Factors To Consider In Litigating Total Return Trust Cases

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A. Introduction

1. Total Return Trusts

   a. A “total return trust” is a trust that has two essential operational components.

      i. Its assets are invested and managed by the trustee as a “prudent investor,” in accordance with the Uniform Prudent Investor Act, with the objective of producing the best possible return without regard to whether the return is in the form of interest, dividends, rents, or royalties (ordinarily, trust accounting income) or capital gains (ordinarily, trust accounting principal).

      ii. Its dispositive provisions, whether derived from a statute or appearing in the governing instrument, enable its investment returns to be allocated and distributed between or among the income beneficiaries and the remainder beneficiaries in a manner that is impartial, based on what is fair and reasonable to all of the beneficiaries. Such dispositive
provisions involve either the power to adjust or the paying of a unitrust amount, in lieu of traditional trust accounting income, to the income beneficiaries.

b. **Power To Adjust**

i. The term “power to adjust” refers to a power enabling the trustee to make transfers or “adjustments” between accounting income and principal in order to fairly allocate the trust’s investment return between the income beneficiaries, on the one hand, and the remainder beneficiaries, on the other.

ii. The power to adjust exists in those states that have enacted a statute based on §104 of the 2000 version of the Uniform Principal and Income Act (the “UPAIA”). See, for example, Mo Rev. Stat. §469.405.

c. **Unitrust Provisions**

i. The term “unitrust” refers to a type of trust under which an individual who would traditionally be thought of as an income beneficiary is entitled to receive an amount (the “unitrust amount”) equal to a stated percentage of the trust’s net fair market value, redetermined annually. The stated percentage is usually in the range of 3–5 percent. A trust’s unitrust amount is analogous to, and takes the place of, traditional trust accounting income and is payable annually.

ii. A beneficiary’s right to receive a unitrust amount, rather than all the trust’s net income, may be derived from a provision in the trust instrument or may result from a provision in state law authorizing the trustee to convert a trust (typically, a mandatory net income distribution trust) to a unitrust. See, for example, Mo Rev. Stat. §469.411.

**B. Reported Cases To Date**

1. **Power To Adjust**

a. **In the Matter of the Jane Bradley Uihlein Trust**, 142 Wis.2d 277, 417 N.W.2d 908 (Ct. App. 1987)

i. This is a pre-UPAIA case dealing with what the court termed an equitable adjustment. In this case, the four trusts at issue, which were created in 1951, sold the stock of a private company in 1985 for $1.6 billion and paid capital gains taxes to the State of Wisconsin of $39,808,936. The trustees deducted the taxes paid on the trusts’ federal income tax return, resulting in tax-free income for the current beneficiaries, and changed the trusts’ investment mix so that the trusts were invested 70 percent in bonds producing taxable income to make use of the tax deduction.

ii. The guardian ad litem for the minor beneficiaries contended that the trustees abused their discretion in: (a) failing to exercise their power of equitable adjustment to reimburse the principal account for the use of the income tax deduction; and (b) more relevant here, failing to exercise their power of equitable adjustment to compensate the principal account for the lost appreciation occasioned by the overweighting of bonds in the investment portfolios.

iii. Interestingly, the provisions of the trusts that the court held amounted to “equitable adjustment” powers contained what many lawyers would consider to be fairly standard powers:
The Trustees shall have the right to determine as to what is ‘income’ and what is ‘principal’ and they shall determine what system of accounting to use.

The Trustees shall in their discretion determine what expenses, fees, costs, taxes and charges of a similar nature shall be charged or credited to income and what to principal.”

iv. The trustees apparently believed that these provisions constituted equitable adjustment powers both for allocation of taxes and for the possibility of making principal whole for the unusual asset allocation but determined not to exercise those powers. Accordingly, their allocation of the burden of expenses and their crediting of accounting income to the income account followed state law. The court of appeals sustained their position, concluding that, when discretionary powers permit trustees to make an equitable adjustment and the trial court finds that their decision not to make such an adjustment was reasonable, the trial court cannot make the equitable adjustment. (The court also did not hold that an equitable adjustment was available on the asset allocation side, despite the trust’s language.)

v. What is particularly curious about the case is that the guardian ad litem’s position was not, as one might have expected, to surcharge the trustees for the loss to principal from “lost” capital gains that a more equity-oriented asset allocation would have produced; rather, he attempted to apply the doctrine of equitable adjustment to make principal whole from the income of the trust.


i. This case was filed by Fred Astaire’s daughter as a “safe harbor” petition under former California Probate Code §21320, requesting a determination that it would not be a violation of a no contest clause for her to file a petition to modify her trust by having the court direct the trustee to exercise its power of adjustment to distribute 4 percent of the trust to her each year. The no contest clause in question would be triggered by any beneficiary who “has, directly or indirectly, alone or in cooperation or conjunction with others, contested or sought to impair, object to or invalidate…” the trust. The court held that the petition to modify would indeed impair the purposes of the trust by converting what was an income interest into the equivalent of a 4 percent unitrust until further notice, thereby “invading” the principal of the trust, which was to be reserved for the next level of beneficiaries. (The safe harbor petition was filed prior to California’s enactment of a unitrust conversion statute, which did not become effective until January 1, 2006.) The court held that the availability of the statutory procedure to adjust income and principal does not exempt the adjustment petition from the scope of the trust’s no contest clause.

ii. There are two interesting aspects to the case, apart from what might be regarded as over-reaching by the petitioner in her request. First, the trustee itself had originally proposed to make an adjustment, at the request of the petitioner, and had sent out the required notification to the next tier of beneficiaries to inform them of what it intended to do. The petitioner alleged that the trustee proposed to make the adjustment on the ground that it was investing the trust assets in accordance with a total return objective. Upon receiving objections from a number of the beneficiaries, the trustee simply decided not to proceed with the adjustment, and under California’s law, very protective of trustees, the trustee faced no liability from this abandonment of what it had earlier determined was appropriate and fair to all beneficiaries.
iii. Second, in its opinion the court made a point of labeling the daughter’s proposal as an “invasion” of principal:

Here, plaintiff…would have the trustee reallocate funds from principal, which is to be reserved to third tier beneficiaries by the terms of the trust. As we have determined, the trust gave the trustee the power to invade the principal in order to make the payments to the first tier beneficiaries, but did not provide the same authority in the case of the second tier beneficiaries [which is what the petitioner was]. The intent of the trustor is clear: The second tier beneficiaries were to receive only the net income from the trust. The adjustment petition would significantly alter those terms.


iv. Although it is clear that an invasion clause is a factor for a trustee to take into account in determining whether to exercise the power to adjust, it is also clear that this is just one factor in the trustee’s deliberations. In fact, it can be argued from the history of UPAIA §104 that including the existence of an invasion clause as a factor to be considered by a trustee suggests that no power of adjustment is needed if there is an invasion clause. In any case, however, it is clear that the exercise of the power to adjust is not intended to be, or to be viewed as, a power of invasion, nor, in the language of the commentary to the UPAIA, does it:

empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio’s total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule.

(1) The history of section 104 of the UPAIA shows the following change from the 1995 draft to the Final Act:

(8) the presence or absence of a power to invade principal or other dispositive provisions, that would reduce the importance of a reallocation, and the apparent reason for the presence or absence of such a provision; 1995 Draft of the NCCUSL Drafting Committee, §601(b)(8) (emphasis added).

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(7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income; UPAIA Final Act §104(b)(7).

Professor Langbein has stated that he believes the factor is indeed intended to show a practical way to the same result—you don’t need to exercise a power to adjust if you can get there using a power to invade. In a 2008 survey of a number of trust companies and banks in New York, corporate trustees unanimously reported that they used an invasion power, when available, in lieu of the power to adjust or unitrust conversion alternatives, to supplement ordinary income when a trust’s investments were being invested under the Uniform Prudent Investor Act and the accounting income from the investments was deemed insufficient. Accordingly, the consensus of these trustees is that fewer than 5 percent of trusts for which these trust companies are serving as trustee are actually using the statutory power to adjust.

v. The California Appeals Court misspoke when it talked of the exercise of the power to adjust as the equivalent of a power to invade.

c. In the Matter of the Orpheus Trust, 179 P.3d 562 (Nev. 2008)