

Trust Reformation and the Trustee's Fiduciary Duties

Take-Away: A trust reformation is one remedy to deal with a trust instrument that does not reflect the settlor's intent. That said, who brings the trust reformation proceeding to change the terms of the trust can seriously implicate the trustee's existing fiduciary duties.

Background: We have covered trust reformations in the past, but primarily from outlining the legal requirements for the trust instrument to be reformed. A trust reformation is an *equitable* proceeding to change the terms of a trust. With the advent of the Uniform Trust Code (UTC), its provision sweeps away former *equitable* restraints on the introduction of extrinsic evidence to determine if the trust instrument is even ambiguous. [UTC 415.] Moreover, the technical legal issue of *standing* seems to no longer be an impediment to bringing an action to reform the terms of the trust under UTC 415.

Michigan Trust Code: The Michigan Trust Code contains a provision taken straight from the Uniform Trust Code, which broadly permits a trust and its terms to be reformed. MCL 700.7415 provides:

"The court may reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intent if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement."

Reformation v. Modification: A trust's reformation is much different than a trust instrument's modification in that if the trust instrument is reformed, its change in terms is retroactive to when the trust was initially executed- a reformation is premised on the principle that a mistake was made in the beginning. In contrast, a trust instrument's modification is effective only prospectively only after the time that the modification occurs. Thus, there is no retroactive effect of the trust's modification. This distinction is important if the proposed change in the trust's terms is prompted by the impact of tax laws, since the IRS will only respect a change to a trust's tax consequences retroactively with a trust reformation, not a trust's modification.

Example: A trust is created for a surviving spouse. That trust was intended to comply with the requirements for the unlimited marital deduction. However, as the trust is drafted, the trustee possesses discretion to pay trust income to the settlor's surviving spouse, instead of reading that the surviving spouse possesses the right to all the trust's income. To have the trust qualify for the unlimited marital deduction, the trust must be *reformed*, so that the surviving spouse possesses the right to all the trust's income from the date that the trust was created and funded. Modifying the trust to give the surviving spouse the right to all the trust's income would give him/her that right but only from the date the trust was modified, which would not satisfy the Tax Code's marital deduction requirements.

Gift Upon Modification?: As an aside, it is also important to remember that recently the IRS has taken the 'new' position that a trust modification consented to by the trust's beneficiaries, which modification alters in any way the beneficiaries' interests in the trust, will result in an implied gift by those beneficiaries whose interests are in some manner diminished with the trust's modification.

Trustees and Trust Reformations: An attempt to reform an irrevocable trust will impact, negatively, the trustee and its relationship with the trust beneficiaries. This is best demonstrated by an example.

Example: Trustco acts as trustee of an irrevocable trust created by the settlor for his sons. The settlor's sons are Tom, Dick and Harry. The trust was created on the settlor's death. Due to ambiguous language used in the trust instrument, it is not clear if the settlor intended all three of his sons to be the trust beneficiaries or only two of them, just Tom and Dick. [MCL 700.7103(1)(i).] Trustco brings a legal proceeding to reform the trust, based on a claim of the settlor's mistake, to reform the trust, effecting removing Harry as a beneficiary. By bringing the reformation action Trustco has implicated Trustco's fiduciary duties of: (i) undivided loyalty to *all* the trust beneficiaries [MCL 700.7802(1).] (ii) impartiality in its treatment of *all* trust beneficiaries; (iii) to defend the trust; and (iv) to not attack the trust—by seeking to change by reformation a material dispositive trust term. Trustco effectively seek to undo part of the trust as it is written. Someone other than Trustco should pursue the trust's reformation. This reformation action would be even more problematic if Tom was acting as the trustee who filed the reformation proceedings, since Harry will surely argue that Tom's motivation is not to clarify their father's intent, but to enhance his own inheritance.

A recent court case out of Missouri closely follows the facts in this example. In *Baldwin v. Baldwin*, 667 S.W.3d 199 (Missouri Court of Appeals, 2023) the court granted the requested trust reformation. However, neither of the awkward fiduciary-duty concerns, nor the trustee's conflict of interests, were considered by the trial court, nor did that court take steps to neutralize the trustee's conflict of interest. The only issue at the appeals court was whether the reformation action had been time-barred, the 'victim' of the trust's reformation having apparently accepted the trial judge's finding that the grounds for reformation had been established. As such, the court did not provide any guidance on whether a trustee can, or should, initiate a trust reformation proceeding in light of the trustee's fiduciary duties.

Standing to Pursue a Trust Reformation: What if a trust was drafted to omit an intended beneficiary? What remedy does that omitted beneficiary have? Another example may help to understand this situation.

Example: The drafting attorney's negligence is only discovered after the settlor's death. The omitted trust beneficiary was the settlor's step-son, who was never mentioned in the final trust instrument, unlike the settlor's children. An action at law against the drafting attorney for the tort of negligent drafting may not be brought by the step-son, since the step-son had no privity with the drafting attorney-only the settlor had a 'privity of contract' with the attorney (or, perhaps, the settlor's probate estate.) The trustee would owe fiduciary duties to the designated trust beneficiaries to defend their equitable property rights in the trust, and thus the trustee would oppose the step-son's legal action against the drafting attorney, otherwise the trustee would breach its duty to loyalty to those beneficiaries. If the step-son recovered a damage award against the drafting attorney, the trustee would presumably not be entitled to share in that award, since the trustee also was not in privity of contract to the attorney.

It might be better for the step-son to first pursue a trust reformation proceeding, before turning against the drafting attorney in a legal negligence proceeding, perhaps as a second-step if the trust reformation proceeding fails. This approach was indirectly suggested in a recent Maryland Supreme Court decision. In *Bennett v. Gentile*, 321 A.3d 34, (2024) that Court said:

" In any event, in the context of a trust instrument, change in the law...have, if anything, ameliorated the perceived harshness of the strict privity rule...We do not know whether [the non-client plaintiff]..sought to invoke the court's ..[reformation powers under Maryland's version of UTC 415].. and, if she did not, we do not opine on whether a claim under it would have been appropriate."

In this case, the plaintiff has sought a legal remedy, i.e., a lawsuit against the drafting attorney, but not an equitable proceeding to reform the decedent's trust, where the court implies her reformation action could have proceeded, even though she had not privity with the settlor or the trust as drafted.

Conclusion: *Equity* looks at the substance of an undertaking, not to its form.

Consequently, the *equitable* proceeding for a trust's reformation can be a powerful remedy to use, especially now that the MCL 700.7415 permits such a reformation, even if the trust's terms are unambiguous, and even if the mistake was in fact or in law, and whether the mistake was in expression or inducement. Less clear, so far anyway, is who has legal standing to assert the trust reformation remedy, now that courts are no longer strictly adhering to privity to the transaction. Probably more clear is that a trustee should not be filing any trust reformation proceedings in light of the trustee's many fiduciary duties associated with the trust- *as written*.

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