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Trusts and Estates Forum

Distinguishing Discretion in Discretionary Trusts - The Letter of Wishes

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You are serving as trustee of a trust established several years ago by a client. Your firm drafted the trust, and in accordance with the client's wishes, it is a "discretionary" trust, meaning (and in fact, stating) that you and your successor trustees may distribute to the beneficiaries any amounts of income and/or principal as you deem appropriate in your absolute discretion for their health, education, maintenance, and support. Both the client and his spouse are deceased, and you are administering the trust for the benefit of their three children and four grandchildren. One of the children is involved in a protracted and difficult divorce litigation and has asked for a distribution of $25,000 to help pay his legal fees. Another child has advised you she wants to purchase a vacation home on the Cape and needs $50,000 for a down payment. And one of the grandchildren, who has recently graduated from college with a degree in mechanical engineering, has told you he wants to go to Italy to study Italian for a year. He estimates that tuition and modest living expenses would amount to about $38,000, which he asks that you pay from the trust. The trust produces gross income of about $90,000 per year, and there appears to

be adequate principal to make all of these distributions without jeopardizing the financial integrity of the trust.

Would you make any or all of these distributions? Surely, studying a foreign language would be considered "education." But would legal fees in a divorce be considered "support"? Or perhaps (mental) "health"? And where does a second home fit in to your guidelines of health, education, maintenance, and support? It is interesting to note that even the Internal Revenue Service suggests that these guidelines (commonly called "standards") may, for tax purposes at least, be construed liberally and "are not limited to the bare necessities of life". Treas. Reg. 20.2041-(c)(2). So, should you or must you do the same?

In exercising your discretion in making any distributions from the trust, what exactly do you consider? It is only normal and expected that as trustee you would use your best judgment and do what you think is appropriate under the circumstances. After all, isn't that why the settlor appointed you as trustee? But what about considering what the settlor himself might have wanted or would do under the same circumstances? Wasn't it his money to being with? Did he blindly assume you would act as he would at all times? You go back and look at your file notes on this matter and find nothing helpful as to the settlor's specific wishes, other than general dispositive provisions. Unfortunately, therefore, you are on your own, and under the law, you have pretty broad leeway. It is well-settled law that a court will not interfere or second-guess a trustee's exercise of discretion unless there is bad faith or an improper motive. *Wright v. Blum,* 114 NE 79 (Mass. 1916). But according to a leading treatise on trust law, "The real question is whether it appears that the trustee is acting in that state of mind in which it was contemplated by the settlor that he would act." (See Austin Wakeman Scott & William Franklin Fratcher, *The Law of Trusts*, section 187 (4th ed. Little Brown & Co. 1987)). How would we know what the settlor contemplated if all we have to work with are broad discretionary powers and broad standards expressed in language that is not even the settlor's? The obvious answer is a settlor's "letter of wishes".

A letter of wishes is a written statement by the settlor designed to offer the trustees of a discretionary trust some guidance in the exercise of their discretion. Although such a statement,

generally non-binding and written by a non-attorney settlor, may contain inconsistencies and raise questions, it would nevertheless be immensely helpful to a trustee in ascertaining the settlor's state of mind and purposes in establishing the discretionary trust. As helpful as such statements might be, however, the sad fact is that they are rarely used in connection with the typical discretionary trust. In addition, most such trusts either say nothing about what the trustee should consider in exercising its discretion, or contain the typical "ascertainable standard" as illustrated above. This approach, while helpful for income and/or estate tax purposes, tells the trustee little if anything about the settlor's actual wishes and, as noted above, gives the trustee extremely broad discretion to determine what falls under those categories. Occasionally, trusts will contain more liberal standards, such as "comfort," or "happiness." When these "standards" are accompanied (as they typically are by habit or custom, if nothing else) by words modifying (i.e., enlarging) the trustee's discretion, such as "sole," "absolute,", "unfettered," or "uncontrolled" (discretion), the scope of a standard becomes even more uncertain. This is because those words modifying the trustee's discretion allow the trustee to act unreasonably when exercising its discretion, so long as he does not act in bad faith, for an improper purpose, or with an improper motive. Scott & Fratcher at section 187.2.

Accordingly, when we establish a trust giving the trustee broad discretionary powers (with or without a standard) and nothing more, we are basically saying to the trustee, "Do whatever **you** think is appropriate, without regard to what I might do in the same situation, being guided of course by so-called fiduciary standards." Is this what clients really want? Aren't we as advisors overlooking a vital issue in drafting the trust? Shouldn't we at least review this issue with clients and give them the opportunity to write a letter of wishes? Or will the existence of such a letter cause more problems than it may solve, especially if the beneficiary gets a look at it? And if a letter does exist, do the beneficiaries have a right to look at it?

In an excellent treatise on the subject of exercise of discretion by trustees, Professor Edward C. Halbach, Jr. points out that "too frequently the trust instruments provide no guidance as to the purpose and scope of the power. [The trustee] should be informed of the purposes of the trust, the factors he is to consider, and something of the general frame of mind in which the settlor wishes him to act." Professor Halbach also observes that the general failure of attorneys to

develop and provide such information "is one of the most neglected aspects of estate planning." Edward C. Halbach, Jr. *Problems of Discretion in Discretionary Trusts*, Col. L. Rev. Vol. 61, p. 1425 (1961).

For reasons we are at a loss to discover or understand, there is absolutely no substantive mention of, reference to, or information on letters of wishes (to a trustee) in any of the trust treatises, reference works, reported cases, or legal encyclopedias pertaining to U.S. law. Further, we could find no articles on the subject in any of the recognized (U.S.) professional legal journals or magazines. There are, on the other hand, a fair but by no means overwhelming amount of reference material and cases on the subject in the United Kingdom and jurisdictions that follow English Law. See, e.g., Hayton & Marshall, *Commentary and Cases on The Law of Trusts and Equitable Remedies, Para. 9-215 – 9-240 (*11th Ed. Sweet & Maxwell 2001*)*; *Re Londonderry's Settlement* (1965) Ch 918 (England); *Re Rabaiotti's 1989 Settlement* (Judgment Number 2000/090) Royal Court of Jersey (unreported). The problem is that almost without exception these materials and cases address only the issue of whether the beneficiaries have the right to see non-binding letters of wishes, rather than how useful and effective they may be from a practical standpoint in effectuating a settlor's wishes in the administration of her trust. Perhaps this is because if the letter is not binding on the trustee, of what value would it be to a court in addressing a beneficiary's complaint that the trustee abused its discretion? The answer is that the letter would be of no value in that regard. The letter is simply to assist the trustee in the process of exercising his discretion. The trustee could actually disregard it if he wished.

Nevertheless, in our opinion, a settlor's letter of wishes should not be binding on the trustee and should contain a clear statement to that effect. A letter that is to be binding on the trustee becomes a part of the trust "documents" and is thus not only discoverable by the beneficiaries but also may be enforced. This is not by any means to say that binding instructions should never be used, but in our opinion they are inconsistent with merely offering the trustee some insight into the settlor's state of mind when the trustee must exercise its discretion. Discretion is a function of objective judgment, and binding instructions can interfere with the concept of full discretion and undermine or diminish the opportunity of exercising that judgment.

Whether a settlor's non-binding letter of wishes ought to be disclosed or available to a beneficiary may also depend on the contents of the letter. If seen by a beneficiary, a letter suggesting that the trustee be exceedingly liberal in making distributions might serve to encourage the beneficiary to request more funds from the trustee for any or even all of the examples given above, but remember the letter is not binding on the trustee, and so there is no obligation to comply with the beneficiaries' requests. It should also be noted that some letters of wishes may contain information that would be hurtful to the beneficiaries and, thus, in their best interests should not be disclosed. For instance, consider the following language inserted in a letter of wishes to the trustees:

> "Where distributions are to be made to my son, keep in mind that although he is a fine person, he has demonstrated bad judgment, is of weak character, and could easily be adversely influenced by outside sources. I prefer that you place as little funds as possible under his direct control. Also keep in mind that my daughter, who has never been gainfully employed and has been married three times, has obvious difficulty with responsibility and relationships. Accordingly, you should keep "strings attached" to all distributions made to her."

Obviously, disclosure of these statements to the beneficiaries would serve no purpose whatever and would be embarrassing and hurtful to the settlor's children. Yet they may be helpful to the trustee in exercising its discretion.

Recommendations

Attorneys habitually draft discretionary trusts offering no real guidance whatever to the trustees in the exercise of their discretion with respect to distributions to beneficiaries. Despite the obvious shortcomings of this approach and the casual treatment of this critical element of a trust, we continue to perpetuate it. This is wrong. We should strongly encourage each settlor to provide a non-binding written expression of the manner in which she would like to see the trustees exercise their discretion, so that the administration of her trust will have a good chance of reflecting the way in which the settlor herself would have administered it. At the same time,

we should caution the settlor not to include in the letter derogatory or inflammatory comments on the character or behavior of the beneficiaries so as to avoid embarrassing or hurtful results if the letter is disclosed. If the settlor feels compelled to comment on the beneficiary's character, it could be done in a separate confidential letter to the trustee, which would most likely not be the subject of a court-ordered disclosure, as that would serve no purpose. Although there is no law or authoritative commentary in the United States relating to the beneficiary's right to see documents relating to the trustee's exercise of discretion, a carefully drafted non-binding letter of wishes given to the trustee, possibly with a copy to the beneficiaries, will enlighten all parties as to the manner in which the settlor contemplated her trust would be administered.