COURT-CREATED TRUSTS IN TEXAS

Revised to Include Amendments Made Through 80th Texas Legislature (2007)

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COURT-CREATED TRUSTS IN TEXAS

1. INTRODUCTION, SCOPE AND ACKNOWLEDGMENTS

1.1. Introduction. This paper examines the history of court-created trusts, explores the statutory and nonstatutory bases for court-created trusts, offers drafting suggestions for creation of the various types of trusts discussed. The purposes of the paper are to offer a perspective on the growing use of court-created trusts, to explore specific problems in drafting court-created trusts and to offer solutions to some of the drafting problems.

1.2. Scope. This paper covers trusts created pursuant to Section 142.005 of the Texas Property Code ("142 Trusts"), trusts created pursuant to Sections 867 -- 873 of the Texas Probate Code ("867 Trusts"), trusts created pursuant to 42 U.S.C.A. § 1396(d)(4)(a) ("(d)(4)(A)" trusts or Medicaid "supplemental needs" trusts), and trusts created by courts pursuant to their equitable power to do so.

1.3. Acknowledgments. The author gratefully acknowledges the assistance of practitioners and judges around the state for their help in preparing this paper, including Judge Guy Herman of Austin, Pi-Yi Mayo of Baytown, Bernard Jones of Houston, Thomas Baird of Temple, Kathleen Ford Bay, Clyde Farrell, Deborah Green and Christine Larson of Austin, and Janice Torgeson of The Frost National Bank in Austin. In addition to the articles cited elsewhere in this paper, other excellent sources of information in this area are Bernard Jones's article, *Estate Planning for Incapacitated Individuals,* 33 Real Estate, Probate & Trust Law Reporter, No. 4, p. 27 (July 1995), and Robert H. Kroney's paper entitled "Court Created Trusts and Related Topics" presented to the State Bar of Texas's 20th Annual Advanced Estate Planning and Probate Course in June, 1996.

2. HISTORY OF COURT-CREATED TRUSTS

2.1. History of Equitable Creation of Trusts. In early Anglo-American jurisprudence, trusts were not recognized by the common law courts. Trusts were first enforced by the court of chancery in England in the early fifteenth century. Bogert, Trusts and Trustees, Rev. 2nd Ed. § 3 (1984). Thus, trusts have their roots in equity, and courts sitting in equity have traditionally enforced trusts. Of course, *creating* trusts and *enforcing* trusts are not the same thing.

The most common type of trust created by courts sitting in equity (and without specific statutory authority) is the constructive trust. A constructive trust is a device used by a court sitting in equity to compel one who unfairly holds a property interest to convey that interest to another to whom it justly belongs. Bogert, Trusts and Trustees, Rev. 2nd Ed. § 471 (1984). The Texas Supreme Court has stated that constructive trusts, being remedial in character, have the very broad function of redressing wrong or unjust enrichment in keeping with the basic principles of equity and justice, and that a transaction may, depending on the circumstances, provide the basis for a constructive trust where one party to that transaction holds funds which in equity and good conscience should be possessed by another. *Meadows v. Bierschwale*, 516 S. W. 2d 125, 131 (Tex. 1974).

Despite its name, a constructive trust typically has few of the characteristics of express trusts. A constructive trust is a means to convey title to property from one person to another. Thus, while there is a res, a trustee (albeit an involuntary one) holding legal title and a beneficiary holding equitable title, there is essentially no trust administration and, from the perspective of this paper, there is no trust instrument to draft and construe.

Another type of trust which arises in equity is the resulting trust. In resulting trusts, the intent of the party creating the trust is presumed or inferred. Resulting trusts include "purchase-money trusts" (where one party pays the purchase price to a seller and directs the seller to place title in the name of a third party, the party paying the purchase price is presumed to be a beneficiary of a trust), instances where an express trust does not exhaust the res, and cases of express trusts which fail in whole or in part. Bogert, Trusts and Trustees, Rev. 2nd Ed. § 451 (1984).

For purposes of this paper, resulting trusts hardly qualify as court-created trusts. Rather than creating the trust, a court merely presumes or infers the intent of a party to create a trust. Nonetheless, resulting trusts come into existence because of court action and involve drafting and administrative considerations similar to the other types of court-created trusts discussed in this paper.

2.2. History of Statutory Trusts in Texas. Prior to 1979, there was no statutory authority for a Texas court to create a trust. In that year, the Legislature amended Article 1994 of the Texas Revised Civil Statutes (the predecessor to Chapter 142 of the Texas Property Code) to permit courts to place the proceeds of a judgment accruing to a minor in a trust.

Since 1893, Texas statutes have permitted minors without guardians to be represented in lawsuits by next friends and for the judgment proceeds payable to the minor to be administered outside of the guardianship system in certain cases. In 1893, the court could permit management of up to $500 on behalf of a minor without the need for a guardianship, provided the person managing the funds posted a bond of double the amount to be managed. Acts 1893, 23rd Leg., p. 3. Between 1893 and 1979, this statute was amended to permit suits by next friends on behalf of incapacitated persons (in addition to minors), to permit bonded, nonguardianship management of up to $1,500 (the precursor to Tex. Prop. Code § 142.002), to permit investment of the judgment proceeds in general investments approved by the court (the precursor to Tex. Prop. Code § 142.001), and to permit investment in federally insured accounts (the precursor to Tex. Prop. Code § 142.004). Each of these alternatives to guardianship had drawbacks. The $1,500 limit on bonded administration obviously had limited usefulness, and trial courts were reluctant to take on long-term court supervision of investments and disbursements, preferring instead to let the probate courts to perform this function in the guardianship process. *See* Bob Burleson and Tom Normand, *Money Judgments for Minors,* Texas Bar Journal, May 1981, p. 485; *see also* Michael J. Cenatiempo, *The Article 1994 Trust for Minors -- A New Solution to An Old Problem,* The Houston Lawyer, May 1981, p. 38.

In 1979, the Legislature addressed these problems in two ways. First, it eliminated the $1,500 ceiling on bonded, nonguardianship management. Second, it permitted the court to create a trust benefitting a minor, so long as a corporate fiduciary was used and so long as the trust contained certain provisions. The authority to create a trust was recodified to Tex. Prop. Code § 142.005 when the Property Code was enacted in 1983. A 1984 amendment permitted 142 Trusts for incapacitated persons (in addition to minors).

There are two significant limitations to the availability of 142 Trusts. First, 142 Trusts can be created only from litigation proceeds -- it is difficult or impossible to get other types of property, such as life insurance proceeds paid directly to a minor, into a 142 Trust. Second, 142 Trusts can be created only if there is no legal guardian for the minor -- once the guardianship is in place, the option of creating a 142 Trust for the litigation proceeds disappears.

Significant changes to Section 142.005 in 2007 make it possible for a person who is disabled for Medicaid and social security purposes but not incapacitated as defined in Section 142.007 to apply personally for creation of a 142 Trust. This and other changes require a re-education of the rules about 142 Trusts.

The limitations on 142 Trusts, together with a general frustration with the expense and inflexibility of traditional guardianships, were the impetus for adoption of Sections 867 -- 873 of the Texas Probate Code. These provisions, adopted in 1993 as part of the bill recodifying Texas's guardianship laws, permit the creation of 867 Trusts on application of a guardian. These statutes have been amended every session since 1993. In general, these amendments have made 867 Trusts easier to create and more flexible to use.

The enactment of 42 U.S.C. § 1396p(d)(4)(A) in the Omnibus Budget Reconciliation Act of 1993 ("OBRA 93") has led to the widespread use of court-created trusts as so-called "supplemental needs trusts." The statutes governing 142 Trusts and 867 Trusts were amended in 1997 specifically to permit these trusts to be supplemental needs trusts.

3. 142 TRUSTS

3.1. Statutory Requirements. There are specific statutory requirements for the creation and terms of 142 Trusts. These changed significantly in 2007. The text of Section 142.005 of the Texas Property Code as amended in 2007 is attached at Exhibit "__". The following discussion includes the 2007 changes.

3.1.1. Basis for Creation. Tex. Prop. Code § 142.005(a) provides:

> (a) Any court of record with jurisdiction to hear a suit involving a beneficiary may, on application and on a finding that the creation of a trust would be in the best interests of the beneficiary, enter a decree in the record directing the clerk to deliver any funds accruing to the beneficiary under the judgment to a financial institution, except as provided by Subsections (m) and (n).

This provision places five prerequisites to the creation of a 142 Trust: (1) a "suit" is required; (2) the suit must involve a "beneficiary;" (3) the suit must be in "any court of record with jurisdiction to hear the suit;" (4) the court must find that creation of the 142 Trust would be in the best interests of the beneficiary; and (5) a judgment must be entered. Only if all five prerequisites are met can a 142 Trust be created.

A. "Suit" Required. A "suit" must exist in order for a 142 Trust to be created. Typically, the suit is a personal injury or other tort action in which damages are sought and recovered, either by trial or settlement. However, Tex. Prop. Code § 142.005 is not limited to tort suits. This presents a possible planning opportunity -- how far can the term "suit" be stretched? While creative use of the "suit" requirement may seem inappropriate at first glance, remember that 142 Trusts can only be created with the approval of the court, and courts retain the right to modify or terminate 142 Trusts.

1) Interpleader. An interpleader seems clearly to be a suit. If a party (such as an insurance company holding the proceeds of a life insurance policy payable to a minor) can be persuaded to interplead the funds rather than waiting for the appointment of a guardian, the court hearing the interpleader action should be able to create a 142 Trust out of the proceeds. (A custodian under the new Uniform Transfer to Minors Act could demand that the insurance proceeds be paid to the custodian. If the insurance company so paid the proceeds, a guardianship would be avoided. If the insurance company did not, the custodian's claim could form the basis for the interpleader.)

2) Declaratory Judgment. Is a declaratory judgment action sufficient to meet the "suit" requirement of Tex. Prop. Code § 142.005(a)? Any court of record within its jurisdiction has "the power to declare rights, status, and other legal relations whether or not further relief is or could be claimed." Tex. Civ. Prac. & Rem. Code § 37.003(a). The Declaratory Judgment Act is remedial in nature and is to be liberally construed and administered. Tex. Civ. Prac. & Rem. Code § 37.002(b). Declarations related to any question arising in the administration of a trust or estate are permitted. Tex. Civ. Prac. & Rem. Code § 37.005. Further relief based on a declaratory judgment or decree may be granted whenever necessary or proper. Tex. Civ. Prac. & Rem. Code § 37.011. Perhaps a declaratory judgement action may be brought by a next friend on behalf of a minor or other incapacitated person who is either holding title to property or is entitled to hold title to property seeking a declaration of the minor's or incapacitated person's rights in the property and seeking creation of a 142 Trust.

3) Probate Proceedings. Is a probate proceeding a "suit" for these purposes? "Probate proceedings" include a matter or proceeding relating to the estate of a decedent. Tex. Prob. Code Ann. § 3 (bb). Could someone appear as next friend (or could the court appoint a guardian ad litem) of a minor in a dependent administration and ask for the creation of a 142 Trust rather than a guardianship? A dependent administration presents a easier case than an independent administration, where there is no court supervision of the administration and no court approval of distributions from the estate.

4) Federal Lawsuit. The "suit" requirement in Tex. Prop. Code § 142.005 is not limited to state court actions. Therefore, there seems no reason why a federal court could not create a 142 Trust for a Texas litigant in a federal proceeding. In fact, it is the author's understanding that it is common for federal courts to create 142 Trusts.

B. Suit Must Involve a "Beneficiary." A 142 Trust is available only if the suit involves a "beneficiary." Section 142.005(o) defines "beneficiary" to mean "a minor or incapacitated person who has no legal guardian and is represented by a next friend or an appointed guardian ad litem," or "a person with a physical disability."

1) "Incapacitated Person." Section 142.007 of the Texas Property Code defines "incapacitated person" for purposes of 142 Trusts:

> a person who is impaired because of mental illness, mental deficiency, physical illness or disability, advanced age, chronic use of drugs, chronic intoxication, or any other cause except status as a minor to the extent that the person lacks sufficient understanding or capacity to make or communicate responsible decisions concerning his person.

This differs from the definition of "incapacitated person" for purposes of creating a guardianship. Section 601 (13) of the Texas Probate Code provides that "incapacitated person" means a minor, a missing person, a person who must have a guardian appointed to receive funds due the person from a governmental source, or "an adult individual who, because of a physical or mental condition, is substantially unable to provide food, clothing, or shelter for himself or herself, to care for the individual's own physical health, or to manage the individual's own financial affairs."

In many cases where a 142 Trust is sought, this requirement is likely to present no practical impediment to creation of the trust. A party's status as a minor should be easy to prove, and a party's status as an "incapacitated person" is likely to have been resolved as a practical matter when the suit was brought by the next friend or when the guardian ad litem was appointed -- long before creation of the 142 Trust is sought. However, the next friend, the guardian ad litem and their attorneys may face liability for their actions and inactions in connection with settling the lawsuit and creating the 142 Trust. *See Byrd v. Woodruff,* 891 S. W. 2d 689 (Tex. App. -- Dallas 1994, writ denied). The procedural safeguards built into Texas's guardianship laws are not present in the case of a 142 Trust -- there are no requirements for personal service on and personal appearance of the allegedly incapacitated person, trial by jury on the issue of incapacity, and proof of incapacity by clear and convincing evidence. *Compare* Tex. Prob. Code Ann. §§ 633, 684 *and* 685 *with* Tex. Prop. Code § 142.001 *et seq.* All persons involved in the creation of a 142 Trust should take care that the rights of the minor or incapacitated person are considered and protected and that the terms of the trust are not adverse to the beneficiary's interests -- especially those terms relating to the term and termination of the trust.

2) Next Friend/Guardian Ad Litem/No Legal Guardian Requirement. If the basis for creation of the 142 Trust is the minority or incapacity of the beneficiary, the trust may be created only if the minor or incapacitated person "has no legal guardian and is represented by a next friend or an appointed guardian ad litem." Tex. Prop. Code § 142.005(o)(1)(A). Rule 44 of the Texas Rules of Civil Procedure provides that minors and other incapacitated persons "who have no legal guardian" may sue and be represented by "next friend." Rule 173 provides that a court shall appoint a guardian ad litem when a minor or other incapacitated person is a defendant to a suit and has no Texas guardian or where a minor or incapacitated person is a party to a suit either as plaintiff, defendant or intervenor and is "represented by a next friend or a guardian who appears to the court to have an interest adverse to such minor" or incapacitated person. Other statutes permit the appointment of guardians ad litem in other cases. *See, e.g.,* Tex. Prob. Code Ann. § 683.

There must be no legal guardian for a minor or incapacitated person when the 142 Trust is created — if a guardian of the estate is appointed during the pendency of the suit or even after judgment is entered but before the trust is created, the guardian is entitled to the judgment proceeds and no 142 Trust can be created. *Rodriguez v. Gonzalez,* 830 S. W. 2d 799, 800-1 (Tex. App. — Corpus Christi 1992, no writ).

a) What About Attorney Ad Litems? Tex. Prob. Code Ann. § 34A permits the judge of a probate court to appoint an attorney ad litem to represent the interests of a person having a legal disability, a nonresident, an unborn or unascertained person, or an unknown heir in any probate proceeding. Can an attorney ad litem apply for the creation of a 142 Trust? One can certainly argue that an attorney ad litem under Tex. Prob. Code Ann. § 34A is, in essence, a Rule 173 guardian ad litem and that there is no reason why an attorney ad litem should not be able to apply for creation of a 142 Trust. A safer solution is for the attorney ad litem to ask the court to also appoint him or her guardian ad litem pursuant to Rule 173 prior to applying for creation of the 142 Trust.

b) Parents Are Natural Guardians, Not "Legal Guardians." Parents are the natural guardians of their minor children, but are not legal guardians for purposes of Tex. Prop. Code § 142.005 (a) unless formally appointed legal guardian in a guardianship proceeding. *See* Tex. Prob. Code Ann. § 676 (b). It is common for a 142 Trust to be created when a minor has a living parent who has not been

appointed legal guardian. *See, e.g., Aguilar v. Garcia,* 880 S. W. 2d 279 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.).

c) What About Temporary Guardians And Guardians of The Person? There are no reported cases on whether a minor with a temporary guardian or a guardian of the person with no guardian of the estate may have a 142 Trust created for him or her. Having a guardian of the person in place with no guardian of the estate should not prevent the creation of a 142 Trust, since a guardian of the person has no authority to manage property or represent a minor's interests in litigation. *See* Tex. Prob. Code Ann. § 767. Read literally, the appointment of a temporary guardian for a minor may not preclude creation of a 142 Trust for the minor, although one might argue that a temporary guardian with the powers of a guardian of the estate is, in effect, a legal guardian. *See* Tex. Prob. Code Ann. § 601 (10) (definition of "guardian" for Probate Code purposes includes a guardian of the person and a temporary guardian).

3) Person with Physical Disability. The 2007 changes created this new alternative basis for creating a 142 Trust. A person with a physical disability may pursue creation of a 142 Trust for himself or herself (or a next friend or guardian ad litem may do so) even if the person suffers no mental incapacity. The principal reason for this change is the growing practice of using 142 Trusts as special needs trusts. Since persons who are physically disabled but have no mental incapacity often are eligible to benefit from a special needs trust, the Texas statute now permits these persons to be beneficiaries of 142 Trusts without the need to "pretend" they meet the incapacity definition.

C. Must be a Court of Record with Jurisdiction to Hear Suit. Based on a 2005 amendment to Section 142.005, "any court of record with jurisdiction to hear the suit" may create a 142 Trust. This change was part of a series of changes to clarify that any court of record – not just district courts – may create and modify a 142 Trust. *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002), and the 2003 changes to Section 142.005 called into question whether county courts at law, statutory probate courts and other "statutory courts" could create or otherwise deal with a 142 Trust.[1] It is now clear that such courts may create, modify, etc., 142 Trusts. Only justice courts and other courts that are not courts of record are prohibited from creating 142 Trusts.

D. Best Interests Finding. A 142 Trust may be created only if the court finds that "creation of the trust would be in the best interests of the beneficiary." Tex. Prop. Code § 142.005 (a).

E. Judgment Required. Even though 142 Trusts are a common settlement solution, a judgment with funds accruing to the beneficiary thereunder is required for creation of the trust. Therefore, as part of the settlement, the case cannot be dismissed with prejudice or otherwise settled short of a judgment in favor of the beneficiary if a 142 Trust will be used.

3.1.2. Mandatory Provisions. Once the basis for creating a 142 Trust is established, the 142 Trust must meet mandatory requirements regarding choice of a trustee and terms of the trust.

A. Must Include Warning Language on First Page of Trust. The 2007 amendments added Subsection 142.005(b)(7), which requires the first page of a 142 Trust trust instrument to contain the following notice:

> (7) The first page of the trust instrument shall contain the following notice:
>
> **NOTICE: THE BENEFICIARY AND CERTAIN PERSONS INTERESTED IN THE WELFARE OF THE BENEFICIARY MAY HAVE REMEDIES**

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[1] Both the *Grizzle* case and the 2003 amendments made the Texas Trust Code applicable to 142 Trusts. Prior to being amended in 2005, Section 115.001 of the Texas Trust Code provided that district courts had exclusive jurisdiction over trust matters, except for certain jurisdiction given to probate courts. Some practitioners were concerned that, since 142 Trusts were subject to the Trust Code, and since the Trust Code said district courts had exclusive jurisdiction over trusts, perhaps only district courts could create or modify 142 Trusts. The 2005 amendments eliminate this concern.

UNDER SECTION 114.008 OR 142.005, PROPERTY CODE.

This warning requirement was added to address the concerns of the mother of a beneficiary of a 142 Trust who were dissatisfied with the performance of the trustee of the trust.

Clearly this warning must appear on every 142 Trust created after September 1, 2007. What about existing trusts? Trustees of existing trusts should consider if they must comply with the new notice requirement in Section 142.005(b), and, if so, how. Two possible ways to comply are: (1) Apply to the court for the warning language to be added to the trust instrument; or (2) Just stick the warning language on the trust instrument without court approval.

Neither of these options seems reasonable in most cases. Spending trust resources to get the notice on the trust instrument seems like a waste, and modifying the trust instrument to include the notice without court approval seems ill-advised. Trustees should consider corresponding with the beneficiary's parents or other surrogates to inform them of the law change, the required notice, and the new rights under Subsection (k) and (l), and to let them know that the trustee doesn't intend to ask the court to modify the trust to include the required notice (due to the expense to the trust) unless requested to do so. That should limit the damages for failing to add the notice.

B. Must Use "Financial Institution" as Trustee, with Two Exceptions. To create a 142 Trust, the court must enter a decree in the record directing the clerk to deliver any funds accruing to the beneficiary under the judgment to a "financial institution," except for the two exceptions noted in Subsections (m) and (n) (discussed below). Tex. Prop. Code § 142.005 (a). Subsection (o) defines a "financial institution" as "a financial institution, as defined by Section 201.101, Finance Code, that has trust powers, exists, and does business under the laws of this or another state or the United States." Individuals may not be trustees of 142 Trusts, except as provided in Subsections (m) and (n), discussed below.

The use of the defined term "financial institution" was added in 2007. For the first time, financial institutions with trust powers with no Texas presence may serve as trustee of a 142 Trust. Prior to 2007, the trustee had trust company or bank "in this state."

One recent trend in at least some courts is to appoint a bank or trust company and an individual as co-trustees. In the author's opinion, this is not permitted by Tex. Prop. Code Ann. §142.005. There is nothing wrong with making an individual or group of individuals "advisory trustees" and permitting them to advise the corporate trustee. Giving an individual co-equal authority with a corporate trustee appears to be contrary to the statute.

Since most 142 Trusts are established at the time a lawsuit is settled, and since often the court is presented with an agreed order and agreed form of trust, judges often do not focus on the terms of the trust to determine if the trust terms meet the statutory requirements. Thus, it is likely that some courts will create 142 Trusts with individual co-trustees notwithstanding the statute.

What should a bank or trust company do if asked to be co-trustee with an individual trustee? There appear to be two possibilities regarding liability for future breaches of such a trust that are attributable to acts of the individual co-trustee:[2] (1) It may be that, since the court ordered the co-trustee arrangement and the bank or trust company is administering the trust as drafted (*i.e.,* as it would administer any other trust with co-trustees), the bank may not be liable for the actions of the individual co-trustee unless the bank itself breached its duties; or (2) It may be that the bank is, in effect, the guarantor of the actions of the individual co-trustee, since the individual is serving as trustee without statutory authority. Certainly the corporate trustee, if faced with a potential liability because of the malfeasance or negligence of the individual co-trustee, can make a forceful argument that the first possibility

[2] If there are two co-trustees (*i.e.,* the corporate trustee and one individual trustee), it may be possible for the corporate trustee to protect itself by not delegating any authority to act independently to the individual trustee. Insisting on joint action by the co-trustees may be burdensome administratively and may give rise to deadlocks, but it may avoid liability. However, under Section 113.085 of the Texas Trust Code, unless otherwise provided by the trust instrument or by court order, a power vested in three or more trustees may be exercised by a majority of the trustees. Thus, if there is one corporate co-trustee and two individual co-trustees, and if the Texas Trust Code applies to 142 Trusts, the corporate co-trustee could be outvoted. In these cases, the corporate trustee should insist on provisions in the trust instrument or court order protecting it, such as a veto power over actions of the majority.

stated above should apply. However, when one considers that (a) the individual co-trustee is likely to be gone or judgment-proof when this issue arises, (b) there is no bond assuring the performance of the individual co-trustee (*see* Tex. Prop. Code §142.005(b)(5)), and (c) the court deciding the case is likely to be the same court who created the trust with the co-trustee arrangement, the judge of which is likely to be looking for some way to make things right, the corporate co-trustee may be in a difficult position.

Therefore, if asked in advance if it is willing to be co-trustee with one or more individuals, a bank or trust company should (a) first try to talk the parties into making the individuals advisory trustees only (there is a good chance that this is what the parties intend in the first place), (b) insist on holding the tie-breaking vote or, at the very least, a veto power, (c) ask for exculpatory and indemnity language to be included in the trust instrument, and (d) plan on administering the trust as if it is solely responsible for the actions of all co-trustees.

C. Two Exceptions to Corporate Trustee Requirement. The 2007 amendments added Subsections (m) and (n), which permit individual trustees of 142 Trusts in two situations. Under Subsection (m), if the value of the trust's principal is $50,000 or less, the court may appoint an individual trustee only if the court finds the appointment is in the beneficiary's best interest. Under Subsection (n), if the value of the trust's principal is more than $50,000, the court may appoint an individual trustee only if the court finds that no "financial institution" is willing to serve as trustee and that the appointment is in the beneficiary's best interest. The most likely use for these new exceptions are in cases where the 142 Trust is a supplemental needs trust.

D. Sole Beneficiary Requirement. Tex. Prop. Code § 142.005 (b) (1) requires that the beneficiary be the sole beneficiary of the trust. It is sometimes tempting to create one 142 Trust for multiple plaintiffs in order to minimize trustee's fees and other administrative expenses. This temptation should be avoided for at least two reasons. First, Tex. Prop. Code § 142.005 (b) (1) appears to prohibit 142 Trusts with multiple beneficiaries. Second, a trust with multiple beneficiaries is more likely to be taxed unfavorably under Internal Revenue Code 468B (discussed below). Perhaps a more favorable fee arrangement may be negotiated with the potential trustee of multiple 142 Trusts and drafted into the trusts.

This sole beneficiary requirement also clears up another potential problem for the trustee. Since the beneficiary is the "sole beneficiary" of a 142 Trust, the trustee does not have to worry about the interests of persons other than the beneficiary for which the trust is created. In a typical trust (an "express trust"), the trustee owes duties not only to the "income beneficiary" – the beneficiary entitled to receive distributions during the term of the trust – but also to the "remainder beneficiaries" – those persons who will receive the remaining trust property when the trust terminates (often on the death of the "income beneficiary"). Under Section 117.008 of the Texas Trust Code, the trustee must administer the trust impartially, respecting the interests of both the income beneficiary and the remainder beneficiaries. However, since the beneficiary for whom the trust is created is the sole beneficiary of a 142 Trust, the trustee must focus only on that beneficiary's interests and not on remainder beneficiaries' interests. Thus, the trustee need not try to preserve or increase trust property for the benefit of remainder beneficiaries at the expense of "the" beneficiary.

E. Mandatory Distribution Provisions. The trust must provide that (1) the trustee may disburse amounts of the trust's principal, income, or both as the trustee in his sole discretion determines to be reasonably necessary for the health, education, support or maintenance of the beneficiary (Tex. Prop. Code § 142.005 (b) (2)) and (2) the income of the trust not disbursed under Section 142.005 (b) (2) is added to the principal of the trust (Tex. Prop. Code § 142.005 (b) (3)).

Except in the case of a (d)(4)(A) supplemental needs trust (see below), these provisions cannot be modified or abrogated by the court. In one case, the Fourteenth Court of Appeals held that the trial judge could not add a provision limiting withdrawals from a 142 Trust to use for medical purposes in situations where the parents have no other means to pay for the required medical care. In *Aguilar v. Garcia*, 880 S. W. 2d 279, 281 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.), the court held:

> The clear language of the statute requires that the trustee have the sole discretion to determine what is in the best interest of the beneficiary and make distributions for the health, education, support, or maintenance of the beneficiary. Tex. Prop. Code Ann. 142.005 (b) (2) (Vernon 1984). The statute also clearly states that this provision is mandatory. Even though the trial judge's

> motives were laudable, she did not have discretion to limit the mandatory powers given to the trustee. We hold that the express terms in section 142.005 (b) (2) are mandatory and the trial court abused its discretion by requiring conflicting modifications to the trust instrument.

[footnote omitted]. If correct, the holding in *Aguilar* could severely limit the ability of a court to design a 142 Trust to meet the specific needs of the trust beneficiary. However, when considering the effect of *Aguilar,* one must consider the following:

1) Agreed Order May Be Different. In *Aguilar,* the trial court sought to impose the modifications to the mandatory statutory distribution standard over the objection of the guardian ad litem. Since only a guardian ad litem (or next friend) can apply for the trust, perhaps *Aguilar* can be read as restricting the ability of the trial court to force modifications of the statutory provisions onto the guardian ad litem and the beneficiaries. *See McGough v. First Court of Appeals,* 842 S. W. 2d 637, 639 (Tex. 1992) (trial court could not force an annuity arrangement over the objection of the guardian ad litem). Thus, in the typical case where the guardian ad litem has requested that a trust have nonstandard provisions and where all parties have agreed to the terms of the proposed trust, the trial court would not be "requiring conflicting modifications to the trust instrument" as it did in the *Aguilar* case.

2) Expanding Standard May Be Different. In *Aguilar,* the court sought to contract or reduce the distribution standard, restricting the discretion of the trustee required by the statute. Perhaps *Aguilar* does not apply in a case where the distribution standard (or other mandatory terms) are being expanded. For example, if, in addition to giving the trustee the statutorily required health, education, maintenance and support standard, the trust also mandated that a specific amount per month be paid to the beneficiary, *Aguilar* may not apply, since the court would not be "limit[ing] the mandatory powers given to the trustee."

F. Supplemental Needs Trust Provisions. As amended in 2007, Section 142.005(g) provides:

> (g) Notwithstanding any other provision of this chapter, if the court finds that it would be in the best interests of the beneficiary for whom a trust is established under this section, the court may omit or modify any terms required by Subsection (b) if the court determines that the omission or modification is necessary or appropriate to allow the beneficiary to be eligible to receive public benefits or assistance under a state or federal program. This section does not require a distribution from a trust if the distribution is discretionary under the terms of the trust.

This is broad authority to alter the terms of the 142 Trust, including the "mandatory" health, education, maintenance and support distribution provision, if the court determines that the omission or modification is necessary or appropriate to allow the beneficiary to be eligible to receive "public benefits or assistance under a state or federal program." Prior to 1997, no special needs trust variation was permitted. Between 1997 and 2007, variations were permitted for 42 U. S. C. Section 1396p(d)(4)(A) trusts, but not to enable receipt of public benefits generally.

G. Mandatory Trust Termination Provisions. The trust must provide that, if the beneficiary is a minor, the trust terminates on the death of the beneficiary, on the beneficiary's attaining the age stated in the trust, or on the 25th birthday of the beneficiary, whichever occurs first, or if the beneficiary is an incapacitated person, the trust terminates on the death of the beneficiary or when the beneficiary regains capacity. Tex. Prop. Code § 142.005 (b) (4). For minors' trusts, the ability to extend the date of trust termination beyond age 18 has been seen as one of its principal advantages over guardianships, which must terminate at age 18 unless the 18-year-old is otherwise incapacitated.

Note that Tex. Prop. Code § 142.005 (b) (4) is somewhat unclear on when a 142 Trust benefiting a minor who also is an incapacitated person or disabled person must terminate. Does the trust have to terminate at age 25, or can it continue until the beneficiary regains capacity or dies? In many cases it may be difficult to predict the level of capacity an incapacitated minor will have at age 25, while in others it may be clear that the minor is unlikely to ever have capacity to manage the trust assets. If the trust for the minor is set to terminate at age 25, and if the minor appears to be incapacitated or disabled at that time, the trust may be amended or modified to continue

until the beneficiary regains capacity. Tex. Prop. Code § 142.005 (d).

Section 142.005(g) permits the court to modify any terms -- including trust termination terms -- if the court determines that "the omission or modification is necessary or appropriate to allow the beneficiary to be eligible to receive public benefits or assistance." This should permit a court to continue a (d)(4)(A) trust beyond age 25. If a minor who does not meet the definition of incapacity in Section 142.007 of the Texas Property Code is the beneficiary of a (d)(4)(A) trust, and if the (d)(4)(A) trust must terminate at age 25, the trust beneficiary would be deprived of the benefits afforded by (d)(4)(A) trusts because at age 25 (1) the government reimbursement provision would kick in and (2) if more than $2,000 was left in the trust, the trust beneficiary would cease to qualify for Medicaid and SSI benefits. Therefore, it is "necessary" under Tex. Prop. Code §142.005(g) for the trust to provide that it continues beyond age 25 until the death of the beneficiary or it is otherwise terminated by order of the court.

H. Trustee Compensation. Tex. Prop. Code § 142.005 (b) (6) states that the trust must provide that "the trustee receives reasonable compensation paid from trust's income, principal, or both on application to and approval of the court." The statute does not define "reasonable compensation," nor does it provide whether such compensation is paid monthly or quarterly as it accrues (as is the case with most express trusts administered by corporate fiduciaries) or in arrears (as is the case with 867 Trusts and guardianships). The statute also is silent on whether one application and approval is required or whether periodic applications and approvals are required.

In most cases, trustees of 142 Trusts are paid currently as fees accrue (*i.e.*, not in arrears) for serving as trustee of 142 Trusts at their usual and customary rates. Also, in most cases, trustees make one application for payment at the commencement of their service as trustee and obtain court approval just once (unless changed facts or circumstances require a subsequent application). This makes 142 Trusts much more attractive for corporate trustees than 867 Trusts, which limit compensation to the statutory formula for guardianship compensation (unless the court otherwise orders) and which provide for payment in arrears upon the annual filing and approval of a guardianship-type accounting.

Trustees should not forget to apply for approval of their compensation. This may seem obvious, but in the typical case the creation of the trust may be handled by the guardian ad litem and counsel for the plaintiff. Since Tex. Prop. Code § 142.005 (b) (6) requires "application to and approval of the court," it is a good idea for the trustee to submit a separate application for compensation and related order for the judge to sign at the time of trust creation so that the requirement is clearly met.

I. Distributions on Termination. In a 142 Trust which is not a (d)(4)(A) supplemental needs trust, on the termination of the trust under its terms or on the death of the beneficiary, the trust principal and any undistributed income must be paid to the beneficiary or to the representative of the estate of a deceased beneficiary. Tex. Prop. Code § 142.005 (e). 867 Trusts offer more flexibility regarding distributions on trust termination.

A supplemental needs trust created under Section 142.005(g) presumably is permitted to have a different distribution scheme, since (d)(4)(A) trusts must provide for the reimbursement to the state of some benefits upon termination of the trust. This may present a planning opportunity for (d)(4)(A) trusts which is not there for other 142 Trusts -- in addition to including the government reimbursement provision, perhaps the trust instrument may provide for a tax-planned distribution scheme.

3.1.3. Optional Provisions. Tex. Prop. Code § 142.005 (b) and (c) permit the trust to contain provisions other than the mandatory provisions described above.

A. Dribble Distributions. The trust may provide that distributions from trust principal before the termination of the trust "may be made from time to time as the beneficiary attains designated ages and at designated percentages of the principal." Tex. Prop. Code § 142.005 (c) (1). Thus, the trust could provide for one-third of the trust principal to be distributed to the beneficiary at age 21, one-third at age 23 and the remainder at trust termination at age 25.

B. Facility of Payment. The trust may permit payments "to the natural or legal

guardian of the beneficiary or to the person having custody of the beneficiary" or "directly to or expended for the benefit, support, or maintenance of the beneficiary without the intervention of any legal guardian or other legal representative of the beneficiary." Tex. Prop. Code § 142.005 (c) (2). This is not as broad as the facility of payment clauses typically used in an express trust. Can the drafter go beyond the optional statutory language to permit distributions to a custodian under the Texas Uniform Transfers to Minors Act, or to the parent of an adult beneficiary? Since 142 Trusts often are created for minors but last beyond the beneficiary's minority, trustees often find themselves faced with the problem of having to determine if payments to the beneficiary's parent may continue after his or her eighteenth birthday. Since Tex. Prop. Code § 142.005 (c) (2) is an *optional* provision, a more universal facility of payment clause which gives the trustee more flexibility in making distributions should fall within the court's power to impose terms of the trust that are not in conflict with the *mandatory* provisions. See Tex. Prop. Code § 142.005 (b).

C. Termination at Age Other Than 25. The trust may provide that it will terminate upon the minor beneficiary's attainment of an age of less than 25. For example, the trust may provide that it terminates when the minor beneficiary attains the age of 21 years. The trust cannot be extended beyond age 25 unless the beneficiary is incapacitated.

D. Other Optional Provisions. The court is authorized to determine the "terms, conditions, and limitations of the trust" that are not in conflict with the mandatory statutory provisions. Most 142 Trusts go well beyond the minimal statutory requirements. Many trusts provide that distributions for the health, education, support, and maintenance of the beneficiary may include enhancements to the family life of the beneficiary, such as the purchase of a new family car or van or the purchase of a new house. These optional provisions can go too far, however. *See Aguilar v. Garcia*, 880 S. W. 2d 279 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.).

3.1.4. The 2003 Change Regarding Exculpation Provisions. In 2003, the Legislature enacted HB 3503 in response to *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002). For more information on the *Grizzle* case and its consequences, see below. The 2003 change added Subsections (h), (i) and (j) to Section 142.005. Subsections (h) and (i) say that a 142 Trust is subject to the Texas Trust Code, to the extent the Trust Code provisions are not in conflict with the provisions of Section 142.005. Subsection (j) makes a provision purporting to relieve a trustee of a 142 Trust from a "duty, responsibility or liability" imposed by Section 142.005 of the Texas Trust Code unenforceable unless:

1. The provision is limited to specific facts and circumstances unique to the property of that trust and is not applicable generally to the trust; and

2. The court creating or modifying the trust makes a specific finding that there is clear and convincing evidence that the inclusion of the provision is in the best interests of the beneficiary of the trust.

HB 3503 became effective September 1, 2003, and applies to new and existing trusts. Therefore, an exculpation provision prohibited by HB 3503 in a trust created prior to September 1, 2003, is now unenforceable unless a later special finding is obtained.

A. The Rationale for Subsection (j). The intended effect of Subsection (j) is to prohibit the trust instrument governing a 142 Trust from exculpating the trustee beyond the default liability rules of the Texas Trust Code. In *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002), the court creating the 142 trust had inserted an exculpation provision in the trust instrument and the Texas Supreme Court said that the provision was enforceable. Subsection (j) is a legislative disapproval of this result. While the Trust Code permits a settlor of a private trust to alter trustee liability terms (to the extent permitted by the Trust Code), the Legislature did not want courts creating 142 Trusts (and, therefore, substituting their judgment for the minor or incapacitated beneficiary) to include such provisions absent a special finding that they are appropriate.

B. What is a "Duty, Responsibility or Liability?" To understand Subsection (j), it is important to distinguish between the court (and the trust instrument) authorizing or directing the trustee to act, or refrain from acting, in a certain way, and the court (and the trust instrument) attempting to relieve the trustee of a

"duty, responsibility or liability." In crafting the terms of the trust, the trustee (and the court) should assure that the terms of the trust are specific enough about the actions the trustee is expected to take and those areas in which the trustee is not expected to act. These types of provisions (directing, authorizing or prohibiting actions) are not (in the author's opinion) provisions relieving the trustee of a duty, responsibility or liability imposed by the Trust Code. Provisions which Subsection (j) are intended to prohibit are provisions which excuse the trustee from liability for its failure to meet its fiduciary duties under the instrument.

Consider the following example: At the creation of a 142 Trust, the trustee knows that the beneficiary's family wants the trustee to use trust funds to buy a new car for the family. If the trust instrument says merely that the trustee shall "disburse amounts of the trust's principal, income, or both as the trustee in his sole discretion determines to be reasonably necessary for the health, education, support or maintenance of the beneficiary" and is silent about the car, a general provision exculpating the trustee from liability for its actions will not protect the trustee from a later claim that the use of trust funds to buy a car failed to meet the "health, education, maintenance and support" standard. On the other hand, if the trust instrument says not only that the trustee is to make distributions for the beneficiary's health, education, maintenance and support but also provides that, for purposes of this trust, the purchase of a car [specifically describing the type of car and its cost, if possible] for the use of the beneficiary's family is considered a proper expense for the health, education, maintenance and support of the beneficiary," then the trustee is authorized to buy the car and is protected from a later claim, not because of a provision relieving the trustee from a "duty, responsibility or liability," but because the terms of the instrument specifically authorized or directed the trustee to act in a certain way.

C. What are "Specific Facts and Circumstances" Justifying an Exculpation Provision? If the court makes a special finding (described below), a provision relieving a trustee of liability may be enforceable if it "is limited to specific facts and circumstances unique to the property of that trust and is not applicable generally to the trust." Tex. Prop. Code §142.005(j)(1). While the Legislature clearly indicated that exculpation provisions should not be included routinely in 142 Trusts, the Legislature recognized that occasionally there may be peculiar assets in a trust that present greater than normal liability risk for the trustee, making it in the best interest of the beneficiary to include a provision limiting the trustee's liability. Note that the "specific facts and circumstances" justifying this exception to the general rule must relate to the "unique property of that trust" and not to the trust as a whole. This means that, while a weird asset (such as a bar in east Austin) may justify the exculpation provision, other "weird" facts that are not property-related do *not* justify exculpating the trustee. Thus, a trustee cannot be exculpated because the distribution standards are particularly hard to meet (as may be the case with a special needs trust) or because the family of the beneficiary has never had money and therefore, may be particularly difficult to deal with or because the beneficiary is the beneficiary from hell. As comforting as it may be for a trustee in these situations to be exculpated from liability, Subsection (j) does not permit it.

What specific facts and circumstances related to property may justify an exculpation provision? Here are a few examples that occur to the author:

1. The 142 Trust contains a liability-ridden real estate asset (such as a bar in east Austin). The court may find it in the beneficiary's best interest to exculpate the trustee for liability related to the real estate until such time as the real estate can be sold.

2. The 142 Trust contains (or is the beneficiary of) a large annuity from a structured settlement. The court may find it in the beneficiary's best interest to provide that the trustee has no liability if the company issuing the annuity fails to make the required payments. (Note that this also may be dealt with by having the court direct that the trustee is not to take any action to investigate or monitor the issuer of the annuity, etc.)

D. Requirements for Court Finding. Even if special facts and circumstances justifying an exculpation provision exist, the provision is unenforceable unless the court creating the trust finds by clear and convincing evidence that the inclusion of the provision is in the best interests of the beneficiary of the trust.

"Clear and convincing evidence" is a particularly high standard. It exceeds the "preponderance of the evidence" standard that usually applies.

The criterion for the court to apply is whether or not the exculpation provision is in the best interests of the beneficiary. This is a tough standard to meet. One way to meet it might be to show that no qualified corporate trustee is willing to serve as trustee unless the exculpation provision is included. Anything short of that may make it difficult, since it is conceptually difficult to see how relieving a trustee of liability to a beneficiary is ever in the beneficiary's best interest.

E. Effect on Existing Trusts. The changes made by HB 3503 apply to new and existing trusts. This means that an exculpation provision in an existing trust is not enforceable (at least with respect to conduct occurring after September 1, 2003, and perhaps with respect to conduct occurring prior to that date) unless the court makes the special finding required by Subsection (j). If appropriate facts and circumstances exist in an existing trust, the trustee should consider asking the court that created the trust to make the special finding to validate the exculpation provision.

3.2. Miscellaneous Issues Regarding 142 Trusts.

3.2.1. The Court's Continuing Jurisdiction. A court which creates a 142 Trust has continuing jurisdiction and supervisory power over the trust, including the power to construe, amend, revoke, modify or terminate the trust. A 2005 change to Section 142.005(d) clarified this authority. Since any court of record with jurisdiction to hear the suit in which the trust was created has jurisdiction to create the trust, this means that any court that creates the trust has the continuing authority to act with respect to the trust, even if it is not a district court.

In *Texas State Bank v. Amaro,* 87 S. W. 3d 538 (Tex. 2002), the Texas Supreme Court found that the court creating the trust had continuing jurisdiction over the trust and that the order of another district court had no effect on the trust. The *Amaro* decision makes it clear that, in exercising its continuing jurisdiction, the court may amend, modify or revoke the trust and approve the trustee's accounting (including the distributions, costs, and expenses of a trust and the trustee's fees). 87 S. W. 3d at 544. In *Amaro* the Supreme Court held that it was improper for the trial court to approve the trustee's investment philosophy and to adjudicate the trustee's potential tort liability as trustee. 87 S. W. 3d at 543. However, it appears that the Supreme Court's main objection to the trial court's action was that it granted more relief than was pled. If the trustee properly pled for its investment philosophy to be approved and/or for its potential tort liability to be adjudicated, *Amaro* should not be an impediment to obtaining relief.

3.2.2. Revocation And Modification. A 142 Trust may be amended, modified or revoked by the court creating it at any time before its termination, but it cannot be revoked by the beneficiary or a guardian of the beneficiary's estate. Tex. Prop. Code § 142.005 (d). A beneficiary, his or her guardian, or another representative of the beneficiary can ask the court to amend or revoke the trust. If the court revokes the trust before the beneficiary is 18 years old, it can make other arrangements for the investment of the trust property under Chapter 142 of the Texas Property Code (and, therefore, keep the property out of the beneficiary's guardianship estate). If the minor has attained age 18 when the court revokes the trust, the trust property must be paid to the beneficiary "after the payment of all proper and necessary expenses." Tex. Prop. Code § 142.005 (d).

3.2.3. Effect of a Guardianship Proceeding. As noted above, a 142 Trust cannot be created for a minor with a legal guardian. If the 142 Trust is established before the guardian is appointed, however, the trust continues in force and effect until terminated or revoked, notwithstanding the appointment of a guardian of the person or the estate of the trust beneficiary and notwithstanding the beneficiary's attainment of the age of majority. Tex. Prop. Code § 142.005 (f).

In *Rodriguez v. Gonzalez,* 830 S. W. 2d 799 (Tex. App. — Corpus Christi 1992, no writ), a grandmother of four minor children brought a tort suit on behalf of the children (apparently as next friend). The parties settled and entered into an agreed judgment whereby the recovered funds were placed into the district court's registry. At that time, there was no guardian of the children's estates. The grandmother then instituted guardianship proceedings, was appointed guardian of the children's estates, and filed an application for possession of the minors' funds held in the court registry. The attorney ad litem in the tort suit then filed a motion with the district court for creation of a 142 Trust. The district court granted the motion to create a 142 Trust, and the guardian appealed. The court of appeals held for the guardian, stating:

> The provision for the creation of such a trust applies only in those cases in which the minor has no legal guardian. . . . However, once the legal guardian has been appointed and qualified, she is entitled to custody and control of the minors' estates.

830 S. W. 2d at 800-1. Thus, in a dispute between a guardian of the estate and the trustee of a 142 Trust over possession of funds, the relevant date is the date of creation of the 142 Trust. If the guardian qualifies before the trust is created, Tex. Prop. Code §142.005(f) is not a bar to recovery of the funds by the guardian. If, on the other hand, the trust is created before the guardian qualifies, Section 142.005(f) prevents the guardian from recovering the funds from the trustee.

Even though a guardian of the estate of a minor or incapacitated person may not be entitled to custody and control of the trust property if the 142 Trust was created prior to the appointment of the guardian, the guardian may be entitled to compel the trustee of a 142 Trust to provide information about the trust to the guardian pursuant to Sections 113.060 and 113.151 of the Texas Trust Code. The trustee has duties to the beneficiary under these sections, and Sections 768, 772 and 773 of the Texas Probate Code give the guardian of the estate of the beneficiary the right to enforce claims on behalf of the beneficiary.

3.2.4. The 2007 Change Regarding a Special Remedy for Trustee's Failure to Make Distributions. Perhaps the most poorly conceived and least understandable provisions of the probate, guardianship and trust statutes of Texas are new Subsections (k) and (l) of Section 142.005, enacted in 2007. Subsection (k) permits the parent of a beneficiary (or certain other persons acting on the beneficiary's behalf) to ask the court that created the 142 Trust to appoint a guardian ad litem to "investigate and report to the court whether the trustee should be removed for failing or refusing to make distributions for the health, education, support or maintenance of the beneficiary required under the terms of the trust." Subsection (l) assures that the parent or other interested person asking for the ad litem gets reimbursed for up to $1,000 in attorneys' fees.

These changes were made to accommodate the wishes of the mother of a 142 Trust beneficiay. The mother believed that the trustee of her son's 142 Trust should be distributing more money from the trust to pay for the medical expenses the mother wished to incur. Rather than petitioning the court that created the trust for relief, the mother sought, and obtained, legislative relief in the form of the adoption of Subsections (b)(7), (k) and (l).

Under this procedure, the mother, next friend, guardian, etc., of a beneficiary of a 142 Trust may ask the court to appoint a guardian ad litem for the narrow purpose of determining if the trustee should be removed for failing to make required health, education, maintenance and support distributions. The mother, next friend, etc., is assured of getting repaid for his or her attorneys fees, up to $1,000. Then, assuming that the court appoints a guardian ad litem pursuant to the request, it is the guardian ad litem, not the mother, etc., who investigates the circumstances (presumably at the expense of the trust) and takes appropriate action.

The author hopes this provision will find limited application for the following reasons:

1. It is limited to 142 Trusts.

2. It is limited to determining if removal is appropriate.

3. It is limited to the question of whether the trustee made mandatory health, education, maintenance and support ("HEMS") distributions.

4. Since it only applies to HEMS distributions, it should not apply to supplemental needs trusts.

5. It is the court-appointed guardian ad litem who investigates, rather than a family member.

6. The attorneys fees paid to the mother or other family member are limited to $1,000.

3.2.5. Funding 142 Trust With Only Part of Judgment. In many cases, the court orders only a portion of the judgment proceeds due to be paid to a minor or incapacitated person to be held in a 142 Trust. A portion of the judgment is kept out of the trust to pay attorneys' fees. Tex. Prop. Code § 142.005 (a) requires the

court to enter a decree in the record directing the clerk to deliver "any funds accruing to the minor or incapacitated person under the judgment" to the trustee of the 142 Trust. It is unclear if this means that all funds accruing to the minor or incapacitated person under the judgment must be placed in the trust. If possible, the judgment should be structured so that attorneys' fees and other items are paid out of the portion of the judgment accruing to another party (such as the parents of the injured minor or incapacitated person) so that all of the judgment accruing to the minor or incapacitated person can be transferred into the trust. Another alternative would be to have the court order the trustee to pay the attorneys' fees out of the trust upon creation of the trust. As a practical matter, however, the practice of placing only a portion of the judgment in the 142 Trust is so widespread that it is doubtful that an appellate court would construe Tex. Prop. Code § 142.005 (a) to prohibit such practice. *But see Aguilar v. Garcia*, 880 S. W. 2d 279 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.).

3.2.6. 142 Trusts and The Texas Trust Code. Although the statute authorizing 142 Trusts is in the Texas Property Code, it is not part of Title 9 of the Texas Property Code, also known as the Texas Trust Code. In *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002), the Texas Supreme Court ruled that 142 Trusts are governed by the Texas Trust Code. This result was reinforced by the Legislature in 2003 with the enactment of Subsections (h) and (j) to Section 142.005, which provide that a 142 Trust is subject to the Texas Trust Code to the extent that those provisions do not conflict with Section 142.005.

3.2.7. Does the Trustee of a 142 Trust Enjoy Judicial Immunity? In *Southwest Guaranty Trust v. Providence Trust,* 970 S. W. 2d 777 (Tex. App. – Austin 1998), the trustee of a 142 Trust tried who invested trust property in an annuity tried to avoid liability on summary judgment by claiming that it was protected by derived judicial immunity. The court rejected that argument, saying that, while the trustee was acting at the direction of the court in purchasing the annuity, it was afforded "considerable discretion," and the question of whether its actions were merely ministerial were for the trier of fact. 970 S. W. 2d at 782 - 3.

This leaves open the possibility that a trustee may avoid liability based on derived judicial immunity for certain specific actions ordered by the court. The trustee should strive for specificity in the order, though, since discretion in executing the order may lead to liability. For example, if the court orders the trustee to buy a car for a ward, the trustee is the most likely to avoid liability if the court order specifies the make, model, features and price of the car rather than leaving such details to the trustee's discretion.

3.2.8. Can a 142 Trust Be a Spendthrift Trust? Should a spendthrift clause be added to a 142 Trust? Tex. Prop. Code § 112.035 (d) provides that, if the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of the settlor's beneficial interest does not prevent the settlor's creditors from satisfying claims from the settlor's interest in the trust estate. The definition of "settlor" in the Texas Trust Code was amended in 2005 to mean "a person who creates a trust or contributes property to a trustee of a trust." Tex. Trust Code §111.004(14). The court "creates" a 142 Trust, not the beneficiary, but does a beneficiary "contribute property" to a 142 Trust?

In *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002), the Texas Supreme Court found that the "settlor" of a 142 Trust was the court that created the trust. *Grizzle* was not a spendthrift trust case, but if the court is the "settlor" for spendthrift trust purposes, then a spendthrift provision in a 142 Trust may protect the assets from the claims of the creditors of the beneficiary.

It is possible, however, that the beneficiary of a 142 Trust would be considered a "settlor" of the trust even though he or she did not create the trust and even though the *Grizzle* case says the court was the settlor. *See Matter of Shurley,* 115 F 3d 333 (5th Cir.), *reh. denied en banc*, 124 F. 3d 1195 (5th Cir. 1997). The fact that the court is the settlor under *Grizzle* and that the beneficiary has no right to the trust assets until they are distributed to the beneficiary strengthens the argument that spendthrift protection is available. Even if the spendthrift clause does not protect the trust assets from the beneficiary's creditors, it may prohibit the beneficiary from voluntarily alienating his or her interest in the trust. Therefore, it is probably a good idea to include a spendthrift provision in the trust.

3.2.9. Trustee's Duty to Account. Section 142.005 of the Texas Property Code provides no special duty of the trustee to account. The court may impose such a duty by including a requirement to account in the trust. If the trust is silent on the trustee's duty to account, then presumably the trustee must meet the requirements of the Texas Trust Code. In all cases, the trustee is a fiduciary and has the same fiduciary duties that

other fiduciaries have. Also, as a practical matter, it probably has a duty to account to the court on request, since the trustee's compensation must be approved by the court and since the court retains the right to terminate or modify the trust.

Since, under Section 142.005 (b) (1) of the Property Code, the minor or incapacitated person is the sole beneficiary of the trust, the trustee should have no duty to account to, or provide information about the trust to, any person other than that beneficiary, unless someone is acting on that beneficiary's behalf (such as a guardian or guardian ad litem of such person).

3.2.10. Distributions For Minor's Support, Education or Maintenance. Tex. Prob. Code Ann. § 777 provides that, absent a court finding of undue hardship, "a *parent* who is the *guardian of the person* of a ward who is 17 years of age or younger may not use the income or the corpus from the ward's estate for the ward's support, education, and maintenance [emphasis added]." This provision was added to the probate code in 1993 as part of the recodification bill; there is no corresponding provision in pre-1993 statutory probate law. It is consistent with the Family Code (*see* Tex. Fam. Code § 151.003(a)(3) -- a parent has "the duty to support the child, including providing the child with clothing, food, shelter, medical and dental care, and education") and prior case law (*see Tharp v. Blackwell,* 570 S. W. 2d 154, 159 [Tex. Civ. App. -- Texarkana 1978, no writ] -- Texas law "imposes upon a parent, who has resources of his own sufficient to maintain his children, and who is also guardian of their estates, to support them out of his own means and he may not have recourse to the estates of the wards.").

Does Texas law (Tex. Prob. Code Ann. § 777 or otherwise) permit or require the trustee of a 142 Trust to withhold payments for the support, education and maintenance of a trust beneficiary under age 18 if the beneficiary's parent or parents have the resources to support the beneficiary? If *Aguilar v. Garcia*, 880 S. W. 2d 279 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.) is decided correctly, then the trust instrument cannot *require* a trustee to withhold trust distributions which would pay for expenses that fall within a parent's legal duty to support the child. In *Aguilar,* the following provision was included in the trust instrument approved by the trial court:

> The Trustee shall pay to or apply for the benefit of the Beneficiary such amounts out of the net income and principal (if income is sufficient) of the Trust as are reasonably necessary in the sole discretion of the Trustee to provide for the health needs of the Beneficiary *when it is demonstrated that the parents have no resources available, such as insurance, or other means to provide for the medical needs of the child . . . .*

880 S. W. 2d at 280 [emphasis added]. The court of appeals said that, while the trial court's motives in including this restriction regarding the parent's means were laudable, the court did not have the discretion to limit the mandatory powers given to the trustee under Tex. Prop. Code § 142.005(b)(2). Thus, requiring the trustee of a 142 Trust to consider parent's resources is prohibited under *Aguilar.*

If the trust instrument merely *permits* the trustee to consider other sources of support in deciding whether to make distributions, or if the trust instrument is silent regarding other sources of support and the trustee considers such sources in exercising its fiduciary duties under the mandatory health, education, maintenance and support standard, then the *Aguilar* rationale seems inapplicable -- the court is not limiting the mandatory powers given to the trustee by Tex. Prop. Code § 142.005. Thus, the trustee probably is justified (and may in fact breach fiduciary duties owed to the trust beneficiary if the trustee fails to do so) in withholding distributions that can be paid, *and in fact are paid*, by the parents pursuant to their support obligations.

What can a trustee do if it withholds distributions because of the parents' support obligation and the parents refuse or fail to satisfy their support obligations? First, and foremost, the trustee probably must assure that the support obligations are met by making distributions from the trust. Second, unlike a guardian, the trustee of a 142 Trust has no direct authority to pursue payment of support obligations by the parents. However, the trustee probably is an "interested person" under Tex. Prob. Code Ann. § 601(14) which is entitled to apply for appointment of a guardian for the trust beneficiary. If a guardian is appointed for the trust beneficiary, that guardian is empowered (and is probably required) to pursue satisfaction of the parent's support obligations on the trust beneficiary's behalf.

If the trust instrument provides that the trustee of a 142 Trust is not required to consider (or is prohibited from considering) other sources of support available to the trust beneficiary in determining whether or not to make distributions, can the trustee (i) ignore the parents' ability to support the trust beneficiary, (ii) make support distributions from the trust and (iii) still avoid liability? Such a trust provision does not limit the mandatory health, education, maintenance and support standard; thus, the court's reasoning in *Aguilar* seems not to apply. It is hard to see how such a provision would be in the trust beneficiary's best interests (thus presenting potential liability for the guardian ad litem or next friend who consents to such a provision), but this may be the best way (from the trustee's perspective) to simplify trust administration and protect the trustee from liability -- the trustee simply follows the trust instrument and makes the support distributions without considering other possible sources of support.

Note that Tex. Prob. Code Ann. § 777 and *Tharp v. Blackwell,* 570 S. W. 2d 154, 159 (Tex. Civ. App. -- Texarkana 1978, no writ) both address the situation where the *parent* is the guardian (although Section 777 applies when the parent is the guardian *of the person* and *Tharp* applies where the parent is the guardian *of the estate*). Obviously, in the case of a 142 Trust, a corporate fiduciary, not the parent, will be trustee, although one or both parents may be the guardian of the person of the trust beneficiary. Tex. Prop. Code § 142.005(c)(2) provides that a 142 Trust may provide that "distributions, payments, uses, and applications of all trust funds may be made *to the legal or natural guardian* of the beneficiary or to the person having custody of the beneficiary or may be made directly to or expended for the benefit, support, or maintenance of the beneficiary *without the intervention of any legal guardian or other legal representative of the beneficiary* [emphasis added]." Could the situation arise where, under Tex. Prop. Code § 142.005(c)(2), the trustee of a 142 Trust may make support distributions to the guardian of the person of the trust beneficiary, but under Tex. Prob. Code Ann. § 777 the parent/guardian may not expend the trust distributions? This situation probably cannot occur because (i) the prohibition against spending money in Tex. Prob. Code Ann. § 777 applies only to "the ward's estate" and the trust distributions should not be considered part of the ward's estate (*see* Tex. Prob. Code Ann. § 601(8)) and (ii) Tex. Prop. Code § 142.005(f) trumps the Probate Code, providing that a 142 Trust "prevails over any other law concerning minors, incapacitated persons, or their property." Of course, the trustee of the 142 Trust can avoid this scenario by directly applying distributions for the benefit of the trust beneficiary instead of making distributions through the parent as legal guardian, but as a practical matter distributions through the parents will be used in many, if not most, cases.

3.2.11. Duties And Liabilities of Next Friend or Guardian Ad Litem. A 142 Trust can be created only if the next friend or guardian ad litem of the minor or incapacitated person applies for its creation. Tex. Prop. Code § 142.005 (a). What duties does the next friend or guardian ad litem owe to the beneficiary in connection with requesting and drafting a 142 Trust? What potential liabilities does the next friend or guardian ad litem face as a result of actions taken in connection with the 142 Trust?

It is clear that a next friend or a guardian ad litem is a fiduciary of the proposed trust beneficiary who owes that beneficiary the same duties that other fiduciaries owe, including the duty of loyalty. In *Byrd v. Woodruff,* 891 S. W. 2d 689 (Tex. App. -- Dallas 1994, writ denied), the court of appeals found that a guardian ad litem for a minor is a fiduciary, and that:

> As a fiduciary, the guardian ad litem shall: (i) use the skill and prudence that an ordinary, capable, and careful person would use in the conduct of his own affairs, (ii) use diligence and discretion in representing the minor's interests, and (iii) be loyal to his fiduciary. *Cf. Interfirst Bank Dallas, N.A. v. Risser,* 739 S. W. 2d 882, 888 (Tex. App.--Texarkana 1987, no writ) (duty of trustee to manage trust property). The fiduciary duty is one of integrity, loyalty, and the utmost good faith. *Coble Wall Trust Co. v. Palmer,* 859 S. W. 2d 475, 481-82 (Tex. App.--San Antonio 1993, writ denied). The guardian ad litem appointed under rule 173 in a settlement hearing is bound to serve the interests of his principal, placing the interests of the minor before his own. *See Crim. Truck & Tractor Co. v. Navistar Int'l Transp.*, 823 S. W. 2d 591, 592 (Tex. 1992).

891 S. W. 2d at 706-707.

In *Byrd,* a 142 Trust was not created. Rather, a portion of the settlement proceeds were held in the registry of the court and/or in the plaintiff attorney's trust account until the minor turned 18, at which point the former minor agreed to the creation of an irrevocable trust to last until age 40. The guardian ad litem participated in the

settlement negotiations and recommended the settlement; he did not participate in the irrevocable trust arrangement. The court of appeals refused to let the guardian ad litem out on summary judgment, holding that he owed the minor fiduciary duties and that he was not entitled to judicial immunity.

While *Byrd v. Woodruff* is not a 142 Trust case, one of the minor's allegations was that the guardian ad litem failed to ensure compliance with Tex. Prop. Code § 142.005 in establishing the trust. 891 S. W. 2d at 697. Also, while the *Byrd* court did not expressly hold that a next friend is a fiduciary, the minor in *Byrd* also sued her parents as next friends, and that part of the case was severed so that the summary judgment in favor of the guardian ad litem was an appealable final judgment. 891 S. W. 2d at 698. Thus, unlike the guardian ad litem, the parents as next friends were unable to win a summary judgment at the trial level (which summary judgment was reversed by the decision in *Byrd).* The Texas Supreme Court denied writ in *Byrd* in 1995.

Since it is clear from the *Byrd* case that next friends and guardians ad litem contemplating applying for 142 Trusts owe fiduciary duties to the minor or incapacitated person they represent, how can they fulfill those duties without fear of liability to the beneficiary? On the one hand, the age of majority in Texas is 18. How can they justify making the beneficiary wait until age 25 to own his or her settlement proceeds outright? On the other hand, if the guardian ad litem or next friend fails to seek a 142 Trust and the minor spends his or her settlement proceeds immaturely between ages 18 and 25, does the guardian ad litem or next friend face liability for not properly safeguarding the minor's funds?

Similarly, what liability does a next friend or guardian ad litem face if he or she asks for the creation of a 142 Trust for a person believed to be incapacitated but who later asserts that he was not and is not incapacitated? Tex. Prop. Code § 142.005 is intended to be a procedure which happens totally outside the guardianship system. Indeed, Tex. Prop. Code § 142.007 provides a special definition of incapacity for 142 Trust purposes, and a 142 Trust cannot be applied for if a guardianship exists. Nevertheless, creation of the 142 Trust is a denial of property rights to the incapacitated person without following the due process safeguards in place under Texas guardianship law.

Byrd v. Woodruff teaches a lesson that we should have known all along -- that next friends and guardians ad litem must take their duties to their minor or incapacitated person seriously. If a 142 Trust is sought, the applicant should make a record of why it is appropriate in that particular case. In some cases, the next friend or guardian ad litem should consider applying for creation of the trust and stating to the court his or her ambivalence about the creation of the trust and the proposed age of trust termination, leaving it to the court to decide. Also, the next friend or guardian ad litem should consider insisting on a form of trust that closely follows the statutory requirements for 142 Trusts.

Another way in which a guardian ad litem can limit his or her liability is to insist on being discharged by the court upon creation of the trust. The guardian ad litem should be dismissed after entry of final judgment, and the guardian ad litem may not recover fees for services rendered after resolution of the conflict for which he or she was appointed. *Brownsville-Valley Regional Medical Center v. Gamez,* 894 S. W. 2d 753 (Tex. 1995). It is the trustee's responsibility to administer the 142 Trust; the guardian ad litem is not responsible for supervising the trustee, nor will the guardian ad litem be compensated if he or she supervises the trustee. Therefore, the guardian ad litem should assure that the final judgment clearly discharges him or her. The guardian ad litem remains liable for his or her actions prior to that time, but he or she should be able to avoid liability for the actions or inactions of the trustee after that time.

3.2.12. Potential Liability of Trustee For Administering Nonstandard 142 Trusts. Does a trustee face potential liability administering a 142 Trust which deviates from the mandatory statutory provisions? There are no cases on this issue, but *Byrd v. Woodruff*, 891 S. W. 2d 689 (Tex. App. -- Dallas 1994, writ denied), and the growing number of fiduciary liability cases involving trustees should signal the need for caution. Trustees should not blindly follow a trust instrument which the trustee knows or suspects is in conflict with the statute. The trustee should consider an application for instructions under Tex. Prop. Code § 115.001 in the event of such a conflict. The availability of this procedure may depend on whether or not the trust instrument specifically makes the Texas Trust Code applicable to the trust. *See* "Are 142 Trusts Subject to the Texas Trust Code?" above.

3.3. Drafting 142 Trusts. When drafting a 142 Trust, the drafter must decide how far from the bare-

bones statutory provisions he or she wishes to go. The trustee usually is interested in more specificity, fleshing out the distribution standard with advice to the trustee regarding what factors to consider in making distributions, whom to consult in making distributions, permissible facilities of payment, etc. The parents or other family members of the beneficiary often are interested in assuring that lifestyle-enhancing distributions, such as distributions to pay for a new or improved house for the beneficiary's family or a new car or van for the family, are permitted by the trust. The drafter may be tempted by his or her own expertise in drafting private trusts to build in greater flexibility.

This usually places the drafter in the dilemma of choosing between making the trust as bare-bones and statute-oriented as possible, which is usually the safest course, or making the trust as client-pleasing as possible, which may raise the problems addressed in *Aguilar v. Garcia*, 880 S. W. 2d 279 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.), and *Byrd v. Woodruff,* 891 S.W.2d 689 (Tex. App. -- Dallas 1994, writ denied).

4. 867 TRUSTS

4.1. Statutory Requirements. Like 142 Trusts, 867 Trusts have certain statutory requirements regarding trust creation and trust provisions which must be met. Amendments over the years changed some of these requirements. The following reflects those changes (through 2005).

4.1.1. Two Paths for Creation – Guardianship and No Guardianship. A significant change in 2005 makes it possible to seek creation of an 867 Trust when no guardianship exists and no guardianship proceeding is pending. Prior to September 1, 2005, only a guardian, guardian ad litem or attorney ad litem in a guardianship proceeding was permitted to apply for the creation of an 867 Trust. Thus, a person interested in the welfare of a minor or incapacitated person who had no guardian could not initiate a proceeding to create an 867 Trust and skip the guardianship step. Rather, he or she had to apply for a guardianship and hope that the attorney ad litem, guardian ad litem or guardian would apply for creation of the 867 Trust. As a practical matter, this often happened, since the attorney ad litem was usually happy to apply for creation of the trust if the family of the minor or incapacitated person wanted an 867 Trust. Still, it caused the proceeding to take an unnecessarily circuitous route.

The rationale for permitting only the guardian, guardian ad litem or attorney ad litem to apply for the creation of an 867 Trust goes back to the inception of 867 Trusts in 1993. At the time, 867 Trusts were viewed as a management alternative for existing guardianships. If a guardian of the estate decided that the ward's assets would be better managed by a corporate trustee in an 867 Trust (with trust-type investment authority rather than guardianship-type authority), he or she could ask the court to, in effect, switch from a guardianship to an 867 Trust. Initially (in 1993), only a guardian could ask for creation of the trust. This was intended to prevent family members who were unhappy that someone else had been selected guardian from doing an end run around the guardian by asking the court to take the property from the guardian and giving it to the trustee of an 867 Trust for management. Permitting only the guardian to ask for creation of the trust prevented re-trying the guardianship contest in an 867 Trust creation hearing.

Over the years, attorneys ad litem and guardians ad litem were added to the list of persons who could apply for creation of 867 Trusts. These court-appointed persons were not motivated by family disharmony, so they could be trusted to apply for creation of the trusts in cases where no guardian had yet been appointed or in cases where the guardian was already serving. This change led family members who wanted an 867 Trust from scratch to (1) file an application for a guardianship, (2) wait for an attorney ad litem to be appointed and (3) ask the attorney ad litem to apply for creation of the trust before a guardian was appointed. In these cases, some courts skipped the appointment of a guardian of the estate entirely, while others required the guardian of the estate to qualify and then permitted the guardian to be discharged after the 867 Trust was set up.[3]

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[3] Prior to 2003, Section 868A of the Texas Probate Code permitted the guardian of the ward's estate to be discharged only if a guardian of the ward's person remained. In 2003, this section was amended to eliminate the guardian of the person requirement. Now Section 868A permits the discharge of the guardian of the estate if the court determines that the discharge is in the ward's best interests.

The 2005 changes keep the restriction that, if an incapacitated person has a guardian of his or her estate, only a guardian, guardian ad litem or attorney ad litem may apply for creation of an 867 Trust. However, with respect to incapacitated persons who have no guardian of the estate, any person interested in his or her welfare may apply for creation of an 867 Trust.

These two paths for creation of 867 Trusts – one path for persons without a guardian of the estate, and one path for persons with a guardian of the estate – are discussed separately below.

A. Creation of 867 Trust for Person Who Has No Guardian of the Estate. Section 867 of the Texas Probate Code imposes these requirements for creation of an 867 Trust for an incapacitated person who does not have a guardian of the estate:

1) Person "Does Not Have a Guardian of the Estate." Section 867 makes these provisions applicable with respect to an incapacitated person (or an alleged incapacitated person) "who does not have a guardian of the estate." While "not having" a guardian of the estate is perhaps open to other more far-fetched interpretations, the only sensible reading of this provision is that it applies when no guardian of the estate has been appointed and has qualified as provided in Section 699 of the Probate Code. This means that these rules apply in each the following cases:

- No guardianship proceeding is pending.
- A guardianship proceeding is pending but no guardian of the person or estate has qualified.
- A guardian of the person has qualified and is serving, but no guardian of the estate has qualified.
- A guardian of the estate dies, is removed or otherwise ceases to serve.

2) Who May Apply. If a person has no guardian of the estate, then Section 867(a-1) provides that any person "interested in the welfare" of the person may apply for creation of an 867 Trust.[4] In addition, Section 867(a-1) specifically permits a guardian of the person or an attorney ad litem or guardian ad litem appointed to represent the ward or the ward's interests to apply for creation of an 867 Trust, even though presumably each of those persons also are persons interested in the beneficiary's welfare.

While the key beneficiaries of these 2005 changes are family members and friends of the alleged incapacitated person who now may apply directly for creation of an 867 Trust without having to rely on a guardian of the estate, guardian ad litem or attorney ad litem to apply for the trust, note that the 2005 changes also permit the following:

- Prior to 2005, guardians of the person could not apply for creation of an 867 Trust. Now they can.
- Prior to 2005, only attorneys ad litem and guardians ad litem appointed under a Probate Code provision could apply for creation of an 867 Trust. Now any attorney ad litem or guardian ad litem appointed to represent the person or the person's interests may apply for creation of an 867 Trust, even if that appointment is by another court. Thus, the guardian ad litem appointed by a district court to represent an incapacitated person or his interests in a suit in that court could apply for creation of an 867 Trust, but he or she would have to do it in a court with probate jurisdiction and not in the district court.[5]

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[4] This is similar, but not identical, to the definition of "interested person" in Section 601(15): "'Interested persons' or 'persons interested' means an heir, devisee, spouse, creditor, or any other persons having a property right in, or claim against, the estate being administered or a person interested in the welfare of an incapacitated person, including a minor.

[5] In most cases the guardian ad litem in a district court proceeding is likely to seek creation of a 142 Trust in that district court rather than using this authority to get an 867 Trust in probate court.

Can a person who has an interest that is adverse to the incapacitated person file an application for creation of an 867 Trust? Section 642(b) prohibits such persons from filing an application to create a guardianship for the incapacitated person, but it does not address the filing of an application for creation of an 867 Trust. Therefore, assuming that the person with the adverse interest can establish that he or she is a person "interested in the welfare" of the incapacitated person, he or she should be eligible to file an application for creation of an 867 Trust.

3) A Proper Court Exercising Probate Jurisdiction. The 2005 changes to Section 867 include new sections (b-1) and (b-2), which were further clarified in 2007 to read:

> (b-1) On application by an appropriate person . . . and regardless of whether an application for guardianship has been filed on the alleged incapacitated person's behalf, ***a proper court exercising probate jurisdiction*** may enter an order that creates a trust for the management of the estate of an alleged incapacitated person who does not have a guardian if the court, after a hearing, finds that:
>
> (1) the person is an incapacitated person; and
>
> (2) the creation of the trust is in the incapacitated person's best interests.
>
> (b-2) If a proceeding for the appointment of a guardian for an alleged incapacitated person is pending, an application for the creation of a trust for the alleged incapacitated person under Subsection (b-1) of this section must be filed in the same court in which the guardianship proceeding is pending.

(emphasis added). Prior to the 2005 changes, all 867 Trusts grew out of guardianship proceedings, so the only court which could create one was a court exercising probate jurisdiction. After the 2005 changes, some practitioners believed that a court without probate jurisdiction could be a proper court for creation of an 867 Trust. The 2007 addition of the words "exercising probate jurisdiction" to Subsection (b-1) put an end to that speculation. Only a court exercising probate jurisdiction may create an 867 Trust.

Section 867A (new in 2005) makes it clear that the guardianship *venue* rules should be followed when filing an application for creation of an 867 Trust when no guardianship proceeding is pending, but it does not address jurisdiction.

4) Determination of Incapacity. If the application for creation of an 867 Trust is filed when the proposed beneficiary has no guardian, then it is likely that there has been no judicial determination that the proposed beneficiary is an incapacitated person.[6] Subsection (b-1) of Section 867 therefore requires the court to determine that the proposed beneficiary is an incapacitated person prior to creation of an 867 Trust for his or her benefit. It also requires that a hearing be held. Subsection (b-3) gives the court guidance on how such a hearing should be conducted:

> The court shall conduct a hearing to determine incapacity under Subsection (b-1) of this section using the same procedures and evidentiary standards as required in a hearing for the appointment of a guardian for a proposed ward.

Thus, among other requirements, an attorney ad litem must be appointed to represent the interests of the proposed beneficiary (Tex. Prob. Code §646(a)) and the determination of incapacity must be based on clear and convincing evidence (Tex. Prob. Code §684(a)).

Under Section 867 as it existed prior to the 2005 changes, it was quite common for a court to have two

[6] If the reason that the proposed beneficiary has no guardian of the estate is that the former guardian has died or been removed, then there would have been a previous determination of incapacity when the guardian was originally appointed. Subsection (b-1) of Section 867 appears to require a new determination of incapacity prior to creation of the 867 Trust in such cases.

applications pending before it at the same time – an application for appointment of a guardian (filed by the applicant) and an application for creation of an 867 Trust (filed by the attorney ad litem). Once the court determined that the proposed ward was an incapacitated person, it had a choice – it could appoint a guardian of the estate, or it could create an 867 Trust.

As revised in 2005, the court still has this choice, even if it only has before it an application to create an 867 Trust. New Subsection (b-4) permits the court to appoint an guardian of the estate for the proposed beneficiary if it determines that it is not in the person's best interests to have an 867 Trust. It is not necessary to delay the appointment of a guardian of the estate until a new application can be filed and served.

B. Creation of 867 Trust for Person Who Has Guardian of the Estate. When an incapacitated person has a guardian of the estate, Section 867 of the Texas Probate Code refers to him or her as a "ward" instead of as an "incapacitated person." Here are the requirements for creation of an 867 Trust for a ward who has a guardian of the estate when the application is filed:

1) Person Has a Guardian of the Estate. These provisions apply if the ward "has" a guardian of the estate. While "having" a guardian of the estate is perhaps open to other more far-fetched interpretations, the only sensible reading of this provision is that it applies when a guardian of the estate has been appointed and has qualified as provided in Section 699 of the Probate Code.

2) Who May Apply. If the ward has a guardian of the estate when the application for an 867 Trust is filed, then any of the following persons may file the application:

- The guardian of the estate of the ward.
- The guardian of the person of the ward.
- The guardian of both the person and estate of the ward.
- An attorney ad litem or guardian ad litem appointed to represent a ward or the ward's interests.

Notably absent from this list are "persons interested in the welfare of the ward." If the ward has a guardian of the estate, then persons merely interested in the ward's welfare may not file the application to create an 867 Trust. This is a holdover from the original rationale, discussed above, that guardians of the estate should not be subjected to opposing applications for trusts from disgruntled family members and friends. When a guardian of the estate is serving, such interested persons must persuade the court to appoint an ad litem and then must persuade the ad litem to apply for creation of the trust.

3) Court With Jurisdiction Over the Guardianship. After the 2005 changes, Section 867(b) now reads:

> On application by an appropriate person . . ., ***the court with jurisdiction over the guardianship*** may enter an order that creates for the ward's benefit a trust for the management of guardianship funds if the court finds that the creation of the trust is in the ward's best interests.

(emphasis added). Thus, when the ward has a guardian of the estate, the application must be filed in the court which is supervising the guardianship.

4) No New Determination of Incapacity. If the ward has a guardian of the estate, then a determination of incapacity already has been made. Therefore, the court is not required to make another determination of incapacity before creating the trust.

4.1.2. Mandatory Provisions. Like 142 Trusts, 867 Trusts must meet mandatory requirements regarding choice of a trustee and terms of the trust. Many of the mandatory provisions are based on the requirements for 142 Trusts and, therefore, are similar or identical to the requirements of Tex. Prop. Code §

142.005. Some of these mandatory provisions may be varied by the court in order to create a supplemental needs trust. See "867 Trusts as Supplemental Needs Trusts" below.

A. Must Use Corporate Trustee, Unless. . . . A financial institution must be named as trustee of an 867 Trust unless (1) the value of the trust's principal is $50,000 or less, (2) the court finds that "no financial institution is willing to serve as trustee," and (3) the court finds that appointing a noncorporate trustee is in the ward's best interest. Section 867 (b), (c) and (d). Before making the finding that no financial institution is willing to serve as trustee, Section 867(e) requires the court to check any list of corporate fiduciaries in Texas maintained in the office of the presiding statutory probate judge or the principal office of the Texas Bankers Association.

B. Sole Beneficiary Requirement. Tex. Prob. Code Ann. § 868 (a) (1) requires that the ward or incapacitated person be the sole beneficiary of the trust (except in the case of supplemental needs trusts -- see "867 Trusts as Supplemental Needs Trusts" below). Notwithstanding the mandatory sole beneficiary requirement, Section 868(b) permits distributions "for the health, education, support, or maintenance of the ward *or of another person whom the ward or incapacitated person is legally obligated to support*." (emphasis added). Presumably this possible conflict can be reconciled by recognizing that, if the beneficiary is legally obligated to support someone, payment for that person's needs benefits the ward/beneficiary.

This sole beneficiary requirement also clears up another potential problem for the trustee. Since the ward or incapacitated person is the "sole beneficiary" of an 867 Trust, the trustee does not have to worry about the interests of persons other than the minor or incapacitated person. In a typical trust (an "express trust") the trustee owes duties not only to the "income beneficiary" – the beneficiary entitled to receive distributions during the term of the trust – but also to the "remainder beneficiaries" – those persons who will receive the remaining trust property when the trust terminates (often on the death of the "income beneficiary"). Under Section 117.008 of the Texas Trust Code, the trustee must administer the trust impartially, respecting the interests of both the income beneficiary and the remainder beneficiaries. However, since the ward or incapacitated person for whom the trust is created is the sole beneficiary of an 867 Trust, the trustee must focus only on that beneficiary's interests and not on remainder beneficiaries. Thus, the trustee need not try to preserve or increase trust property for the benefit of remainder beneficiaries at the expense of the ward or incapacitated person.

C. Mandatory Distribution Provisions. Except in the case of supplemental needs trusts (see "867 Trusts as Supplemental Needs Trusts" below), the trust must provide that the trustee may disburse an amount of the trust's principal or income as the trustee determines is necessary to expend for the health, education, support or maintenance of the beneficiary. Tex. Prob. Code Ann. § 868 (a) (2). The trust also must provide that the income of the trust that the trustee does not disburse under Section 868 (a) (2) must be added to the principal of the trust. Tex. Prob. Code Ann. § 868 (a) (3). This distribution standard is virtually identical to the one required in 142 Trusts. Does this mean that the reasoning of the court of appeals in *Aguilar v. Garcia*, 880 S.W.2d 279, 281 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.), which was a 142 Trust case, applies with equal force to 867 Trusts? Obviously, the same bases for distinguishing *Aguilar* in the case of 142 Trusts apply as well in the case of 867 Trusts. In addition, one may argue that *Aguilar* does not apply directly to 867 Trusts and, at most, applies only by analogy, so that until a similar appellate decision is reached with respect to an 867 Trust, practitioners and courts are free to structure 867 Trusts as if *Aguilar* did not exist. Finally, one may argue that Tex. Prob. Code Ann. § 867 imposes a less stringent requirement on the trial court regarding varying from the "mandatory" provisions -- while Tex. Prop. Code § 142.005 provides that the court may provide for the terms, conditions and limitations of the trust "that are not in conflict with" the mandatory provisions in the statute, Tex. Prob. Code Ann. § 867 contains no such statement restricting the court's ability to include conflicting provisions in the trust.

The requirement of Section 868 (a) (3) that income not distributed under Section 868 (a) (2) must be added to principal presents a potential problem for 867 Trusts, since distributions from the trust may be made under Section 868 (b) as well as under Section 868 (a) (2). Section 868 (b), which is discussed in more detail below, permits distributions benefitting those persons who the ward or incapacitated person is legally obligated to support (such as his or her spouse and minor children). Does Section 868 (a) (3) prohibit a distribution of *income* to benefit the his or her spouse or minor child, since that distribution cannot be made under Section 868 (a) (2)? Perhaps. Section 868 (a) (3) is an unnecessary provision that should be deleted from the statute. However, until that

happens, the best solution probably is: (a) continue to include the Section 868 (a) (3) provision in the trust, since the statute says it is mandatory and since the court in *Aguilar* suggests that the mandatory requirements must be taken seriously; (b) include the optional provision permitting distributions benefitting the spouse and minor children if desired; and (c) assure that any distributions benefitting the spouse or children are made from the *principal* of the trust.

Ironically, the inclusion of the useless and apparently contradictory requirement about adding income to principal in Tex. Prob. Code Ann. § 868 (a) (2) may actually bolster arguments that more flexible distribution standards are permitted in an 867 Trust. Notwithstanding *Aguilar* and the "mandatory" statutory provisions, it is not uncommon to see 142 Trusts and 867 Trusts with additional distribution provisions. One may argue that these additional distribution provisions are permitted by the general terms of Tex. Prop. Code § 142.005 (b) and Tex. Prob. Code Ann. § 867, so long as they do not conflict with the mandatory statutory provisions. However, if these additional distribution provisions permit *income* distributions, they may conflict with Tex. Prop. Code § 142.005 (b) (3) and Tex. Prob. Code Ann. § 868 (a) (3), which require income not distributed in accordance with the *mandatory* provisions to be added to principal. In the case of 867 Trusts, one may argue that the legislature must have anticipated that distributions that go beyond the mandatory distribution standard are permitted since the statute expressly permits other, optional distributions pursuant to Tex. Prob. Code Ann. § 868 (b). Therefore, other custom-drafted distribution provisions should not be considered inconsistent with the mandatory provisions and should be permitted in an 867 Trust. (The same argument is unavailable in the case of a 142 Trust, since Tex. Prop. Code § 142.005 does not permit distributions to persons whom the beneficiary is legally obligated to support.)

D. Trustee Compensation. One of the most controversial statutory provisions regarding 867 Trusts is the mandatory trustee compensation provision. The trust instrument must provide that:

> the trustee, on annual application to the court and subject to the court's approval, is entitled to receive reasonable compensation for services that the trustee provided to the ward or incapacitated person as the ward's or incapacitated person's trustee that is:
>
> (A) to be paid from the trust's income, principal, or both; and
>
> (B) determined in the same manner as compensation of a guardian of an estate under Section 665 of [the Probate Code].

Tex. Prob. Code Ann. § 868 (a) (5).

Corporate trustees who administer 142 Trusts are used to getting their compensation approved when the trust is created and being paid "reasonable" compensation, which is usually based on their fee schedules and is paid currently (in other words, as services are rendered and not in arrears at the end of the year). Section 868 (a) (5) requires them to use the "5% in, 5% out" formula that guardians use (unless they can convince the court that such formula produces an unreasonably low fee). In addition, Section 868 (a) (5) and Section 871 require them to file an annual guardianship-style accounting with the court and obtain the court's approval thereof before being compensated.

A bill backed by the Texas Bankers Association in the 1995 legislative session would have allowed corporate trustees of 867 Trusts to charge their fee schedules and to use its trust accounting statements as the statutory accounting requirement unless the court otherwise ordered. This bill received strong opposition from statutory probate judges and did not pass. No similar bill was introduced in 1997. Therefore, the current scheme for compensating trustees of 867 Trusts appears likely to stay.

While the trustee compensation provisions have caused some corporate trustees to be reluctant to take on 867 Trusts, there clearly are trustees who are willing to serve, especially on larger trusts. Even in the case of small guardianship estates, it may be possible to use 867 Trusts if the drafter, the trustee and the ward's family are willing to be creative. The author participated in one proceeding in which the trust provided that the trustee's fees were to be paid by a family member of the ward. This enabled the trust to be created, which in turn kept the trust principal out of the soon-to-be-18-year-old ward's hands until the ward was a little older.

4.1.3. Optional Provisions. Like 142 Trusts, 867 Trusts may include certain optional provisions in addition to the mandatory provisions discussed above.

A. 1997 Change Clarifies That 867 Trusts May Contain Extra Provisions. Many practitioners incorporate additional provisions in 867 Trusts which address issues which are not addressed by the statute. Prior to September 1, 1997, the only bases for including these provisions were (1) common sense and (2) two cryptic provisions in the statutes -- first, a provision in Section 867 stating that the court's order creating an 867 Trust "shall include terms, conditions, and limitations placed on the trust," and, second, a provision in Section 869 (a) stating that the court may amend or modify the trust.

A change made in 1997 (which applies to trusts existing on its September 1, 1997, effective date) added subsection (e) to Section 868, which reads as follows:

> The court may include additional provisions in a trust created or modified under this section if the court determines an addition does not conflict with Subsection (a) and, if appropriate, Subsection (d) of this section.

Subsection (a) contains the mandatory provisions of an 867 Trust and subsection (d) contains the new exception for supplemental needs trusts. This new subsection goes a long way toward justifying the additional provisions which are often routinely included in an 867 Trust.

Does subsection (e) require a finding that the additional provisions do not conflict with Tex. Prob. Code Ann. § 868 (a) or (d)? Prudence dictates that the order creating the trust should include such a finding. For example, routinely including the following phrase among the findings in the order should do the trick:

> that the additional provisions of the trust do not conflict with Tex. Prob. Code Ann. § 868 (a) or (d);

In light of the *Aguilar* case, *supra,* subsection (e) of Section 868 gives 867 Trusts an advantage over 142 Trusts as a flexible tool to be used in unusual situations. The trial court's determination that the additional provisions do not conflict with the mandatory provisions, coupled with new subsection (e), should go a long way toward avoiding an *Aguilar*-type problem with 867 Trusts.

The provisions of the 1997 legislation and its legislative history make it clear that the changes apply to 867 Trusts created before September 1, 1997, without the need for modifying the trusts. However, the order creating existing trusts may or may not include a determination that the additional provisions are not in conflict with the mandatory provisions. Can one assume that there was an implied finding that the additional provisions were not in conflict? Perhaps it is a good idea for trustees to review the orders creating 867 Trusts to see if the determination of no conflict is implicitly or explicitly stated. While the author suggests that it should be unnecessary to go back and obtain such a determination for existing 867 Trusts with nonstandard language, it would be a simple matter to include a request for clarification from the court that such a determination was made in the order approving a future annual account.

B. 867 Trusts as Supplemental Needs Trusts. Subsection (d) of Section 868 reads as follows:

> When creating or modifying a trust, the court may omit or modify terms required by Subsection (a)(1) or (2) of this section only if the court determines that the omission or modification:
>
> (1) is necessary and appropriate for the ward or incapacitated person to be eligible to receive public benefits or assistance under a state or federal program that is not otherwise available to the ward or incapacitated person; and
>
> (2) is in the ward's or incapacitated person' best interests.

This provision was added in 1997 to make it clear that 867 Trusts may be established as supplemental

needs trusts under 42 U.S.C.A. § 1396(d)(4)(a). All that is required is a court determination that (1) omission or modification of a mandatory term is "necessary or appropriate" for the beneficiary to qualify for government benefits and (2) the omission or modification is in the ward's best interests.

C. Distributions to or for the Benefit of the Ward/Incapacitated Person or Another Person Whom the Ward/Incapacitated Person Is Legally Obligated to Support. In addition to the mandatory distributions provided for in Section 868 (a) (2), the trust instrument may provide that a trustee may:

> make a distribution, payment, use, or application of trust funds for the health, education, support, or maintenance of the ward or incapacitated person or of another person whom the ward or incapacitated person is legally obligated to support, as necessary and without the intervention of a guardian or other representative of the ward or of a representative of the incapacitated person, to:
>
> (1) the ward's guardian;
>
> (2) a person who has physical custody of the ward or incapacitated person or another person whom the ward or incapacitated person is legally obligated to support; or
>
> (3) a person providing a good or service to the ward or incapacitated person or another person whom the ward or incapacitated person is legally obligated to support.

Tex. Prob. Code Ann. § 868 (b).

In the 1993 version of Section 868 (b), distributions were permitted only for the benefit of the ward or for the support, maintenance and education of the ward's children if the ward was an incapacitated adult.

In 1995, this section was amended to permit distributions for the health, education, support and maintenance of persons whom the ward (regardless of age) is legally obligated to support. Presumably the persons whom the ward is legally obligated to support include the ward's spouse and the ward's minor children. Thus, it is clear that the legislature intended to enlarge the pool of potential recipients of trust benefits beyond the ward and an adult ward's minor children. Unfortunately, this clear intent nonetheless left a confusing statute to construe and a confusing trust provision to administer.

In 1997 the legislature made further repairs to this section. As a result, the statute is much clearer. The 1997 changes make it clear that "facility of payment" distributions for the benefit of a ward (or a person the ward is legally obligated to support) may be made directly to persons providing goods and services -- it is not necessary for the payment to go through the hands of the guardian or the person having physical custody of the ward. While this 1997 change makes it less important to include an additional facility of payment provision in the trust, a broad facility of payment provision seems to be permitted by the statute and is probably a good idea.

In 2005, the Legislature made this subsection apply not only to wards but also to incapacitated persons who are not wards.

D. Paying Guardian's Compensation. If the beneficiary has a guardian, consider including a provision in the trust instrument requiring the trustee to pay court-approved fees of the guardian of the person and/or guardian of the estate of the ward. Since most, if not all, of the guardianship assets will be in the trust, this prevents later conflicts between the trustee and the guardians regarding how they are to be paid.

E. Trust Termination Age. Tex. Prob. Code Ann. § 870 (a) permits the court to provide for a trust for a minor to terminate as late as the ward's twenty-fifth birthday. If the court does not otherwise provide in its order, the trust for a minor will terminate on the earlier of the minor's death or the minor's eighteenth birthday. Thus, while the court may order the trust to continue beyond the minor's eighteenth birthday, the trust will terminate at age 18 if the trust instrument is silent. This is different from 142 Trusts, where the statute provides that the trust will terminate at age 25 unless the court otherwise orders. Tex. Prop. Code § 142.005 (b) (4).

Should a court routinely extend the trust termination age to age 25? Many practitioners would argue that it should, since the statute permits it and since most 18-year-olds are too immature and uneducated to handle large sums of money. However, some judges are reluctant to set the trust termination age at age 25 when the beneficiary is young, preferring instead to wait until close to the beneficiary's eighteenth birthday before deciding whether to continue the trust. The statute does not require the court order creating the trust to be the court order that extends the trust beyond age 18; therefore, an order amending or modifying the trust to extend it beyond age 18 can be entered after the trust is created.

As discussed above with respect to 142 Trusts, in order for a (d)(4)(A) trust established for a minor who does not meet the Tex. Prob. Code Ann. §601(13) definition of "incapacitated person" (other than because of his or her minority) to properly benefit that minor, it must not terminate at age 25. If the trust terminates at age 25, the trust beneficiary would be deprived of the benefits afforded by (d)(4)(A) trusts because at age 25 (1) the government reimbursement provision would kick in and (2) if more than $2,000 was left in the trust, the trust beneficiary would cease to qualified for Medicaid and SSI benefits. Therefore, it is necessary for the trust to provide that it continues beyond age 25 until the death of the beneficiary or it is otherwise terminated by order of the court. However, the wording of Section 868(d), enacted in 1997 to permit 867 Trusts to be (d)(4)(A) trusts), arguably only permits the distribution standard of an 867 Trust to be modified (found in Section 868(a)(2)), not the trust termination provisions (found in Section 870). (The author of this paper suggested a broader provision enabling (d)(4)(A) trusts that would have covered the termination issue, but the bill that was introduced was more restrictive.)[7] Since altering the termination age is necessary for the (d)(4)(A) trust to accomplish its purpose, and since the legislature clearly indicated its intent that 867 Trusts be adaptable to be (d)(4)(A) trusts, the statute should be construed to permit trusts to last beyond age 25.

F. Distribution on Trust Termination. Unlike Tex. Prop. Code § 142.005, which requires the trust on termination to be distributed to the beneficiary or to the personal representative of the beneficiary's estate, Tex. Prob. Code Ann. § 873 permits greater flexibility. Section 873 provides:

> Unless otherwise provided by the court, the trustee shall:
>
> (1) Prepare a final account in the same form and manner that is required of a guardian under Section 749 of this Code; and
>
> (2) On court approval, distribute the principal or any undistributed income of the trust:
>
> (A) To the ward or incapacitated person when the trust terminates on its own terms;
>
> (B) To the successor trustee on appointment of a successor trustee; or
>
> (C) To the representative of the deceased ward's or incapacitated person's estate on the ward's or incapacitated person's death.

The magic words that every draftsperson loves, of course, are: "unless otherwise provided by the court." (Wouldn't life be a lot simpler if that modifier was placed on all of the requirements for 142 Trusts and 867 Trusts?) This permits a number of creative dispositive possibilities, so long as the court can be convinced to approve them. For example, this could permit basic bypass or generation-skipping planning.

Of course, if the 867 Trust also is a (d)(4)(A) supplemental needs trust, it must include a provision reimbursing the government for certain costs on trust termination.

4.1.4. The 2003 Change Regarding Exculpation Provisions. In 2003, the Legislature enacted HB 3503 in response to *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002). For more

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[7] A careful reader may notice that the author of this paper seems to take the blame for nothing.

information on the *Grizzle* case and its consequences, see below. The 2003 change added Subsection (c) to Section 868. Subsection (c) makes a provision purporting to relieve a trustee of an 867 Trust from a "duty, responsibility or liability" imposed by Subpart N of the Probate Code (Sections 867 – 873) or the Texas Trust Code unenforceable unless:

1. The provision is limited to specific facts and circumstances unique to the property of that trust and is not applicable generally to the trust; and

2. The court creating or modifying the trust makes a specific finding that there is clear and convincing evidence that the inclusion of the provision is in the best interests of the beneficiary of the trust.

HB 3503 became effective September 1, 2003, and applies to new and existing trusts. Therefore, an exculpation provision prohibited by HB 3503 in a trust created prior to September 1, 2003, is now unenforceable unless a later special finding is obtained.

A. The Rationale for Subsection 868(c). The intended effect of Subsection 868 (c) is to prohibit the trust instrument governing an 867 Trust from exculpating the trustee beyond the default liability rules of the Texas Trust Code. In *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002), the court creating the 142 Trust had inserted an exculpation provision in the trust instrument and the Texas Supreme Court said that the provision was enforceable. Subsection 868 (c) is a legislative disapproval of this result. While the Trust Code permits a settlor of a private trust to alter trustee liability terms (to the extent permitted by the Trust Code), the Legislature did not want courts creating 867 Trusts (and, therefore, substituting their judgment for the minor or incapacitated beneficiary) to include such provisions absent a special finding that they are appropriate.

B. What is a "Duty, Responsibility or Liability?" To understand Subsection 868(c), it is important to distinguish between the court (and the trust instrument) authorizing or directing the trustee to act, or refrain from acting, in a certain way, and the court (and the trust instrument) attempting to relieve the trustee of a "duty, responsibility or liability." In crafting the terms of the trust, the trustee (and the court) should assure that the terms of the trust are specific enough about the actions the trustee is expected to take and those areas in which the trustee is not expected to act. These types of provisions (directing, authorizing or prohibiting actions) are not (in the author's opinion) provisions relieving the trustee of a duty, responsibility or liability imposed by the Trust Code. Provisions which Subsection (j) are intended to prohibit are provisions which excuse the trustee from liability for its failure to meet its fiduciary duties under the instrument.

Consider the following example: At the creation of an 867 Trust, the trustee knows that the beneficiary's family wants the trustee to use trust funds to buy a new car for the family. If the trust instrument says merely that the trustee shall "disburse amounts of the trust's principal, income, or both as the trustee in his sole discretion determines to be reasonably necessary for the health, education, support or maintenance of the beneficiary" and is silent about the car, a general provision exculpating the trustee from liability for its actions will not protect the trustee from a later claim that the use of trust funds to buy a car failed to meet the "health, education, maintenance and support" standard. On the other hand, if the trust instrument says not only that the trustee is to make distributions for the beneficiary's health, education, maintenance and support but also provides that, for purposes of this trust, the purchase of a car [specifically describing the type of car and its cost, if possible] for the use of the beneficiary's family is considered a proper expense for the health, education, maintenance and support of the beneficiary," then the trustee is authorized to buy the car and is protected from a later claim, not because of a provision relieving the trustee from a "duty, responsibility or liability," but because the terms of the instrument specifically authorized or directed the trustee to act in a certain way.

C. What are "Specific Facts and Circumstances" Justifying an Exculpation Provision? If the court makes a special finding (described below), a provision relieving a trustee of liability may be enforceable if it "is limited to specific facts and circumstances unique to the property of that trust and is not applicable generally to the trust." Tex. Prob. Code §868(c)(1). While the Legislature clearly indicated that exculpation provisions should not be included routinely in 867 Trusts, the Legislature recognized that occasionally there may be peculiar assets in a trust that present greater than normal liability risk for the trustee, making it in the best interest of the beneficiary to include a provision limiting the trustee's liability. Note that the "specific facts

and circumstances" justifying this exception to the general rule must relate to the "unique property of that trust" and not to the trust as a whole. This means that, while a weird asset (such as a bar in East Austin) may justify the exculpation provision, other "weird" facts that are not property-related do *not* justify exculpating the trustee. Thus, a trustee cannot be exculpated because the distribution standards are particularly hard to meet (as may be the case with a special needs trust) or because the family of the beneficiary has never had money and, therefore, may be particularly difficult to deal with or because the beneficiary is the beneficiary from hell. As comforting as it may be for a trustee in these situations to be exculpated from liability, Subsection 868(c) does not permit it.

What specific facts and circumstances related to property may justify an exculpation provision? Here are a few examples that occur to the author:

1. The 867 Trust contains a liability-ridden real estate asset (such as a bar in East Austin). The court may find it in the beneficiary's best interest to exculpate the trustee for liability related to the real estate until such time as the real estate can be sold.

2. The 867 Trust contains (or is the beneficiary of) a large annuity from a structured settlement. The court may find it in the beneficiary's best interest to provide that the trustee has no liability if the company issuing the annuity fails to make the required payments. (Note that this also may be dealt with by having the court direct that the trustee is not to take any action to investigate or monitor the issuer of the annuity, etc.)

D. Requirements for Court Finding. Even if special facts and circumstances justifying an exculpation provision exist, the provision is unenforceable unless the court creating the trust finds by clear and convincing evidence that the inclusion of the provision is in the best interests of the beneficiary of the trust.

"Clear and convincing evidence" is a particularly high standard. It exceeds the "preponderance of the evidence" standard that usually applies.

The criterium for the court to apply is whether or not the exculpation provision is in the best interests of the beneficiary. This is a tough standard to meet. One way to meet it might be to show that no qualified corporate trustee is willing to serve as trustee unless the exculpation provision is included. Anything short of that may make it difficult, since it conceptually difficult to see how relieving a trustee for liability to a beneficiary is ever in the beneficiary's best interest.

E. Effect on Existing Trusts. The changes made by HB 3503 apply to new and existing trusts. This means that an exculpation provision in an existing trust is not enforceable (at least with respect to conduct occurring after September 1, 2003, and perhaps with respect to conduct occurring prior to that date) unless the court makes the special finding required by Subsection 868 (c). If appropriate facts and circumstances exist in an existing trust, the trustee should consider asking the court that created the trust to make the special finding to validate the exculpation provision.

4.2. Miscellaneous Issues Regarding 867 Trusts.

4.2.1. Transferring Property Into an 867 Trust. Changes in 1997 and 2005 make it clear that a third party holding property belonging to the beneficiary of an 867 Trust (whether or not the beneficiary has a guardian of the estate) may pay or deliver the property directly to the trustee of the 867 Trust. *See* Tex. Probate Code §867(f). The third party is not required to deliver the property first to the guardian of the estate or to the registry of the court. The order creating the trust should take into consideration the assets likely to be transferred into the trust and the likely requirements of the person or persons holding those assets. For example, if the applicant knows that a particular insurance company is holding the proceeds of a particular life insurance policy, he or she could draft the order to include a specific direction that the insurance company deliver the proceeds to the trustee of the trust. This should not be necessary, but it may go a long way to satisfying the third party's concerns, since the third party may not be used to dealing with 867 Trusts.

4.2.2. Trust Amendment, Modification or Revocation. An 867 Trust may be amended, modified or revoked by the court creating it at any time before the date of its termination, but it cannot be revoked

by the ward or incapacitated person or by the guardian of the ward's estate. Tex. Prob. Code Ann. § 869. While the ward, the incapacitated person or the ward's guardian cannot unilaterally revoke the trust, they may of course ask the court to amend or revoke the trust.

4.2.3. Can and Should Guardian Be Discharged When Trust Is Created? Prior to 2003, Section 868A provided that the court could discharge the guardian of a ward's estate after the creation of an 867 Trust *only if a guardian of the ward's person remained.* This created a problem in some cases and was viewed as unnecessary by many judges and practitioners. As a consequence, Section 868A was amended in 2003 to read as follows:

> On or at any time after the creation of a trust under this subpart, the court may discharge the guardian of the ward's estate if the court determines that the discharge is in the ward's best interests.

Gone is the requirement that the guardian of the person must remain in place. So, once the 867 Trust is created, there is no requirement that a guardian of the person or a guardian of the estate remain as a watchdog for the trust. In an analogous situation, the Texas Supreme Court has ruled that no watchdog is needed for the trustee of a 142 Trust. *See Brownsville-Valley Regional Medical Center v. Gamez,* 894 S. W. 2d 753 (Tex. 1995).

Even though a guardian is not required, in some cases it is advantageous for a guardian of the estate to serve concurrently with the existence of an 867 Trust. For example, if one of the ward's assets is a claim which must be pursued in litigation, it usually will make more sense for a guardian to pursue that claim, rather than transferring the claim into the trust and having the trustee pursue the claim. Similarly, a guardian of the estate may be necessary if tax-motivated gifts are to be made pursuant to Tex. Prob. Code Ann. § 865, since Section 865 provides for the guardian, not the trustee, to make such gifts.

In most cases, however, it is wise for the guardian of the estate to ask to be discharged. This eliminates the bond requirement and saves the ward's estate money (although if the same corporate fiduciary that is trustee of the 867 trust also is guardian of the estate, no bond would be required). It also eliminates the requirement for the guardian to file an annual account (although the trustee must file such accounts). Finally, it eliminates the possibility of liability for the person serving as guardian.

If a guardian of the estate is needed, it should be possible to minimize the amount of the guardian's bond by transferring all (or substantially all) of the liquid assets into the trust and limiting the powers of the guardian with respect to those assets requiring the guardian's care and attention.

4.2.4. Texas Trust Code Applies to 867 Trusts. Section 869B of the Probate Code reads as follows:

> Sec. 869B. APPLICABILITY OF TEXAS TRUST CODE.
>
> (a) A trust created under Section 867 of this code is subject to Subtitle B, Title 9, Property Code.
>
> (b) To the extent of a conflict between Subtitle B, Title 9, Property Code, and a provision of this subpart or of the trust, the provision of the subpart or trust controls.

4.2.5. Jurisdiction of Courts Supervising 867 Trusts. Any court with authority to create an 867 Trust has the same jurisdiction to hear matters related to the trust as the court has with respect to guardianship

and other matters covered by Chapter XIII of the Probate Code. Tex. Probate Code §869C. Even courts that otherwise have no trust jurisdiction have such jurisdiction with respect to 867 Trusts they create. Tex. Trust Code §115.001(d).

4.2.6. Can an 867 Trust Be a Spendthrift Trust? Should a spendthrift clause be added to an 867 Trust? Tex. Prop. Code § 112.035 (d) provides that, if the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary transfer of the settlor's beneficial interest does not prevent the settlor's creditors from satisfying claims from the settlor's interest in the trust estate. The definition of "settlor" in the Texas Trust Code was amended in 2005 to mean "a person who creates a trust or contributes property to a trustee of a trust." Tex. Trust Code §111.004(14). The court "creates" a 142 Trust, not the beneficiary, but does a beneficiary "contribute property" to a 142 Trust?

In *Texas Commerce Bank, N. A. v. Grizzle*, 96 S. W. 3d 240 (Tex. 2002), the Texas Supreme Court found that the "settlor" of a 142 Trust was the court that created the trust. *Grizzle* was a 142 Trust case, not an 867 Trust case, but the case seems analogous on this point. *Grizzle* is not spendthrift trust case, but if the court is the "settlor" for spendthrift trust purposes, then a spendthrift provision in an 867 Trust may protect the assets from the claims of the creditors of the beneficiary. However, the chances of an 867 Trust being a spendthrift trust are not as great as the chances of a 142 Trust, since the property placed in the 867 Trust is the beneficiary's -- it is not going directly from a third party to the trust as is the case with a 142 Trust. However, one can certainly argue that the court, not the beneficiary, creates the trust, and the beneficiary has no right to the trust assets until they are distributed to the beneficiary. Even if the spendthrift clause does not protect the trust assets from the beneficiary's creditors, it may prohibit the beneficiary from voluntarily alienating his or her interest in the trust. Therefore, it is probably a good idea to include a spendthrift provision in the trust.

One way to, in effect, strengthen the spendthrift argument is for the order creating the guardianship and/or 867 Trust to provide that the court expressly finds that the beneficiary does not have the power to contract.[8] This is not appropriate in every case and may do nothing to protect against tort liabilities, but it should make it easier to protect the trust corpus from claims of the would-be contract creditors of the beneficiary.

4.2.7. Trustee's Duty to Account. Tex. Prob. Code Ann. § 871 requires the trustee to prepare and file with the court an annual accounting of the transactions in the trust in the same manner and form that is required of a guardian under the Texas Probate Code. If the beneficiary has a guardian, a copy of the annual account must be provided to the guardian of the ward's estate or person (the statute says "estate *or* person," but the safe practice would be to send a copy to both the guardian of the estate and the guardian of the person if they are not the same person). The annual account is "subject to court review and approval in the same manner that is required of the annual account prepared by a guardian." Tex. Prob. Code Ann. § 871 (c). The annual account forms the basis for determining the trustee's compensation under Tex. Prob. Code Ann. § 868 (a) (5).

If the trustee of an 867 Trust is required to file an annual account which is subject to court review and approval in the same manner that is required of an annual account prepared by a guardian, should the trustee seek pre-approval of extraordinary expenditures much like a guardian might be expected to seek in a guardianship? The safe answer (from the trustee's perspective) is yes. However, the trustee is likely to make fewer trips to the courthouse for preapproval of expenditures than a guardian for the following reasons:

- The mandatory provisions of an 867 Trust permit income and principal distributions, so no further order of the court is needed to authorize corpus distributions for maintenance and education of the ward. *Compare* Tex. Prob. Code Ann. § 776 (guardian not allowed to expend corpus for maintenance and education without court authority).

[8] If the outright prohibition of the power to contract is inappropriate, then perhaps the court could find that the beneficiary does not have the power to enter into a contract which exceeds a certain dollar amount, *e.g.,* $500.00.

- If the trustee anticipates the need for extraordinary expenditures, it can obtain court approval of such expenditures when the trust is created, either by specifically authorizing such expenditures in the terms of the trust or by separate order approving such expenditures as proper trust distributions.

The Texas Bankers Association backed a bill in 1995 that would have permitted bank-trust-department-type accountings unless the court otherwise ordered. This bill failed to pass, so guardianship-type accountings are required.

In addition to annual accounts, the trustee is required to file a final account. Tex. Prob. Code Ann. § 873 (1).

4.2.8. Investments in Texas Tomorrow Fund. Subparagraph (f) of Section 868 permits the trustee to invest trust property in the Texas Tomorrow Fund (Subchapter F, Chapter 54, Texas Education Code) if the trustee determines that doing so is in the best interests of the ward or incapacitated person. Presumably this means that the trustee may make this investment without court approval.

4.2.9. Distributions For Minor's Support, Education or Maintenance. Tex. Prob. Code Ann. § 777 provides that, absent a court finding of undue hardship, "a *parent* who is the *guardian of the person* of a ward who is 17 years of age or younger may not use the income or the corpus from the ward's estate for the ward's support, education, and maintenance [emphasis added]." This provision was added to the probate code in 1993 as part of the recodification bill; there is no corresponding provision in pre-1993 statutory probate law. It is consistent with the Family Code (*see* Tex. Fam. Code § 151.003(a)(3) -- a parent has "the duty to support the child, including providing the child with clothing, food, shelter, medical and dental care, and education") and prior case law (*see Tharp v. Blackwell,* 570 S. W. 2d 154, 159 (Tex. Civ. App. -- Texarkana 1978, no writ) -- "The law of this state imposes upon a parent, who has resources of his own sufficient to maintain his children, and who is also guardian of their estates, to support them out of his own means and he may not have recourse to the estates of the wards.").

Does Texas law (Tex. Prob. Code Ann. § 777 or otherwise) permit or require the trustee of an 867 Trust to withhold payments for the support, education and maintenance of a trust beneficiary under age 18 if the beneficiary's parent or parents have the resources to themselves support the beneficiary? As discussed above with respect to 142 Trusts, *Aguilar v. Garcia*, 880 S.W.2d 279 (Tex. App. -- Houston [14th Dist.] 1994, orig. proc.) would seem to prohibit *requiring* a trustee of an 867 Trust to withhold trust distributions which would pay for expenses that fall within a parent's legal duty to support the child. *Aguilar* involved a 142 Trust, not an 867 Trust, but the distribution standard in Tex. Prob. Code Ann. § 868 is very similar to the one in Tex. Prop. Code § 142.005. However, for practical reasons, the *Aguilar* result may not hold with an 867 Trust.

It is a longstanding rule (albeit a rule found only in case law until 1993) in Texas that guardians should not make distributions for support of a minor ward if the ward's parents can support the child. *See Tharp v. Blackwell,* 570 S. W. 2d 154, 159 (Tex. Civ. App. -- Texarkana 1978, no writ), and the cases therein cited. Since 867 Trusts are outgrowths of guardianship proceedings and are essentially an alternative means of managing guardianship assets, it is hard to believe that a trust requiring consideration of parents' ability to support the trust beneficiary would be held to contravene the statute. Also, if the 867 Trust was established in a statutory probate court, it is likely that the judge will be familiar with the *Tharp* rule and will be supportive of a trustee's desire to withhold support payments in cases where the parents are able to support the minor child. Since 867 Trusts are subject to the continuing jurisdiction of the probate court, an application for instructions regarding withholding such payments should quickly clear up the issue for the trustee.

If the trust instrument merely *permits* the trustee to consider other sources of support in deciding whether to make distributions, or if the trust instrument is silent regarding other sources of support and the trustee considers such sources in exercising its fiduciary duties under the mandatory health, education, maintenance and support

standard, then the *Aguilar* rationale clearly seems inapplicable -- the court is not limiting the mandatory powers given to the trustee by Tex. Prob. Code Ann. § 868. Thus, the trustee probably is justified (and may in fact breach fiduciary duties owed to the trust beneficiary if the trustee fails to do so) in withholding distributions that can be paid, *and in fact are paid*, by the parents pursuant to their support obligations.

What can a trustee do if it withholds distributions because of the parents' support obligation and the parents refuse or fail to make the corresponding payments? The trustee can file an application for instructions with the probate court and follow the court's instructions regarding what to do.

If the trust instrument provides that the trustee of an 867 Trust is not required to consider (or is prohibited from considering) other sources of support available to the trust beneficiary in determining whether or not to make distributions, can the trustee (i) ignore the parents' ability to support the trust beneficiary, (ii) make support distributions from the trust and (iii) still avoid liability? It seems highly unlikely that a statutory probate judge would approve such a trust, but if he or she did (of if another court exercising probate jurisdiction approved such a trust), then this may be the best way (from the trustee's perspective) to simplify trust administration and protect the trustee from liability -- the trustee simply follows the trust instrument and makes the support distributions without considering other possible sources of support.

Note that Tex. Prob. Code Ann. § 777 and *Tharp v. Blackwell,* 570 S. W. 2d 154, 159 (Tex. Civ. App. -- Texarkana 1978, no writ) both address the situation where the *parent* is the guardian (although Section 777 applies when the parent is the guardian *of the person* and *Tharp* applies where the parent is the guardian *of the estate*). Obviously, in the case of an 867 Trust, a corporate fiduciary, not the parent, will be trustee, although one or both parents may be the guardian of the person of the trust beneficiary. Even though Section 777 only specifically applies in cases where the parent is the guardian of the person, it is the author's experience that, regardless of who the guardian of the person is, the probate court will not approve distributions by a guardian of the estate for a minor child with a parent absent some evidence of the parent's inability to support the child.

4.2.10. Duties And Liabilities of Guardian And Ad Litem. What duties do guardians, guardians ad litem and attorneys ad litem owe to wards and incapacitated persons with respect to creation of 867 Trusts?

A guardian clearly is a fiduciary of the ward and owes the ward the same duties that other fiduciaries owe, including the duty of loyalty. Similarly, a guardian ad litem and attorney ad litem probably are fiduciaries and owe the ward or incapacitated person similar duties. *See Byrd v. Woodruff,* 891 S.W.2d 689 (Tex. App. -- Dallas 1994, writ denied). Therefore, the duties owed and the matters to be considered by guardians, guardians ad litem and attorneys ad litem are similar to those discussed above with respect to next friends and guardians ad litem in connection with creation of 142 Trusts.

Tex. Prob. Code Ann. § 872 provides that neither the guardian of person or the estate of the ward nor the surety on the guardian's bond is liable for "an act or omission of the trustee." This statute does not protect the guardian for actions taken or not taken in connection with creation of the 867 Trust.

Tex. Prob. Code Ann. § 646 provides that, in a proceeding for the appointment of a guardian, an attorney ad litem shall be appointed "to represent the interests of the proposed ward." The attorney ad litem must interview the proposed ward before the hearing and, to the greatest extent possible, discuss with the proposed ward the law and facts of the case, the proposed ward's legal options regarding disposition of the case, and the grounds on which the guardianship is sought. Tex. Prob. Code Ann. § 647. None of this directly applies to creation of an 867 Trust.

To be safe, should the attorney ad litem ask for the creation of an 867 Trust in every case where a guardianship of the estate is sought? After all, there always is a corporate fiduciary where there is an 867 Trust,

and the ultimate decision regarding creation of the trust falls upon the court. Why not ask for creation of an 867 Trust in every case and let the court decide? Hopefully, attorneys ad litem will exercise good judgment and ask for 867 Trusts only when appropriate.

4.2.11. Potential Liability of Trustee For Administering Nonstandard 867 Trusts. As with nonstandard 142 Trusts, trustees should be careful when administering an 867 Trust which ventures far from the statutory norm. Trustees should seek instructions from the court pursuant to Tex. Prop. Code § 115.001 to avoid liability. Additional comfort can be gained from new subsection (e) of Section 868, discussed above, which expressly permits courts to include additional terms in the trust upon a determination that they additional terms are not in conflict with the mandatory provisions of Section 868.

4.3. Drafting 867 Trusts. The drafting considerations for 867 Trusts are similar to those for 142 Trusts. There remains the friction between closely following the statute and drafting creatively to meet the needs of the trustee, the beneficiary and the guardian.

One difference between drafting 867 Trusts and 142 Trusts is that the court is likely to be more familiar with the statutory requirements in the case of 867 Trusts, especially in counties with statutory probate judges. Statutory probate judges have occasion to be very familiar with guardianships generally and are more likely to have their own opinions about straying too far from the statutory requirements for 867 Trusts. They also are necessarily more involved with the ongoing administration of 867 Trusts since they must approve annual accountings and trustee's fees.

5. MEDICAID (D)(4)(A) SUPPLEMENTAL NEEDS TRUSTS

In Texas, an individual whose resources or income exceed certain limits cannot qualify for Medicaid benefits. A detailed discussion of the resource and income limits is beyond the scope of this paper. There are certain resources, or assets, which do not count toward the resource limit for Medicaid eligibility purposes. For example, in most cases an individual's homestead does not count as a resource.

The general rule is that any trust created with an individual's own assets will count against the resource limit for that individual for Medicaid purposes. However, the Omnibus Budget Reconciliation Act of 1993 ("OBRA 93") recognized three types of trusts which could be established with an individual's own assets which would not be deemed available for purposes of determining Medicaid eligibility. These are: (1) trusts for disabled persons under age 65 established pursuant to 42 U.S.C. § 1396p(d)(4)(A), commonly called "(d)(4)(A) trusts" or "supplemental needs trusts;" (2) trusts designed to capture excess income established pursuant to 42 U.S.C. § 1396p(d)(4)(B), commonly called "Miller Trusts;" and (3) trusts established by a non-profit corporation pursuant to 42 U.S.C. § 1396p(d)(4)(C).[9]

Of these three types of trusts, the one which typically involves issues of court creation is the "(d)(4)(A) trust" or "supplemental needs trust." This paper will focus on the issues associated with supplemental needs trusts which are unique to Texas in light of our statutory scheme for court-created trusts. As such, this is a very general discussion of (d)(4)(A) trusts that is included as introductory information only. Persons desiring to create (d)(4)(A) trusts should rely on one or more of the many fine papers written on this subject by practitioners in this area.

5.1. Statutory Requirements. OBRA 93 provides that the following type of trust shall not be deemed available (in other words, count against the resource limit) for Medicaid eligibility purposes:

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[9] This paper does not discuss (d)(4)(B) "Miller Trusts" or (d)(4)(C) trusts. The Arc of Texas has a Master Pooled Trust which apparently is intended to qualify as a (d)(4)(C) trust.

> A trust containing the assets of an individual under age 65 who is disabled (as defined in section 1614(a)(3)) [42 U. S. C. § 1382c(a)(3)] and which is established for the benefit of such individual by a parent, grandparent, legal guardian of the individual, or a court if the State will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual under a State plan under this title.

42 U.S.C. § 1396p(d)(4)(A).

Thus, there are five statutory requirements for a (d)(4)(A) trust: (1) the trust must contain the "assets of an individual;" (2) the individual must be under age 65 when the trust is created; (3) the individual must be "disabled;" (4) the trust must be established by a parent, grandparent, legal guardian or court; and (5) the trust must provide for repayment of the state upon termination.

Note that (d)(4)(A) does not require "supplemental needs" language. A (d)(4)(A) trust may contain any distribution standard, so long as the trustee may *not* be compelled to provide the beneficiary's "support" needs (*i.e.,* food, clothing, shelter or cash).[10] Typically, this is accomplished either by giving the trustee absolute discretion to make distributions for the benefit of the beneficiary, or by limiting distributions to "supplemental needs" (defined, generally, as distributions supplementing but not supplanting public benefits). If the trust requires furnishing of food, clothing and shelter of the beneficiary, or cash distributions to the beneficiary, public benefits administrators may count the corpus of the trust as a "resource," thus denying eligibility until the corpus is less than $2,000.[11] Thus, drafters routinely include "supplemental needs" or "absolute discretion" distribution standards in (d)(4)(A) trusts so that trust funds may be used for "luxuries" while SSI and Medicaid pay for basic services.[12]

5.1.1. Assets of an Individual. A (d)(4)(A) trust is a trust established with assets of the individual applying for Medicaid. Thus, any property of the individual, whether it originated from earnings, savings, inheritance or otherwise, may be used to fund a (d)(4)(A) trust. One common use of (d)(4)(A) trusts is to hold property received by judgment or in settlement of a personal injury claim or other legal claim on behalf of the individual.

There are different, more lenient rules, for trusts benefitting a Medicaid-eligible person which are created by someone else using someone else's property. For example, parents can establish "supplemental needs" trusts for their children using the parents' funds without providing for state reimbursement. This type of "supplemental needs" trust is not within the scope of this paper. Practitioners should be careful when considering outright devises or other Medicaid-disqualifying devises to Medicaid-eligible persons. Also, practitioners should not plan on using disclaimers as a way to prevent disqualifying assets from passing to a Medicaid-eligible person. OBRA 93 defines "assets" to include property that would have been received by the individual but for a disclaimer. 42 U.S.C. §1396p(e)(1). While there is some debate on this point, most commentators appear to believe that a disclaimer will be treated as a transfer without consideration, which will create a penalty period — and, if a Medicaid application is filed within the penalty period, possible criminal liability.

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[10] It is true that (d)(4)(A) has no requirement regarding distribution standards, but as noted below, most under-65 Medicaid recipients must have SSI to receive Medicaid. For many years, the cases and Social Security policy have held that if a trustee can be compelled legally to distribute food, clothing, shelter or cash, the whole corpus is "available" and the beneficiary is disqualified. Thus, including support language in one of these trusts could preclude SSI eligibility and thereby disqualify the beneficiary, indirectly, for Medicaid as well.

[11] By this mechanism, the agency in effect requires payments from the trustee of a support trust, but it does this by denying eligibility, not by demanding the trustee to make payments.

[12] Some practitioners argue that "supplemental needs" language, as opposed to "absolute discretion" language, is safer because some state courts have construed even "absolute discretion" language to allow the beneficiary to sue the trustee for support. Others prefer the "absolute discretion" language because it eliminates any uncertainty as to the trustee's authority to make distributions that disqualify the beneficiary for public benefits, if that is in the beneficiary's best interests.

5.1.2. Under Age 65. The individual must be under age 65 when the trust is established.

5.1.3. Disabled. Only persons who are disabled for purposes of the Social Security Act may benefit from creation of one of these trusts. An individual is considered disabled for these purposes if he or she:

> is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months (or, in the case of a child under the age of 18, if he suffers from any medically determinable physical or mental impairment of comparable severity).

42 U. S. C. § 1382c(3)(A).

Note that this is a very different definition than the definitions of incapacity in Tex. Prop. Code § 142.007 and Tex. Prob. Code Ann. § 601. It should be much easier to reach this definition of disability than to reach the Probate Code's or Property Code's definition of "incapacitated person" for purposes of creating a guardianship, 867 Trust or 142 Trust. It is easy to imagine a situation where a (d)(4)(A) trust is called for but the statutory requirements for a 142 Trust or an 867 Trust cannot be met.

5.1.4. Established by a Parent, Grandparent, Legal Guardian or Court. The trust must be established by a parent, grandparent, legal guardian or the court. Noticeably absent from this list of persons who may create a (d)(4)(A) trust is the individual himself or herself. Presumably, since the individual must be disabled to qualify, Congress assumed that he or she would not be able to create the trust. This is not a serious problem, so long as a parent or grandparent is surviving, since the trust may be "established" by the parent or grandparent and the disabled person can transfer his or her property into the trust. Estate planners can make it easier to establish supplemental needs trusts in the future if they routinely include a provision in durable powers of attorney which expressly authorize the agent to transfer funds into a supplemental needs trust created by a court or third party.

Of course, the disabled person does not always have the capacity to transfer assets into the trust, nor has he or she always properly appointed an agent to transfer the assets under a power of attorney. In an attempt to get around the problems of court-created (d)(4)(A) trusts (discussed below), many practitioners have sought and obtained court-ordered transfers of funds into trusts established by a parent or grandparent. This approach permits avoidance of some of the requirements of 867 or 142 Trusts (such as the corporate trustee requirement), but it does not address where the court gets the authority to transfer the disabled person's property into a trust created by the parent or grandparent. Presumably, the court is exercising its general equitable powers when ordering such a transfer.

5.1.5. State Repayment. In order for the trust to qualify, the trust instrument must provide that the state will receive all amounts remaining in the trust upon the death of such individual up to an amount of Medicaid benefits the individual received. This is why a (d)(4)(A) trust works as a supplemental needs trust but not as a family wealth-transfer device. The property left in the trust must go to repay the state for the Medicaid benefits it paid out. However, while the trust is in existence, it can pay for extras -- for those lifestyle-enhancing things that go beyond food, clothing and shelter.

5.2. Basis for Creation of Supplemental Needs Trusts in Texas. If the disabled individual has a living parent or grandparent and if the disabled individual either has the mental capacity to transfer his or her property or has appointed an agent with authority to transfer his or her property, then clearly the best way to establish a (d)(4)(A) trust is for the parent or grandparent to establish the trust and for the disabled individual or his or her agent to transfer the desired property into the trust. This assures the greatest flexibility in the terms of the trust and least involvement of courts and other third parties in the process.

Of course, it is not always possible for the disabled person or his or her family to establish the trust in this way. If the disabled person is incapacitated and has not appointed an agent prior to incapacity, another means of getting the property into the trust must be found. Here are four possible ways, all of which have been used in Texas:

5.2.1. 142 Trust. One way to create a (d)(4)(A) trust is to ask a court to create a 142 Trust with special provisions intended to meet the Medicaid requirements. The principal special provisions which must be included are: (1) a different distribution standard that permits distributions only for supplemental needs; and (2) a different trust termination provision so that the State is repaid for Medicaid expenses.

Prior to the enactment of SB 912 in 1997, an apparent conflict existed between Tex. Prop. Code § 142.005 and (d)(4)(A). This resulted in much consternation and nail-biting by attorneys, but in the end many courts created (d)(4)(A) trusts under Tex. Prop. Code § 142.005, modifying the trust to meet the supplemental needs requirements.

The 1997 changes eliminate the concern that 142 Trusts cannot be modified to be supplemental needs trusts. New subsection (e) of Section 142.005 permits the court create trusts containing provisions determined by the court to be necessary to establish a special needs trust as specified under 42 U.S.C. Section 1396p(d)(4)(A) upon a finding by the court that such provisions are in the best interests of the trust beneficiary.

One drawback that remains in using a 142 Trust as a (d)(4)(A) trust is that a lawsuit is required for trust creation. This is not a problem if the assets for the supplemental needs trust are coming from a personal injury or other settlement, but it may be a problem if other assets of the disabled person are to be used.

5.2.2. 867 Trust. Another way to create a supplemental needs trust in Texas is to apply for creation of a guardianship (or use an existing guardianship) and ask the probate court to create an 867 Trust with special Medicaid provisions. Again, the principal provisions to be included are a different distribution standard (a "supplemental needs" standard) and a different dispositive plan on death.

As with 142 Trusts, 1997 legislative changes make it clear that an 867 Trust can be used to create a supplemental needs trusts if the court finds that this is in the best interests of the ward/beneficiary.

5.2.3. Parent-Created Trust/Court-Authorized Transfer. Another solution is to have a parent or grandparent establish a trust and to have a court order the transfer of property into the trust. This assumes that a court has the authority to (and is willing to) order the transfer of one person's property into a trust established by another person. As a practical matter, this may work, since in virtually every case all parties will agree to the transfer.

5.2.4. Court-Created Trust Without Reference to Sections 142.005 or 867. Prior to the enactment of SB 912 and HB 1314, some Texas courts created supplemental needs trusts by referring to the federal statute and not mentioning Tex. Prop. Code § 142.005 or Tex. Prob. Code Ann. § 867, either using its general equitable powers to create a trust or based on the theory that OBRA 93 pre-empted Texas law regarding court-created trusts to the extent they are inconsistent with OBRA 93.

Happily, now that there are two ways to establish supplemental needs trusts under the Texas statutes, courts may rely on a statutorily-authorized trust (either a 142 Trust or an 867 Trust) when creating (d)(4)(A) supplemental needs trusts and need no longer rely on equitable or pre-emption theories.

5.3. Drafting Supplemental Needs Trusts. Courts were willing to create (d)(4)(A) trusts in the

appropriate cases without clear authority to do so in Texas statutes. Now that the statutes governing 142 Trusts and 867 Trusts both expressly permit supplemental needs trusts, there appears no impediment to drafting trusts to meet the (d)(4)(A) requirements and seeking their creation under Tex. Prop. Code § 142.005 or Tex. Prob. Code Ann. § 867 as appropriate.

In August, 1996, Congress passed and President Clinton signed the Health Insurance Portability and Accountability Act of 1996 (H. R. 3103, Public Law 104-191, became law August 21, 1996). This act criminalizes transfers of assets for Medicaid purposes. It imposes fines of up to $10,000 and jail sentences of up to one year for a person who "knowingly and willfully disposes of assets (including by any transfer in trust) in order for an individual to become eligible for . . . [Medicaid]. . . if disposing of the assets results in the imposition of a period of ineligibility for such assistance under section 1917(c)." It seems clear that this statute is directed at covert transfers of assets, not overt ones such as a (d)(4)(A) trust. If properly done, a transfer of assets to a (d)(4)(A) trust does not result in a period of ineligibility for Medicaid. However, a transfer to a defective (d)(4)(A) trust may create a problem, since the transfer would be a knowing and willful disposition of assets in order to become eligible for Medicaid and since, because of the defective nature of the trust, the transfer may result in the imposition of a period of Medicaid ineligibility. For this reason, it may be prudent to include a savings clause in all trusts intended to be (d)(4)(A) trusts similar to the following: "In creating this trust, the parties hereto do not intend to violate any provisions of federal or state law, including but not limited to the Health Insurance Portability and Accountability Act of 1996, and this trust shall be construed and, if necessary, reformed accordingly."

The requirements of (d)(4)(A), including the government reimbursement on termination requirement, apply to trusts which are created with the beneficiary's own money. If a parent or other family member wishes to create a trust benefitting someone who also receives SSI and/or Medicaid, and if the family member does not wish for the trust to disqualify the beneficiary from such government assistance, he or she can set up a "supplemental needs trust" for the benefit of such person by trust agreement or by will. This type of "supplemental needs trust" must contain a distribution standard similar to (d)(4)(A) trusts — making it clear that the beneficiary is not entitled to receive distributions for food, clothing, shelter or cash — but it is not required to include a provision providing for the reimbursement of the government upon termination. Given this flexibility, it obviously is a good idea to deal with property passing to or for the benefit of a Medicaid recipient **before the Medicaid recipient actually has a right to the property.** Parents of disabled children and children with parents confined to nursing homes should be counseled not to make outright distributions to, or distributions in trust subject to a health, education, maintenance and support standard for the benefit of, such persons without first considering creation of a supplemental needs trust. It is very easy to confuse the (d)(4)(A) variety of supplemental needs trusts (trusts created with the beneficiary's own money) with the third party variety of supplemental needs trusts (trusts created with a third party's money), but there are important distinctions between the two

6. CONCLUSION

Court-created trusts are increasingly common in Texas. The legislative changes over the years should make court-created trusts easier and more flexible to use.

Exhibit "A" -- 2007 Amendments to Tex. Prop. Code Sec. 142.005

Sec. 142.005. TRUST FOR PROPERTY.

(a) Any [~~In a suit in which a minor who has no legal guardian or an incapacitated person is represented by a next friend or an appointed guardian ad litem, any~~] court of record with jurisdiction to hear a [~~the~~] suit involving a beneficiary may, on application [~~by the next friend or the guardian ad litem~~] and on a finding that the creation of a trust would be in the best interests of the beneficiary [~~minor or incapacitated person~~], enter a decree in the record directing the clerk to deliver any funds accruing to the beneficiary [~~minor or incapacitated person~~] under the judgment to a financial institution, except as provided by Subsections (m) and (n) [~~trust company or a state or national bank having trust powers in this state~~].

(b) The decree shall provide for the creation of a trust for the management of the funds for the benefit of the beneficiary [~~minor or incapacitated person~~] and for terms, conditions, and limitations of the trust, as determined by the court, that are not in conflict with the following mandatory provisions:

(1) The beneficiary shall be [~~the minor or incapacitated person is~~] the sole beneficiary of the trust.[~~;~~]

(2) The [~~the~~] trustee may disburse amounts of the trust's principal, income, or both as the trustee in the trustee's [~~his~~] sole discretion determines to be reasonably necessary for the health, education, support, or maintenance of the beneficiary. The trustee may conclusively presume that medicine or treatments approved by a licensed physician are appropriate for the health of the beneficiary.[~~;~~]

(3) The [~~the~~] income of the trust not disbursed under Subdivision (2) shall be [~~is~~] added to the principal of the trust.[~~;~~]

(4) If [~~if~~] the beneficiary is a minor, the trust shall terminate [~~terminates~~] on the death of the beneficiary, on the beneficiary's attaining an age stated in the trust, or on the 25th birthday of the beneficiary, whichever occurs first, or if the beneficiary is an incapacitated person, the trust shall terminate [~~terminates~~] on the death of the beneficiary or when the beneficiary regains capacity.[~~;~~]

(5) A [~~the~~] trustee that is a financial institution shall serve [~~serves~~] without bond.[~~; and~~]

(6) The [~~the~~] trustee shall receive [~~receives~~] reasonable compensation paid from trust's income, principal, or both on application to and approval of the court.

(7) The first page of the trust instrument shall contain the following notice:

NOTICE: THE BENEFICIARY AND CERTAIN PERSONS INTERESTED IN THE WELFARE OF THE BENEFICIARY MAY HAVE REMEDIES UNDER SECTION 114.008 OR 142.005, PROPERTY CODE.

(c) – (f) [No change]

(g) Notwithstanding any other provision of this chapter, if the court finds that it would be in the best

interests of the beneficiary [~~minor or incapacitated person~~] for whom a trust is established [~~created~~] under this section, the court may omit or modify any terms required by Subsection (b) if the court determines that the omission or modification is necessary or appropriate to allow the beneficiary to be eligible to receive public benefits or assistance under a state or federal program. This section does not require a distribution from a trust if the distribution is discretionary under the terms of the trust [~~may contain provisions determined by the court to be necessary to establish a special needs trust as specified under 42 U.S.C. Section 1396p(d)(4)(A)~~].

(h) – (j) [No change]

(k) In addition to ordering other appropriate remedies and grounds, the court may appoint a guardian ad litem to investigate and report to the court whether the trustee should be removed for failing or refusing to make distributions for the health, education, support, or maintenance of the beneficiary required under the terms of the trust if the court is petitioned by:

(1) a parent of the beneficiary;

(2) a next friend of the beneficiary;

(3) a guardian of the beneficiary;

(4) a conservator of the beneficiary;

(5) a guardian ad litem for the beneficiary; or

(6) an attorney ad litem for the beneficiary.

(l) A person listed in Subsection (k) shall be reimbursed from the trust for reasonable attorney's fees, not to exceed $1,000, incurred in bringing the petition.

(m) If the value of the trust's principal is $50,000 or less, the court may appoint a person other than a financial institution to serve as trustee of the trust only if the court finds the appointment is in the beneficiary's best interests.

(n) If the value of the trust's principal is more than $50,000, the court may appoint a person other than a financial institution to serve as trustee of the trust only if the court finds that:

(1) no financial institution is willing to serve as trustee; and

(2) the appointment is in the beneficiary's best interests.

(o) In this section:

(1) "Beneficiary" means:

(A) a minor or incapacitated person who:

(i) has no legal guardian; and

(ii) is represented by a next friend or an appointed guardian ad litem; or

(B) a person with a physical disability.

(2) "Financial institution" means a financial institution, as defined by Section 201.101, Finance Code, that has trust powers, exists, and does business under the laws of this or another state or the United States.

Amended by Acts 2007, 80th Legislature, Ch. ___ (HB 564), effective September 1, 2007. Section 23 of HB 564 provides: "Except as otherwise provided by the terms of a trust, the changes in law made by this Act apply to a trust existing or created on or after the effective date of this Act."