Title

The retroactive application of judicial decrees and legislation to pre-existing irrevocable trusts

Text

Judicial orders. Section 416 of the UTC (modification to achieve settlor's tax objectives) would authorize modifications that are effective retroactively. The accompanying official commentary is cryptic and tax-focused. There is no discussion of why an involuntary retroactive judicial modification of the dispositive terms of a trust would not implicate the Takings Clause of the U.S. Constitution, particularly when the result is a reordering of equitable property rights such that there are winners and losers. An order of reformation, on the other hand, alters the text of a donative document so that it expresses the intention it was intended to express. *See* Restatement (Third) of Property: Wills and Other Donative Transfers §12.1, cmt. *f*. "Thus, unless otherwise stated, a judicial order of reformation relates back and operates to alter the text as of the date of execution rather than as of the date of the order or any other post-execution date." *Id*. What about pre-reformation distributions? Section 1006 of the UTC provides that "a trustee who acts in reasonable reliance on the terms of the trust as expressed in the trust instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from the reliance." What about the fate of a pre-reformation distribution that was made and received in good faith? Presumably where the equities are equal the law shall prevail. In other words, the no-longer-beneficiary distributee may keep the pre-reformation distribution, particularly if there has been a change of position in reasonable reliance on the terms of the trust as they had been expressed in the trust instrument pre-reformation.

Legislation. The retroactive application of a statute to a pre-existing irrevocable trust also can implicate the Takings Clause, a topic that is taken up in §8.15.71 of *Loring and Rounds: A Trustee's Handbook*. The section is reproduced in its entirety in the Appendix immediately below.

Appendix

§8.15.71 *The Constitutional Impediment to Retroactively Applying New Trust Law* [from *Loring and Rounds: A Trustee's Handbook* 2019]

> *While expediency can furnish no reason or basis upon which to determine the constitutionality of the retroactive operation of the Act, we cannot refrain from noting the unworkability of the Rule under present day economic conditions.*[1153]

Taking by redefinition. A model codification of some aspect of state trust law is likely to provide that its rules of construction and presumptions shall apply retroactively upon enactment. §8-101(b)(5) of the UPC[1154] and §1106(a)(4) of the UTC[1155] do just that. While the application of new substantive law to a trust

[1153] *In re* Trust of Catherwood, 405 Pa. 61, 74, 173 A.2d 86, 92 (1961) (referring to the Pennsylvania rule of apportionment, which is discussed in §8.15.14 of this handbook), *overruled, in part, by In re* Pew Trust, 411 Pa. 96, 103 (1963).

[1154] "…(5) any rule of construction or presumption provided in this Code applies to governing instruments executed before the effective date unless there is a clear indication of a contrary intent …"

[1155] "…(4) any rule of construction or presumption provided in this[Code] applies to trust instruments executed before [the effective date of the [Code]] unless there is a clear indication of a contrary intent in the terms of the trust …"

that is fully revocable on the date a statute becomes effective, or a court decision is handed down, is unlikely to violate the Takings Clause of the Fifth Amendment to the U.S. Constitution (which has been made applicable to the states by the Fourteenth Amendment), there would be a violation if the trust were irrevocable, particularly if the equitable property rights of its beneficiaries, whether vested or contingent, would be diminished or eliminated as a consequence.[1156]

To illustrate, let us assume that in 1900 an irrevocable trust was created. Its terms provide that, upon its termination at the death of the last survivor of the settlor's children, the property passes outright and free of trust to the "then living issue" of the settlor. Let us assume further that the term *issue* as understood in 1900 did *not* include persons who were adopted. At the time the trust was created, members of the class of the settlor's grandchildren and more remote descendants, whether born or unborn, acquired property rights in the form of equitable contingent remainders. It is a popular misconception that contingent interests under trusts are not property interests—nothing could be further from the truth.[1157] The office of the guardian ad litem itself has evolved to represent just such property interests on behalf of minors, the unborn, and the unascertained.[1158] Thus, when the state, effective retroactively, redefines a class designation in an irrevocable trust to capture persons not encompassed in the designation's plain meaning at the time the trust became irrevocable, the state dilutes the property interests, contingent or otherwise, of the persons who were contemplated, whether those persons are born or unborn.[1159] In other words, we have a taking by redefinition. Likewise, the property rights of "adopted outs" ought to be determined by the settlor, not by the retroactive application of statutes and/or case law.[1160]

Not everyone sees it that way. New Jersey courts now seem relatively comfortable applying adoption-related rules of construction retroactively, at least in most cases.[1161] As mentioned, §1106(a)(4) of the UTC

[1156]*See generally* §8.11 of this handbook (the agency-like nature of the revocable inter vivos trust) and §8.2.2.2 of this handbook (the will-like nature of the revocable inter vivos trust).

[1157]*See generally* §2.1 of this handbook (types of property interests).

[1158]*See* §3.5.3.2(h) of this handbook (the power to exclude the remainderman from the accounting process), §5.1 of this handbook (who can be a beneficiary?), and §8.14 of this handbook (representing contingent remainder interests); and Restatement (Second) of Trusts §214 cmt. a.

[1159]McGehee v. Edwards, 268 Va. 15, 597 S.E.2d 99 (2004) (to protect the property interests of beneficiaries, their interests having accrued at the time the trust was created, the court construed the terms of the trust as of that time); Wachovia Bank & Trust Co. v. Andrews, 264 N.C. 531, 142 S.E.2d 182 (1965) (holding that the state may not retroactively redefine a class to include adopteds and thus dilute the property interests of nonadopted members); Continental Bank, N.A. v. Herguth, 248 Ill. App. 3d 292, 187 Ill. Dec. 395, 617 N.E.2d 852 (1993) ("Because the settlor is presumed to have known these legal principles when he executed the trust, the terms 'descendant' and 'per stirpes' unmistakably evidenced his … intent to limit the class of beneficiaries to his natural born progeny."). *But see* Anderson v. BNY Mellon, 463 Mass. 299, 974 N.E.2d 21 (2012) (the retroactive application to a preexisting irrevocable trust of a statutory presumption that the term issue encompasses adopteds is unconstitutional on substantive due process grounds rather than on the grounds that there has been an uncompensated partial taking by the state). *See generally* §8.15.6 of this handbook (plain meaning rule).

[1160]One court that was asked to construe the terms of a testamentary trust determined that when the testator/settlor employed the word issue, he meant biological issue including adopted-out biological issue. Lockwood v. Adamson, 409 Mass. 325, 566 N.E.2d 96 (1996). Another, finding no guidance within the four corners of the governing instrument, looked to the intestacy statute in effect at the time the will was executed. The result: adopted-outs were out. "A testator is presumed to be aware of the public policy reflected in the statutory definitions of the terms used in a will at the time the will is executed and to intend that those definitions be followed in construction of the will unless a contrary intent is expressed in the will." Newman v. Wells Fargo Bank, 59 Cal. Rptr. 2d 2, 14 Cal. 4th 126, 926 P.2d 969 (1996).

[1161]*See In re* Trust under Agreement of Vander Poel, 396 N.J. Super. 218, 227–230, 933 A.2d 628, 633–636 (App. Div. 2007).

provides that unless there is a clear intention of a contrary intent, its rules of construction and presumptions apply to trust instruments executed before its effective date. The UPC has similar language.[1162]

In one case, however, a court *declined* to apply a double-damages provision of Kansas's UTC retroactively *against a trustee* who had misappropriated trust funds. Its rationale was as follows: "Because substantive laws affect vested rights, they are not subject to retroactive legislation because doing so would constitute the taking of property without due process."[1163] Why the constitutional rights of trust beneficiaries should be entitled to less deference than the constitutional rights of their trustees merely because the means of divestment, or partial divestment, of their equitable property rights is the retroactive application of a rule of construction is not entirely clear to these authors. Nor presumably would it be to the justices of the Supreme Judicial Court of Massachusetts, who, in 1987, changed the default presumption that the term *issue* shall be construed to mean "lawful issue" to the default presumption that the term shall be construed to include all biological issue, including those born out of wedlock. It did so, however, prospectively. The court ordered that the new rule of construction shall apply only to instruments executed after the date of its opinion.[1164] In 1984, the same court had prospectively construed the Massachusetts spousal election statute as applying not only to probate assets but also to assets in *revocable* trusts.[1165] This departure from past law was made applicable only to inter vivos trusts created or amended after the date of the opinion.[1166] Similarly, when the Florida legislature revised the Florida spousal election statute, it provided that the changes were to be applied prospectively.[1167]

In 1991, the Court of Appeals for the Eighth Circuit in *Whirlpool Corp. v. Ritter*[1168] held the retroactive default application of a statute that would nullify a revocable life insurance beneficiary designation in favor of the spouse of the policy owner should the couple divorce to be an unconstitutional violation of the Contracts Clause. The decision unsettled the probate codification community. In response, the Joint Editorial Board of the UPC fired off a statement to the effect that "[t]he Contracts Clause has never been read to pose any obstacle to the application of legislatively altered constructional rules to preexisting donative documents such as revocable trusts that have no contractual component."[1169] The statement is even referenced in the General Comment to Part 7 of the UPC. What needs to be kept in mind here is that the subject of the case and the statement in response to it was a *revocable* beneficiary designation. Diluting or eliminating fixed vested or contingent equitable property rights under irrevocable trusts by state action without just compensation would be quite a different matter. That would or should implicate not so much the Contracts Clause as the Takings Clause.

In 2012, the Massachusetts Supreme Judicial Court in *Anderson v. BNY Mellon*[1170] ruled that the dilution of a beneficiary's equitable interest under a testamentary trust occasioned by the retroactive application of a default statutory rule of construction, namely that the term issue shall include adopted issue

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[1162]*See* UPC §2-705 ("Adopted individuals and individuals born out of wedlock, and their respective descendants if appropriate to the class, are included in class gifts and other terms of relationship in accordance with the rules of intestate succession."); UPC §8-101(b)(5) (providing that "any rule of construction or presumption provided in this Code applies to governing instruments executed before the effective date unless there is a clear indication of a contrary intent").

[1163]McCabe v. Duran, 180 P.3d 1098, 1100 (Kan. Ct. App. 2008).

[1164]*See* Powers v. Wilkinson, 399 Mass. 650, 506 N.E.2d 842 (1987).

[1165]Sullivan v. Burkin, 390 Mass. 864, 460 N.E.2d 572 (1984).

[1166]Sullivan v. Burkin, 390 Mass. 864, 871, 460 N.E.2d 572, 577 (1984).

[1167]*See* Estate of Magee, 988 So. 2d 1 (Fla. Dist. Ct. App. 2008) (involving a trust that was amended after the effective date of the statutory amendments).

[1168]929 F.2d 1318 (8th Cir. 1991).

[1169]*See Joint Editorial Board Statement Regarding the Constitutionality of Changes in Default Rules as Applied to Pre-Existing Documents*, 17 ACTEC Notes 184 (1991).

[1170]463 Mass. 299, 974 N.E.2d 21 (2012).

as well as blood issue, was in violation of *substantive due process* under the Commonwealth's constitution.[1171] The court seems not to have fully appreciated the fact that an equitable interest under a trust, even one that is contingent, is a true property interest.[1172] Rather than deciding the case on federal taking principles, which would have been the simplest and most direct route, the court decided it on state substantive due process principles. It found the constitutional question not to be whether the statute's retroactive application "results in deprivation of property" (which we suggest it clearly did) but whether the retroactive application was "unreasonable."[1173] Thus, the decision may not necessarily stand for the proposition that such enactments are *per se* unconstitutional.

Taking by antilapse. Under the model UPC's antilapse default provisions applicable to trusts certain equitable future interests *that had traditionally been construed as vested* would become subject to the condition precedent of survivorship.[1174] This could, for example, cause the contingent equitable interests of some takers in default of survivorship to violate the Rule Against Perpetuities, at least in jurisdictions where the rule is still enforced.[1175] What had once been safely vested would no longer be.[1176] "To prevent an injustice from resulting because of this, the Uniform Statutory Rule Against Perpetuities, which has a wait-and-see element, is incorporated into the Code as part 9."[1177] Still, the legislative conversion of one's vested equitable interest into an interest that is nontransmissible postmortem in the absence of an overt expression of intent on the part of the settlor that the interest be vested would seem to pose a problem under the U.S. Constitution.[1178] The U.S. Supreme Court in *Hodel v. Irving* has confirmed that the right to pass property postmortem is a property right that is covered by the Takings Clause.[1179]

Taking by changing the rules of the income allocation and apportionment game. We now turn to the matter of altering the economic interests of trust beneficiaries by redefining, either by statute, regulation, or court decision, trust accounting income and principal, specifically by applying new definitions retroactively to preexisting irrevocable trusts. The general subject of allocating and apportioning receipts to income and principal is covered in §6.2.4 of this handbook. One's point of departure when analyzing the constitutionality of retroactive application of new allocation and apportionment rules would seem to be the U.S. Supreme Court case of *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, which involved a state taking of the income generated by an interpleader fund administered in the registry of a county court.[1180] As is the case with most such escrow-trust arrangements, the long-standing rule had been that any interest on an interpleaded and deposited fund followed the principal and was allocated to those who were ultimately to be the owners of the principal.[1181] The Court held that the state could not take the income for itself. "Neither the Florida Legislature by statute, not the Florida courts by judicial decree, may accomplish the result the county seeks simply by recharacterizing the principal as 'public money' because it is held temporarily by

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[1171]Article 10 of the Massachusetts Declaration of Rights provides, in pertinent part: "Each individual of the society has a right to be protected by it in the enjoyment of his life, liberty and property, according to standing law … [N]o part of the property of any individual can, with justice, be taken from him, or applied to public uses, without his own consent, or that of the representative body of the people."

[1172]*See generally* §5.1 of this handbook (equitable property interests).

[1173]Anderson v. BNY Mellon, 463 Mass. 299, 974 N.E.2d 21 (2012).

[1174]*See generally* UPC §2-707; §8.2.1.3 of this handbook (vested and contingent equitable interests) and §8.15.55 of this handbook (lapse and antilapse).

[1175]*See generally* §8.2.1 of this handbook (the Rule against Perpetuities) and §8.2.1.9 of this handbook (abolishing the Rule against Perpetuities).

[1176]*See generally* §8.2.1 of this handbook (the vesting concept).

[1177]UPC §2-707 cmt. *See generally* §8.2.1.7 of this handbook (perpetuities legislation).

[1178]*See* UPC §2-707 cmt. (some examples of overt expressions of the intent to vest).

[1179]481 U.S. 704, 104 S. Ct. 2076 (1987).

[1180]449 U.S. 155, 101 S. Ct. 446 (1980).

[1181]Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 162, 101 S. Ct. 446, 451 (1980). *See generally* §9.9.2 of this handbook (agency arrangements).

the court."[1182]

Webb's involved a state taking by redefinition for a public purpose of the income that had accrued on entrusted funds. When new apportionment and allocation default rules are made applicable to re-existing irrevocable trusts, the issue is not whether there has been an uncompensated taking by the state for a public purpose but whether there has been an uncompensated taking by the state for a private purpose. The private purpose is the reordering of the respective equitable interests of the income and principal beneficiaries, in this case by redefining what is trust accounting income. The victims of the taking would be any beneficiaries who were adversely affected economically by a change of the rules in the middle of the game. Thus, when an irrevocable traditional trust is judicially reformed into a unitrust, a topic we take up in §6.2.2.4 of this handbook, care should be taken that one class of beneficiary not be advantaged at the expense of another, unless the terms of the trust so permit.[1183]

In the 1961 Pennsylvania case of *In re Trust of Catherwood*, the Court had no problem upholding the application of the income apportionment rules that were set forth in an updated version of the Uniform Principal and Income Act to preexisting irrevocable trusts.[1184] The majority's rationale was that while one may have a vested equitable right to trust accounting income, in the case where an interest in a corporation is a trust asset, a beneficiary can have no vested right in the default rule as to how internal corporate income must be apportioned between the life tenant and the remaindermen in order to arrive at trust accounting income. "A vested property right cannot exist in a rule of law, although a rule of law may establish a vested property right."[1185] We are not convinced that the *Webb's* court would necessarily have agreed with the logic of that aphorism, or that its sentiments would pass constitutional muster. The *Catherwood* dissenters certainly did not buy it. Justice Bell wrote in dissent: "The majority not only repudiated the 100 year old Pennsylvania rule of apportionment which was unanimously reaffirmed approximately one year ago, but they further declare that what this Court repeatedly said was unconstitutional, was constitutional and vice versa … Once again I plaintively ask: Stare Decisis –' Quo Vadis?' "[1186]

Taking by retroactively applying a modified Rule against Perpetuities. Apparently in deference to the vested equitable property rights (reversionary interests) of those who would take upon imposition of a resulting trust should an express trust fail,[1187] the Uniform Statutory Rule Against Perpetuities (USRAP) would only interfere with certain problematic nonvested equitable interests under express trusts, namely those interest that would come into existence on or after the effective date of the legislation.[1188] The authors of the UPC, however, have suggested that a court might have the equitable power to reform a problematic contingent disposition under an irrevocable express trust created before enactment. This would be done by judicially inserting a perpetuity saving clause, "because a perpetuity saving clause would probably have been used at the drafting stage of the disposition had it been drafted competently."[1189] Those who would

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[1182]Webb's Fabulous Pharmacies, Inc. v. Beckwith, 449 U.S. 155, 164, 101 S. Ct. 446, 452 (1980).

[1183]*See, e.g.*, *In re* Moore, 41 Misc. 3d 687, 971 N.Y.S.2d 419 (Sur. Ct. 2013) (the court justifying its granting of a unitrust conversion application on the grounds that conversion is consistent with settlor intent and will not result in a "rapid depletion" of corpus).

[1184]405 Pa. 61, 173 A.2d 86 (1961), *overruled, in part, by In re* Pew Trust, 411 Pa. 96, 103 (1963).

[1185]*In re* Trust of Catherwood, 405 Pa. 61, 72, 173 A.2d 86, 91 (1961), *overruled, in part, by In re* Pew Trust, 411 Pa. 96, 103 (1963).

[1186]*In re* Trust of Catherwood, 405 Pa. 61, 72, 173 A.2d 86, 91 (1961), *overruled, in part, by In re* Pew Trust, 411 Pa. 96, 103 (1963). *See generally* §8.15.14 of this handbook (the Massachusetts rule of allocation and the Pennsylvania rule of apportionment).

[1187]*See generally* §4.1.1.1 of this handbook (the vested equitable reversionary interest and the resulting trust).

[1188]UPC §2-905 (USRAP's prospective application).

[1189]UPC §2-905 cmt. *See generally* §§8.2.1.6 of this handbook (the perpetuities saving clause) and 8.15.22 of this handbook (reformation proceedings).

take upon imposition of a resulting trust could be expected to oppose such a reformation initiative, which, after all, would seek to have the state extinguish their equitable property interests. In any case, in light of the trustee's duty of impartiality, it difficult to see why the trustee would or should be afforded the standing to bring such an action.[1190]

[1190] *But see* UPC §2-903 cmt. ("The 'interested person' who would frequently bring the reformation suit would be the trustee."). *See generally* §6.2.5 of this handbook (trustee's duty of impartiality).