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# Adjustment For Inflation For Fixed-Income Trust Beneficiaries

Lawrence A. Frolik\*

## I. Introduction

The use of trusts as the central feature of an estate plan continues to grow. Whether in the form of an inter vivos or testamentary creation, testators increasingly elect their use. The trust has become the preferred method whereby the dead hand of the past reaches into the future to affect lives and events yet to transpire. To what extent and in what manner the past will control the future is limited largely by the imagination of the testator, his lawyer's competence and imagination, and the Rule Against Perpetuities.<sup>1</sup> Many settlors<sup>2</sup> probably use trusts because their lawyers advise them that trusts, particularly a "marital trust" and a corresponding "family" or "B" trust, are the standard form of modern estate planning.<sup>3</sup> These settlors will desire and consequently impose few, if any, restrictions upon the use and distribution of income and principal of the trust. Beyond insuring that there is adequate management and investment counsel, the settlor is generally not concerned with imposing restrictions or conditions upon the use and enjoyment of the trust fund by the beneficiary. Other settlors, however, may be unable to resist the temptation of burdening their largess with restrictions, limitations, and contingencies that to a greater or lesser extent reflect the considered wisdom of the settlor.

Although the variety of restrictions, limitations and conditions that can be placed upon the use and enjoyment of a trust fund are almost without limit, practically all can be placed into one or another of four basic categories. Restrictions and limitations operate by: (1) *Time or Age*—Typically the beneficiary's enjoyment or use is postponed or restricted for a period of years or until the beneficiary (or some other measuring life) reaches a prescribed age. (2) *Amounts*—Use of the trust fund is often limited to the current income, or the income and a limited right of withdrawal of the principal. In some cases the beneficiary is limited to a specified dollar payout (either out of income or principal or both). (3) *Conditional*—The beneficiary's interests are conditional upon described standards, e.g., payment to be forthcoming only if the beneficiary has educational needs. Conditions can be vague, such as "health and welfare" or very definite—"only if she shall attend medical school." In many cases the beneficial interest arises only if the beneficiary survives the term of interest of another,

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1 Every state has adopted some form of the traditional Rule Against Perpetuities as a device to require the vesting of future interests. While not directly a limit on the duration of a trust, the requirement of timely vesting provides a de facto limitation. See G. BOGERT & G. BOGERT, *TRUSTS & TRUSTEES* § 214 (2d ed. 1965).

2 The term settlor will be used throughout this article in lieu of the terms testator or grantor.

3 See generally A. CASNER, *ESTATE PLANNING* (3d ed. 1961). See also *id.* at 1162 app.; D. WESTFALL, *ESTATE PLANNING PROBLEMS* 587 app. (1973).

interposed beneficiary— typically a life estate. (4) *Discretionary*— Many settlors, perhaps realizing their lack of omnipotency, elect to leave the distribution of some or all of the benefits of the trust to the wisdom of the future trustee. Here again the discretion can be practically unlimited as to who are the beneficiaries and how much may be paid to them;<sup>4</sup> or the trustee can be bound to a narrow path from which he cannot swerve. He must make his decisions fit within the narrow, albeit discretionary, confines granted to him.

Regardless of the type of restriction that a settlor may select, one universal problem can arise: the beneficiary (and perhaps the trustee) may believe that the trust lacks sufficient flexibility to meet the needs of the beneficiary.<sup>5</sup> If the settlor is still alive and consents, the trust often can be modified or terminated.<sup>6</sup> If the settlor has died or is incompetent, however, modification or termination, unless specifically provided for in the trust instrument, may be difficult to obtain. Where the settlor has failed to grant clear authority for the trustee to adjust the beneficial interests based on a change of circumstances then the only recourse is for the appropriate court to grant relief.<sup>7</sup> Fortunately for beneficiaries, courts have frequently been willing to allow modification of trust provisions.<sup>8</sup> The willingness of the courts to act has greatly mitigated what might otherwise have been oppressive situations where the decisions of long-dead settlors irrationally interfered with the present enjoyment of trust assets. Unfortunately for some beneficiaries, the activism of courts in approving deviation has not been without limits. Even today we find courts concluding in a lamentful fashion that they are powerless to grant relief from an oppressive trust provision because the wishes of the settlor, no matter how shortsighted or irrational, must nevertheless be upheld.<sup>9</sup> One particular class of beneficiaries for whom relief has often not been forthcoming are those who receive a fixed sum payout annuity from a trust and who are not the eventual takers of the remainder. When faced with inflation, which relentlessly reduces the value of the annuity, the beneficiaries have approached the courts to seek relief. Despite the entreaties of these beneficiaries the courts have almost uniformly held that no legal basis exists to justify granting an increase in the annuity.<sup>10</sup>

It is the thesis of this article that the judicial refusal to grant greater benefits

4 An essential element of a trust is an identifiable beneficiary or class of beneficiaries. Hence, there must be some limit on the number of potential beneficiaries. A trust which allows the trustee complete discretion as to beneficiaries would normally be declared invalid. See A. SCOTT, *SCOTT ON TRUSTS* §§ 112, 122, 123 (3d ed. 1967).

5 For an article discussing the need for a settlor to anticipate the problem caused by an inflexible trust, see Marshall, *Principal Invasion Clauses/Minority Trust Extension*, 6 REAL PROP., PROB. & TR. J. 307 (1971).

6 See SCOTT, *supra* note 4, at § 329A.

7 Typically, the beneficiary will sue the trustee in the appropriate court, e.g., Probate, Surrogate, or Orphan's Court, requesting as relief, deviation from the provisions of the trust. This assumes, of course, that the settlor is deceased and cannot consent to the requested modification.

8 SCOTT, *supra* note 4, at ch. 10.

9 E.g., *Application of Renn*, 29 N.Y.S.2d 410, 177 Misc. 195 (Sup. Ct. 1941).

10 See *New England Merchants Nat. Bank of Boston v. Kann*, Mass., 294 N.E.2d 390 (1973); *In Re Trusteeship Under Will of Whelan*, 263 Minn. 476, 116 N.W.2d 811 (1962); *Rogers v. English*, 130 Conn. 332, 33 A.2d 540 (1943); *Moeller v. Kautz*, 112 Conn. 481, 152 A. 886 (1931). *Contra*, *Thompson v. Dunlap*, 244 Ark. 178, 424 S.W.2d 360 (1968); *In Re Hess' Will*, 198 N.Y.S. 573, 120 Misc. 372 (1923). See also Comment, *Investment in Management of Trust Funds in an Inflationary Economy*, 126 PENN. L. REV. 1171 (1978).

under appropriate circumstances represents a shortsighted, unimaginative and confused notion of trust law and the judicial role in that law. The failure of the courts to perceive their proper role has doomed countless beneficiaries to passively observe their fixed trust payout being continuously eroded by inflation. For example, if a trust was established in 1950 and provided a \$5,000 per year annuity, that same trust would have to pay \$14,900 in 1978 in order to provide the annuitant with a constant purchasing power. An annuity established as late as 1967 will have suffered sufficient erosion of purchasing power. It would require \$1,861 in 1978 to provide the same purchasing power that \$1,000 provided in 1967. Even a \$1,000 annual annuity begun in 1973 would require an increase in 1978 to \$1,400 in order to provide a constant purchasing power.<sup>11</sup>

The cautious response of courts that are faced with beneficiaries requesting greater benefits because of the pernicious effects of inflation is somewhat at variance with the usual judicial response to a request for deviation. While most lay persons may believe that once executed, an irrevocable trust is as enduring and inflexible as the pyramids of Egypt (and may have been encouraged by their lawyers to so believe), the law is quite different. In numerous cases, courts have found justification to deviate from the apparently clear and binding language of a trust instrument.<sup>12</sup> Even premature termination of trusts is condoned under appropriate circumstances.<sup>13</sup>

## II. Existing Remedies in Trust Law: Deviation and Modification

### A. Deviation

While courts have administrative supervision over trusts amounting to practically unlimited powers over them, as a practical matter, courts have felt highly constrained by principles of *stare decisis* and have not generally granted modification on account of inflation.<sup>14</sup> Examination of cases where deviation has been allowed for other reasons reveals principles and patterns that, if imaginatively applied, could result in appropriate judicial relief.

#### 1. Terms of the Instrument

Many settlors have the foresight to provide within the trust instrument means and methods of modifying or terminating the trust. If the settlor is alive at the time that the proposed modification or termination is suggested, the terms of the trust may provide him the power to unilaterally modify or terminate the trust. In some instances, as protection against senility or misjudgment, the settlor will

11 Calculations are based upon the Consumer Price Index prepared by the U.S. Department of Labor, Bureau of Labor Statistics. Using base year 1967 = 100, then 1950 = 72.1, 1973 = 133.1, and December, 1977 = 186.1.

12 G. BOGERT & G. BOGERT, *supra* note 1, at §§ 561, 994; A. SCOTT, *supra* note 4, at § 167; First Nat'l Bank of Mobile v. Waters, 220 Ala. 356, 125 So. 222 (1930); Cranley v. Schirmer, 27 Conn. Supp. 258, 236 A.2d 332 (1967); Low v. First Nat'l Bank & Trust Co. of Vicksburg, 162 Miss. 53, 138 So. 586 (1932); Pennington v. Metropolitan Museum of Art, 65 N.J. Eq. 11, 55 A. 468 (1903).

13 See A. SCOTT, *supra* note 4, at Ch. 10, §§ 336, 337, 340.2; G. BOGERT & G. BOGERT, *supra* note 1.

14 See note 10 *supra*.

require joint action by both himself and another person, e.g., the trustee. In any event, where properly provided for by the settlor, such modifications or terminations may occur without any necessary action or concurrence by the beneficiaries of the trust. Court action is only required to the extent that a cautious trustee wishes for a stamp of approval by the appropriate court in order to protect against any future challenges to the modification or termination.

Court approval is naturally forthcoming because it is, after all, the essence of the obligation of the court to carry out the directions of the settlor. The only question is whether the power to effect the proposed modification or termination is clearly expressed in the trust instrument. Usually the settlor will have expressly provided for unilateral or other form of modification and termination. In some instances, however, the settlor's power to modify or terminate will be conditioned upon the happening of certain described circumstances having occurred. Termination by the settlor might be allowed only if certain financial events occur, e.g., a decline in the settlor's financial well-being, or the death of all the named beneficiaries. A settlor who relies upon a special circumstance rule is more at the mercy of the court. Unless the special circumstances are described with great specificity and are easily and objectively measured, the settlor faces the possibility that a court will find that modification or termination is not allowable because the required condition precedent, the special circumstance, has not transpired.

In any event, whether the power to modify or terminate is absolute or conditional the court will approve the settlor's request because it is the perceived duty of the court to carry out the *intent* or *purpose* of the settlor as expressed in the trust instrument. In short, courts do not grant a power of modification or termination, rather, they approve the requested interpretation of the trust instrument. The court is not creating a power, but only discovering and interpreting a power created by the settlor. This emphasis on *intent* of the settlor, and the desire of courts to uncover powers created by the settlor rather than acting merely under their judicial authority are common themes that account for much of the pattern of response in the trust deviation cases.

## 2. Statutes

Another source of judicial authority to modify or terminate trusts is found in various state statutes. Trusts have traditionally been subject to judicial control through the application of common law, but increasingly they have been subjected to statutory regulation. Many states have adopted laws that expressly empower courts to modify or terminate trusts under specified conditions.<sup>15</sup> The

<sup>15</sup> The various conditions cited by state statutes that justify modification or termination include:

- (1) Insufficient maintenance or the presence of a destitute beneficiary, e.g., CAL. CIVIL CODE § 726 (West 1971); IND. CODE ANN. § 32-1-4-5 (Burns 1974); LA. REV. STAT. ANN. § 2066 (West 1969); MINN. STAT. ANN. § 500.17 (West 1977) (applies to destitute infants); MONT. REV. CODES ANN. § 67-414 (1947); N.Y. EST., POWERS & TRUSTS LAW § 9-2.2 (Consol. 1971); VA. CODE § 31-10 (1950).
- (2) Underproductive Property, e.g., CAL. CIVIL CODE § 730.13 (West 1971); IDAHO CODE § 68-1012 (1972); KAN. STAT. § 58-911 (1976).
- (3) Change in tax laws, e.g., IND. CODE ANN. § 30-4-3-31 (Burns 1974); N.H. REV. STAT. ANN. § 564.22 (1955).

statutes act as a kind of legislative injection of a "special circumstances" clause into all trusts. Pennsylvania, for example, has enacted a "Termination of Trusts" statute which allows the court to partially or wholly terminate any trust or make an allowance from the principal to the settlor's spouse, parents or issue provided that they are income beneficiaries. The court is authorized to grant the termination or an allowance if the ". . . original purpose of the conveyer cannot be carried out or is impractical of fulfillment *and* . . . the termination . . . or allowance more nearly approximates the intention of the conveyer. . . ."<sup>16</sup> Distributions under this section are limited to \$50,000 from all trusts established by the settlor.

New York has also provided for deviation from the terms of a trust instrument by statutory means. The court is authorized by statute to make allowances (without any dollar limit) from principal for the benefit of income beneficiaries whose "support or education" are "not sufficiently provided for" if the court "is satisfied that the original purpose of the creator of the trust cannot be carried out and that such allowance effectuates the intention of the creator."<sup>17</sup>

These states, and others with similar legislation, set up hurdles that must be met before the court is authorized to grant an increased allowance to a beneficiary. First, the requesting party must already be an income beneficiary of the trust. Second, both Pennsylvania and New York require a finding by the court that the "original purposes" of the trust cannot be carried out or that fulfillment would be impractical. Finally, the proposed allowance must effectuate the intention of the settlor. Pennsylvania requires a finding that the requested allowance "more nearly approximates the intention of the conveyer." (The third requirement that the deviation be more in line with the intent of the settlor than with the original impractical trust provisions does not appear to be a significant variance from the New York statute and will be ignored.) The second and third elements could, of course, be collapsed under the single title, "settlor's intent." If circumstances have blocked the trust from fulfilling the intent of the settlor, the statute permits the court, by means of advances from the principal, to insure that the intent of the settlor is not thwarted.

While basing deviation from trust provisions upon a finding that the deviation effectuates the intent of the settlor sounds reassuring, it obscures the reality that may be less comforting. The statutes, by using a standard focusing on the intent of the settlor, imply that it is either single and unidirected or that there is an identifiably predominant intent of the settlor. Either assumption may be true, but it is hopeless to pretend that trust instruments will always reveal the dominant or singular nature of the settlor's intent. Thus, courts are encouraged, particularly in situations where the equitable considerations of the beneficiary's claim are strong to "discover" the necessary object and intent that will allow the proposed modification. Why legislatures should encourage courts to unearth and categorize something as illusive and ambiguous (even to the settlor) as intent is not difficult to answer. Faced with the anomaly of a beneficiary of a trust being denied reasonable support or education because of the shortsightedness of settlors to provide sufficient flexibility in the trust, the legislatures have granted the courts

16 20 PA. CONS. STAT. § 6102 (1972) (emphasis added).

17 N.Y. EST., POWERS & TRUSTS LAW § 7-1.6 (McKinney 1971).

the power to right the wrongs of the past. Granting discretion to a court, however, is fraught with potential problems.

At the most elementary level, such modification power gives the appearance of displacing the free will of the individual settlor with that of the judge. To allow judges an unfettered right to authorize trustees to deviate from trust provisions would give rise to absolute judicial control as there would be no way of reviewing or appealing from the modification. The free will of the judge would no more be subject to review and censure than that of the settlor.

If, however, the statute proscribes the limits and manner of judicial modification, then the legislature, in effect, has sharply limited the freedom of testation. When faced with a trust instrument whose effect on its beneficiaries is in sharp contrast with standards of the statute, a court will be compelled to modify the trust. The will of the settlor remains effective only so long as it does not conflict with the "standards" mandated by the legislature. Statutes, such as that of New York or Pennsylvania, authorizing judicial modification of trusts necessarily substitute the will of the court for the will of the settlor and create *de facto* limits on the freedom of testation. Judicial intervention rests on the finding that the intent of the settlor is clear but that he failed to provide the means by which the intent was to be realized. It matters not whether the deviation flies in the face of an expressed prohibition against deviation, or whether the deviation modifies a trust that, although silent as to deviation, fails to provide for any flexibility in the face of changed circumstances or whether the court modifies a trust in which the settlor clearly approved of flexibility. In all cases there is a consistent rationale: The court is empowered by the statute to provide the means required to fulfill the settlor's intent.<sup>18</sup>

### 3. Needs of the Beneficiary

Using the intent of the settlor as the controlling factor is by no means the only plausible approach that the statutes could have taken. The statutes focus on the intent of the settlor and provide courts with the power to carry out that intent. Rather than addressing the intent of the settlor, the statutes might have focused upon the needs of the beneficiary or upon fulfilling a defined public policy that might override the needs of either the settlor or the beneficiary. Emphasis upon the needs of the beneficiary would direct a court to examine the financial circumstances of the beneficiary and to use the assets of the trust to alleviate the financial difficulties of the beneficiary without regard to the intent of the settlor. Even statutes that focus upon the intent of the settlor, of course, explicitly or implicitly require the court to examine and take into account the financial situation of the beneficiary. Under New York's law, for example, the court is empowered to grant deviation from the trust only in the event that the trust does not "sufficiently provide for"<sup>19</sup> the education or support needs of the beneficiary. In Pennsylvania, while the statute makes no specific mention of the financial needs of the beneficiaries, it would be incorrect for a court to conclude that "the

18 See note 15 *supra*.

19 See note 17 *supra*.

original purpose of the conveyer cannot be carried out . . ."<sup>20</sup> absent a showing that the financial status of the income beneficiary was below the minimum acceptable to the settlor. In short, it must be established that the trust failed to fulfill the settlor's intent to provide a minimum standard of living for the income beneficiary. To test the effectiveness of a trust, the court would have to examine the finances of the beneficiary.

A statute that focused on the needs of the beneficiary would differ from the present statutes since it would use a standard of whether the beneficiary had needs unmet by the trust. The present statutes look to the wishes of the settlor to judge whether the trust is fulfilling the needs of the beneficiary. The court, by examination of the intent of the settlor, supposedly can divine whether the beneficiary should receive greater benefits. If the statute were to focus on the financial needs of the beneficiaries without regard to the intent of the settlor, then the statute would necessarily have to establish standards by which the court could determine whether the financial needs of the beneficiary warranted judicial modification of the trust. Failure to delineate such standards would mean that the courts would be given *carte blanche* discretion to apply the trust assets as they saw fit. Even assuming that such a statute would meet with no state or federal constitutional problems, it is doubtful whether any state legislature would want to give courts such authority. Consequently, any legislation that looks to the needs of the beneficiaries rather than at the intent of the settlor must articulate the remedies available to the court.

The most likely standard would be one which would require that the beneficiary be guaranteed some degree of support, maintenance, and education. Presumably a beneficiary would approach the court if the income from the trust failed to provide the requisite support, maintenance, and education authorized by the statute. The court, were it to find the requisite need, would then order the modification needed to fulfill the needs of the beneficiary. Two problems, however, present themselves.

The first is the timeworn issue whether the other assets of the beneficiary should be weighed in deciding whether the beneficiary qualifies for additional benefits from the trust.<sup>21</sup> The question is whether the trust can be expected to be the sole supporter of the minimum needs of the beneficiary. The answer would presumably be no; the other resources of the beneficiary would be taken into account. To require the trust to be the primary and initial source of the support of the beneficiary would seem unreasonable absent a specific showing that such was the settlor's intent. A subcategory of the question of the beneficiary's resources would be whether individual characteristics and needs of the beneficiary ought to be taken into account in judging whether to grant relief, e.g., the spendthrift nature of the beneficiary.

The second, and more significant, problem arises from the question whether an income beneficiary of a trust ought to have a legislatively endowed right to expect that the trust will provide a minimum standard of support, maintenance,

<sup>20</sup> See note 16 *supra*.

<sup>21</sup> See A. SCOTT, *supra* note 4, at § 128.4; RESTATEMENT (SECOND) OF TRUSTS § 128, Comment e (1959).



and education. Traditionally, state legislatures have not felt that the children or other relatives of a decedent should have any statutory right to any of the assets of the decedent.<sup>22</sup> Only a surviving spouse has been provided such a right.<sup>23</sup>

Freedom of testation is paired with a corresponding denial of a right to inherit. Except for the limited rights of a surviving spouse, no individual has any enforceable claim against a properly executed will or trust. Why then, we might ask, should any such "right to inherit" or "right to support" arise merely because the testator established a trust with fixed, limited payouts to the beneficiary? To do so would allow a testator to freely limit the inheritance of potential beneficiaries in a will but would create a right of minimal support if those beneficiaries were named in a trust. Such legislative favoritism is not to be anticipated even if it could be justified. Hence, we cannot expect any change from the current principles and laws that justify a modification of a trust solely because of the needs of the beneficiary. The justification for judicial modification of trusts will continue to be based upon the fulfillment of the intent of the settlor.

### B. *Modification of Purpose or Administration*

Judicial approval of deviation may find support in provisions of the trust or by statute. In either case, justification rests on a finding that the settlor would have desired the deviation in order to fulfill the purposes of the trust. Courts, however, feel free to modify trusts even though they lack explicit authorization from the trust instrument or from a statute.<sup>24</sup> The cases dealing with modification fall into various classifications, but they share the common theme that the deviation is required in order to promote the intent of the settlor. An examination of the major classifications of those cases is useful in revealing the means by which the courts are willing to employ their power and the limits to which they are willing to extend that power.

#### 1. Mistake, Impossibility and Illegality

It is common wisdom that a trust may be reformed or rescinded because of mistake, even if the mistake is unilateral on the part of the settlor. Modification on account of mistake must be allowed if the trust is to perform in a manner not inconsistent with the intent of the settlor.<sup>25</sup> A court will modify a trust to conform with the intent of the settlor. Such intent is most likely to be found in extrinsic evidence and not within the trust instrument. To say that extrinsic evidence is

22 Only Louisiana requires a testator to provide some portion of his estate for his children. LA. CIV. CODE ANN. art. 1493, 1495 (West 1952). All other states allow a testator to disinherit his children.

23 Even the "forced share" of a spouse may be forfeited. In Pennsylvania, for example, a spouse who has for one year or more "wilfully neglected" the other spouse has no rights of inheritance. 20 PA. CONS. STAT. § 2106 (1972).

24 *E.g.*, *Security-First Nat'l Bank of Los Angeles v. Easter*, 136 Cal. App. 691, 29 P.2d 422 (1934); *Davison v. Duke Univ.*, 282 N.C. 676, 194 S.E.2d 761 (1973); *Pennington v. Metropolitan Museum of Art*, 65 N.J. Eq. 11, 55 A. 468 (1903).

25 *See A. SCOTT, supra* note 4, at § 333.4; *G. BOGERT & G. BOGERT, supra* note 1, at § 997. If the gift in trust was supported by consideration or if the beneficiary has relied to his detriment on the trust, a court might not grant rescission or reformation because of the settlor's unilateral mistake. *E.g.*, *In Re Trust Estate of LaRocca*, 411 Pa. 633, 192 A.2d 409 (1963).

allowable is only to reiterate a well-known principle of judicial interpretation of documents.<sup>26</sup> The point, however, is that the reformation due to mistake *necessarily* involves the use of extrinsic evidence to demonstrate the intent of the settlor at the time of the establishment of the trust. Hence, there is no bar to examining all the circumstances existing at the time of the establishment of a trust. Reformation of trusts because of mistake tells us that where the face of the instrument and extrinsic evidence are at variance as to the intent of the settlor, extrinsic evidence may prevail, provided the court is persuaded that the extrinsic evidence better reveals the settlor's intent.<sup>27</sup>

A trust may also be modified when its activity or the fulfillment of the trust becomes impossible or illegal because of a change in circumstances that occurred after the commencement of the trust. In such cases a court must look beyond the trust instrument to the settlor's intent for guidance. Extrinsic evidence of the settlor's intent will almost always be required to determine if: (a) the settlor would have preferred failure of the trust rather than modification, or (b) what modification would be appropriate. For example, the classic application of the impossibility doctrine arises in the context of charitable gifts where the particular charity no longer exists or else the particular limitation on the use or application of a charitable gift has become impossible of fulfillment. Judicial modification rests on the doctrine of *cy pres* and a finding of general charitable intent in the mind of the settlor. Unless the requisite general charitable intent can be found, no modification is allowable. The search for the general charitable intent is not limited to the bare words of the trust instrument, but can and often does extend into an extensive examination of the settlor's probable (or actual) state of mind as well as the surrounding facts and circumstances that illuminate the settlor's intent.<sup>28</sup>

The use of extrinsic evidence, however, is not limited to revealing the settlor's intent at the time of the creation of the trust. If that were the case, questions such as, "Did the settlor by the use of the name Ted mean Edward X or Theodore Y?" or "Did the settlor intend the charitable gift to hospital Z to fail if the hospital closes?" would be asked. These questions require only that we ascertain the settlor's intent at the time of the trust's creation. Extrinsic evidence, however, is sought also to indicate the probable settlor's intent in view of the changed circumstances. Therefore, it is not only important to ascertain what was the settlor's intent at point in time A, but also, what would he have desired at point in time A + 1 given the changed circumstances. For example, suppose a settlor leaves a legacy of the income of \$50,000 to the University of West Virginia. In fact, there is no such university. The state school is officially West Virginia University. There is little problem in determining that the settlor's intent at the creation of the trust was to benefit West Virginia University by a

26 "Certain kinds of illegality, accident and mistake have been said to make a transaction 'void' to prevent the existence of a contract. In such cases, parol evidence is admissible. . . ." A. CORBIN, CORBIN ON CONTRACTS § 580 (1960).

27 *E.g.*, *Harrison v. Eaves*, 130 P.2d 841 (Okla. 1942); *Estate of Duncan v. Ritter*, 426 Pa. 283, 232 A.2d 717 (1967).

28 *Coffee v. William Marsh Rice Univ.*, 408 S.W.2d 269 (Tex. Ct. App. 1966); *Cutrer v. Cutrer*, 162 Tex. 166, 345 S.W.2d 513 (1961); see 90 C.J.S. *Trusts* § 165b (1955); A. SCOTT, *supra* note 4, at § 399.2.

\$50,000 gift. But what if West Virginia University elects to merge with the University of Pittsburgh to form a new entity named Western Allegheny University? What then becomes of the gift of income? At this point, it is not sufficient to ask what was the settlor's intent, because he certainly intended nothing as to the absorption of the old University and the creation of a new university. It is impossible to say anything about his intent concerning an event of which he had no knowledge and had never imagined. Therefore, extrinsic evidence is sought in order to reveal the settlor's intent as of the commencement of the trust *and* to indicate the probable reaction and desire of the settlor in light of the changed reality. Extrinsic evidence is thereby valuable not merely as evidence of the settlor's state of mind at the creation of the trust, but as a predictive tool. The particular response of the court is a function of perceived probabilities rather than known realities.

## 2. Administration

Modification of a trust due to change in circumstances is not limited to instances of mistake, impossibility, or illegality. Change of circumstances also justifies judicial modification of administrative provisions of trusts. Under appropriate conditions, for example, courts will allow trustees to sell trust property even though the trust specifically bars the sale of the corpus.<sup>29</sup> Trustees who find themselves barred by reason of the provisions in the trust from mortgaging the trust property or leasing it, or making a particular investment often seek and find judicial relief.<sup>30</sup>

Modification in such circumstances is based upon proof that, despite specific trust language to the contrary, were the settlor to have been confronted with the changed circumstances, he would have agreed that the requested deviation was necessary and desirable. One of the oldest and most-often quoted cases concerning this aspect of trust law is the Illinois case of *Curtiss v. Brown*.<sup>31</sup>

Exigencies often arise not contemplated by the party creating the trust, and which, had they been anticipated, would undoubtedly have been provided for, where the aid of the court of chancery must be invoked to grant relief imperatively required; and in such cases the court must, as far as may be, occupy the place of the party creating the trust and do with the fund what he would have dictated had he anticipated the emergency. . . . From very necessity a power must exist somewhere in the community to grant relief in such cases of absolute necessity, and under our system of jurisprudence, that power is vested in the court of chancery.<sup>32</sup>

Cases granting deviation rely upon a theory that the failure of a settlor to foresee and provide for future vicissitudes justifies the judicial intervention and

29 Perhaps the most renowned case of a judicially-approved change in administrative provisions was *In Re Pulitzer's Estate*, 139 Misc. Rep. 575, 249 N.Y.S. 87 (Sur. Ct. 1931) where the court allowed the trustees to cease publication of Pulitzer's paper, "The New York World"; *Carroll v. Carroll*, 464 S.W.2d 440 (Tex. Civ. App. 1971).

30 *Adams v. Cook*, 15 Cal. 2d 352, 101 P.2d 484 (1940); *In Re Trusteeship Under Agreement with Mayo*, 105 N.W.2d 900 (Minn. 1960); *In Re Kourbage's Estate*, 52 Misc. 2d 15, 274 N.Y.S.2d 762 (Sur. Ct. 1966).

31 29 Ill. 201 (1862).

32 *Id.* at 230.

modification of the trust's administrative provisions.<sup>33</sup> In essence, courts hold that if the settlor had envisioned the particular circumstances that came about, either he would have not inserted the limitation on administrative activity or he would have specifically provided an exception to that prohibition. Thus, court-approved deviation corrects the shortsightedness of the settlor.

Courts traditionally have found support for modification of administrative provisions in the principle that all administrative trust provisions exist to further the general purpose of the trust.<sup>34</sup> That is, the settlor's fundamental intent was that the primary purposes of the trust be fulfilled; and the administrative terms of the trust merely express the settlor's belief of the best means by which the primary purpose of the trust can be enacted. If a particular provision inhibits the furtherance of the primary purpose of the trust, then the impeding provision must give way. A particular provision can only be impervious to change if its fulfillment is the primary purpose of the trust. Determination of the primary purpose of a trust rests upon a finding of the settlor's intent and that, in turn, must be found through the interpretation of the trust instrument and the extrinsic evidence surrounding the creation of the trust. If the court finds that the settlor's primary purpose was to be fulfilled by strict adherence to the particular means or investment requirement from which the trustee has asked relief, the court will deny deviation,<sup>35</sup> absent a showing of severe emergency or that failure to modify would result in the destruction of the trust.<sup>36</sup>

Where an administrative change on account of a change in circumstances has been requested, courts cannot ascertain and then act upon what the particular settlor would have done had he considered the situation or what he would have done had he confronted the actual events facing the trustee. It may be possible for a court to decide what a "reasonable" settlor would have done, but the application of such a generalized standard would transgress the fundamental rule of trust law which is to carry out the intent and desires of even the most unreasonable, unwise, or eccentric settlor, (so long as the trust has a legal purpose).<sup>37</sup> To interject a standard of reasonable behavior as the guiding light of trusts would effectively bar freedom of choice, for if one is precluded from choosing irrationally, unreasonably, or unwisely, then one has the freedom only to "choose" correctly, which is a little like having no choice at all. The use of a "reasonability" test is a veiled usurpation of the judgment of the court for the judgement of the settlor. Only if unwise or eccentric decisions by settlors are

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33 *Coquillard v. Coquillard*, 113 N.E. 481 (Ind. App. 1916); *Porter v. Porter*, 138 Me. 1, 20 A.2d 465 (1941); *Evans v. Grossi*, 324 Mich. 297, 37 N.W.2d 111 (1949); *Bond v. Tarboro*, 217 N.C. 289, 7 S.E.2d 617 (1940); *Donnelly v. National Bank of Wash.*, 179 P.2d 333 (Wash. 1947).

34 See G. BOGERT & G. BOGERT, *supra* note 1, at § 146.

35 *E.g.*, *Porter v. Porter*, 138 Me. 1, 20 A.2d 465 (1941).

36 *Id.*

37 The purposes for which a trust can be created are limited "only by the imagination of lawyers and men of business and by the policy of the law against using the trust for illegal purposes." A. SCOTT, *supra* note 4, at § 59.

"An active, private trust may be created, except in a few jurisdictions which have limited trust purposes by statute, for any purpose which does not contravene the common law or some federal or state statute or public policy." G. BOGERT & G. BOGERT, *supra* note 1, at § 47.

upheld and enforced by courts can it be said that there is freedom of testation.<sup>38</sup>

If a court cannot ascertain what a settlor would have done were he living, or what he would have done had he considered the events that have called his original instructions into question, and if the application of a reasonable man standard would violate the principle of freedom of testation, then what standard should a court use when determining whether to allow deviation from the administrative provisions of a trust?

When discussing court-approved deviation arising in circumstances of illegality or impossibility it was pointed out that extrinsic evidence serves to reveal the intent of the settlor. The intent, in turn, indicates the probable action that the settlor would have taken had he been alive and allowed to modify the trust. Similarly, in instances of requested deviation from administrative provisions of trusts the settlor's intent may be clearly indicated by extrinsic evidence. If, however, extrinsic evidence is scanty or ambiguous, or if the requested deviation is too extreme or too unusual to be supported by the intent of the settlor, courts will be forced to look elsewhere.

A possible answer may be to apply both a reasonable man standard and the intent of the settlor. What is a reasonable response would be the touchstone, but it would not be the conclusion of the "reasonable man," but rather the conclusion of the particular settlor. Extrinsic evidence and the language of the trust would be used to formulate the character and state of mind of the settlor. The court would then assume that the resurrected settlor would have acted reasonably within the framework of his particular beliefs, prejudices, and desires. The court would attempt to ferret out the probable behavior of the settlor on the assumption that he would have acted in a manner internally consistent with his own intent or goals regardless of whether the probable pattern of behavior would be reasonable when compared to some more general standard of behavior. In short, the court would attempt to determine what would be the reasonable response of the particular individual.

This standard is somewhat different from the previously discussed traditional test of divining what the settlor would have done had he considered the change in circumstances, or as it is alternatively expressed, what the settlor would have done had he been alive and capable of modifying the trust were he faced with the particular set of circumstances confronting the trustee. While the two standards sound very much alike, they in fact contain subtle differences that are worthy of note. The first standard asks what the settlor would have done if he had considered the possibility at the time of the establishment of the trust. Implicit, therefore, is the assumption that the court test the settlor's behavior against what he knew, and what the world was like at the time of the creation of the trust. The attitudes of the settlor are frozen in time. We are asked to retreat in time to the creation of the trust and ask of our long since dead settlor, "Now what

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<sup>38</sup> Of course, it is not an unquestionable assumption that freedom of testation should be without limits or that society should unthinkingly enforce the most absurd or impracticable schemes of long-dead settlors, but the examination of such a fundamental question is beyond the scope of this article. It is assumed that freedom of testation is a desirable goal and one that should be supported. Hence, suggestions in this article for legal reform assume that any such reforms will reinforce the principle of freedom of testation.

would you have provided for had you been astute enough to have anticipated the very circumstances that in fact have come to pass?"

If we use the second standard, then we are asked to imaginatively place our settlor into a time machine and transport him into the present, show him the sad state of affairs that have come to pass, and ask, "Now that you see how poorly you planned, what would you have us do?"

These questions overlook, however, certain critical factors about the way in which courts reconstruct the state of mind of the settlor. In the case of the first standard, the "if you had anticipated" standard, the state of mind of the settlor, by definition, must be frozen as of the date of the creation (or the point in time at which the trust became irrevocable or unalterable). Therefore, the settlor is not perceived to be aware of the actual changes in the world that might be relevant to what he would have done had he anticipated the events that necessitate judicial intervention. For example, if the trust were created at the death of the settlor in 1940, then theoretically the court would need to determine what the settlor would have provided in 1940 had he anticipated the possible change in circumstances. If the second standard is used, the "what would our settlor do if he were alive and capable of modifying the trust" standard, then the focus is upon the state of knowledge to be ascribed to the settlor. Using the facts of the above example, do we merely transport our settlor from 1940 to 1978 and not give him the advantage of the information and attitudes of the last 38 years, or do we update his attitudes and information to the present?

If we fail to update his presumed state of knowledge then we are actually only applying the first standard, the "what would you have done if you had anticipated standard." We, in effect, have supplied the settlor only with the knowledge of the circumstances that the trustee claims justify deviation. Hence, if this second statement of the issue is to be anything other than a mere rephrasing of the first standard, then it must be read to mean that the settlor is presumed to be aware of the events that have transpired since the creation of the trust. If such "updating" is allowed, then we have two different standards, one asking what the settlor would have done had he anticipated the particular change in circumstances at the time of the creation of the trust, the other asking what the settlor would do were he alive today. In short, we postulate a "modern" or "current" settlor.

The latter standard should provide a basis for a more liberal application of judicial modifications of trusts. A judge ought to experience less difficulty in concluding that a "current" settlor would agree with the trustee that circumstances warrant modification of administrative provisions of the trust. If the trustee, acting in good faith, has rationally and reasonably concluded that circumstances have necessitated a change, then in the absence of any explicit evidence to the contrary it would seem logical for a court to conclude that the settlor would concur. Only if the settlor were perceived as irrational, unreasonable, or particularly eccentric should the court hesitate to conclude that he would take umbrage at a rational, reasonable decision of the trustee. The second standard would, therefore, be close to, but not precisely, a reasonable settlor standard. It only approximates the reasonable man standard of tort law because

it allows the court to take cognizance of the particular attributes of the settlor.<sup>39</sup> The probable action of the settlor is then projected as being the rational and reasonable decision of that particular settlor as opposed to some hypothetical reasonable man settlor.

A case that demonstrates something akin to the above described test is *Davison v. Duke University*.<sup>40</sup> In that case, the court was asked to approve a request that the trustees be allowed to deviate from the limitations on investments provided for by the settlor, James B. Duke. The court's opinion clearly evidenced its concern that the personal characteristics of the settlor be given due consideration:

We think it necessary to consider some of James B. Duke's personal characteristics and attributes. His financial genius guided the American Tobacco Company to its place as one of the giants of American industry. He was the guiding hand in the creation and building of the great Duke Power Company. He has been characterized as being astute and adaptable to the changing needs of his time.<sup>41</sup>

At the time of the opinion Duke had been dead for 49 years, yet his personality was still thought to be relevant. The court, after citing particular examples of Duke's "astute and adaptable" nature, concluded:

We are convinced that this perceptive and shrewd businessman, were he alive today, would direct the Trustees of the Duke Endowment to take immediate action to prevent erosion of the corpus of the trust in order to preserve the dominant purposes of the Duke Endowment. . . .<sup>42</sup>

In justifying its modification of the trust, the court emphasized the "perceptive and shrewd" nature of the settlor, who, based upon those characteristics, would presumably have endorsed the action of the court. In short, the settlor is expected to have acted reasonably and in a manner consistent with his particular characteristics.

### 3. Change of Circumstances

In addition to the above tests, there also exists the broad justification that deviation is necessary to avoid the defeat or impairment of the accomplishment of the trust because of a change of circumstances. The Restatement of Trusts, § 167 allows deviation whenever circumstances . . . "not known to the settlor and not anticipated by him . . ." would impair or defeat the trust purposes.<sup>43</sup> Until now courts have not generally used this broad power to authorize deviation on account of inflation.<sup>44</sup>

Professor Scott has written that under "proper circumstances," courts may

39 See RESTATEMENT (SECOND) OF TORTS § 283, Comment c (1965).

40 282 N.C. 676, 194 S.E.2d 761 (1973).

41 *Id.* at 776.

42 *Id.* at 777.

43 RESTATEMENT (SECOND) OF TRUSTS § 167 (1959).

44 See note 10 *supra*.

authorize deviations from the trust instrument. Scott maintains that by doing so, the court does not hold "that the trustee has [the] power but . . . confer[s] power upon him."<sup>45</sup> Of course, a court will confer such power upon the trustee only if by so doing the essential intent of the settlor would be fulfilled.<sup>46</sup>

Courts prefer not to directly overturn the express instructions of the settlor. Hence, the cases refer to events unforeseen or unanticipated by the settlor which have occurred since the creation of the trust. Presumably, the court is free to modify the trust to deal with events not anticipated by the settlor. Of course, not all changes of circumstances will warrant modification of a trust. The change must render the instructions in the trust instrument "highly disadvantageous and obstruct the trustee in carrying out the purposes which the settlor expressed."<sup>47</sup> The original trust provisions become counterproductive; rather than promoting the intent of the settlor, they block the fulfillment of the trust.<sup>48</sup> Of particular interest are those instances where a court has allowed the trustee to deviate from specific limitations on investments. Traditional trust law holds that a court will not allow a trustee to transgress investment provisions of the trust instrument merely to increase the trust income.<sup>49</sup> Courts, however, have approved deviation when the trust instrument requires certain investments which have become significantly less productive because of changes in economic circumstances, namely, inflation, since the creation of the trust.<sup>50</sup> The court allows deviation on the theory that the restrictions on investment thwart the more fundamental intent of the settlor to produce a certain amount of income. That is, if the investment means selected by the settlor become unreasonable because of a change in circumstances, the court is free to refashion the means available to the trustee and thereby ensure the accomplishment of the ends for which the trust was established. Hence, deviation from the express language of the trust is granted in order to carry out the implied underlying intent of the settlor.

### C. *Modification Per Request or Need of the Beneficiary*

Perhaps the most frequently litigated trust modification cases arise from the desires and needs of the beneficiaries for additional or accelerated benefits.<sup>51</sup> Although the cases arise from a multitude of facts and raise a variety of legal issues, it is enough for present purposes to organize and analyze the cases in two categories: (1) those in which the requested modification could result in re-

45 A. SCOTT, *supra* note 4, § 167.

46 G. BOGERT & G. BOGERT, *TRUSTS & TRUSTEES* § 146 (5th ed. 1973).

47 *Id.*

48 A. SCOTT, *supra* note 4, at § 167.

49 *E.g.*, *Crocker-Citizens Nat'l Bank v. Younger*, 4 Cal. 3d 202, 481 P.2d 222 (1971); *Toledo Trust Co. v. Toledo Hosp.*, 174 Ohio St. 124, 187 N.E.2d 36 (1962). *See also* Annot., 56 A.L.R.3d 1228 (1974); A. SCOTT, *supra* note 4, at § 167 n.32; P. HASKELL, *preface to THE LAW OF TRUSTS* 75 (1975).

50 *Bank of Delaware v. Clark*, 249 A.2d 442 (Del. Ch. 1968); *Carrick v. Keiler*, 375 S.W.2d 397 (Ky. App. 1964); *John A. Creighton Home for Girls' Trust v. Waltman*, 140 Neb. 3, 299 N.W. 261 (1941). In a similar vein, but without an express reliance on inflation are: *St. Louis Union Trust Co. v. Ohio*, 240 Mo. 1033, 222 S.W.2d 556 (1949); *Citizens Nat'l Bank v. Morgan*, 94 N.H. 284, 51 A.2d 841 (1947).

51 *E.g.*, *Petition of Wolcott*, 95 N.H. 23, 56 A.2d 641 (1948); *In Re Ryan's Estate*, 404 Pa. 229, 172 A.2d 584 (1961); *In re Trusteeship Under Will of Whelan*, 263 Minn. 476, 116 N.W.2d 811 (1962); *Thompson v. Dunlap*, 244 Ark. 178, 424 S.W.2d 360 (1968).



distribution of benefits between beneficiaries, and (2) those lacking redistributive effects because the requested modification is only for an acceleration of benefits. The latter need not concern us for it is only the application of the *Clafin v. Clafin*<sup>52</sup> doctrine. The sole issue in a *Clafin* case is whether or not the deferral of benefits is an essential element of the trust. If the court finds that such deferral is essential to fulfill the intent of the settlor, then no acceleration will be forthcoming. On the other hand, if deferral is not essential or if it interferes with other more compelling interests of the settlor, then partial or even total acceleration may be forthcoming.<sup>53</sup> Closer examination of cases involving redistribution of benefits, however, is warranted.

Although several forms of redistributive modifications are conceivable, in reality the redistribution is usually at the expense of the remainder interests and in favor of the income beneficiaries. Typically the income beneficiary will request invasion of the corpus or of accumulated income for his benefit. In a surprising number of cases (considering the solicitude of the court for the right of a settlor to arrange for the disposition of his property as he sees fit without regard for his wisdom or acumen) courts have granted modification of a trust even though such modification necessarily reduced the value of the remainder interests.<sup>54</sup>

Whether the court grants the requested deviation seems to depend on the presence of four factors. First, extreme financial need of the income beneficiary often appears to be a compelling enough reason for the court to grant the trustee the right to invade principal for the benefit of the income beneficiary.<sup>55</sup> Second, the relationship between the income beneficiary and the settlor is another critical factor.<sup>56</sup> If the settlor and the income beneficiary had a close, supportive relationship (either financially or even emotionally), courts are more likely to allow additional aid to income beneficiary. Typically the income beneficiary will have been the spouse of the settlor.<sup>57</sup> The possibility of success for the income beneficiary increases if the remainder interest is destined to pass to individuals either unknown to the settlor or not likely to have been favored by the settlor at the expense of the income beneficiary. For example, if the settlor's spouse is suffering extreme financial hardship and the remainder is to go to after-born nieces and nephews, there exists a high probability that the court will order an invasion of the trust corpus in order to aid the current income beneficiary. Third, a factor tending to deter judicial relief is an unknown or minor remainder taker. If, at the time of the income beneficiary's request, the remainder parties are minors or cannot be determined, the court may be reluctant to take action, because the beneficiary can only be represented through the device of a guardian *ad*

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52 149 Mass. 19, 20 N.E. 454 (1889).

53 *In Re Ryan's Estate*, 404 Pa. 229, 172 A.2d 584 (1961); *Petition of Wolcott*, 95 N.H. 23, 56 A.2d 641 (1948).

54 See note 12 *supra*.

55 E.g., 404 Pa. 229, 172 A.2d 584; 95 N.H. 23, 56 A.2d 641.

56 E.g., 404 Pa. 229, 172 A.2d 584; *Hardy v. Bankers Trust Co.*, 137 N.J. Eq. 35, 44 A.2d 839 (1945); *Shepard v. Shepard*, 57 Conn. 24, 17 A. 173 (1889); *Cranley v. Schirmer*, 27 Conn. Supp. 258, 236 A.2d 332 (1967).

57 404 Pa. 229, 172 A.2d 584; 95 N.H. 23, 56 A.2d 641; *Thompson v. Dunlap*, 244 Ark. 178, 424 S.W.2d 360 (1968). *Contra*, *In Re Cosgrove's Will*, 225 Minn. 443, 31 N.W.2d 20 (1948).

*litem*.<sup>58</sup> Fourth, courts will also refuse relief if they perceive that the essential or primary purpose of the trust was the preservation of the corpus for the benefit of the remainder takers.<sup>59</sup> If the settlor's primary intent was to aid the remainder takers the court will not deliberately undermine the accomplishment of that intent by increasing benefits of the income beneficiary at the expense of the remainder. Therefore, courts will not allow the current use of principal unless they are satisfied either that the present emergency compels such an extreme measure, or the income beneficiary is so old as to make fears of depletion of the trust or reduction of the future income unfounded.<sup>60</sup>

These admittedly brief summations of current trust law reveal a significant principle. Courts will use their broad powers of equitable relief to redistribute trust benefits without regard for the original distribution plan of the settlor. They will do so when they perceive that the provisions of the trust do not accomplish or interfere with the primary goals of the settlor. In short, when the intent of the settlor is thwarted by his own hand, courts feel free to step in and undo the error.

### III. Deviation Based Upon Inflation: The Case Law

Having examined many principles and illustrative cases that support the right of a court to grant increased benefits to the beneficiary we turn to the subject at issue: deviation to aid the fixed-income beneficiary whose trust benefits have been eroded by inflation. As seen earlier a limited income trust beneficiary may qualify for increased benefits under current principles of trust law. If the beneficiary can convince the court that the need is great enough and that the settlor's primary concern was with the well-being of the income beneficiary, then the beneficiary has hope of a court-approved increase in benefits. But if either factor is unprovable or unpersuasive, the beneficiary, according to prevailing case law, can expect no relief from the courts.

Perhaps because lack of success has discouraged such litigation, there are only a handful of reported cases involving fixed-income beneficiaries citing inflation as grounds for increased payouts.

One of the oldest and more famous cases (at least in the sense of being oft-cited) is *In re Hess' Will*,<sup>61</sup> which proved to be something of an exception to the rule. The plaintiffs, German nationals who were legatees under a will of a German-American, were left gifts of 5,000 marks each. All the assets were situated in America, and at the time of the execution of the will in 1914, 5,000 marks were worth approximately \$1,150. By the time of the decedent's death in 1920, the 5,000 marks were worth about 10 cents. The plaintiffs asked that they be paid in gold. The court held that payment of the depreciated marks would violate the testator's intent, something that "equity will not permit it to be

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58 *In re Van Deusen's Estate*, 30 Cal. 2d 285, 182 P.2d 565 (1947); *Chicago Title and Trust Co. v. Schwab*, 347 Ill. App. 233, 106 N.E.2d 857 (1952); *Hughes v. Federal Trust Co.*, 119 N.J. Eq. 502, 183 A. 299 (1936). See also A. SCOTT, *supra* note 4, at § 168.

59 404 Pa. 229, 172 A.2d 584.

60 *Id.*

61 198 N.Y.S. 573, 120 Misc. 372.

done."<sup>62</sup> *Hess* may stand as the high-water of judicial sympathy towards the problems of inflation.<sup>63</sup>

More in the tradition of the lack of judicial action was *Moeller v. Kautz*,<sup>64</sup> an early case in which deviation from a trust was requested because of inflation. In that case, a trust fund of over \$1,000,000 was limited to a total payout of \$36,000 to the children of the testator. No child was to receive more than \$4,000 per year. The children requested distribution of the accumulated income which totalled \$350,000. The court denied the request. The court admitted that the testator neither expected the large accumulation of income nor anticipated the decline in purchasing power of the fixed payout. Nevertheless, the court held: "These circumstances cannot, however, justify a disregard of the plain words of the will and the intent [the testator] has expressed in it."<sup>65</sup> The court concluded that it was reasonable to believe that the testator preferred accumulation for the benefit of the remaindermen (grandchildren and great-grandchildren) at the expense of more lavish treatment of his children.<sup>66</sup> The issue in the case was not limited to an adjustment of the payout to account for inflation, but whether the court would disregard specific directions to accumulate the excess income in order to grant more favorable treatment to the income beneficiaries. Following traditional trust law the court found nothing that would support a holding that the intent of the testator was not plainly and unequivocally expressed in the trust instrument.<sup>67</sup>

The income beneficiaries were by no means satisfied with the decision, however. Twelve years later they again went to court seeking increased benefits. In *Rogers v. English*,<sup>68</sup> the beneficiaries requested that the trustees be allowed to make larger annual payments. Two reasons were given. First, the imposition of the federal income tax since the creation of the trust decreased the disposable income of the beneficiaries. Second, the increase in the cost of living and the decrease in the purchasing power of the dollar. The beneficiaries claimed that an increase in the annual payment was necessary to accomplish the general intent of the trust which was, "to provide a standard of living in keeping with that which he had taught them to expect."<sup>69</sup> The beneficiaries once again lost.

The court held initially that the trust was not designed to insure the beneficiaries a comfortable support or a minimum standard of living. Hence, there could not be a finding that the primary support goal of the trust was being frustrated by the limit on income payout. The court dismissed the decline of the value of the dollar or the inflation argument saying that the testator by his silence on the

62 *Id.* at 576, 120 Misc. at 376.

63 *Hess*, of course, is not so much a judicial reaction to inflation as is it a judicial determination as to what intent and what interpretation should be given to amounts or payments described in foreign currency. A fair number of cases exist in which payment is allowed in dollars even though the will or trust calls for another medium of exchange or for foreign currency. *See* Annot., 63 A.L.R. 524 (1929). The result is to protect the legatees from being paid in greatly depreciated currency. *Contra*, *In re Lendle's Estate*, 250 N.Y. 502, 166 N.E. 182 (1929).

64 112 Conn. 481, 152 A. 886 (1931).

65 *Id.* at 487, 152 A. at 888.

66 *Id.* at 488, 152 A. at 888.

67 *Id.*, 152 A. at 889.

68 130 Conn. 332, 33 A.2d 540.

69 *Id.* at 337, 33 A.2d at 543.

matter had indicated that he had rejected any such adjustment. The court held that the absence of any allowable deviation coupled with the "astute businessman"<sup>70</sup> nature of the testator evidenced a willingness on the part of the testator to allow the effects of the fluctuating business cycle to fall unmitigated upon the beneficiaries. Finally, the income tax argument was rejected without meaningful comment.<sup>71</sup>

The next case (other than cases that dealt with the effect of the federal income tax)<sup>72</sup> to deal with the issue of inflation was *In re Trusteeship Under Will of Whelan*.<sup>73</sup> Again the court rejected the request of fixed income beneficiaries for greater benefits to offset inflation. The court cited the settlor's intent as controlling and held that the settlor did not intend that the fixed income amounts should be adjusted for inflation. The court raised another, perhaps more telling argument. If the court authorized increased payments to the life annuitants there would be less income accumulation for the benefit of the remainderman.<sup>74</sup> The court in citing the trial court's memorandum also raised the red herring of deflation: should the amount of the annuity be lowered if "the buying power of the dollar be increased substantially. . . ."<sup>75</sup> Given the increasing intensity of post-World War II inflation, the "problem" of significant deflation seems quite unlikely. The court's concern for the remainderman seems better founded, but its analysis was simplistic.<sup>76</sup>

In a 1968 Arkansas case, *Thompson v. Dunlap*,<sup>77</sup> a settlor with unusual foresight provided that a \$150 per month lifetime annuity could be increased by the Chancery Court in the event of "unusual economic inflation."<sup>78</sup> In 1967, ten years after the death of the settlor and the establishment of the trust, the lifetime annuitant, the widow of the settlor, requested the Chancery Court to increase her monthly payments from \$150 a month to \$300 a month. The trustee resisted the increase citing the fact that there had only been an 18.1% increase in the cost-of-living since the settlor's death. The Chancery Court granted an increase from \$150 per month to \$200 per month. The increase was upheld on appeal. The court did not deal with the discrepancy between an increase of 33 1/3% in the payout while the cost-of-living had increased only 18%. Nor did the court take up the issue whether inflation of 18% constituted "unusual economic inflation" which would justify an increased payout.<sup>79</sup> Because the decision is so dependent upon the particular language of the trust instrument, the case has not

70 *Id.* at 339, 33 A.2d at 543.

71 *Id.* at 337, 338, 33 A.2d at 543.

72 *E.g.*, *Hardy v. Bankers Trust Co.*, 137 N.J. Eq. 352, 44 A.2d 839 (1945). Several cases have arisen on account of the Tax Reform Act of 1969, *e.g.*, *Davison v. Duke Univ.*, 282 N.C. 676, 194 S.E.2d 761 (1973); *In Re Roche's Will*, 69 Misc. 2d 481, 330 N.Y.S.2d 441 (1972); *Estate of Bird*, 69 Misc. 2d 1015, 332 N.Y.S.2d 85 (1972); *In re Estate of Barkey*, 65 Misc. 2d 738, 318 N.Y.S.2d 843 (1971); *In re Estate of Klosk*, 65 Misc. 2d 1005, 319 N.Y.S.2d 685 (1971). *See also* Annot., 57 A.L.R.3d 1044 (1974); *Canal Nat'l Bank v. Old Folks' Home Assoc. of Brunswick*, 347 A.2d 428 (Me. 1975). *Contra*, *Chicago Title & Trust Co. v. Schwab*, 347 Ill. App. 233, 106 N.E.2d 857 (1952).

73 263 Minn. 476, 116 N.W.2d 811.

74 *Id.* at 478, 116 N.W.2d at 813.

75 *Id.* at 480, 116 N.W.2d at 815.

76 *Id.* at 478, 116 N.W.2d at 813, 814.

77 244 Ark. 178, 424 S.W.2d 360.

78 *Id.* at 179, 424 S.W.2d at 361.

79 *Id.* at 180, 424 S.W.2d at 362.

been cited for the proposition that inflation may justify an increase payout to the income annuitant.

The most recent case to deal directly with the argument is *New England Merchants National Bank of Boston v. Kann*.<sup>80</sup> In that case, an income annuitant who received \$5,000 per annum requested an increase to \$14,034.25 to reflect the inflation that had occurred since the establishment of the trust in 1932. The trust was to accumulate the excess income for the benefit of certain named charities who were to receive the corpus upon the death of the remaining annuitant (originally there had been two, but one had died). The corpus of the trust had increased from a value of approximately \$450,000 in 1935 to a 1973 value of approximately \$1,870,000 and produced an annual net income of approximately \$48,000. The charities, as the takers of the remainder, objected to the increased payout and counterclaimed for partial termination of the trust leaving only enough funds in the trust to produce the necessary annual payment of \$5,000 per annum. The charities requested that the excess funds be immediately passed out to them. The court turned down the requests of both parties. The annuitant's request was denied out of hand. As the court pointed out, "During oral arguments, the trustees conceded that this court is without power to modify this trust as urged by the petition in the absence of agreement of all the parties in interest."<sup>81</sup>

As for the charities' request for partial termination, the court refused to exercise its equitable jurisdiction because "[it felt] that no persuasive and convincing reason ha[d] been presented by the charities for opposing an equitable increase in the stipend to the annuitant."<sup>82</sup> The court went on to chastise the charities since it believed the adjustment sought was fair and reasonable.<sup>83</sup>

Perhaps the trustees conceded too much when they failed to argue that the annuitant could have been granted relief even in the absence of the consent of the charities. Even the court admitted that "[i]t is difficult to conceive on the record before us of any rational argument that such an adjustment would be contrary to the wishes of the testatrix."<sup>84</sup> In any event, even in the face of the compelling equities, the court refused to authorize an increase in the annuity.

#### IV. Justification for Deviation: The Effects of Inflation

Much of the hesitance of the courts to grant relief to the income annuitant can be traced to a reluctance to diminish the remainder interests. The problem, however, is not merely one of robbing Peter (the remainderman) to pay Paul (the annuitant). Any time a trust is subject to severe inflation there exists the possibility that the rate of investment return will not keep pace with the rate of inflation. A trust corpus left on deposit with a savings bank may earn 5¼% interest. In any year that the rate of inflation exceeds 5¼%, the trust will suffer a loss of value. Of course, the rate of inflation need not exceed the rate of return

80 363 Mass. 425, 294 N.E.2d 390 (1973).

81 *Id.* at 427, 294 N.E.2d at 392.

82 *Id.* at 428, 294 N.E.2d at 393.

83 *Id.*

84 *Id.*

in order that a trust corpus suffer shrinkage. All that is required is that the rate of inflation combined with the required rate of payout exceed the trust's rate of return. If the rate of inflation were 5%, the required rate of payout 4%, and the rate of earning were 6%, the value of the remainder interest would decline. The erosion of the remainder would occur even though the settlor had selected a rate of payout payable solely out of income. In short, a trust designed to preserve the corpus and accumulate excess income may do both, but because of inflation, may nevertheless sustain a loss of value of the remainder interest. The diminution of the remainder in a manner not anticipated by the settlor may be a possibility and a problem even in the absence of the granting of additional income to the annuitant. If, for example, a settlor has expressly stated that his primary intent is to accumulate part of the income for the benefit of the remainder, should the court reduce the payout of income to the annuitant in order to implement the primary purpose of the settlor: to provide for the remainder interests?

The above hypothetical raises only one possibility. There are three different possible patterns depending on the rate of trust earnings. The following chart is illustrative.

	Rate of Inflation	Rate of annuitant payout*	Rate of return	Gain or loss in purchasing power of the trust corpus
I. Zero inflation	0%	4%	6%	+2%
II. Inflation offset by greater rate of return	6%	4%	12%	+2%
III. Inflation outstrips rate of return	6%	4%	6%**	(-4%)

\*Actually a fixed sum payout which equals 4% of the initial trust corpus, e.g., \$100,000 trust fund and a \$4,000 annual payout.

\*\*Assumes that trustee cannot legally invest in assets which would grow at a rate equal to inflation.

In I, zero inflation, the value of the annuity remains constant while the remainder slowly grows in purchasing power as excess income is accumulated. In II, inflation offset by a greater rate of return, the growth of the purchasing power of the remainder is not harmed by the inflation. The income annuitant, however, bears the full brunt of the inflation. The 4% or \$4,000, when faced with an inflation rate of 6% suffers a reduction in purchasing power. In 5 years of 6% inflation (i.e., 6% as measured against a base year) the purchasing power of the annuity will have declined by 30%. The result is the same as if the trust had provided for a gradual reduction in the annuity from 4% to 2.8% of the original corpus over a five-year period.

In III, when inflation outstrips the rate of return, the annuitant suffers the

effects of the inflation, and, because the corpus declines, the remainder also loses purchasing power—the degree of the loss being dependent upon the rate of inflation and the amount of the annual payout.

While the annuitant is losing ground to inflation the remainder interest may actually gain. The following chart demonstrates the effects of inflation using gross amounts, rather than percentages. The trust is originally funded with \$100,000 with a mandated payout of \$4,000 per year.

<i>Year 1</i>				
	Rate of Inflation	Annual Payout	Trust <sup>(1)</sup> Income	Year-end Dollar Value of Corpus
I. Zero inflation	0%	\$4,000	\$ 6,000	\$102,000
II. Inflation off-set by a greater rate of return	6% <sup>(2)</sup>	\$4,000 <sup>(3)</sup> [\$3,774] <sup>(5)</sup>	\$12,360 <sup>(4)</sup> [\$11,660]	\$108,360 [\$102,226]
III. Inflation out-strips rate of return	6%	\$4,000 [\$3,774]	\$ 6,180 [\$ 5,831]	\$102,180 [\$ 96,396]

  

<i>Year 2</i>				
	Rate of Inflation	Annual Payout	Trust <sup>(1)</sup> Income	Year-end Dollar Value of Corpus
I. Zero inflation	0%	\$4,000	\$ 6,120	\$104,120
II. Inflation off-set by a greater rate of return	6% <sup>(2)</sup>	\$4,000 <sup>(3)</sup> [\$3,520] <sup>(5)</sup>	\$13,003 <sup>(4)</sup> [\$11,610]	\$117,363 [\$104,788]
III. Inflation out-strips rate of return	6%	\$4,000 [\$3,520]	\$ 6,131 [\$ 5,474]	\$104,311 [\$ 93,135]

(1) Assumes all income is current i.e., interest. There are no capital gains.

(2) Measured from base year of 100. Inflation is assumed to be uniform and constant throughout the year.

(3) Assumes payout occurs on December 31.

(4) Assumes earnings are compounded.

(5) Figures in brackets indicate values expressed in preinflation constant dollars.

The above calculations demonstrate that if a trust is able to increase its earnings at a rate equal to that of inflation, the remainder interest suffers no diminution of "real" or constant value dollars. Because of the effects of compounding, the remainder may grow more rapidly in the presence of inflation. (This assumes that the trust is able to achieve an increased rate of return that at least matches the inflation.)

Because inflation has been so persistent in the last few years,<sup>85</sup> it is not realistic to postulate zero inflation. Even if we assume that inflation at the rate of 3% is the "norm," it remains true that so long as the rate of return exceeds the sum of the rate of inflation and the required rate of the annuity, the purchasing power of the remainder continues to grow. For example, if the trust earns an 8% rate of return and the rate of inflation is 5% and the effective rate of the annuity is 3%, then the remainder will "grow" with inflated dollars and retain its value as measured in constant value dollars.

Inflation may actually benefit the remainder interest. If we assume that inflation may cause interest rates to rise and therefore the earnings of the trust to rise, the effective percentage payout rate of the annuity is in constant decline. The trust has ever-increasing earnings (because it is compounding its undistributed earnings) with which to pay off a fixed obligation. Moreover, the trust is able to pay off the obligation with "inflated" dollars. The combination of the declining burden of the annuity (as measured by the comparative size of the annuity to the size of the corpus) coupled with the payoff being made with "inflated" dollars adds up to a net gain for the eventual taker of the corpus—the remainder interest.

The remainder interest will suffer because of inflation if, and only if, the trust earnings are insufficient to pay the required annuity (plus any other charges or expenses) and accumulate sufficient income to permit the remainder interest to maintain its value as measured in constant dollars. No generalization can be made about the likelihood of any particular remainder suffering loss of purchasing power because of inflation. The probability of that loss increases with the relative size of the annuity and if the trust is proscribed from desirable investments. Diminution of the remainder is, however, only a possibility. Erosion in the value of a fixed annuity is assured no matter how low the rate of inflation. A variable rate of inflation is of no solace to the annuitant except that the degree of annual erosion due to inflation may be smaller in some years than in others. The remainder, on the other hand, may well suffer erosion in years of high or "double-digit" inflation when the trustee is unable to produce a rate of return commensurate with inflation, but such erosion may be counteracted in other years when, as seen above, the remainder benefits from a rate of inflation which is equalled by the rate of return. Hence, inflation uniquely and invariably operates to the detriment of the fixed-income annuitant.

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85 Since 1967, for example, the Consumer Price Index has risen from 100 (1967 base year) to 186.1 in December, 1977. Source: U.S. Dept. of Labor, Bureau of Labor Statistics.



## V. Conclusion

### A. *Justification from the Trust Instrument*

Case law gives faint hope to the fixed-income annuitant who requests an increase in the annual payout because of the debilitating effects of inflation. The courts have failed to understand either what would appear to be a proper application of the principles of trust law or economic realities.<sup>86</sup> The fundamental legal principle that would support a court's approval of increased payout to the annuitant is the precept that the courts should endeavor to promote the basic intent of the settlor. If, because of inflation, a fixed annuity cannot fulfill the intent of the settlor to provide a particular yearly value to an annuitant, the courts should recognize that they have the authority to modify the terms of the trust. Thus, the essential issue is the identification of the intent of the settlor. Often the solution will be found through extrinsic evidence which will indicate the attitude of the settlor towards deviation to account for inflation. Before turning to an examination of the relevant extrinsic evidence, there remains within the trust instrument other possible indicia of the intent of the settlor, specifically, provisions for the accumulation of income (either mandatory or reasonably anticipated) and the presence or absence of a right to draw on principal in order to pay the annuity.

In the absence of inflation, a trust that is required to pay an annual annuity which is less than the annual earnings of the trust will, in the absence of any instructions to the contrary, necessarily accumulate value for the benefit of the remainder interest.<sup>87</sup> The excess income will be added to the corpus for eventual distribution to the remainder interest. The selection by the settlor of a low annual payout and income accumulation might reflect a conservative estimate by the settlor of the potential earnings of the trust. The payout would reflect the settlor's belief of the prospective earnings of the trust, the payout being somewhat less than the expected earnings. Limiting the annual payout to an amount which will result in income accumulation could indicate either a specific desire to increase the value of the remainder or it could be a device calculated to insure the ability of the trust in the future to pay the annuity. The latter interest is served since income accumulation increases the corpus which in turn should result in an increase in the trust income. Nothing on the face of the trust is likely to indicate which was the predominant intent of the settlor. Therefore, the mere existence of income accumulation does not compel the conclusion that the settlor intended to favor the remainder interest at the expense of the income annuitant.

The second possible indicium of the settlor's intent is the existence of a right to use principal if the trust income is insufficient to meet the required annual payout. An authorization to use principal may be a significant clue as to the intent

<sup>86</sup> A. SCOTT, *supra* note 4, at § 128.2.

<sup>87</sup> See text accompanying notes 84 and 85 *supra*. *Contra*, *Davis v. Margolis*, 144 A. 665 (1929); *Shepard v. Union & New Haven Trust Co.*, 138 A. 809 (1927); a trust might provide for priority accumulation by requiring that a certain sum or percentage of the income be set aside for the remainder prior to any payment being made to the income annuitant. However, such a provision is probably very rarely used, and so will be ignored for purposes of this discussion.

of the settlor. If the trustee is authorized to use principal, then the settlor apparently favored the income annuitant over the taker of the remainder interest. Use of principal would not only reduce the remainder interest, but would necessarily reduce future income earning, reduce accumulation of income, and increase the possibility of a future need to use principal to pay the annuity. Hence, the settlor's allowance of the use of the principal for the benefit of the income annuitant would seem to indicate a primary concern for that annuitant. Conversely, if the settlor has provided that the income annuity is payable only from income and that no principal may be used, then the intent of the settlor is either: (a) to assure a fixed amount for the remainder interest, or (b) to protect the income annuitant from a possible exhaustion of the trust corpus prior to the death of the annuitant. What in fact was the intent of the settlor would have to be determined, as with all trusts, by initially examining the trust instrument, and if that failed to provide an answer, then by looking to extrinsic evidence which might indicate the settlor's state of mind. The relationship of the annuitant to the settlor, the relationship of the remainder taker to the settlor, the amount of the annuity versus the probable annual income—all this information would aid in the determination of the settlor's intent.

If the trust instrument is silent on the question whether the trustee may draw down principal in order to meet the obligation to the income annuitant, then either of two possibilities may be true. First, the settlor may merely have failed to foresee the possibility that invasion of principal would ever be required. He may have done so under the mistaken belief that the income produced by the trust would always be sufficient to meet the annuity payment or the settlor may merely have failed to consider the possibility of inadequate income and a corresponding necessity to invade principal. Second, the settlor may have failed to provide for the right to draw down principal because he preferred that the value of the remainder not suffer diminution on account of a decline in income. Only if this is the case, did the settlor necessarily favor the remainder at the expense of the income annuitant.

Assuming that extrinsic evidence reveals that the settlor is of the first category, that is, he either failed to recognize the possible need for principal payments to the annuitant or mistakenly believed that the income would be sufficient, what can be assumed about his intent towards the annuitant? Apparently, very little if anything. Under such a situation, it is undeterminable whether the settlor's concern for the annuitant was such that he might have authorized adjustment for inflation in the payout to the annuitant. Nor could it be assumed that the settlor preferred the remainder party to the annuitant. As was previously pointed out, no presumption can be read into a settlor's mistake about the nature of the instrument that he has created.<sup>88</sup> If a settlor has mistakenly underfunded a trust corpus in the sense that the corpus cannot produce sufficient income to pay the annuity, there can be no presumption from such a mistake that the settlor necessarily had a primary intent of preserving capital for the remainder interest rather than ensuring that a sum certain be paid annually to the annuitant. The analysis of the settlor's intent would require additional extrinsic evidence to

88 See text accompanying notes 25-28 *supra*.

indicate whether the failure to allow invasion of principal was an oversight, a mistake in judgment, or a deliberate attempt to protect the value of the remainder.

The second possibility supposes a settlor who had deliberately failed to provide for the right to invade principal or had specifically denied the trustee the power to invade principal for the benefit of the income annuitant. The settlor did so because of a desire to insure that the remainder interest would not suffer. Under such a condition, only one thing is certain: that the settlor does not wish the remainder interest to suffer even if it means that the income annuitant may be injured because of a decline in the purchasing power of the trust income. It could *not* be said, without additional evidence, that the settlor would have objected to any adjustment of the annuity to reflect inflation. It is possible, of course, that the settlor might have intended that neither the remainder nor the annuitant should suffer in future years because of the drawing down of principal. The settlor may have concluded that to draw down principal would: (a) harm the remainder interest and (b) diminish the opportunity for income in future years. If the annuitant lived sufficiently long enough, continued use of principal might result in its eventual exhaustion. The risk of such an occurrence might have appeared to be a greater risk in the mind of the settlor than a gradual reduction in the annual annuity because of insufficient trust income.

Finally, a third possible interpretation of a settlor's refusal to allow invasion of principal for an annuitant is conceivable. A settlor might have feared the onset of a deflation in which interest rates fall with a corresponding fall in the income of the trust. Under such conditions, if the income were insufficient to pay the annuity, the settlor might have thought that because the value of the payments to the annuitant would have increased (assuming deflation), a decrease in the dollar amount of the payment would not cause any particular harm to the annuitant. Thus, barring the use of the principal could be viewed as a crude shortcut by the settlor to bar the annuitant from profiting from any deflation.

### B. *Justification from Legal Principles*

The appropriateness of judicial deviation on account of inflation will be certain in only two circumstances: first, if the settlor specifically authorizes deviation on account of inflation; second, if the settlor by specific reference declares that the effects of inflation should never be grounds for adjustment of the payout to the income annuitant. In all other cases, the appropriateness of judicial intervention will be unclear.<sup>89</sup> As previously pointed out, almost nothing else that the settlor does can be seen as a definite signal of approval or disapproval of judicial intervention. The beneficiary's need for additional income is not

<sup>89</sup> In some trusts, the selection by the settlor of the right to use principal for the benefit of the annuitant will indicate an overriding goal to aid the income annuitant. In those cases, at least, it would seem that there is a presumption that deviation on account of inflation would be within the intent of the settlor. However, should the settlor deny the right to use principal for the benefit of the annuitant, no contrary conclusion can be reached. (*See* text accompanying notes 87 and 88 *supra*.) In the vast majority of cases, however, we can assume that the trust instrument itself will be inconclusive on the question of the appropriateness of judicial intervention.

sufficient reason for modification of the trust; to look only to the needs of the beneficiary would overturn freedom of testation.<sup>90</sup> The question is not what the beneficiary needs, but what the settlor desired. The question is, therefore, whether adjustment for inflation would be compatible with the primary goal and intent of the settlor. If a court has been asked by the income annuitant to adjust the payout to reflect inflation and the court is inclined to grant the request, two areas of investigation present themselves. First, the court requires standards by which to determine whether adjustment for inflation is justified. Second, the court will require legal principles to authenticate its decision.

## 1. The Legal Theories

### a. *Statutes*

Earlier some of the legal underpinnings that justify court modification of trusts under a variety of situations were examined, beginning with state statutes.<sup>91</sup> Naturally, a statute will not justify court intervention unless it is broad enough to encompass inflation. At present, no state has adopted a statute that empowers judicial modification on account of inflation. Statutes, therefore, offer no direct solace for trust annuitants. Yet, the very existence of deviation statutes signifies legislative, and therefore, societal approval of judicial modification of trusts when appropriate. Although the statutes vary, two common themes may be observed. Many of the statutes rely on a judicial finding that events have thwarted the original purpose of the trust.<sup>92</sup> This rationale picks up on the judicially-created theory of a change of circumstances. Other states, e.g., New York, have looked to some standard of the insufficiency of the support or maintenance of the beneficiary.<sup>93</sup> This test is not to be thought of as a pure "need of the beneficiary" test which would implicitly overthrow the principle of freedom of testation.<sup>94</sup> Rather, the standard more likely finds its roots in a legislative belief that the state welfare system should not be unnecessarily burdened with the upkeep of an individual who, because of the trust, has other means of support. In short, private sources should be looked to for support before the public purse is called upon. Another conceivable notion is that the settlor, by providing at least a measure of support for the beneficiary, would have preferred that the amount be increased if necessary to provide basic support. Here again, deviation is justified on account of a change in circumstances not foreseen by the settlor.

The widespread prevalence of these "deviation" statutes suggests that the public sympathizes with the concept that freedom of testation does not imply unfeeling rigidity in the face of changing circumstances. The statutes act as safety nets that catch settlors who failed to conceive of or were unwilling to grant discretion to the trustee. Judicial deviation is thus not an aberration, but a normal judicial involvement in the affairs of a trust.

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90 See text accompanying notes 51-60 *supra*.

91 See text accompanying notes 15-17 *supra*.

92 See note 15 *supra*.

93 See note 17 *supra*.

94 See text accompanying notes 51-60 *supra*.

### b. *Mistake, Illegality and Impossibility*

In the examination of the doctrines of mistake, illegality, and impossibility as justifications for judicial modification of a trust, it was observed that courts rely heavily on the use of extrinsic evidence.<sup>95</sup> The use of extrinsic evidence to reveal the settlor's intent is required in cases of mistake because the trust instrument either failed to reveal the settlor's intent or misstated it. In the case of inflationary situations, extrinsic evidence should be looked to on the theory that the trust instrument does not reveal the settlor's intent per the inflation. In a sense, the settlor has made a "mistake" by failing to provide for what should occur in the event of significant inflation. Correspondingly, in deviation based upon illegality or impossibility, the trust has become, because of particular changes in circumstances, impossible of fulfillment. Arguably severe inflation has made at least part of the trust, i.e., the income annuitant's benefits, impossible to fulfill. Thus, just as in the case of illegality and impossibility where courts look to extrinsic evidence for an indication of what the settlor would have wanted to be done, so too, courts should in the case of inflation look to extrinsic evidence for guidelines as to the settlor's intent.

### c. *Limitations on Investment and Administration*

In the examination of changes of trust instruments on account of limitations on investment or administration, it was noted that courts feel free to "correct" the shortsightedness of the settlor.<sup>96</sup> The courts hold to the principle that administrative or investment limitations should be seen as tools of the settlor selected by him to accomplish a larger end. If the tools prove inappropriate, they may be discarded in favor of more appropriate ones. The issue is whether the administrative or investment prohibition is itself an end rather than a means. In the case of inflation, courts need not be caught up in such a quandary because the income annuitant payment is clearly both a means and an end. It is a means insofar as the payment to the annuitant is seen as giving the annuitant consumption choices otherwise unavailable to him. It is an end if we think of income payments as themselves being the gift which was the intent of the settlor. If we think of the income as being a means or a tool by which the settlor intended to provide a range of consumption choices to the income annuitant, then inflation clearly has undercut that means and its eventual end by diminishing the consumption choices available to the annuitant. If the payment is thought of as being an end in itself, then inflation may still be seen as eroding the settlor's intent by continually shrinking the value of the gift. Hence, regardless whether the income is seen as a means or as end, inflation must be seen as undercutting the intent of settlor vis-à-vis the gift. Such a conclusion, is, of course, not determinative for it must still be decided whether any deviation to preserve the value of the annuity is an acceptable solution within the parameter of the general intent of the settlor. It is, of course, the answer to this last question which is the crux of the matter.

95 See text accompanying notes 24-30 *supra*.

96 See text accompanying notes 42-53 *supra*.

d. *Change of Circumstances*

The broadest category justifying judicial modification of trusts is that of change of circumstances. The best definition of this principle is contained in the Restatement of Trusts: deviation is allowed whenever “. . . circumstances not known to the settlor and not anticipated by him” would impair or defeat the trust purposes.<sup>97</sup> The use of the change of circumstances doctrine, therefore, depends upon the finding of two elements. First, the inflation has impaired or defeated the trust purposes. (This issue will be taken up during the discussion of the standards by which a court could conclude that adjustment for inflation is justified.<sup>98</sup>) Second, the effects of inflation must not have been known to the settlor or anticipated by him. Until now courts have uniformly held that inflation is not a change of circumstances that warrants judicial intervention. These cases, however, are not very clear in their analysis of what particular facts compelled a finding that deviation would be improper.<sup>99</sup>

Although not necessarily so stated by the courts, there would seem to be three possible justifications for a refusal to allow deviation on account of a “change of circumstances”:

- 1) The inflation does not impair or defeat the trust purposes.
- 2) The inflation was known to the settlor at the creation of the trust or was not impossible for settlor to have imagined.
- 3) The inflation was or could have been anticipated by the settlor.

The first possibility again goes to the factual standard needed to justify the finding that inflation has in fact interfered with the settlor's goals.<sup>100</sup>

Perhaps the most telling argument against adjustment for inflation is that inflation has always been with us. Anyone setting up a trust at any time in the history of this country would be aware of the fluctuating value of the dollar. Prior to World War II the fluctuation was upward as well as downward as there were alternating periods of deflation and inflation. Since World War II, however, there has been no deflation and the value of the dollar has steadily declined in its purchasing power.<sup>101</sup> Although it is arguable that government policies have eliminated the possibility of deflation in the future, it is by no means certain that we have seen the end of it. Thus it does not seem profitable to base any principle of trust deviation upon the assumption that deflation is impossible. The reality of post-World War II inflation, however, cannot be ignored. If we are discussing

97 RESTATEMENT (SECOND) OF TRUSTS § 167 (1959).

98 See text accompanying note 105 *infra*.

99 See text accompanying note 61 *supra*.

100 See text accompanying note 105 *infra*.

101 In 1945, the purchasing power of the consumer dollar (1967 = \$1.00) was \$1.855. By 1974, it had declined to \$.678. Only in two years did the dollar register a slight gain in purchasing power. Between 1949 to 1950, it increased from \$1.387 to \$1.401, but by 1951, it had declined again to \$1.387. Again, from 1954 to 1955, there was a slight gain from \$1.242 to \$1.247. In 1956, it fell to \$1.229 and has since been in continuous decline.

a post-World War II settlor we are discussing the state of mind of an individual who might have lived through deflation or surely was aware of the deflation that occurred prior to World War II, but who nevertheless lived in a world of constant inflation at the time of the creation of the trust.

The application of the change of circumstances test, therefore, must admit that the settlor was aware of the existence of inflation. Should this be seen as an absolute prohibition to judicial deviation? The answer must surely be no. If the settlor "knew of" the particular circumstances, the implication arises that at the creation of the trust the events which caused the requested deviation were within the knowledge and ken of the settlor. The conclusion is, therefore, that the settlor expressed his opinion about the significance or worthiness of those circumstances as they bore upon the trust in the terms that he provided in the trust. The settlor is seen to have rejected the importance of those circumstances when he created the trust. Can the same thing be said about inflation? The answer is no. Even if it is assumed that a settlor was aware of the inflation (and deflation) that occurred prior to the creation of the trust, it cannot assume that the settlor "knew" of the inflation that was to occur after the creation of the trust. To know of something for purposes of a change of circumstances should mean that the party was aware of the events prior to the creation of the trust and might have reasonably concluded what effects those events or facts should or could have upon the beneficiaries of the trust. For example, one may know of a relative who has a crippled arm and whose earning power is reduced accordingly. One could not be said, however, to "know" that a relative who smoked cigarettes continuously was going to later develop emphysema and consequently suffer the loss of earning power. That is, one is only expected to know events which have already occurred. A settlor should not be expected to extrapolate and prognosticate the future from trends which may have developed prior to the creation of the trust.<sup>102</sup>

A second factor undercutting the claim that a settlor might have known of inflation at the creation of the trust is the rate of inflation. Surely an increase in the rate of inflation is a change of circumstances which no settlor could "know" about at the time of the creation of the trust. Note that even a one percent rise in the rate of inflation from, for example, four percent to five percent per year, is a twenty-five percent increase in inflation. A twenty-five percent change in almost anything would seemingly qualify as a change of circumstances not "known" by the settlor at the time of the creation of trust.

The third standard for the change of circumstances test is that the events were not anticipated by the settlor or, according to some courts, were impossible of anticipation by the settlor at the time of the creation of trust.<sup>103</sup> Here again it must be asked what is within the reasonable anticipation of a settlor. Two ques-

102 In at least three cases involving settlor-imposed restrictions on investments, courts have held that because the settlor could not have anticipated future inflation, the trustees would be granted more liberal investment rights. The hope was that the trustees, once freed of the investment restrictions, would be able to invest the trust corpus more productively, thereby allowing the disposable income of the trust to keep pace with inflation. *Bank of Delaware v. Clark*, 249 A.2d 442 (Del. 1968); *In Re Trusteeship Under Agreement with Mayo*, 259 Minn. 91, 105 N.W.2d 900 (1960); *Carlick v. Keiler*, 375 S.W.2d 397 (Ky. Ct. App. 1964). See also RESTATEMENT (SECOND) OF TRUSTS, *supra* note 97. *Contra*, *Union Sav. Bank & Trust Co. v. Alter*, 103 Ohio St. 188, 132 N.E. 834 (1921).

103 See note 43 *supra*.

tions present themselves. First, should a settlor be deemed to anticipate continued inflation at a rate equal to or less than the rate of inflation that existed at the time of the creation of the trust? Second, can the settlor be expected to anticipate a rate of inflation higher than that which existed at the time of the creation of the trust?

The second question may clearly be answered in the negative. No settlor should be expected to necessarily have anticipated and provided for an increasing or increased rate of inflation. It is possible that a settlor has done so and evidence of such might be found either in the explicit language of the trust or implicitly within the provisions of the instrument, but absent such evidence, no such inference can be assumed. Asking the first question, whether a settlor can be said to anticipate inflation equal to or less than that which existed at the time of the creation of the trust, requires that one venture beyond the bounds of normal legal analysis. It would seem reasonable for a court to find that the settlor could have anticipated constant or lesser inflation. After all, to do so would be no different from anticipating that a crippled beneficiary will remain crippled or at least not significantly improve. To say so, however, is to remove the human element from such anticipation and reduce it to a mere "knowledge of" test. The issue should not be whether settlor could have reasonably anticipated continued inflation, but rather, did the settlor appreciate the effects of continued inflation upon the terms of the trust. By "appreciate" it is meant that the settlor was cognizant of the deleterious effects of inflation upon the various beneficiaries of the trust. Suppose a settlor who established an irrevocable trust in 1967 provided that an income beneficiary should receive one thousand dollars per year for life. It would be asked whether the settlor fully appreciated the fact that where, as in 1967, one thousand dollars was sufficient to purchase, for example, new kitchen appliances, in 1978, because of inflation, to buy those same appliances would require \$1,860.<sup>104</sup> In short, not only must it be ascertained whether the settlor anticipated inflation, but also whether he appreciated its impact upon the purchasing power of a fixed annuity.

By labelling a change of circumstance as one which could not have been foreseen by the settlor because it was "impossible" to do so, courts cannot mean that it was absolutely impossible for the settlor to perceive the circumstances. If an event has come to pass, then short of it being categorized a miracle, it is not impossible to imagine its occurrence. What the courts must mean is that the probability of any reasonable person anticipating the event was so small as to make the presumption one that the person did not conceive of the event. Inflation as a change of circumstances would not seem to meet this standard. It would seem that any settlor should be able to at least conceive the possibility of significant inflation occurring after the creation of the trust. Even though the occurrence of inflation may not meet this so-called impossibility test, however, it does not follow that in those jurisdictions which rely upon an impossibility test no modification on account of inflation is possible.

If a change of circumstance is "impossible" to foresee, it is reasonable to presume that the settlor never considered the event. But if a change of circum-

104 See note 11 *supra*.



stances is not impossible to perceive, and if the trust instrument is silent as to whether the settlor ever conceived of the issue, what is the appropriate court response? Silence either in the trust instrument or in the extrinsic facts might indicate that the settlor considered the possible change in circumstances, but rejected any possible modification. There seems to be, however, no logical reason to grant such a presumption. Silence could as well mean that the settlor failed to consider the possible change of circumstances no matter how probable its occurrence might have been. Silence in the trust instrument or in the extrinsic evidence should be seen as neutral and giving no indication of the intent to the settlor. Therefore, the impossibility of foreseeability should not be required to create the presumption that the settlor failed to consider inflation in order to allow a court to modify a trust under the doctrine of change in circumstances.

## 2. Factors Calling For Deviation

If a court is willing to adjust the amount of the annuity to reflect erosion by inflation, what factors should be relevant in deciding whether a particular case warrants such action? The fundamental hurdle for the income annuitant would be to prove that inflation had significantly undercut the purpose of the trust or the intent of the settlor. Courts should not intervene in trusts merely because changing circumstances have affected the impact of the trust benefits. What is needed is a showing that the change of circumstances has thwarted the settlor's intent. The initial question then is whether the inflation is severe enough so that the annuity no longer fulfills its function as intended by the settlor. How much inflation is necessary for this to occur? There seems to be no clear answer. The difficulty arises from the current state of inflation. If inflation continues at rates between 5 and 7 percent per year, then declines of 20 to 25 percent in the purchasing power of income annuities will be experienced in as short a time as 5 or 6 years. While there is nothing in trust law that says a change of circumstances cannot occur so soon after the establishment of the trust, nevertheless one cannot help but be disturbed at the prospect of courts authorizing deviation from trusts not more than 5 or 6 years old. Moreover, it is possible, although not probable, that the inflation will cease or reverse itself and the value of the annuity will increase during a deflationary cycle. Courts may therefore prefer to demand that there be both a significant amount of inflation and that a significant amount of time have passed since the establishment of the trust prior to approving any deviation. Arbitrary guidelines, however, seem unnecessary in light of the state statutes which authorize judicial intervention. None of these statutes uses fixed numbers or fixed time periods to delineate when judicial action would be appropriate. Therefore, there seems to be no reason to interject arbitrary time limits into adjustments for inflation.

In addition to considering the degree of inflation and the time elapsed since the creation of the trust, the courts also ought to consider the age of the annuitant. Clearly the older the annuitant, the sooner the courts should feel free to act. Waiting too long will find annuitants dying prior to receiving judicial aid. In addition, the age of the annuitant and the health of the annuitant when combined indicate the severity of the inflation upon the well-being of the beneficiary.

The 40-year-old healthy annuitant seems less a candidate for judicial relief than a 70-year-old invalid. Finally, the court will have to decide whether the extent of the other financial resources of the beneficiary should be taken into account.

Perhaps in some theoretical world the economic circumstances of the beneficiary would be considered irrelevant. It is, after all, the question of the intent of the settlor that is decisive. If inflation has significantly undercut the settlor's intent by severely diminishing the value of beneficial interest then it should be irrelevant as to what other means are available to the beneficiary. However, in reality, the economic circumstances of the income annuitant are likely to be highly significant. The poorer the annuitant the greater the probability of judicial approval of an increase in the annuity. This is a prediction not only sound in probability, but is also a prediction sound in theory. If the settlor wanted the beneficiary to have a certain amount of consumption (i.e., the annuity), it would not be unreasonable to conclude that even if the consumption powers of the annuity were undercut, there would be no need for modification so long as the other financial resources of the beneficiary had grown enough to make up the difference. In short, the intent of the settlor may have been to provide a minimum standard of living for the beneficiary (at least when coupled with the beneficiary's other sources of income). If the beneficiary has successfully provided for himself in other ways, then perhaps the settlor would not have intended or approved of an increase in the annuity to reflect its erosion in value by inflation. The crossover point at which the other resources of the beneficiary are low enough to warrant adjustment for inflation in the annuity is probably largely a function of the effect of increasing the annuity on the interests of the other beneficiaries of the trust.

The effect that an increase in the annuity has on other beneficial interests may prove critical in determining whether judicial approval is forthcoming. Ideally for an annuitant, the trust would provide current benefits only for the income annuitant; all other income being accumulated for the remainder. In such a case, an increase in the annuity would affect only the remainder and then only to the extent of reducing its growth. A more complex case is presented if other current beneficiaries exist (either mandatory or discretionary). If an increase in the annuity would necessitate a decrease in the benefits paid to other income beneficiaries, the question arises whether the increase would harm such other beneficiaries. If the other beneficiaries are entitled to a fixed payout, then no adjustment for the annuitant is possible if that could only occur at the cost of lowering another fixed payout.<sup>105</sup> If the other beneficiaries are entitled only to variable or discretionary amounts, or are entitled to an amount that is to be dependent upon the income not needed to meet the annuity payment, then the issue is somewhat more complicated. The annuity could be increased without

<sup>105</sup> Were a court to authorize an increase in the benefits to be paid to one annuitant at the expense of another current beneficiary, then the court would be dramatically overthrowing the freedom of testation. Not even the broad equitable powers of the court would allow it to redistribute current benefits. *See* A. SCOTT, *supra* note 4, at § 168 n.7. The only exception would be if the beneficiaries agreed to such a modification. In short, some beneficiaries renounced part of their rights so that others could be granted greater benefits. But even an intrabeneficiary agreement might run into judicial opposition if it was seen as undermining a material purpose of the trust. *See id.* at § 337.

any potential decrease of the other income beneficiaries' payments only if inflation was reflected in a corresponding growth in the income of the trust. In such an instance, or whenever the trust income represented inflationary growth, an adjustment for inflation would merely allocate that growth (not real growth, i.e., growth in purchasing power, but only growth in the number of dollars) between the annuitant and the other income beneficiaries. Although no general rule can be pronounced, it should not prove difficult for a court to allocate the inflationary growth in income between the fixed-income annuitant and the variable or discretionary income beneficiary. Even if the increase of income failed to keep pace with inflation, there is no reason why the annuitant should be the only party to suffer. A court should not hesitate to increase the annuity and partially offset the effects of inflation. In short, the inflation should be borne equitably among the fixed annuity and the other current income beneficiaries.<sup>106</sup>

In addition to the question of other income beneficiaries is the interplay between the annuity and the remainder. An increase in the annuity will lessen the income accumulation, and thereby reduce the eventual value of the remainder. This consequence should not prove an insurmountable hurdle, however. If the trust is able to earn a rate of return which keeps pace with the inflation, then in the absence of an adjustment of the income annuitant's payout, the remainder interest actually benefits from inflation.<sup>107</sup> Because accumulated income can be compounded, a remainder interest is favored by inflation where the distribution from the trust is limited to a fixed sum. Here again, a court should be able to determine when a remainder has been favored at the expense of an annuitant because of the inflation. If there is no evidence that the settlor intended such favoritism, then the annuity should be increased.

As with competing income beneficiaries, the effects of inflation should be allocated between the annuitant and the remainder. When the rate of return of a trust fails to keep pace with inflation, then both the remainder and the annuitant must necessarily suffer a loss in purchasing power. There is, however, no reason that all the burden should fall upon the annuitant. A more equitable solution, in the absence of any specified intent to the contrary by the settlor, is to apportion the burden of inflation between the annuitant and the remainder interest.

The final, but most important, factor which would indicate the appropriateness of judicial relief is the intent of the settlor. There are a variety of items within a trust which might alert a court to the probable views of the settlor as to the appropriateness of adjustment for inflation.<sup>108</sup> However, assuming that no such clear evidence exists in the trust, or assuming that the language of the trust is ambiguous, certain facts remain which ought to be seen as demonstrative of the intent of the settlor.

Certainly, the relationship of the income annuitant to the settlor is signifi-

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<sup>106</sup> Perhaps the most compelling analogy is Social Security. Since 1975 Social Security benefits have been automatically adjusted upward to reflect increases in the cost of living. The burden of inflation is shifted thereby from the beneficiaries (largely retirees) to the contributors (the employed). U.S. Dept. of H.E.W., Social Security Administration, *Social Security Handbook* 128 (5th ed.).

<sup>107</sup> See text accompanying note 85 *supra*.

<sup>108</sup> See text accompanying notes 86-89 *supra*.

cant. The closer the relationship, the more supportive the relationship between the settlor and the beneficiary, the more likely the settlor would have approved of an adjustment for inflation. Similarly, the relationship of the remainder interests to settlor versus the relationship of the income annuitant to the settlor should be noted. If the remainder qualifies as a "natural object of the settlor's bounty" e.g., his children, whereas the income annuitant is a more distant and less "natural object," then the court ought to be wary of adjusting for inflation. Here there seems to be no hard and fast rule that can be drawn to denote what different relationships must necessarily connote in the terms of the settlor's intent. Beyond the blood relation, a court should be interested in the relative personal and economic relationships between the settlor and the income annuitant and remainder interests during the settlor's life. If the remainder passes to individuals or to a class with whom the settlor was not personally acquainted, then adjustment of the annuity may seem more appropriate.

Secondly, the amount of annuity may also be indicative of the settlor's intent: the larger the amount of the annuity, the more probable that the settlor's intent was that it suffice as a major, if not sole, means of support of the annuitant. A relatively small annuity would seem to indicate it represented something akin to a symbolic or token representation of the settlor's attitude toward the annuitant. In those cases, it might be thought that the settlor did not intend the amount to represent a support or even a significant source of income to the annuitant, but rather, an attempt to indicate the settlor's affection toward the individual. Here, too, the relative size of the annuity must be measured against the other economic resources of the beneficiary, particularly as those resources were known to the settlor. The greater the relative size of the annuity in relationship to the other financial resources of the annuitant, then the greater is the likelihood that the settlor would have preferred adjustment for inflation.

Finally, courts should press the parties in a lawsuit to bring forth evidence indicating the state of mind of the settlor at the time of the creation of the trust. There may well be written indications of the settlor's intent in the form of letters to the interested parties, to his lawyers or financial advisors. The settlor may have written a diary or private memorandum indicating his goals. Finally, oral testimony of the settlor should not be automatically excluded. The settlor may have discussed the problem with friends, relatives or even the lawyers who drew up the instrument, and in those conversations may be found the kernel of the settlor's intent. If it appears that modification of the trust would not be at cross-purposes with the settlor's intent, then appropriate relief should be forthcoming.

## VI. Summary

Courts have been extremely reluctant to approve modification of a trust on account of inflation. Although such an attitude is understandable, it is unfortunate and unnecessary. The imaginative application of fundamental principles of trust law provides sufficient justification for judicial intervention, while principles of economics and justice demand that benefits be adjusted to reflect inflation.