semisecret trust is created. For the grantee to keep the gift would constitute unjust enrichment, but extrinsic evidence is not admissible to clarify the terms. Consequently, the express trust fails because there is no one to enforce it. There is a split of authority on whether the trust property is returned to the settlor (or settlor's successors) or whether the trustee

holds it on a constructive trust for the benefit of the intended beneficiaries.

On the other hand, where the testator makes a wholly incomplete gift in trust, a secret trust, it will be enforced through a constructive trust arrangement (see Part 2). In a secret trust, there is no trust arrangement apparent at all, but rather an outright gift. In a separate interaction, the grantee promises to hold the property for the benefit of others. Extrinsic evidence is allowed in order to prove that the grantee is not personally entitled to the proceeds. Once evidence of unjust enrichment is before the court, a constructive trust will be imposed for the benefit of the intended beneficiaries.