WEALTH MANAGEMENT

# DELAWARE TRUSTS

## Safeguarding Personal Wealth

2021 EDITION

# DELAWARE TRUSTS: SAFEGUARDING PERSONAL WEALTH

Many families and their advisers have found the State of Delaware to be a trust-friendly jurisdiction that promotes modern laws and enjoys attractive income tax advantages. This paper highlights the most significant legal and tax benefits for nonresidents, and their professional advisers, who may be considering whether to establish a trust in Delaware.

The Northern Trust Institute brings the breadth and depth of the firm to address the increasingly complex and sophisticated wealth management needs of our clients and their advisers. Informed by the latest insights and continually vetted through feedback, our advice is grounded in real-world outcomes and backed by proven credibility.

We believe you will find this information helpful as you work to create meaningful legacies.

## WHAT'S NEW FOR THE 2021 EDITION?

The Delaware Trust Act 2020 (the "2020 Act") was signed into law on August 6, 2020 by Governor John C. Carney. The 2020 Act did not introduce any new statutes but merely revises various existing statutes. Highlights of these revisions are summarized below.

### Authority to Allocate Trustee Duties Among Multiple Trustees

The 2020 Act revised 12 *Del. C.* § 3343 originally enacted in 2019. The statute provides that any fiduciary who has the power to appoint a successor trustee includes the power to appoint multiple successor trustees and additional trustees. Notably, this appointment power includes the power to allocate various trustee powers "exclusively to 1 or some of the trustees serving from time to time." This statute is a tool that potentially could eliminate the need to modify irrevocable trusts by decanting, merger, or non-judicial settlement agreement because the trustees' roles and powers could be modified simply by using the revised statute to allocate powers among current or new trustees. For example, this statute could be used to create a trust with a directed trustee where the trust currently does not have a directed trustee.

The 2020 Act makes various clarifying changes to 12 *Del. C.* § 3343. Importantly, the revisions make it clear that this statute can be used to give a trustee the power to direct another trustee. Although the statute initially allowed this, it was not entirely clear from the language of the statute as initially enacted. The revised statute expressly states that if one trustee directs another trustee, the directed trustee will not be subject to liability unless the directed trustee acts with willful misconduct. It further provides that if trustee powers are truly bifurcated with a trustee not having certain powers, the trustee without the specified powers is an excluded trustee and will not be subject to liability for the exercise of powers by the other trustees.

The 2020 Act adds a 30-day notice provision so that if a trustee finds itself unexpectedly removed under this statute, that trustee has time to take any actions they deem necessary. This notice period can be waived by the removed trustee.

### Nonjudicial Settlement Agreements and Modification of Trust by Consent while Trustor is living

Delaware has had a nonjudicial settlement agreement ("NJSA") statute since 2013. This statute, 12 *Del. C.* § 3338, is similar to the NJSA statutes of many other states in that it allows the interested persons in a trust to enter into an agreement regarding any matter involving the trust, provided the agreement does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the Court of Chancery.

Unlike some states, the Delaware NJSA statute also provides that if the grantor is alive, the grantor must be a part of the agreement if the agreement could be interpreted to violate a material purpose of the trust. In 2016 Delaware enacted 12 *Del. C.* § 3342 which allows the modification of a trust by consent while the grantor is living. This statute requires that the grantor (or "trustor") as an interested person be a party to the modification agreement, and permits any modification regardless of whether the modification violates a material purpose of the trust. The 2020 Act made similar revisions to both statutes, with slightly more extensive revisions to the NJSA statute.

The revisions to the NJSA statute address the definition of interested persons required to participate in the NJSA, and the ability of the grantor to represent and bind other beneficiaries.

The first revision to the NJSA statute redefines the "interested persons" required for a nonjudicial modification agreement. As originally enacted, interested persons were defined as: (1) trustees and any other fiduciaries; (2) beneficiaries with a present interest in the trust and those whose interest in the trust would vest if the present interests in the trusts terminated on the date of the agreement; (3) the grantor if living; and (4) all other persons having an interest in the trust according to the express terms of the trust agreement. The NJSA statute was amended to provide that if the NJSA alters any beneficial interests in the trust, all of the trust's beneficiaries must be parties to the agreement, not just beneficiaries with a present interest. So conceivably there could be remaindermen whose interest would not vest if the trust terminated currently, but would only vest upon a certain condition or specific event. These parties would be necessary persons for the NJSA if beneficial interests are being changed.

The second revision addresses the grantor's ability to represent and bind other beneficiaries, whether as a Designated Representative of a confidential trust or through virtual representation. As noted in the synopsis for the 2020 Act, the NJSA statute is amended to specify that, consistent with the Uniform Trust Code, when a grantor is a party to an NJSA, then unless the transfer in trust is an incomplete gift for federal gift tax purposes, the grantor may not represent and bind any beneficiary other than the grantor.

The amendment to the Modification of Trust by Consent While Trustor is Living is parallel to the change in the NJSA statute which specifies that unless the transfer in trust is an incomplete gift for federal gift tax purposes, the grantor may not represent and bind any beneficiary other than the grantor, again whether as Designated Representative of a confidential trust or through virtual representation.

The changes to both statutes limit the ability of the grantor to represent and bind beneficiaries when beneficial interests are being changed. This addresses the concern that a grantor representing and binding beneficiaries when beneficial interests are being changed could result in adverse transfer tax consequences for the grantor retaining power over the trust.

### Limitation of Action Against Trustee following Trustee's Report

Delaware statute 12 *Del. C.* § 3585 sets forth the statute of limitations for a party to bring a cause of action against a trustee under various scenarios, provided a trustee has fulfilled its duty to report to that person. The period is generally one year after receipt of a report from the trustee that covers the item that is the subject of the cause of action. In 2017 this statute was amended to add a provision that when a trustee will cease serving due to resignation, removal, or termination of the trust, the period for a party to bring a cause of action is 120 days. Although a useful provision for the orderly succession of events when a trustee will no longer be serving, there was uncertainty about what happens if the trustee is not able to wind up matters and stop serving within the 120-day period. The 2020 Act clarifies that an outgoing trustee may rely on the statute even if the trustee will continue to serve for a reasonable period of time after the 120-day period. The trustee does remain liable for its actions and would be subject for surchargeable misconduct during the period it remains in office.

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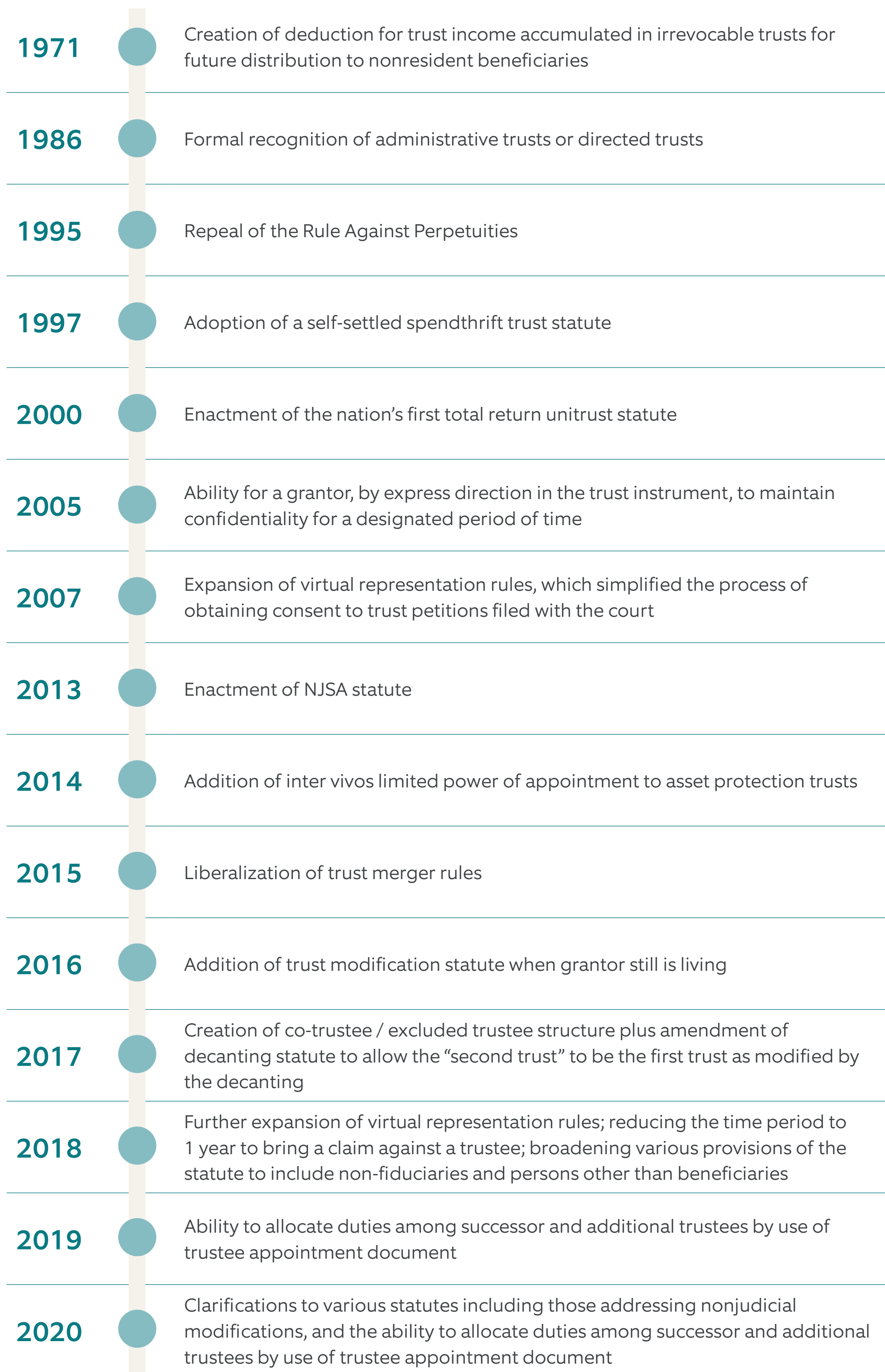
## INNOVATIVE JUDICIAL INFRASTRUCTURE

Delaware has long been home to substantial personal wealth including long-term trusts funded by local residents. Delaware began to attract wider attention as a trust jurisdiction in 1986 when its General Assembly completed a massive overhaul of its trust laws. Although Delaware had earlier granted a deduction for trust income of trusts held for nonresident beneficiaries, the 1986 revision began the formal recognition of so-called administrative trusts or directed trusts. The repeal of the rule against perpetuities in 1995, the adoption of a self-settled spendthrift trust statute, the Qualified Dispositions in Trust Act in 1997, and the enactment of the nation's first total return unitrust statute in 2000 firmly established Delaware's reputation as an innovative jurisdiction for safeguarding personal wealth.

While the advances in trust law have been significant, an equally important benefit is the exclusive jurisdiction of the Delaware Court of Chancery over matters of equity, which generally covers all fiduciary proceedings and disputes (other than the rare case involving a non-fiduciary claim for monetary damages against a trust or a trustee). With an established body of fiduciary law and a bench of highly experienced jurists, the Court of Chancery offers lawyers and their clients the assurance that, should a trust dispute ever arise, Delaware has the judicial infrastructure to resolve it efficiently and fairly.

FIGURE 1: KEY MILESTONES OF DELAWARE TRUST LAW



| Year | Milestone |
|---|---|
| 1971 | Creation of deduction for trust income accumulated in irrevocable trusts for future distribution to nonresident beneficiaries |
| 1986 | Formal recognition of administrative trusts or directed trusts |
| 1995 | Repeal of the Rule Against Perpetuities |
| 1997 | Adoption of a self-settled spendthrift trust statute |
| 2000 | Enactment of the nation’s first total return unitrust statute |
| 2005 | Ability for a grantor, by express direction in the trust instrument, to maintain confidentiality for a designated period of time |
| 2007 | Expansion of virtual representation rules, which simplified the process of obtaining consent to trust petitions filed with the court |
| 2013 | Enactment of NJSA statute |
| 2014 | Addition of inter vivos limited power of appointment to asset protection trusts |
| 2015 | Liberalization of trust merger rules |
| 2016 | Addition of trust modification statute when grantor still is living |
| 2017 | Creation of co-trustee / excluded trustee structure plus amendment of decanting statute to allow the “second trust” to be the first trust as modified by the decanting |
| 2018 | Further expansion of virtual representation rules; reducing the time period to 1 year to bring a claim against a trustee; broadening various provisions of the statute to include non-fiduciaries and persons other than beneficiaries |
| 2019 | Ability to allocate duties among successor and additional trustees by use of trustee appointment document |
| 2020 | Clarifications to various statutes including those addressing nonjudicial modifications, and the ability to allocate duties among successor and additional trustees by use of trustee appointment document |

## SAVINGS ON FIDUCIARY INCOME TAXES

**The State of Delaware provides appealing opportunities for tax savings through irrevocable trusts.**

### STATE INCOME TAX SAVINGS

State income taxes can be a significant drag on the growth of an irrevocable trust. In many states, a trust's realized capital gains and accumulated ordinary income are taxed at rates between 5 and 10 percent, with rates in California as high as 13.3 percent. Thus, in addition to the 20 percent rate on capital gains at the federal level, plus the potential net investment income tax of 3.8 percent, state income taxes can greatly reduce trust earnings. It is worth noting that at the time of this paper, California is considering raising its current income tax rates.

Delaware offers an appealing alternative venue for irrevocable trusts because it does not impose any state income tax on income that is accumulated for distribution to nonresident beneficiaries in future years.[1] As a practical matter, an irrevocable trust for nonresident beneficiaries should not be subject to any Delaware income tax because its income either will be distributed to its beneficiaries (with a corresponding deduction for the distribution under 30 *Del. C.* § 1635(a)), or will be accumulated (with a deduction under 30 *Del. C.* § 1636(a)).

As an example of the potential tax savings, if two trusts (one in California and one in Delaware) were to sell a zero-basis asset for net proceeds of $5 million, the after-tax proceeds of the sale in the Delaware trust would probably be worth $665,000 more because the proceeds in the California trust would be subject to California income tax at a rate of 13.3 percent. (See Figure 2.)

FIGURE 2:

| | Sale in Delaware Trust | Sale in California Trust |
|---|---|---|
| Sale Proceeds | $5,000,000 | $5,000,000 |
| Tax Cost | $0 | $0 |
| Gain on Sale | $5,000,000 | $5,000,000 |
| State Income Tax | $0 | $665,000 |
| Federal Income Tax | $1,190,000 | $1,190,000 |
| **Proceeds Net of Tax** | **$3,810,000** | **$3,145,000** |
| Delaware Benefit = | $665,000 | |

Assumptions:

1. Federal capital gains rate: 23.8%.
2. California state income tax rate: 13.3% (maximum rate of 12.3% plus a mental health services tax of 1% for taxable income over $1,000,000).
3. No federal tax deduction for state taxes paid.

### POTENTIAL "TRAPS"

For a trust to take full advantage of Delaware's deduction for trust income accumulated for nonresident beneficiaries, it is essential that the trust avoid a tax nexus with another jurisdiction. A number of factors can cause a Delaware trust to become subject to state income tax in another state. For example:

- Many jurisdictions will treat a trust as a resident trust, and subject to state income tax, if the trust has a fiduciary residing in that state, or if the trust administration occurs in that state. For example, if a Delaware trust has an individual co-trustee or investment or distribution adviser located in California, that state would consider the trust to be subject to its tax regime. Similarly, if a Delaware corporate trustee delegates a major portion of its trust administration duties to an affiliate in another state (i.e., the affiliate has full discretion to manage the trust's investment portfolio without any supervision of the Delaware trustee), there is a risk that the affiliate's state would consider the trust to be resident and fully taxable in that state.[2]
- If a Delaware trust has source income from an operating business or real estate located in another state, that state likely will claim that it is entitled to tax at least a proportionate share, if not all, of the trust's federal taxable income.[3] Portfolio managers of Delaware trusts must be aware of investments that could generate source income from a high tax state. Investments like hedge funds and private equity funds often have layers of entities, and managers should be mindful that a fund could allocate state sourced income to a trust on a Form K-1.
- Perhaps most significantly, a considerable number of states will attribute resident status to an irrevocable trust established in another state if the grantor of the trust was a resident of the state when the trust became irrevocable. Examples of states that have adopted this treatment of non-domiciliary trusts — known as the "residence-by-birth" approach — include, but are not limited to, Connecticut, Illinois, the District of Columbia, Michigan, Minnesota, Ohio, Pennsylvania, Virginia and Wisconsin.[4] There may be due process grounds for challenging the constitutionality of residence-by-birth tax schemes under the Supreme Court's decision in *Quill Corp. v. North Dakota*.[5] Following the *Quill* decision, state courts were notably unfriendly to states' attempts to assert taxing jurisdiction, and until recently the Supreme Court had declined to address the issue. Thus, fiduciaries are often left with little guidance regarding their

obligations to pay fiduciary income tax to another state.[6] There have been two cases where the state court ruled that the mere fact that the trust was created by a grantor of that state was not sufficient to create a taxable nexus where there were no other connections with the state. These cases are the *McNeil* case in Pennsylvania and the *Linn* case in Illinois, and they are notable in part because they were decided in residence-by-birth states.[7] But, because both *McNeil* and *Linn* relied on their specific facts, care should be used in relying on these cases. Residents of Pennsylvania, Illinois, and other residence-by-birth states should not assume their trusts will be exempt from state income taxes merely because the trust is located in Delaware or another trust-friendly jurisdiction.

- Note that the trend of determining taxation to be unconstitutional continues in the more recent Kaestner decision which came from the North Carolina Courts and was ultimately decided in the U.S. Supreme Court.[8] In this case the U.S. Supreme Court addressed the constitutionality of state taxation of a trust's undistributed income, based solely on a beneficiary living in the state imposing the taxation. North Carolina imposed an income tax on a trust over a four-year period even though the beneficiaries received no income in those tax years, had no right to demand income in those years, and could not count on ever receiving income from the trust.
- The Court held that this imposition of tax violated the Due Process Clause of the U.S. Constitution.
- In 2014, New York State changed the way it might tax a beneficiary of a Delaware trust. Historically, if a Delaware trust created by a New York resident did not have a New York fiduciary, New York source income, or New York real or tangible personal property owned by the trust, New York would not impose fiduciary income tax on the trust. However, under the New York 2014–2015 Budget, which became effective April 1, 2014, distributions to a New York resident beneficiary from a New York resident trust will be subject to a throwback tax on previously undistributed income accumulated during any tax year starting after December 31, 2013, while the trust was not already subject to New York fiduciary income tax. Under the throwback rules, a beneficiary's distribution is deemed to include income earned in prior years, and thereby potentially increases the beneficiary's tax liability. The throwback tax will apply only to New York resident beneficiaries of trusts created by a New York resident grantor, where the trust is exempt from New York income taxation because it has no New York resident trustees, no New York source income, and no New York real estate or tangible personal property located in the state.[9] Note that the throwback rules do not apply to a Delaware Incomplete Non-Grantor ("DING") Trust, which has separate and distinct status under New York law and is discussed on page 22.
- A discussion of state taxing schemes would be incomplete without a discussion of California's reliance on the residence of trust beneficiaries to exact an income tax from what would otherwise be a nonresident trust. Section 17742(a) of the California Revenue and Taxation Code instructs trustees that the entire income of a trust is taxable in California if the fiduciary or the beneficiary is a California resident (unless the interest of the beneficiary in the trust is "contingent"). If there are multiple beneficiaries, some of whom are not California residents, the income taxable under § 17743 and § 17744 is apportioned according to the "number of fiduciaries and the number of and interest of beneficiaries" resident in California.[10]

The most meaningful question that § 17742(a) poses is whether a California resident's interest is "contingent." The California Franchise Tax Board has not given substantial clarity to the meaning of a "contingent" beneficiary. It may be that a beneficiary's right to receive distributions from a trust that is subject to the trustee's discretion results in the trust having a contingent beneficiary for California income tax purposes, particularly where there is an independent trustee. Further, the right to receive distributions conditioned on the beneficiary's survival constitutes a contingency as to that beneficiary's interest. The Franchise Tax Board's 2017 Form 541 Booklet states on page 14:

> *The taxability of non-California source income retained by trust and allocated to principal depends on the residence of the fiduciaries and noncontingent beneficiaries, not the person who established the trust. Contingent beneficiaries are not relevant in determining the taxability of a trust.*
>
> *A noncontingent or vested beneficiary has an unconditional interest in the trust income or corpus. If the interest is subject to a condition precedent, something must occur before the interest becomes present, it is not counted for purposes of computing taxable income. Surviving an existing beneficiary to receive a right to trust income is an example of a condition precedent.*[11]

What happens in the case of a California beneficiary of a Delaware trust that is fully discretionary as to the payment of principal and income? A resident beneficiary whose interest in

a trust is discretionary and who receives no distribution from the trust during the year is a contingent beneficiary, meaning that no California tax is caused for the trust by that California beneficiary.[12] On the other hand, a resident beneficiary whose interest in a trust is discretionary and who receives a distribution of trust income is a noncontingent beneficiary, meaning California tax would apply but only with respect to the amount distributed.[13]

## ADMINISTRATIVE OR DIRECTED TRUSTS

### INVESTMENT FLEXIBILITY

When the General Assembly crafted its revisions to Delaware's trust laws in 1986, the most remarkable change was the adoption of a modern portfolio approach to trust investing. Although the prudent investor rule has now been adopted in nearly every state, Delaware's enactment seemed almost revolutionary at the time. The new principle, codified at 12 *Del. C.* § 3302(b), allowed trustees to depart from the traditional rule of ensuring that each and every investment was both safe and productive.[14] Rather, § 3302(b) permitted trustees to acquire assets of virtually any nature because their investment performance would be judged on the basis of the entire portfolio. Thus, trustees could invest in a manner that had the potential to generate higher returns through investments in growth stocks, emerging markets, and alternative investments as long as the portfolio as a whole was invested in a manner that a prudent investor would adopt.

In its 2007 legislative session, the Delaware General Assembly revisited the concept of investment freedom. An amendment to 12 *Del. C.* § 3303(a) allows a trust grantor to limit a trustee's liability to willful misconduct for not diversifying trust assets if the language of the trust agreement directs the trustee not to diversify, or specifies the circumstances in which the assets are to remain undiversified.

### Environmental, Social, and Governance ("ESG") Investing

Delaware statute has also recognized the growing interest by beneficiaries in investing in holdings that promote environmental, social, and governance ("ESG") goals. The following language was added to 12 *Del. C.* § 3302, "... when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries." Section 3303(a) also was modified to enable ESG investing by adding that the trust instrument may expand the laws of general application to fiduciaries including laws pertaining to, "The manner in which a fiduciary should invest assets, including whether to engage in one or more sustainable or socially responsible investment strategies, in addition to, or in place of, other investment strategies with or without regard to investment performance..."

Under Delaware law, trustees have a general duty to exercise prudence in managing a concentrated position, a duty that often requires a trustee to reduce the position despite family opposition. A 2009 decision of the Delaware Court of Chancery, *Merrill Lynch Trust Co., FSB. v. Campbell*, reaffirmed the critical role of a trust agreement in determining the limits on a trustee's liability for a trust's poor investment performance.[15] In Campbell, an elderly client established a charitable remainder unitrust with a substantial unitrust payout of ten percent annually. Designed to benefit the client and her children, the trust had a projected life of nearly 50 years. To meet the cash needs of the client while sustaining the trust for its substantial duration, the trustee allocated the trust assets with an aggressive tilt toward equities, which at times exceeded 90 percent of total assets. After early increases in value, the trust lost 58 percent of its value during the 2001 recession. In absolving the trustee of liability for its "disturbingly high" reliance on equity securities, the court concluded that the fault lay in the trust agreement whose sizable payout and long duration made the trustee's investment choices seem reasonable under the circumstances.[16]

### ADMINISTRATIVE FLEXIBILITY AND PROTECTION

The unique nature of Delaware's law on "administrative" or "directed" trusts has led to a substantial influx of trusts in which some party other than the trustee has exclusive responsibility for the investment of the trust assets. This party generally is an investment adviser, and may or may not be registered under the Investment Advisers Act of 1940. Specifically, 12 *Del. C.* § 3313(b) authorizes trustees to take investment direction from investment advisers named in a trust instrument, without liability for the advisers' investment results (except in the event of the trustee's willful misconduct).[17] With the bifurcation of the trustee's traditional duties of administration and investment management, the designated investment adviser is treated as a fiduciary for the investment component, absent language in the trust agreement to the contrary.

To bolster a directed trustee's protection from liability for the conduct of an adviser, 12 *Del. C.* § 3313(e) explicitly absolves a directed trustee of a duty to monitor the conduct of the adviser, provide advice to the adviser or consult with the adviser, or communicate with or warn or apprise any beneficiary or third party concerning instances in which the trustee would have exercised its own discretion in a manner different from the manner directed by the adviser. Actions of the trustee which are seemingly within the scope of the adviser's duties (such as confirming that the adviser's directions have been implemented) are presumed to be administrative in nature and not an undertaking of the trustee to become a co-adviser.

The extent of an administrative trustee's protection from liability under 12 *Del. C.* § 3313(b) was the subject of the dispute in *Duemler v. Wilmington Trust Co.*, in which the co-trustee and sole investment adviser brought an action against an administrative trustee for losses the trust incurred after the investment adviser elected not to tender a bond in an exchange offer and the bond issuer subsequently defaulted on its obligation.[18] The investment adviser claimed that the trustee wrongly failed to deliver to him a copy of the prospectus for the exchange offer. In concluding that § 3313(b) insulated the administrative trustee from liability, the Vice Chancellor observed:

> *In connection with Plaintiff's decision not to tender the securities in the Exchange Offer, [the trustee] acted in accordance with Plaintiff's instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information concerning the Exchange Offer.*[19]

Given the plain language of the trust agreement defining the respective duties of the administrative trustee and the investment adviser, it is not surprising that the Vice Chancellor ruled against the plaintiff.

Note that 12 *Del. C.* § 3313 also makes it clear that the statutory protection is also available when a trustee is directed not to take specified actions unless directed. The statute also specifies that the definition of "investment decision" includes powers commonly understood to be part of investment decisions but which were not specifically covered in the statute previously. This includes matters such as the power to lend and borrow for investment purposes, the power to vote, and various powers and activities that are generally part of investment decisions. Thus, it is clear that a trustee can be directed in these matters and be protected by the statute.

At times the question arises in the administration of a trust as to whether a loan to a beneficiary falls within the discretion of the trustee or is under the purview of the adviser directing the trustee. Subsection (d) of the statute clarifies that "investment decisions" which would fall under the purview of an adviser directing a trustee on investments do not include loans that are made in lieu of a distribution to a beneficiary that could have been made to or for the benefit of a beneficiary.

*As illustrated below, apart from the obvious application of 12 Del. C. § 3313(b) to permit a professional investment adviser to manage a trust's assets, the administrative trust statute has provided a useful solution to a number of common trust problems.*

| CLIENT SITUATION: | POTENTIAL SOLUTION: |
|---|---|
| **Concentrated position**<br>A trustee of a trust with a concentrated position in a particular asset may want to sell a substantial portion of the asset to achieve greater diversification and reduce the concentration risk. The beneficiaries may oppose a sale because of their emotional attachment to the asset or simply the belief that the asset will perform well over the long term. | **Family committee manages concentration**<br>To resolve this familiar conflict, the parties can seek to modify the trust into an administrative trust in which a family committee (composed of family members who are experienced professionals) has exclusive investment responsibility for the concentrated asset, while the trustee retains management authority over the more diversified assets. |
| **Funding with closely held assets**<br>A client wants to contribute to a family trust certain interests in a closely held operating business or investment entity, but the client is uncomfortable with the notion that the trustee would have investment responsibility for the closely held asset. | **Client retains control**<br>If the client designates himself or herself as the investment adviser for the closely held asset, the trustee will not have any authority to participate in decisions regarding the client's business or investment entity.[20] |
| **Non-U.S. person custodies assets in U.S.**<br>A non-U.S. person who is a citizen of a politically unstable nation wants to maintain custody of his or her financial assets in the U.S. without subjecting the assets to U.S. income tax. | **Foreign trust avoids U.S. income tax**<br>The grantor can create a "foreign trust" with a U.S. trustee if the trust fails the "control test" under I.R.C. § 7701(a)(30)(E). The control test requires one or more U.S. persons to have the authority to control all substantial decisions of the trust. Thus, by vesting a non-U.S. person with authority to control substantial decisions of the trust (i.e., investments, distributions, termination, and the like), the foreign trust should not be subject to U.S. income taxation except on its U.S. source income. The Delaware directed trust rules nicely accommodate the non-U.S. person's desire to control the substantial decisions of the trust, leaving the trustee to furnish administrative support without liability for the actions of the non-U.S. person. |

Note that 12 *Del. C.* § 3313(b) also applies to "distribution decisions or other decisions of the fiduciary" and is not limited to investment decisions. The appointment of a distribution adviser in a trust agreement may be especially useful if the grantor wants to impose "lifestyle" standards or other subjective criteria for the beneficiaries' eligibility (or ineligibility) to distributions of income and principal of the trust. These sorts of standards may be difficult for corporate trustees to apply if they lack intimate knowledge of the beneficiaries' lifestyles and it is impracticable to gather the information on which to base a distribution decision. If a grantor feels strongly about incorporating subjective standards into his or her trust agreement, it may make sense to appoint a family member, a family confidante, or even a professional individual fiduciary to make potentially controversial judgments about the beneficiary's lifestyle, moral character, or productivity.

Furthermore, 12 *Del. C.* § 3313(f) allows a directed trustee to follow the direction of a trust protector without concern for vicarious liability stemming from the protector's actions. The trust protector can take a wide variety of actions, including the exercise of removal and appointment powers, the modification or amendment of a trust instrument to achieve a favorable tax result or improve the trust's administration, and the modification of a beneficiary's power of appointment under the governing instrument.

### Excluded trustees

In 2017, the General Assembly added § 3313A to Title 12. This section goes beyond the concept of a directed trust, and creates a true division of labor among parties. In a directed trust, an adviser will direct a trustee, and the trustee enjoys limited liability. But, in a § 3313A arrangement, a trust will have a trustee and an "excluded trustee."

The excluded trustee could be an administrative trustee and the non-excluded trustee could be an adviser, but the excluded administrative trustee does not take direction from the adviser. Instead, each trustee has its own sphere of responsibility. And § 3313A provides that the excluded trustee is not liable (individually or as a fiduciary) for any loss resulting directly or indirectly from the action taken by the other trustee, as long as the trust agreement gives that other trustee exclusive authority in a given realm. The excluded trustee concept gives grantors enhanced flexibility, and reflects Delaware's commitment to legal innovation.

Subsection (a)(2) of § 3313A provides that while the excluded trustee is not a fiduciary for any power that falls to the co-trustee, the excluded trustee remains a fiduciary with respect to any powers or other matters over which the co-trustee does not have exclusive authority under the terms of the trust.

## DYNASTY TRUSTS

### THE RULE AGAINST PERPETUITIES

Prior to the latter part of the 20th century, every state had adopted, in one form or another, the rule against perpetuities (the "Rule"), which has the effect of limiting the duration of a trust. Under the traditional common law Rule, all interests in the trust must vest, and the trust must terminate, within 21 years after the death of all identified individuals living at the creation of the trust. The Rule reflects a policy judgment that property owners should not be permitted to restrict the transfer of their property beyond the lives of persons who were likely known to the owner plus the minority period of the next generation. The practical effect of the rule against perpetuities was that trusts could last only a few generations, after which the remainder interests would have to be distributed outright to the class of remainder beneficiaries.

The complexity of applying the Rule caused a number of states to develop alternatives to the common law Rule, such as the 90-year period under the Uniform Statutory Rule Against Perpetuities. But, it was not until the Tax Reform Act of 1986 (the "1986 Act") that states began to seriously consider abolishing the Rule outright. This is because the 1986 Act introduced the transfer tax on generation-skipping transfers. Congress intended the GST tax to apply to transfers that skipped the next immediate generation and would otherwise avoid an estate tax at that intermediate generation.[21] The 1986 Act provided each transferor with a lifetime exemption from the GST tax, which, under the law known as the Tax Cuts and Jobs Act, is $11.7 million in 2021 and indexed for inflation for subsequent years.[22] Note that under the Tax Cuts and Jobs Act of 2017, this basic exclusion amount will return to the lower amount of $5 million on December 31, 2025. Importantly, the IRC does not place any limit on the duration of a transferor's GST exemption or the duration of corresponding GST-exempt trusts. Thus, if the limit on the length of a GST-exempt trust were the applicable rule against perpetuities, an extension or outright abolition of the Rule would vastly increase the number of generations who could enjoy the fruits of the transferor's GST-exempt trust, without diminution of the trust assets on account of any federal transfer tax.

### 1995 REPEAL

In 1995 Delaware became the first state after the passage of the 1986 Act to repeal its rule against perpetuities, thus permitting trusts of personal property to last potentially forever.[23] Although direct interests in real property remain subject to a perpetuities period of 110 years, a Delaware trust may be able to hold real property without limitation if the property is held through a corporation, limited partnership, limited liability company, or other entity.[24]

In the ensuing years, many states have adopted legislation that either allows a trust agreement to opt out of the Rule, extends the Rule to a finite period (which can be as long as 1,000 years), or repeals the Rule altogether.

The economic benefit of a GST-exempt (or dynasty) trust can hardly be denied. As Figure 3 demonstrates, a client's ability to contribute assets to a trust that will continue for generation after generation without the imposition of any transfer tax is an extraordinary opportunity when compared to the alternative of passing assets outright, from generation to generation, subject to a federal transfer tax at each generation. Assuming an $11.7 million contribution to a trust, a 5 percent after-tax rate of return on the investment assets, a new generation every 25 years, and a federal estate tax of 40 percent applied at each generational transfer, the GST-exempt trust would have an approximate value of $454 million after only 75 years. The same sum of $11.7 million held outside of a trust (and subject to a gift tax or estate tax upon transmittal to each successive generation) would have an approximate value of $98 million. (See Figure 3.)

With the passage of each generation, the difference in value between the GST-exempt trust and the "no-trust" alternative becomes exponentially larger. With such a compelling financial outcome, it is not surprising that Delaware fiduciaries have witnessed an influx of dynasty trusts.[25]

Common funding examples of Delaware dynasty trusts include the following:

- A grantor contributes cash, marketable securities, or interests in a closely held entity (in the latter case, often at discounted values) to an irrevocable trust, using the grantor's lifetime applicable gift tax exclusion ($11.7 million in 2021). The grantor then allocates a portion of his or her lifetime GST exemption (also $11.7 million in 2021). Trust beneficiaries will benefit from the trust for years to come.
- A grantor sells assets to a trust on the hope that they will appreciate. The trust that purchases the assets is an irrevocable trust that is "defective" for income tax purposes, meaning that it includes powers that will cause it to be treated as a grantor trust. The grantor contributes seed money to the trust in order to collateralize the trust's purchase of the assets, and the grantor may use some of his or her annual or lifetime gift tax exclusion in order to avoid making a taxable gift to the trust. The trust then purchases the appreciating assets from the grantor in exchange for a promissory note that is collateralized by the seed money. The promissory note will bear interest at the appropriate applicable federal rate, which is a minimum rate of interest set by the IRS (the "AFR"). If the rate of return on the purchased assets exceeds the interest rate on the promissory note (i.e., the hurdle rate), then the grantor will have successfully transferred the appreciated value of the asset out of his or her estate and to the beneficiaries for their enjoyment. A trustee of an irrevocable life insurance trust with Crummey powers (with multiple Crummey beneficiaries) acquires a life insurance policy on the life of the grantor (or a joint and survivor policy on the lives of the grantor and the grantor's spouse). The grantor(s) contributes the annual insurance premiums using his or her annual gift tax exclusions ($15,000 in 2021) or, in the case of a single premium insurance policy, using his or her lifetime applicable gift tax exclusion ($11.7 million in 2021). Death benefits payable to the trust often will vastly exceed the premium expense, and the insurance proceeds are excludable from the grantor's estate and exempt from GST tax (assuming an allocation of the grantor's GST exemption to the trust).

FIGURE 3:

| | DELAWARE DYNASTY TRUST Transfers in Trust to Next Generation Every 25 Years | TAXABLE OUTRIGHT Transfers To Next Generation Every 25 Years |
|---|---|---|
| Year 1 | $11,700,000 | $11,700,000 |
| Year 25 Value | $39,620,353 | $39,620,353 |
| Transfer Tax | — | ($15,848,141) |
| Ending Value | $39,620,353 | $23,772,212 |
| Year 50 Value | $134,168,577 | $80,501,147 |
| Transfer Tax | — | ($32,200,459) |
| Ending Value | $134,168,577 | $48,300,688 |
| Year 75 Value | $454,342,425 | $163,563,273 |
| Transfer Tax | — | $65,425,309 |
| Ending Value | $454,342,425 | $98,137,964 |
| Delaware Benefit = | $356,204,461 | |

Assumptions:

1. Federal estate tax rate: 40%.
2. Return on investment assets: 5% annually.
3. No state income taxes.
4. No distributions from trust or consumption of principal or income.

## DELAWARE ASSET PROTECTION TRUSTS

### THE DEVELOPMENT OF DELAWARE ASSET PROTECTION TRUSTS

With the passage of the Qualified Dispositions in Trust Act (the "QDTA") in 1997, Delaware became the second state to enact legislation allowing domestic asset protection trusts.[26] Other states now have similar statutes. In essence, the QDTA allows a grantor to create an irrevocable trust of which he or she is a beneficiary, while retaining various interests in, and powers over, the trust.[27] Despite the grantor's continuing interest in potential distributions of income and principal from the trust, the grantor's creditors should not be able to reach the assets of the trust to satisfy their claims unless they can timely establish that the funding of the trust amounted to a fraudulent transfer.

Delaware trustees have seen an increase in the prevalence of asset protection trusts. Physicians often use asset protection trusts to protect a portion of their wealth against excessive, uninsured liabilities. Asset protection clients also include corporate directors who have concerns about personal liability for uninsured claims arising out of shareholder litigation. Asset protection trusts should be funded with a portion of a grantor's net worth, but the grantor should retain sufficient assets outside of the trust to satisfy his or her ongoing lifestyle expenses.

In short, asset protection trusts serve a variety of well-intentioned clients who simply seek to safeguard a portion of their net worth from unforeseen and uninsured claims against their wealth.

*Examples of asset protection trusts range well beyond the obvious candidates.*

SITUATION 1

Delaware trustees are seeing couples establish asset protection trusts to protect their combined assets from family and purported friends who may attempt to exert pressure or undue influence on the surviving spouse should he or she become vulnerable due to advancing age and/or declining health.

SITUATION 2

Asset protection trusts are also serving as a substitute for prenuptial agreements, offering protection of the pre-marital estate of an individual.

SITUATION 3

Frequently, young adults establish asset protection trusts at the recommendation of their parents, who prefer making gifts into a vehicle that offers protection against future creditor and spousal claims.

SITUATION 4

As a result of the increase in the federal gift tax exemption to $11.7 million per person for 2021, Delaware trustees have seen clients acting on a unique opportunity to transfer significant wealth out of their estates without the imposition of federal transfer taxes by making completed gifts to asset protection trusts. In these cases, the client makes a transfer to an asset protection trust of up to $11.7 million and allocates his or her gift tax exemption to the trust, which in turn provides that the trustee may distribute income and principal to the client and other beneficiaries in the sole discretion of the trustee. Clients retain sufficient wealth outside of the asset protection trust to fund their lifestyle needs and other planning goals. This strategy may enable the client to transfer wealth out of his or her estate without the imposition of federal gift tax and also allows the client to remain a potential beneficiary of the trust in the unlikely event the client needs access to the trust assets in the future.

## THE PREREQUISITES OF A DELAWARE ASSET PROTECTION TRUST

In order to qualify for the protection afforded under the QDTA, the transaction must satisfy the following basic elements:

- **Transfer to an Irrevocable Trust.** A Delaware asset protection trust begins with a transfer of assets to an irrevocable trust with a Delaware trustee. The grantor may make a direct transfer to the trustee or may exercise a lifetime power of appointment under an existing trust. The QDTA also recognizes transfers to a Delaware trustee from a trustee of an existing trust in another jurisdiction, to the extent that the original instrument is consistent with the requirements of the QDTA.

- **Delaware Trustee.** A Delaware asset protection trust must have a Delaware-resident trustee that is either a regulated financial institution or an individual resident. In either case the Delaware trustee must “materially participate” in the administration of the trust through various administrative activities.

- **Reliance on Delaware Law.** A trust subject to the QDTA must expressly incorporate Delaware law to govern its validity, construction, and administration unless the Delaware trust results from a trustee-to-trustee transfer from a trust existing in another jurisdiction.

- **Spendthrift Language.** A spendthrift clause that bars the attachment or assignment of a beneficiary’s interest in a trust is essential to the enforceability of the trust.

- **The Grantor’s Interests and Powers.** The QDTA appears to offer a broad array of interests in, and powers over, a trust that a grantor may retain:

  — A grantor’s power to veto or consent to distributions from the trust;

  — A limited power of appointment effective during the grantor’s lifetime, as well as a limited power of appointment exercisable by will or other written instrument of the grantor effective only upon the grantor’s death;

  — The grantor’s potential or actual receipt of income, including rights to such income retained in the trust instrument;

  — The grantor’s potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust;

- The grantor's potential or actual receipt of income or principal from a grantor-retained annuity trust or grantor-retained unitrust, and the grantor's receipt each year of a percentage (not to exceed five percent) specified in the trust instrument of the initial value of the trust or its value determined from time to time;
- The grantor's potential or actual receipt or use of principal if such potential or actual receipt or use of principal would be the result of the Delaware trustee's acting:
  - In such trustee's discretion;
  - Pursuant to a standard that governs the distribution of principal and does not confer upon the grantor a substantially unfettered right to the receipt or use of the principal; or
  - At the direction of a distribution adviser who is acting either in such adviser's discretion or pursuant to a standard that governs the distribution of principal and does not confer upon the grantor a substantially unfettered right to the receipt or use of principal.
- The grantor's right to remove a trustee or adviser and to appoint a new trustee or adviser;
- The grantor's right to serve as the investment adviser for the trust;
- The grantor's potential or actual use of real property held under a qualified personal residence trust;
- The grantor's potential or actual receipt of income or principal to pay income taxes due on the income of the trust if the trust agreement so provides and the grantor's receipt is subject to the trustee's discretion or the direction of a distribution adviser;
- The grantor's right to direct payment of taxes due on income attributable to the grantor's reservation of a lifetime power of appointment; and
- The grantor's right to have the trustee, acting either pursuant to direction, discretion or the grantor's exercise of a testamentary power of appointment, pay the grantor's outstanding debts at the time of the grantor's death, the expenses of administering the grantor's estate or any estate or inheritance tax imposed on or with respect to the grantor's estate. This last option permits the grantor to retain a general power of appointment over the trust, exercisable in favor of his or her creditors.

- **Prohibited Grantor Powers.** Although the QDTA permits the grantor to retain many interests and powers, it does prohibit the grantor from retaining certain powers:
  - The power to serve as trustee of the trust;
  - The power to serve as a distribution adviser for the trust;
  - The power to serve as a trust protector for the trust;
  - The power to direct distributions from the trust; and
  - The power to demand a return of assets transferred to the trust.

### THE "TAIL PERIOD" FOR CREDITOR CLAIMS

Upon the transfer of assets to a Delaware trustee, the QDTA begins a limited "tail period" during which the grantor's creditors have the right to have their claims satisfied from the assets of the trust, but only if a creditor can prove by clear and convincing evidence that the grantor's transfer was fraudulent within the meaning of the QDTA. The length of the tail period will depend upon whether a particular creditor's claim was a future claim (i.e., one that was not already in existence when the transfer occurred), or an existing claim whose inception predated the transfer. A creditor holding a future claim has a four year tail period during which it can assert its claim of a fraudulent transfer.[28]

**Creditors have a "tail period" during which their claims may be satisfied from trust assets — but only if it can be proven that the grantor's transfer was fraudulent.**

For existing creditors, the tail period runs until the later of four years from the time of the transfer or one year from the time the creditor could reasonably have discovered the existence of the trust.[29]

After the applicable tail period expires, the QDTA does not permit any action to enforce a claim against a Delaware asset protection trust. Each transfer to the same trust will have its own tail period. In this fashion, a subsequent transfer will not cause the tail period to begin anew for an earlier transfer. Conversely, a small initial transfer for which the tail period has expired will not immediately safeguard new transfers to the same trust.

The tail period incorporates a "tacking" provision that recognizes the earlier formation of a self-settled spendthrift trust that is transferred to a Delaware trustee.[30] Thus, a trust established under foreign law and later transferred to Delaware will have its tail period begin with the funding of the foreign trust. The practical effect of the tacking provision is to substantially shorten the tail period of a Delaware trust resulting from a trustee to trustee transfer. And, tacking also applies for a distribution that results from the decanting of an existing asset protection trust.[31] Thus, it is possible to decant an existing asset protection trust into a different asset protection trust and tack the tail period of the original trust.

### EXEMPT CLASSES OF CREDITORS

The QDTA establishes two classes of "creditors" who are not subject to having their claims extinguished at the expiration of the tail period and who do not have to prove that the grantor's transfer was fraudulent. They are as follows:

- **Spouses and Children.** A spouse or child with a claim for unpaid alimony, child support or a share of marital property incident to a separation or divorce proceeding can satisfy its claim out of trust assets irrespective of the time or the circumstances under which the transfer to the trust occurred.[32] It is significant, however, that § 3570(9) of the QDTA limits a "spouse" to a person who was married to the grantor on or before the transfer to the trust.[33] This means that pre-marital transfers to a Delaware trust are not subject to the spousal exemption and can serve as a substitute for a prenuptial agreement.[34]

- **Personal Injury Claimants.** A person with a claim for death, personal injury or property damage that predates a transfer to a Delaware trust may satisfy its claim out of trust assets if the claim arose out of the grantor's act or omission or the act or omission of someone for whom the grantor is vicariously liable.[35]

### THE EFFECT OF FRAUDULENT TRANSFERS

Just as the QDTA imposes different tail periods on existing creditors and future creditors, it also establishes different standards that each creditor must meet in order to prove a fraudulent transfer.

A future creditor may establish a fraudulent transfer only if the grantor made the transfer with actual intent to defraud that particular creditor.[36] The standard of actual fraud applicable to a future creditor is subjective in nature and considers "badges of fraud," which are factual circumstances that are suggestive of the grantor's intent to defraud a creditor. As listed in the Delaware version of the Uniform Fraudulent Transfers Act, the "badges of fraud" include:

- whether the grantor is already in litigation or is threatened with litigation;

- whether the grantor retained effective control over the assets;

- whether the grantor transferred substantially all of his or her assets to the trust; and

- whether the grantor transferred the assets shortly before or after incurring a substantial debt.[37]

The essence of the analysis of actual fraud is whether the grantor could reasonably have anticipated the particular future creditor's claim at the time of the funding of the trust.

An existing creditor may establish a fraudulent transfer on several grounds under 6 *Del. C.* §§ 1304 and 1305. A transfer is fraudulent as to an existing creditor if the grantor did not receive reasonably equivalent value in exchange for the transfer and (i) the grantor was engaged in a transaction for which his or her remaining assets were unreasonably small, (ii) the grantor intended to incur (or believed he would incur) debts beyond his or her ability to repay, or (iii) the grantor was insolvent at the time of the transfer or the transfer rendered the grantor insolvent. In addition to these "capital sufficiency" and "balance sheet" tests, an existing creditor may rely on the standard of actual intent to defraud available to a future creditor.

A creditor that successfully challenges a transfer to a Delaware trust is entitled to recover its claim plus any costs and attorneys' fees allowed by the court. Importantly, the presence of a fraudulent transfer with respect to one creditor will not invalidate the trust as to all creditors. Rather, each creditor must demonstrate that the grantor's transfer was fraudulent in the context of that creditor's circumstances.

If the assets of a trust are not sufficient to satisfy a creditor's claim, the creditor has a limited right to proceed against trust beneficiaries to recover prior distributions. A trust beneficiary who has not acted in bad faith has the right to retain distributions resulting from the Delaware trustee's exercise of its discretion or trust powers prior to the creditor's

commencement of an action to avoid the grantor's transfer to the trust. In addition, unless a creditor can demonstrate that the trustee has acted in bad faith, the creditor's claim is subject to the trustee's prior lien for the costs and expenses it incurred in defending the trust against the creditor's claim.

## THE EFFECTIVENESS OF DELAWARE ASSET PROTECTION TRUSTS

### Full Faith and Credit

A frequent criticism of domestic asset protection trusts is that they are susceptible to the argument that the Full Faith and Credit Clause of the U.S. Constitution compels the home jurisdiction of such trusts to recognize and enforce foreign judgments.[38] That is, if a creditor seeks to avoid a transfer to a Delaware trust but is unable to prove a fraudulent transfer or does not assert its claim within the tail period, the argument goes, the Delaware courts will still have to enforce the creditor's foreign judgment against the trust.

Delaware has already had one experience with a party invoking the Full Faith and Credit Clause in seeking to enforce a foreign judgment that invalidated a Delaware trust. In *Lewis v. Hanson*, the beneficiaries of a Delaware trust brought an action in Florida challenging their mother's exercise of a power of appointment that arose under her trust.[39] The Florida Supreme Court held that the plaintiffs' mother had failed to exercise her power because it did not satisfy Florida's standards for a testamentary disposition. Since the Delaware trustee had not been a party to the Florida litigation, the children sought the aid of the Delaware courts to enforce the Florida order against the Delaware trustee. In finding a valid exercise of the donee's power of appointment under the trust, the Delaware Supreme Court refused to enforce the Florida judgment, on the basis that Delaware trusts are under the exclusive supervision of Delaware courts. It stated:

To give effect to the Florida judgment would be to permit a sister state to subject a Delaware trust and a Delaware trustee to a rule of law diametrically opposed to the Delaware law. It is our duty to apply Delaware law to controversies involving property located in Delaware and not relinquish that duty to courts of a state having at best only a shadowy pretense of jurisdiction.[40]

Thus, there is basis to believe that Delaware courts will not honor foreign judgments against Delaware trusts.

### Jurisdiction Over a Delaware Trustee

There is always a risk, of course, that a creditor will try to avoid bringing its claim against the trust in a Delaware court, on account of its reluctance to enforce foreign judgments that purport to determine the validity and enforceability of a Delaware trust. If the creditor can manage to obtain long-arm jurisdiction over a Delaware trustee and compel it to appear in a foreign court, the Delaware trustee may be faced with a court order declaring the trust to be governed by the law of the forum state, under whose law the self-settled trust is invalid, and ordering the trustee to satisfy the creditor's claim from the trust assets. No trustee would likely defy the foreign court's mandatory order to release trust assets, at the peril of being found in contempt of a court that asserts personal jurisdiction over the trustee.

To avoid those compulsory circumstances, § 3572(g) of the QDTA strips a Delaware trustee of its authority to transfer assets to a creditor, or take any action other than to deliver the assets to a successor Delaware trustee, if a foreign court refuses to apply Delaware law to determine the validity, construction or administration of a Delaware trust. Instead, the Delaware trustee is removed from office, with the sole duty of transferring the trust assets to a successor trustee.[41] The selection of the successor trustee is determined under the terms of the trust agreement or, if the agreement is silent, by the Delaware Court of Chancery.

### Protection in Bankruptcy

The 2005 amendments to the federal bankruptcy code may lend support to the domestic asset protection trust as a planning device. Bankruptcy code § 541(c)(2) excludes from a debtor's bankruptcy estate a debtor's beneficial interest in a trust if that interest is subject to transfer restrictions enforceable under applicable nonbankruptcy law. Under this provision, a debtor's beneficial interest in a traditional spendthrift trust should be protected from adjudication in bankruptcy, because the debtor does not have the authority under state law to transfer any interest in the trust.[42] The same provision of the bankruptcy code also serves as the basis for excluding a debtor's interest in ERISA-qualified retirement plans from the bankruptcy estate.[43] In short, the effect of § 541(c)(2) is to put the debtor's excluded assets beyond the jurisdiction of the bankruptcy court to order a distribution in favor of the debtor's creditors.

It has long been the opinion of attorneys practicing in the asset protection field that § 541(c)(2) likely encompasses self-settled spendthrift trusts. Indeed, a debtor's reliance on a self-settled spendthrift trust is no different than the use of an ERISA-qualified retirement plan to shelter assets from the reach of creditors while at the same time retaining a beneficial interest in, and some control over, the assets. If the ERISA assets are excluded from a debtor's bankruptcy estate, there is no meaningful reason not to give similar treatment to the assets of a self-settled trust under Delaware law. And, in case a bankruptcy court had any doubt about whether a debtor's interest in a QDTA trust is transfer-restricted, the QDTA is explicit in its meaning that the spendthrift provision of a self-settled Delaware trust is a restriction on a transfer of the grantor's beneficial interest in his or her self-settled trust, within the meaning of § 541(c)(2) of the bankruptcy code.[44]

The bankruptcy code does not protect fraudulent prepetition transfers to self-settled trusts, and this bolsters the argument that self-settled trusts are protected from creditors in bankruptcy. Bankruptcy code § 548(e) authorizes the bankruptcy trustee to avoid any transfer to a self-settled trust or similar device made within ten years of the filing of the bankruptcy petition if the debtor transferred the property to the trust with actual intent to hinder, delay or defraud creditors. If self-settled trusts were not protected from creditors under § 541(c)(2), Congress would not have needed to carve out fraudulent transfers to self-settled trusts. Thus, to avoid the conclusion that § 548(e) is superfluous, principles of statutory construction should indicate that not only are traditional spendthrift trusts and qualified retirement plans protected in bankruptcy, but also that self-settled trusts are excluded from the grantor's bankruptcy estate (absent the grantor's fraud).

### Federal Tax Liens

A 2008 addition to Delaware's trust statutes, in 12 *Del. C.* § 3315(b), increases the potential that a purely discretionary trust established under the QDTA should not be subject to federal tax liens for the grantor's tax liabilities, at least those tax liabilities assessed after the funding of a trust. Section 3315(b) specifies that if a beneficiary has a discretionary interest in a trust, a creditor may not directly or indirectly compel a distribution from the trust. Such a discretionary interest should not be subject to a creditor's foreclosure action or any legal or equitable remedy by a creditor.

The federal tax lien statute, IRC § 6321, authorizes a lien for unpaid taxes in favor of the United States against "all property and rights to property, whether real or personal, belonging to such [taxpayer]." A grantor's interest in a trust arises, if at all, under state law, and if applicable state law denies the grantor a property interest in a trust, there is nothing in the trust to which a federal tax lien can attach. In the words of the U.S. Supreme Court,

> *The threshold question in this case, as in all cases where the Federal Government asserts its tax lien, is whether and to what extent the taxpayer had "property" or "rights to property" to which the tax lien could attach. In answering that question, both federal and state courts must look to state law, for it has long been the rule that "in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property sought to be reached by the statute."*[45]

Thus, if a client establishes an asset protection trust in which he or she has retained only the right to income and principal in the sole discretion of the trustee, Delaware law seems to disavow the existence of an enforceable property interest to which a federal tax lien could attach. Without an attachable interest, the IRS would be left to its remedy under the QDTA as a general creditor, by filing a claim to set aside the transfer to the trust as a fraudulent transfer.

### Tenancy By The Entirety Trusts

The QDTA provides that tenancy by the entirety ("TBE") property transferred into an irrevocable trust, including an asset protection trust, shall retain its TBE character until the death of the first grantor.[46] Depending on the circumstances, there can be benefits of transferring TBE property to an asset protection trust. First, creditors of both grantors have the additional hurdle of proving that the grantors fraudulently transferred assets to the trust before reaching the TBE property. Second, if a creditor of one grantor successfully reaches the assets of the trust, the sole remedy is an order directing the trustee to transfer the property to the co-grantors as TBE property. Accordingly, the TBE property should still be protected from the creditors of the one grantor even if the creditor proves a fraudulent transfer. When the first spouse dies, the TBE character of the property is destroyed and the creditor of the other spouse can then reach the property. If the TBE property is held in trust when the first grantor dies, the creditor still will have to prove a fraudulent transfer to reach the property or may be barred from reaching the property if the applicable tail period has passed.

## FEDERAL TAX CONSEQUENCES

### Federal Income Tax

If the grantor of an asset protection trust retains the right to receive distributions of income and principal, the trust will be treated as a grantor trust for purposes of federal income tax.[47] As a result, the trust is disregarded and the grantor is considered the owner of all of the trust's income and deductions. However, if an adverse party (such as a member of a sprinkle class of beneficiaries) must approve all distributions of income and principal to the grantor and the grantor's spouse, the trust should be a non-grantor trust and the grantor should not have a tax liability for the trust's undistributed income. Such a non-grantor trust may also avoid state fiduciary income tax. For a discussion of state fiduciary income tax savings, see page 8.

### Federal Gift Tax

If, as in many states, the law governing a self-settled trust allows the grantor's creditors to reach the assets of the trust, the grantor is deemed to have retained dominion and control over the trust assets because the grantor may relegate his or her creditors to the assets of the trust.[48] As a result, the transfer of assets to the trust will result in an incomplete gift. If, on the other hand, the law governing the self-settled trust does not allow the grantor's creditors to reach the assets of the trust, the transfer of assets to the trust may result in a completed gift.[49] This is the case for a Delaware asset protection trust. Accordingly, the gift tax consequences of a grantor's transfer of assets to an irrevocable asset protection trust will turn on the nature of the grantor's retained interests in, and powers over, the trust. If the grantor relinquishes control over the assets and retains no interest other than the right to receive distributions of income and principal in the sole discretion of the trustee, the grantor likely will have made a completed gift of the assets. However, if the grantor retains other rights or powers, such as a limited power of appointment over the assets, the transfer to the trust probably will not be a completed gift.[50]

### Federal Estate Tax

Generally, assets transferred to a self-settled trust will be included in the grantor's estate so long as the grantor's creditors can reach the trust assets to satisfy the obligations of the grantor.[51] The passage of self-settled asset protection legislation, however, resulted in the possibility for a grantor to make a completed gift to an asset protection trust and have the assets transferred to the trust excluded from the grantor's estate. If under the law governing the trust, the grantor's creditors do not have the ability to satisfy the obligations of the grantor from the assets of the trust, it follows that the grantor does not retain the right to possess or enjoy the property and, therefore, the trust assets should not be included in the grantor's estate under IRC § 2036(a)(1). The IRS has ruled privately that a trustee's discretionary authority to distribute income and/or principal to the grantor does not, by itself, cause the assets of the trust to be included in the grantor's estate.[52] However, the trustee's discretionary authority to distribute income and/or principal to the grantor, when combined with other factors, such as an understanding or pre-arrangement with the trustee to permit distributions, may cause the assets of the trust to be included in the grantor's estate.[53]

Some commentators argue that assets transferred to an asset protection trust governed by the law of a jurisdiction that permits certain classes of creditors, such as a spouse, to reach the assets of the trust will not be excluded from the grantor's estate. As discussed above, the QDTA permits a spouse (who was married to the grantor at the time of the transfer of the assets to the trust) or child to bring a claim for unpaid alimony, child support or a share of marital property in connection with a separation or divorce proceeding. It is reasonable to ask whether the assets in the self-settled asset protection trust will be included in the grantor's estate by virtue of the fact that spouses and children can reach the assets in the event of divorce. However, the doctrine of "acts of independent significance" would indicate that the assets would not be included in the grantor's estate. Relying on the acts of independent significance doctrine, the IRS has ruled that a trust provision allowing a wife to terminate the trust and receive all of the assets of the trust if she and her husband divorce does not cause the assets of the trust to be included in the wife's estate.[54] The act of divorcing a spouse is considered to be an act of independent significance, and a power over trust assets that is contingent upon a divorce does not amount to a power that would cause estate tax inclusion. Thus, the acts of independent significance doctrine appears to mitigate concern that a transfer of assets to a Delaware asset protection trust results in estate tax inclusion for the grantor.

Some grantors who want to use their increased estate tax exclusion amounts and remove assets from their estates, but who remain concerned that they might need access to trust assets in the future, have been using "springing" asset protection trusts to accomplish their objectives.

A springing asset protection trust is designed to comply with the requirements of the QDTA, but the grantor is not named as a discretionary beneficiary unless and until an independent trust protector exercises its authority to add the grantor as a discretionary beneficiary of the trust. Some practitioners take the position that this strategy alleviates any concern that the assets of the trust will be included in the grantor's estate because the grantor is not a discretionary beneficiary and may never be added as a discretionary beneficiary. In the event that the grantor experiences a financial emergency and needs to access the trust assets, the grantor may be added as a discretionary beneficiary and may request distribution of trust assets to address the financial concern. Proponents of this strategy argue that inclusion of the assets in the grantor's estate would be a secondary concern under these circumstances.

## DELAWARE INCOMPLETE NON-GRANTOR ("DING") TRUSTS

A client whose portfolio includes an asset with substantial unrealized gains or recurring ordinary income often is interested in planning devices that will minimize the state income tax consequences from the realization of such income, while allowing him or her to retain the economic benefit of the asset. Historically, clients have relied upon the disconnect between the federal income tax regime and the federal gift tax regime to create an irrevocable trust that eliminates the state income tax liability attributable to the asset while avoiding or deferring a gift for federal gift tax purposes. These have become known as "Incomplete Non-Grantor Trusts" or "ING" trusts. In Delaware, as mentioned above, these trusts are known as Delaware Incomplete Non-Grantor Trusts or "DING" trusts.

As of the date of this paper, pursuant to Rev. Proc. 2021-3 Incomplete Non-grantor Trusts have been placed on the no ruling list for 2021 by the Internal Revenue Service (the "IRS"). Thus at this time, the viability of creating and funding a DING is uncertain.

Prior to incomplete non-grantor trusts being placed on the no ruling list, over the past several years, private letter rulings from the IRS had confirmed that a client may rely on the law of any state that permits the creation of self-settled asset protection trusts to create a trust that "traps" income within the trust and does not pass such income through to the trust's grantor for income tax purposes. Such non-grantor trusts may be funded with contributions that are not taxable gifts for federal gift tax purposes.[55]

Crafting a DING trust agreement requires a bit of maneuvering between the income tax and gift tax provisions of the Internal Revenue Code (the "IRC"). The grantor must relinquish sufficient interest in, and control over, the trust so as to avoid grantor trust status for the trust, without surrendering so much interest and control that he or she will have made a completed gift upon funding the trust. In order to avoid grantor trust status, the trust agreement establishes a distribution committee comprised of other beneficiaries of the trust (i.e., "adverse parties" within the meaning of IRC § 672(a)), whose consent is required in order for the grantor or the grantor's spouse to receive discretionary distributions from the trust or for the trustee to accumulate income in the trust potentially subject to the grantor's testamentary limited power of appointment. The other beneficiaries are typically the grantor's parents, siblings, or adult children.

If the grantor retains a limited power of appointment over all of the trust property and the power of appointment is effective at the grantor's death, the transfer of assets into the trust will be incomplete for gift tax purposes until the earlier of the grantor's death or a distribution of trust assets to one of the other beneficiaries (but only as to such distributed assets).

State taxing authorities may attack obviously abusive transactions using DING trusts that are designed primarily to avoid the imposition of state income tax on a particular transaction, such as the disposition of a block of highly appreciated stock. Consequently, advisers should counsel their clients to avoid funding a DING trust with assets that are certain or even likely to be sold shortly after the creation of the trust. A DING trust can become even more vulnerable to attack if a sale of its principal asset were followed by a distribution back to the grantor of all, or a large portion, of the sale proceeds. The grantor's home state taxing authority could view such a transaction as a "sham" and might attack it on the basis of substance over form, assignment of income, or some similar theory that would effectively disregard the non-grantor trust and treat the grantor as the seller in fact.

Ideally, DING trusts should be created only with the intent to continue the trust at least for the lifetime of the grantor. Grantors should avoid transferring a portion of their assets to a trust that is so large that the grantor will need routine distributions from the trust to pay for living expenses. Optimally, for creditor protection as well as sound tax planning, advisers should generally recommend that their clients fund such trusts only with those assets that the client likely will never need to expend, absent extraordinary events.

A 2011 memorandum from the IRS caused some concern about the viability of the DING structure.[56] The IRS ruled that the donors made a completed gift of the beneficial term interest, notwithstanding that they retained a testamentary limited power of appointment. Some practitioners argue that the memorandum should not affect the DING strategy because the grantors were not discretionary beneficiaries. The practitioners argue that a grantor's retention of a beneficial interest along with a testamentary limited power of appointment should cause the transfer to be an incomplete gift as to the entire interest. Other practitioners, however, have decided to give the grantor the additional discretionary power to appoint assets of the trust among a class of beneficiaries subject to an ascertainable standard.

After several years, the IRS released another private letter ruling that addressed the income and gift tax consequences of ING trusts.[57] The trust agreement established a distribution committee. The committee included the grantor and his four sons acting in a non-fiduciary capacity, and it was authorized to make distributions of income and principal to the grantor and his issue by: (i) a majority vote of members with the written consent of the grantor; or (ii) the unanimous direction of the members excluding the grantor. In addition, the grantor acting in a non-fiduciary capacity retained the power to make distributions of principal to his issue for their health, maintenance, support and education. The power retained by the grantor to distribute principal to his issue is a power not seen in prior private letter rulings. The trust did not require that the distribution committee members be replaced, but did require that there be at least two "eligible individuals" (defined as adult issue of the grantor, a parent of minor issue of the grantor, and the legal guardian of minor issue of the grantor) acting as members of the distribution committee in addition to the grantor. If at any time fewer than two eligible individuals were able to serve as members, the distribution committee would cease to exist. In any event, the distribution committee would cease to exist at the grantor's death. The IRS determined that the grantor would not be treated as the owner of the trust under IRC §§ 673, 674, 676, or 677, and that none of the distribution committee members would be treated as owners of the trust under IRC § 678(a).

The grantor was deemed to have made an incomplete gift based on several retained powers. The grantor retained the power to consent to distributions to any beneficiary including himself with an affirmative vote by a majority of the distribution committee. The members of the distribution committee were considered to be "co-holders" of the power and not adverse parties with respect to the grantor as they ceased to act at the grantor's death and could not exercise any power in favor of themselves, their estates, their creditors, or the creditors of their estates.

The ruling expressly states: "The retention of this [consent] power causes the transfer of property to the Trust to be wholly incomplete for gift tax purposes." The grantor's sole power to distribute principal to his issue also resulted in an incomplete gift because he could change the interests of the beneficiaries. Finally, the grantor held a broad special testamentary power of appointment over the trust that caused the gift to be incomplete as to the remainder for gift tax purposes. It would not be advisable for a grantor to serve as a member of a distribution committee under a DING trust. A consent power coupled with a limited testamentary power of appointment retained by the grantor and careful drafting of the distribution committee structure should result in an incomplete gift in light of PLR 201310002.[58]

We can summarize subsequent rulings on ING trusts as follows. As indicated in the 2012 CCA as well as the 2013 and later private letter rulings, a testamentary power of appointment held by the grantor will only cause the remainder interest of the trust to be an incomplete gift for federal transfer tax purposes, with a value of zero under Chapter 14 of the IRC valuation rules. But, the term interest would still be a completed gift. The 2013 and later private letter rulings concluded that either the "grantor's sole power" or the "grantor's consent power" caused the transfer of property into a trust to be wholly incomplete for federal gift tax purposes. At the time of the 2013 private letter ruling, one difference between the Delaware statute, and the statute governing the ING in the ruling was the fact that the statute which governed the INGs in the ruling allows the grantor to have an inter vivos limited power of appointment. At the time of these rulings, the Delaware statute did not permit the grantor of a DING to have an inter vivos power of appointment, although it does now.[59] However, it would appear from the private letter rulings that either the "grantor's sole power" or the "grantor's consent power" are sufficient to cause the transfer to the trust to be an incomplete gift for federal transfer tax purposes.

Finally, under New York law, New York residents do not enjoy the state tax benefits of a DING. Effective January 1, 2014, any "ING" trust is treated as a grantor trust for New York state income tax purposes.[60] Thus, a New York grantor cannot establish a trust that is both an incomplete gift and a non-grantor trust. As of the writing of this paper, California has introduced similar legislation, although it has not yet become law.

*The following illustrates the potential tax savings:*

| THE CLIENT'S GOALS | ADVANTAGES OF THE DING TRUST |
|---|---|
| • The client is in the highest federal income tax bracket, resides in a high income tax rate jurisdiction and is sensitive to state and local tax burdens.<br>• The client is concerned about liability to future creditors.<br>• The client is eager to reduce state and local income tax burden.<br>• The client does not want to pay gift tax or use any of his or her lifetime gift tax exemption. | • As the grantor, the client could retain the right to receive distributions from the trust (subject to the consent of the distribution committee which is comprised of his or her adult children, who are also beneficiaries).<br>• The client has a safety net against the possibility of a major financial setback.<br>• The trust's income would not be subject to tax in the high income tax rate jurisdiction (provided there is no nexus to that state for the trust), and would not be subject to Delaware state income tax if the trust is for the benefit of non-Delaware residents only, which allows the trust property to increase in value unimpaired by such tax obligations.<br>• Trust assets would have creditor protection. |

## FREEDOM OF DISPOSITION

For a variety of reasons, a grantor may not want to disclose the existence of a trust to his or her beneficiaries because he or she fears that the knowledge of substantial wealth will destroy the incentive to lead a productive life or for other reasons. Whatever the grantor's motivation to keep a trust confidential, this desire runs counter to a trustee's common law duty to disclose to a beneficiary his or her interest in a discretionary trust.[61] But, Delaware law, in 12 *Del. C.* § 3303(a), permits a grantor to direct the trustee "for a period of time" not to fulfill its duty to inform the beneficiary of the beneficiary's interest in the trust. A grantor might choose, for example, to prohibit the trustee from disclosing the existence of the trust until the grantor's youngest child reaches, say, 25 years of age. Or, the trust could remain confidential for a term of years, until a specific date, or until a specific event that is certain to occur.[62] The grantor should appoint a "designated representative" who is authorized to receive trust information on behalf of the beneficiary but who is not obligated to disclose the information to the beneficiary.[63] Whatever the nature of the restriction a grantor imposes on the flow of information to beneficiaries, the grantor may direct nondisclosure to the beneficiaries as long as the expression of that intent is clear from the terms of the trust instrument and the restriction on disclosure ends within a defined period of time .

### AVOIDING POST-MORTEM CHALLENGES TO TRUSTS

Delaware law limits a person's ability to contest the validity of a trust if certain requirements are met. Under 12 *Del. C.* § 3546(a), a trustee is permitted to give a person notice of the existence of a trust. This notice starts a 120-day period for the person to contest the trust. The written notice must specify the trustee's name and address, whether the person is a beneficiary of the trust, and the time period the statute allows for bringing an action to contest the validity of the trust. Section 3546 effectively compels a dissenting person to mount a challenge to the validity of the trust while the grantor of the trust is still living and able to provide testimony to defeat allegations of incapacity or undue influence. The statute also forces the dissenting person to make the claim knowing that the grantor will be well aware of the claim. This statute may be very attractive to a client who wants to create a trust for the benefit of certain family members or charities , and who also wants the comfort of knowing that the family members will be precluded from challenging the trust after the grantor passes away. Section 3546 offers the grantor finality and certainty.[64]

Trust Act 2015 revised the statute to state that either mailing or delivering the notice to a person's last known address constitutes receipt, absent evidence to the contrary. The 2015 changes to the statute also added Sections 1311 and 1312 to Title 12 to create the same type of pre-mortem validation for wills and certain exercises of powers of appointment.

If a pre-mortem notice seems a bit extreme for a particular client, grantors still have the option to use a no-contest or "in terrorem" clause in a will or a trust.[65] An in terrorem clause is a provision that, if given effect, would reduce or eliminate the interest of any beneficiary of the will or trust who sues to contest the validity of the will or trust or to vary its terms. In terrorem clauses generally are enforceable under Delaware law, unless the court determines that a beneficiary who has brought an action has "prevailed substantially" in that action.[66]

### PURPOSE TRUSTS

At common law, a trust without definite beneficiaries, or at least readily identifiable beneficiaries, failed for lack of a proper object unless it qualified as a charitable trust.[67] The problem with such trusts was that without a certain class of beneficiaries, there was no one to enforce the trustee's duties under the trust agreement. In the case of a charitable trust, the power of enforcement resides in the attorney general, who has plenary authority to enforce a charitable trust within his or her jurisdiction.

A pair of Delaware statutes, *Del. C.* §§ 3555 and 3556, eliminate the common law rule prohibiting non-charitable purpose trusts. Section 3555 permits a client to establish a pet trust — a trust for the benefit of "specific animals" living at the time of the settlor's death. Section 3556 authorizes a client to create a trust for a declared non-charitable purpose that is "not impossible of attainment."

Sections 3555(c) and 3556(c) authorize a person appointed under the trust agreement (i.e., a trust protector) or, if there is no such person, the Court of Chancery to enforce a purpose trust. The same provisions also give standing to a person who has an interest (other than a general public interest) in the welfare of the designated animal or in the declared purpose of the trust to petition the Court of Chancery to appoint a protector or remove an existing protector.

Apart from the "lives in being" limit on a trust created to care for one or more animals in § 3555(a), there is no stated limit on the duration of a purpose trust. Since Delaware has repealed its rule against perpetuities, a Delaware purpose trust can exist indefinitely. Upon the termination of a purpose trust, whether by its terms, the fulfillment of its purpose or the depletion of its assets, any remaining assets are to be distributed under the terms of the trust agreement or, in the absence of any such direction, to the grantor's intestate heirs under Delaware law.

Trust Act 2017 amended the nonjudicial settlement agreement statute (discussed in next section) to provide that NJSAs may be used to modify charitable trusts and non-charitable purpose trusts.[68] The limitation is that an NJSA may not be used unless (a) the purpose of the trust has become unconstitutional under Delaware law, (b) the trust would no longer serve a charitable purpose unless it were amended, or (c) the grantor is a party to the NJSA.[69]

## METHODS FOR MODIFYING A TRUST IN DELAWARE

### DECANTING EXISTING TRUSTS

Beginning with New York State in 1992, more than 30 states have adopted legislation to allow trustees with discretion to distribute trust principal to appoint some or all of such principal in favor of another trust. This process is known as "decanting" a trust, and it offers trustees the ability to modify terms of an irrevocable trust. Delaware's decanting statute, 12 *Del. C.* § 3528, was first enacted in 2003. Under the statute, a trustee who has authority to make distributions out of principal may instead exercise such authority by appointing all or part of the principal in favor of a trustee of a second trust. The second trust can be a new trust, or, thanks to an amendment that the General Assembly enacted in 2017, the second trust can be a modified version of the original trust.[70] But, in order to decant a trust under § 3528, the trustee must also satisfy the following conditions:

1. The trustee must exercise the decanting authority in favor of a receptacle trust having only beneficiaries who are "proper objects" of the exercise of the power (i.e., the second trust may narrow or limit the permissible beneficiaries of the first trust, but it may not add beneficiaries who were not already "proper objects" of the first trust);

2. If the first trust qualifies for treatment as a minor's trust under IRC § 2503(c), the beneficiary's remainder interest in the second trust must vest and become distributable no later than the date upon which such interest would have matured under the first trust;

3. The trustee's exercise of decanting authority cannot reduce any income interest of any income beneficiary of a trust for which a marital deduction is taken under IRC § 2056 or § 2523 or comparable state law;

4. The trustee's exercise of decanting authority cannot apply to assets subject to a beneficiary's presently exercisable power of withdrawal if that beneficiary is the only person to whom, or for the benefit of whom, the trustee has authority to make distributions; and

5. The trustee's exercise of such authority shall comply with any standard that limits the trustee's authority to make distributions from the first trust. The process of decanting may be useful anytime an irrevocable trust agreement does not readily permit modifications under the authority of the trustee or a trust protector. Those modifications might include:

- Changing the law governing the administration of the trust to the law of a more favorable state;
- Dividing an existing trust to achieve tax benefits, such as maximizing GST-exempt assets;
- Transferring the situs of a complex trust from a high income tax state to one without an income tax on fiduciary income;
- Converting a non-grantor trust into a grantor trust or a grantor trust to a non-grantor trust for fiduciary income tax purposes; and
- Modernizing a trust's governance procedure by appointing trust advisers and protectors.

A Delaware trustee has significant latitude to decant a trust, even if the trustee's ability to make distributions is limited to an ascertainable standard. The Delaware decanting statute says that if the trustee has the power to distribute the principal or income (or both) of the first trust, then it can decant all or part of the principal or income (or both) to a second trust, as long as: (i) the second trust is for the benefit of one or more proper objects of the exercise of the trustee's power; and (ii) the exercise of a trustee's decanting authority complies in all respects with any standard that limits the trustee's authority to make distributions from the first trust. These rules set Delaware apart from other states that say that a trustee can only decant if it has unlimited rights to invade principal, or that a trustee can only decant income if the trustee has first accumulated the income and added it to principal. And, unlike some other states, the Delaware decanting statute does not require notice to, or consent from, the beneficiaries before the decanting becomes effective. Thus, a trustee with sufficient discretion to invade principal or pay income can enhance the benefits of an existing trust through judicious reliance on Delaware's decanting statute.

Prior to Trust Act 2018, the statute required the trustee to file a written statement of decanting in the trust files. The 2018 amendment removes this requirement to file the document in the trust files, although a written document is still required. In practice this writing is sometimes referred to as an invasion document or a decanting document.

## NON-JUDICIAL SETTLEMENT AGREEMENT STATUTE

As noted earlier in this piece, in 2013 Delaware enacted an NJSA statute that provides a method for the "interested persons" of a trust to resolve matters regarding the administration of a trust without judicial involvement.[71] This statute is substantially similar to the NJSA statute found in the Uniform Trust Code. However, unlike the Uniform Trust Code version, the Delaware statute provides that any interested person may bring a proceeding in the Court of Chancery to interpret, apply, enforce, or determine the validity of a nonjudicial settlement agreement.[72] The statute defines interested persons as those persons whose consent would be necessary to achieve a binding settlement if the settlement were approved by the Court of Chancery. The rules of the Court of Chancery provide that such persons include, but are not limited to the following: (i) trustees and other fiduciaries; (ii) trust beneficiaries (including remaindermen) with a present interest in the trust or whose interest would vest if the trust terminated currently, or if the agreement changes any beneficial interests, all beneficiaries are necessary parties, not just beneficiaries who would take currently if the trust were to terminate (so conceivably there could be remaindermen who whose interest would not vest if the trust terminated currently, but would only vest upon a certain condition or specific event, and these parties would be necessary persons to the NJSA if beneficial interests are being changed); (iii) the grantor, if living; and (iv) all other persons having an interest in the trust pursuant to the express terms of the trust instrument, such as holders of powers and persons with other rights held in a non-fiduciary capacity.[73] The statute provides that interested persons may enter into a binding nonjudicial agreement with respect to any matter involving a trust, provided it does not violate a material purpose of the trust, and includes terms and conditions that could be properly approved by the Court of Chancery.[74]

Modeled after the Uniform Trust Code version of the NJSA, the Delaware statute provides a non-exclusive list of six matters that may be resolved by a nonjudicial settlement agreement. These include: (i) interpreting or construing the terms of a trust; (ii) approving the report or accounting of a trustee; (iii) directing a trustee to refrain from exercising a power or granting a power to a trustee; (iv) resignation, appointment, or determination of compensation of a trustee; (v) transferring the principal place of administration of a trust; and (vi) determining the liability of a trustee for an action relating to the trust.[75] As noted, this statute was based on the Uniform Trust Code, and comments to the Uniform Trust Code indicate

that this list is a "non-exclusive list." This is of note since the list does not include an enumeration that the NJSA may be used to modify a trust. Historically, there were differing opinions among Delaware practitioners as to whether an NJSA could be used to modify a trust, or whether modifying a trust "violates a material purpose" of the trust.[76] When the grantor is alive and an interested person to the NJSA, it is generally believed that modifying the trust is not a material violation of the trust as the grantor is available to state his or her intention as to the material purpose of the trust.

Trust Act 2016 was enacted to amend the NJSA statute. The 2016 amendment was designed to remove some of the uncertainty around the NJSA statute described in the preceding paragraph. The 2016 amendment eliminates the restriction that an NJSA may only include terms and conditions that could be properly brought before the Court of Chancery, and provides that if the NJSA involves a trust whose grantor is living and a necessary party to the NJSA, the NJSA may violate a material purpose of the trust.

Trust Act 2020 added a new requirement that when a grantor is a party to an NJSA, then unless the transfer in trust is an incomplete gift for federal gift tax purposes, the grantor may not represent and bind any beneficiary (as a Designated Representative of a confidential trust or through virtual representation) other than the grantor. The grantor, or a representative for the grantor, is required to confirm that the transfer to the trust was an incomplete gift for federal gift tax purposes. This provision is intended to address the concern that a grantor representing and binding beneficiaries when beneficial interests are being changed could have adverse transfer tax consequences due to the grantor having a retained power over the trust.

As noted under the discussion of Purpose Trusts, the Delaware NJSA statute provides that an NJSA may be used with charitable trusts and non-charitable purpose trusts. The limitation is that the NJSA statute may not be used to change the trust's purpose unless the trust has become unlawful under the Delaware Constitution or no longer serves any religious, charitable, scientific, literary, educational, or non-charitable purpose (although these restrictions do not apply if the grantor is a party to the agreement).

The NJSA statute expressly provides that the removal of a trustee is included in the list of matters that may be the subject of a nonjudicial settlement agreement.

### MODIFICATION OF TRUST BY CONSENT WHILE THE GRANTOR IS LIVING

Section 3342 of the Delaware statute provides for modification of a trust by consent while the grantor is living. This statute allows any trust to be modified while the grantor is living to include any provision, as long as that provision could be included in the trust instrument upon the date of the modification, and even if that modification would not have been permitted when the trust was created.

The statute provides that a grantor's power to participate in a trust's modification may be exercised by an agent under a power of attorney, to the extent that that power expressly authorizes the agent to do so, or to the extent that the agent is expressly authorized by the terms of the trust's governing agreement.[77] Alternatively, the guardian (or similar court appointed representative) of the grantor's property can authorize the trust's modification with the approval of the supervising court.[78] The statute also provides that a modification under the statute requires the participation of all grantors, if there is more than one grantor.

Trust Act 2018 modified this statute to make it clear that the statute can be used to modify existing provisions and add new provisions, so long as such provisions could have been included in the governing instrument if the trust were created upon the date of the modification. Prior to this amendment it was not clear that the statute could be used to modify existing provisions.

Similar to the NJSA statute, unless the transfer in trust is an incomplete gift for federal gift tax purposes, the grantor may not represent and bind any beneficiary (as a Designated Representative of a confidential trust or through virtual representation) other than the grantor. The grantor, or a representative for the grantor, is required to confirm that the transfer to the trust was an incomplete gift for federal gift tax purposes. This provision is intended to address the concern that a grantor representing and binding beneficiaries when beneficial interests are being changed could have adverse transfer tax consequences due to the grantor having a retained power over the trust.

### DELAWARE'S MERGER STATUTE

In addition to decanting, and the use of an NJSA, another method of potentially modifying a trust is the use of Delaware's merger statute, 12 *Del. C.* § 3325(29).[79] Although this provision has long been one of several powers listed in the specific powers granted to trustees under the Delaware statute, this provision has gained additional utility in recent

years, especially when decanting is not an option because the trustee lacks specific discretionary authority to distribute principal. The merger statute is often used in a manner similar to a decanting, where a new trust is created and the original trust is merged into the new trust.

Delaware's merger statute gives a trustee the power to merge any two or more trusts, whether or not created by the same grantor, as long as the merger does not result in a material change in the beneficial interests of the trust beneficiaries. The statute does not require that the trusts that are being merged be created under the same instrument, or even by the same grantor. The statute does not define what constitutes a material change in the beneficial interests of trust beneficiaries. However, most practitioners in Delaware feel that as long as the resulting change is only administrative, such as adding an investment adviser, there is not a material change in the beneficial interests. Thus, in recent years, for administrative changes such as adding an investment adviser or updating investment language, the merger statute has become an alternative to decanting, or the use of an NJSA.

The merger statute was amended in 2015 to reflect its increased usage. The statute was revised to expressly provide that the power to merge trusts is available when one of the trusts was created in order to participate in the trust merger, and to provide that a trustee has the power to declare trusts for the purpose of merging existing trusts with that new trust. The changes also provide that the power to declare trusts and merge trusts exists even if one or both of the trusts is not funded prior to the merger. This is important because it clarifies that the trust merger statute can be used to modify a trust, even if it is necessary to create a new trust that is not funded prior to the merger.

In addition to the requirement that the merger must not result in a material change in the beneficial interests of the trust beneficiaries, there are a number of other important considerations for a merger. If a trust is being moved from another state and is being modified as part of that move, advisers must examine the application (if any) of the other state's merger statute. Additionally, any merger provision contained within the trust instrument must be considered. And, under Section 3341 of the Delaware statute, a "merger" includes any transaction in which all of the property of a trust is transferred to another trust, such as a decanting. This means that the attributes and obligations of the transferor trust carry to the transferee trust. In short, even with these considerations, the Delaware merger rules can be a helpful way to make administrative changes to a trust.

Trust Act 2018 amended the merger statute by modifying subsection (5). The purpose of this modification is to prevent a donee of a power of appointment from inadvertently losing a power of appointment as a result of a merger or other type of modification, unless that is the intended result. This subsection now provides that, "In cases where the initial funding of the transferee trust occurs prior to the merger, any power of appointment exercisable over property of either trust participating in the merger shall, following the merger, be exercisable over property of the transferee trust only to the extent expressly provided by the terms of the instrument of merger or other written documents effecting the merger; provided, however, that if any person holds substantially identical powers of appointment over all of the property of each trust participating in the merger, such person's power of appointment over the property of the transferee trust shall be exercisable over all of the property of the transferee trust following the merger unless the instrument of merger or other written document effecting the merger expressly provides otherwise."

### Authority to Allocate Trustee Duties Among Multiple Trustees

Delaware statute, 12 *Del. C.* §3343 is another tool that could be used to modify irrevocable trusts rather than using other modification techniques such as decanting, merger, or a non-judicial settlement agreement where the desired modification solely addresses powers of the trustee. It provides an alternate method to create a bifurcated trustee role in an existing trust, without having to utilize a decanting, merger, or NJSA process. The statute provides that any fiduciary who has the power to appoint a successor trustee has the power to appoint multiple successor trustees and additional trustees. Notably, this appointment power includes the power to allocate various trustee powers "exclusively to 1 or some of the trustees serving from time to time." Pursuant to section 3343(c) and in accordance with section 3313A, a trustee to whom powers are exclusively allocated under this section is a fiduciary only with respect to the powers that are allocated. The statute makes clear that the other/remaining trustees who were not allocated such power have no liability for, and no duty to monitor, the actions of the trustee to whom those powers, duties, and responsibilities were allocated. The statute was amended in 2020 to clarify that this statute can be used to give a trustee the power to direct another trustee. Although the statute as enacted permitted this, it was not entirely clear from the original language of the statute. The statute also clearly states that if one trustee directs another trustee, the directed trustee will not be subject to liability unless the directed trustee acts with willful misconduct. It further states that if the powers are

truly bifurcated with the one trustee not having certain powers, the trustee that does not have those powers is an "excluded trustee" and will not be subject to liability with regard to those powers.

Therefore, advisers and fiduciaries might now consider using section 3343 (in concert with section 3301(e) and section 3313A) to specifically allocate powers and duties among different trustees, limit liability, avoid the need for a full decanting, but still obtain all the benefits of a decanting.

### THE CONSENT PETITION PROCESS IN THE DELAWARE COURT OF CHANCERY

Historically, the Delaware Court of Chancery allowed "consent petitions" for the purpose of reforming irrevocable trusts. If all of the interested parties to the trust agreed, the trust could be reformed for a proper purpose.

On June 2, 2010, the Court entered a standing order formalizing the longstanding procedure for filing consent petitions in the Court of Chancery. On October 31, 2012, the Court of Chancery entered a standing order amending the rules governing the consent procedure process. This standing order increased the requirements for a successful consent petition and indicated the Chancery Court's desire to look more closely at the overall procedure.

In December 2012, the Court of Chancery continued its increased scrutiny of the consent petition process in its opinions in the *Peierls* matter.[80] In these decisions, the court questioned whether a family of related trusts could be transferred to Delaware and modified through the consent petition process. The rulings were appealed to the Delaware Supreme Court, which ruled on the Chancery Court's holdings on October 4, 2013.[81] The Delaware Supreme Court's opinions in *Peierls* provide a road map for the successful use of the consent petition procedure and set out the following guidelines:

1. Unless a choice of law provision in the trust specifically and expressly provides that another jurisdiction's laws shall always govern administration, Delaware law will govern the administration of any trust that allows the appointment of a successor trustee without geographic limitations, once the Delaware trustee is appointed and the trust is administered in Delaware;

2. While it is possible for the Delaware Court to have jurisdiction along with another state, if that other state has exercised primary supervision, such as court accountings for the trust, Delaware will not exercise jurisdiction over the trust until the other court has expressly relinquished primary supervision;

3. While historically Delaware trustees accepted their appointment contingent upon the modification of the trust, Delaware trustees must now accept their appointment before the Delaware Court will accept jurisdiction. Thus, the practice of accepting an appointment contingent on the modification of a trust is no longer in existence;

4. Whereas the consent petition process referred to the "reformation" of a trust, the actual effect is now a modification of a trust, since a reformation is used only where there is a mistake by all parties during the creation of the trust, and not merely where the parties are requesting a subsequent change to the trust; and

5. The Court of Chancery will not issue advisory opinions, in that it will no longer enter an order regarding any matter that could be accomplished without court approval, such as the appointment of a successor trustee where such a provision is contained in the trust.

On balance, although the Court of Chancery opinions initially cast doubt on the viability of the consent petition process, the Delaware Supreme Court decision in *Peierls* validated the process and provided a road map for utilizing the process successfully.

In 2015, Section 3332 of the Delaware statute was modified to codify and expand on the *Peierls* decision. The revised statute provides that when a trust is transferred to Delaware from another jurisdiction, Delaware law will govern the administration of the trust while the trust is administered in Delaware, with certain exceptions. The exceptions are where the trust instrument expressly provides either: (i) that the laws of another jurisdiction govern the administration of the trust (more than just a general choice of law provision in the trust); or (ii) that the laws governing the administration of the trust will not change due to a change in the place of administration of the trust.

In June 2015, the Court of Chancery issued an order in the *Flint* case, which established an additional test for the judicial modification of trusts.[82] The new test requires the court to consider the grantor's intent as part of the modification process. In the *Flint* matter, the petitioner was seeking an order to modify the trust to clarify the governing law of the trust and to add an investment adviser. The court declined to

determine the governing law because it felt the language of the proposed modification was too vague to be implemented. More importantly, the court did not grant the order to add an investment adviser, stating that modifying a trust requires the court to consider the grantor's intent, and the grantor was no longer alive. This appears to add a new "grantor intent" test to the consent petition process.

## PROCEDURAL MATTERS

### VIRTUAL REPRESENTATION OF MINOR, UNBORN, AND OTHER BENEFICIARIES WHO CANNOT REPRESENT THEIR OWN INTERESTS

#### Background of Delaware's Virtual Representation Statute

Enacted in 2000, Delaware's virtual representation statute, Section 3547 of Title 12 of the Delaware Code, provides that a minor, an incapacitated person, unborn person, or a person whose identity is unknown or not reasonably ascertainable, may be represented and bound in judicial and nonjudicial matters by another person who has a substantially identical interest with respect to the matter at hand. However, this is limited in that the person can represent and bind another only to the extent there is no material conflict of interest with respect to the particular question or dispute, between the representative and the person being represented. Another limitation is that if a person is acquiring or increasing a fiduciary or nonfiduciary role as part of the particular question or dispute for which representation is being sought, that person cannot represent and bind others as this is deemed to be a material conflict. For example, if as part of a proceeding a person is becoming an investment adviser who will direct the trustee, that person cannot represent and bind others for that proceeding.

The parent or parents of a minor or incapacitated beneficiary may represent and bind the child, as long as neither parent has a material conflict of interest with the child with respect to the question or dispute that is the subject of the representation. The statute also provides the ability of the parent or parents to represent and bind unborn or unascertainable persons with an interest that is substantially identical to their child's interest.

A presumptive remainder beneficiary can represent and bind contingent successor remainder beneficiaries as long as there is no material conflict. As described on the next page, the Act provides new definitions that clarify this authority.

#### Changes to the Virtual Representation Statute under Trust Act 2018

An expansion of the parties who can represent and bind others is found in the new Subsection (c), which provides that "the holder of a general testamentary or inter vivos power of appointment — or a nongeneral testamentary or inter vivos power of appointment that is expressly exercisable in favor of any person or persons, excepting such holder, his or her estate, his or her creditors, or the creditors of his or her estate — may represent and bind persons whose interests, as takers in default, are subject to the power, but only to the extent that there is no material conflict of interest between the holder and the persons represented with respect to the particular question or dispute." This means that a holder of a power of appointment of any type, other than a power limited to a specific class, can serve as the representative. As a result, presumptive remainder beneficiaries, contingent successor remainder beneficiaries, and more remote beneficiaries can all be represented by a holder of a power of appointment as long as there is no material conflict of interest. As a result of this increase in the parties who can serve as a virtual representative, it is possible to represent and bind these beneficiaries without having a remainder beneficiary serving as a representative.

As noted above, the virtual representation statute allows a parent to represent and bind minor, incapacitated, and unborn children as long as there is no material conflict of interest between the parent and that child. Another expansion to this statute provided by the Act is that parents can now also represent and bind another minor, incapacitated, or unborn person who has an interest that is substantially identical to the parents' minor, incapacitated, or unborn child, provided there is no material conflict of interest between their child and the other minor, incapacitated, or unborn person. An example of where this could be useful is where a parent is becoming an investment adviser as part of the proceeding, and as noted above, the parent would not be able to serve as the virtual representative for his or her own children due to the deemed conflict of interest. However, if the class of beneficiaries included "descendants" and included nieces or nephews of that parent, assuming the niece or nephew has a substantially identical interest as the child of the parent who cannot serve in this role, the parent of the niece or nephew (the sibling of the conflicted parent) could serve as the virtual representative for all of the beneficiaries with the substantially identical interest, including the children of the parent who cannot serve in this role due to the deemed conflict.

A clarification of parties who can represent and bind others is found in new Subsection (g) which provides that "when a trust (the "beneficiary trust") is a beneficiary of another trust, the beneficiary trust shall be represented by its trustee or, if the beneficiary trust is not in existence, the beneficiary trust shall be represented by those persons who would be beneficiaries of the beneficiary trust if the beneficiary trust were then in existence."

Trust Act 2018 modified subsection (g) to augment the provisions concerning presumptive remainder beneficiaries, contingent successor remainder beneficiaries, and more remote beneficiaries. The Act provides definitions for contingent successor remainder beneficiaries and more remote beneficiaries, providing certainty to the way these terms have been interpreted in practice (presumptive remainder beneficiary was already defined). More importantly, the Act also revised subsection (b) to provide that contingent remainder beneficiaries may represent and bind more remote contingent successor remainder beneficiaries. As a result, in a situation where a presumptive remainder beneficiary is not able to represent and bind contingent successor remainder beneficiaries, for example if the presumptive remainder beneficiary is assuming a fiduciary or nonfiduciary role, a contingent successor remainder beneficiary can fill the role of virtual representative for more remote beneficiaries.

### ACTIONS AGAINST A TRUSTEE

Section 3585 of Title 12 places a limit on the time that a party may initiate a claim against a trustee. As originally enacted, the statute provided that a beneficiary may initiate a proceeding up to the earlier of two years after the beneficiary was sent a report that adequately disclosed the facts constituting a claim, or the date the proceeding was otherwise precluded by adjudication, release, consent, limitation or pursuant to the terms of the governing document. This is generally satisfied by trust statements showing the trust assets and transactions. This statute was amended in 2019 to make two significant changes. First, the statute was amended to provide that any person, no longer limited to beneficiaries, is subject to the time limit under the statute. Second, subsection (a)(1) shortens the time period to one year from two years. Although a useful provision for the orderly succession of events when a trustee will no longer be serving, there was uncertainty about what happens if the trustee is not able to wind up matters and stop serving within the 120-day period. In 2020 this statute was amended to provide that the outgoing trustee may rely on this statute even if the trustee will continue to serve for a reasonable period of time after the 120-day period. The trustee does remain liable for its actions and subject for surchargeable misconduct during the period it remains in office.

Section 3588, which is frequently used in conjunction with Section 3585, provides that if a beneficiary has consented to, ratified, or released a trustee from liability for a given matter, that beneficiary is precluded from bringing a cause of action against the trustee for that matter. This statute was also modified in 2019. The statute was modified to cover all persons, and is no longer limited to beneficiaries. In addition, indemnifications need not be supported by consideration, similar to consents and releases, which are not required to be supported by consideration.

### THE *MENNEN* CASE

This paper has covered various case law throughout the discussion of different topics. The *Mennen*[83] ruling addresses several important Delaware topics including the effect of 12 *Del. C.* § 3303(a), willful misconduct standard, virtual representation, and the effectiveness of a spendthrift provision in Delaware trusts. Given the breadth of topics addressed in the *Mennen* case, it is covered here as a separate topic.

In *Mennen*, the Delaware Court of Chancery found that an adviser with the power to direct the trustee on investment matters, within the meaning of § 3313, was liable for his breach of duties. This case was originally heard in 2014 by a Master in Chancery who issued a draft report in 2015 and a Final Report in April 2015. The Court of Chancery then issued an order formally adopting the Final Report. This ruling was affirmed by the Delaware Supreme Court in 2017. Ultimately, the judgment against the adviser was over $86 million, plus interest.

This case involves a Trust created in 1970, before § 3313 was enacted in 1986. George *Mennen* created a trust for the benefit of his son John, and John's descendants. George also created similar trusts for George's other children and their descendants. The trustees of John's trust were a corporate trustee and an individual co-trustee, John's brother Jeff. The individual co-trustee had the power under the trust instrument to direct the corporate trustee on certain investment matters. The beneficiaries of the trust, John and his children, alleged that Jeff directed the corporate trustee to invest substantially all of the trust's assets in various companies in which Jeff was personally involved as an investor, director, or officer — with a resulting decline in value from approximately $100 million to approximately $25 million. It should be noted that the

similar trusts created for the other children of George did not experience the same dramatic decrease in value. The beneficiaries brought a cause of action against both the corporate trustee and Jeff. The beneficiaries settled their claim with the corporate trustee for an undisclosed amount. They did not settle their claims against Jeff.

The case against Jeff was heard by a Master in Chancery, who issued a Draft Report in December 2014 entering a judgment against Jeff of approximately $72 million, plus interest. In that decision the Court found that Jeff had engaged in an extensive pattern of bad faith conduct.

The beneficiaries also brought a claim against the trust established by George for Jeff, asking for a transfer of assets from that trust on equitable grounds to be used to satisfy the amount of the judgment. In a landmark ruling upholding the enforceability of a spendthrift provision in a Delaware trust, this request was denied.[84]

In April 2015, the Master issued a Final Report which increased the judgment to $96,978,299.93, plus pre-judgment interest at a rate of 7.75%. In December 2015 a Vice Chancellor stated that the Court of Chancery expressly agreed with the analysis in the Master's Final Report and entered an order and final judgment against Jeff in the amount of $86,599,200.26 plus $18,387.50 per day in post-judgment interest. In June 2017 the Delaware Supreme Court upheld the final order entered by the Court of Chancery.

The Master's Report held that for the beneficiaries to prevail, they must prove that Jeff's actions were the result of his acting in bad faith or with willful misconduct. The trust instrument provided a "good faith" standard, and Delaware statute, 12 *Del. C.* § 3303(a), allows a trust instrument to exculpate a trustee for action other than willful misconduct. The trust instrument waived the duty to diversify the trust assets and allowed the trustee to engage in transactions that pose a conflict of interest for the trustee.

## SECTION 3303

As noted earlier on page 13 of this paper, 12 *Del. C.* § 3303(a) provides that a trust instrument can vary any laws of general application to fiduciaries, trusts and trust administration, including any laws pertaining to the circumstances in which the fiduciary must diversify investments. In addition § 3303(a) provides that the rule that statutes in derogation of the common law are to be strictly construed, shall have no application to the trust instrument and that it is the policy of § 3303(a) to give maximum effect to the principle of freedom of disposition and to the enforceability of the governing instrument.

The Master's Report began with an analysis of § 3303(a). The Master's Report stated, "That settlors are accorded wide latitude to structure their trusts in a manner that varies from the default statutory scheme or the common law is a hallmark of Delaware's Trust Act."[85] The Master's Report then cited portions of § 3303(a), and noted that under Delaware law and the terms of the trust agreement, the trustees' discretion was constrained in two important respects. First, § 3303(a) precludes a settlor from exculpating a trustee for willful misconduct. Second, the trust agreement required the trustees to exercise their authority in "good faith." The Master's Report noted that the beneficiaries argued that the trust instrument could not exculpate the trustee for decisions and actions that were grossly negligent. Their argument was based on the fact that § 3303(a) was revised in 2003 to allow a trust instrument to exculpate a trustee for any action except for willful misconduct, whereas before 2003 a trustee could not be exculpated for gross negligence or any lesser standard of liability. Since the trust instrument was created in 1970, the beneficiaries argued that at the time of the trust's creation a trustee could not be exculpated for gross negligence. In holding that the standard of liability could be willful misconduct, the Master's Report stated that, "Those revisions, adopted in 2003, permit a settlor to exculpate a trustee from liability for anything except willful misconduct, and expressly apply to 'wills and trusts whenever created'... This Court is bound by the General Assembly's instructions, and the Trust Agreement's exculpatory clauses therefore must be read as excusing grossly negligent conduct."[86]

## WILLFUL MISCONDUCT STANDARD — GOOD FAITH STANDARD

Putting all of this together, the Court held that since the trust instrument created a good faith standard, waived the duty to diversify, and authorized the trustee to engage in conflicted transactions — for the beneficiaries to prevail they must prove that Jeff's decision to cause the trust to make the challenged transactions was the result of willful misconduct or bad faith. The Court went on to hold that Jeff did not meet the good faith standard in making several of the investments, with the following being an example in the language of the Final Report, "In other words, because the bulk of Jeff's personal wealth was tied up in his own trust, which was administered by an independent trustee, Jeff used the Trust [referring to John's trust which was the subject of the litigation] to fund his effort to live up to the family name. In that way, Jeff acted

in bad faith by ignoring the interests of the beneficiaries and pursued a pattern of investing that was patently unreasonable, bore no relation to the long-term security of the Trust, and is inexplicable apart from Jeff's need to prove himself."[87]

The court noted that willful misconduct is defined in 12 *Del. C.* § 3301(e) as, "malicious conduct or conduct designed to defraud or seek unconscionable advantage." The Court stated that, "to the extent that the record shows as it does — that some of Jeff's investment decisions were motivated by Jeff's preference for his personal interests, those decisions are, by definition, bad faith, if not willful misconduct, and are not exculpated by the Trust Agreement."[88] The Master's Report went on to state that "Jeff's irrationality and unconsidered and self-interested conduct was so far beyond the bounds of reason that it cannot be explained by anything short of bad faith."[89]

### VIRTUAL REPRESENTATION UNDER DELAWARE LAW

Delaware's virtual representation statute, *Del. C.* § 3547, is discussed beginning on page 30.

The Court relied on an analysis of Delaware's virtual representation statute to refute Jeff's claims that the beneficiaries were time barred from bringing a cause of action. Jeff argued that the beneficiaries' claims were barred by the doctrine of laches. The doctrine of laches bars a claim if a plaintiff unreasonably delayed in pursuing it after he knew or should have known about the facts giving rise to the claim, and if such delay materially prejudiced the defendant. The Master's Report noted that the Court frequently uses the analogous statute of limitations as a presumptive limitations period for the period of laches. "When a complaint is filed after the presumptive limitations period, the Court need not engage in a traditional laches analysis, and instead may bar the claim except in 'rare' and 'unusual' circumstances."[90] The applicable statutes would have barred a claim in this instance after a period of three years. However, the Court noted that the statute of limitations for the children was tolled until they reached the age of majority. "Put another way, because some of the Beneficiaries turned 18 less than three years before this action was filed, the claims against Jeff are not time-barred unless those beneficiaries were virtually represented by another person (John) who was on inquiry notice of the claims..."[91] From there the Court analyzed § 3547 and held that John could not serve as the virtual representative for his children with respect to the transactions in this action, because John had a material conflict with his children. The conflict of interest was based on two factors. First, John placed nearly complete emphasis on the current income of the trust, living off of the monthly distributions, without any apparent concern for the capital growth of the trust. The Court stated that this alone is sufficient evidence of a material conflict under the virtual representation statute. Secondly, John was beholden to Jeff to the point that John could not himself take action to remedy Jeff's bad faith conduct. The Court noted the importance of considering the facts in each case in determining the validity of virtual representation. "John's complete dependence on Jeff emotionally and financially left him unable to represent the interests of his minor children. Although the virtual representation statute is an important component of the State's trust code and a necessary element to protecting trustees from confronting challenges to their decisions decades after they are made, the statute cannot be applied mechanically and without a studied view of the various relationships at issue in a particular case."[92]

CONCLUSION

For decades Delaware has been recognized as a leading jurisdiction for flexible trust laws. This is largely due to the flexible laws that have been described in this piece, its deep infrastructure for the trust and estates industry, a sophisticated legal bar and judicial system, and a progressive and flexible legislative process. To learn more, please contact your Northern Trust representative or one of the individuals provided below.

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ENDNOTES

1 30 *Del. C.* § 1636(a).

2 Cal. Rev. and Tax. Code § 17742(b).

3 See, e.g., Cal. Rev. and Tax. Code §§ 17734, 17737; N.Y. Tax Law § 633(a).

4 The Appellate Court of Illinois, in *Cain v. Hamer*, 975 N.E.2d 321 (Ill. App., 1st Dist., 2012), ruled in favor of taxpayers who had renounced their residency in Illinois in favor of Florida, but then continued to split their time between Florida and Illinois. The court held that the couple intended Florida to be their permanent home, as evidenced by changing their voter registrations to Florida, paying Florida taxes, obtaining residency cards and drivers' licenses in Florida, and filing a declaration of Florida residency, even though the couple maintained a residence and other contacts and associations in Illinois. This decision raises the question of whether the case, although interpreting residency requirements for purposes of personal income tax, will have a bearing on the taxation of non-grantor trusts created by an Illinois resident who later establishes residency in another jurisdiction.

5 504 U.S. 298 (1992) (due process clause requires minimum contacts between a state and a taxpayer to justify state's authority to impose tax).

6 See, e.g., *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999); *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997).

7 *McNeil v. Commonwealth of Pa.*, 67 A.3d 185 (Pa. Commw. Ct. 2013) (holding that despite the grantor's Pennsylvania residency at the time of the trust's creation, because the trust had no Pennsylvania beneficiaries or other connections, the imposition of a Pennsylvania fiduciary income tax violated both the Pennsylvania and U.S. Constitutions); *Linn v. Department of Revenue*, 2 N.E.3d 1203 (Ill. App. Ct. 2013) (finding that the income taxation of the trust in question violated the Due Process Clause of the U.S. Constitution because there was not a sufficient minimum connection between the trust and the state of Illinois).

8 North Carolina Department of Revenue v. Kimberly Rice Kaestner 1992 Family Trust, 588 U.S. (June 21, 2019).

9 N.Y. Tax Law § 612(b)(40).

10 Cal. Rev. and Tax. Code § 17744.

11 Of course, even if a trust with "contingent" beneficiaries is able to accumulate gains and income without the incidence of a California income tax, future distributions to California beneficiaries may well carry out taxable accumulated income under § 17745(b) when actually distributed.

12 Cal. Franchise Tax Bd. TAM 2006-0002 (Feb.17, 2006) at 2. But see *Paula Trust v. California Franchise Tax Bd.* No. CGC-16-556126 (Cal. Super. Ct. 2018)

13 Id.

14 See, e.g., *Lockwood v. OFB Corp.,* 305 A.2d 636 (Del. Ch. 1973) (a trustee is obliged to see that a trust is productive and that its corpus is preserved).

15 2009 WL 2913893 (Del. Ch. 2009).

16 *Id*. at 2.

17 Willful misconduct means "intentional wrongdoing, not mere negligence, gross negligence or recklessness." 12 *Del. C.* § 3301(g). The 2011 amendment to § 3301(g) further clarified the meaning of willful misconduct by defining "wrongdoing" as "malicious conduct or conduct designed to defraud or seek an unconscionable advantage." Notably, in July 2017, the Uniform Laws Commission finalized the Uniform Directed Trust Act, which is a model law that states can adopt. The willful misconduct standard in this Uniform Act is based on the Delaware statute, affirming Delaware's leadership in the development of directed trusts.

18 C.A. No. 20033 N.C. (Del. Ch. 2004).

19 *Id*. at 2.

20 If the client does not want the closely held assets included in his or her federal estate, a practitioner who relies on this trust structure must avoid the "controlled corporation" provision in IRC § 2036(b)(1) under which a client's right to vote at least 20 percent of the combined voting power of the stock will amount to retention of enjoyment of the transferred property. This can be accomplished by drafting a provision in the trust for a "special investment adviser" other than the grantor, who directs the trustee on the stock of the controlled corporation.

21 IRC § 2601.

22 IRC § 2631(a); An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97, 131 Stat. 2126 (2017).

23 25 *Del. C.* § 503(a). Three other states — South Dakota, Idaho, and Wisconsin — had repealed the Rule prior to 1986, for reasons obviously unrelated to the advent of the GST tax.

24 25 *Del. C.* § 503(e).

25 See, R. Sitkoff and M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 Yale Law Journal 356 (2005).

26 12 *Del. C.* § 3570 *et seq*.

27 12 *Del. C.* § 3571.

28 12 *Del. C.* § 3572(b)(2).

29 12 *Del. C.* § 3572(b)(1).

30 12 *Del. C.* § 3572(c).

31 *Id*.

32 12 *Del. C.* § 3573(1).

33 The definition of spouse includes spouses in same sex marriages, as Delaware passed the Delaware Civil Marriage Equality & Religious Freedom Act of 2013.

34 The QDTA specifically provides that the spousal exemption does not include "any claim for forced heirship, legitimized or elective share." 12 *Del. C.* § 3573. Accordingly, during the grantor's lifetime, a spouse may satisfy his or her claim for a share of marital property in connection with a divorce proceeding out of trust assets. However, after the grantor has passed away, the same spouse will become a normal creditor and will be required to satisfy the requirements of the QDTA for reaching trust assets if he or she decides to bring an elective share claim.

35 12 *Del. C.* § 3573(2).

36 But see, *Oberst v. Oberst*, 91 B.R. 97 (D.C. Cal. 1988) (transfers prompted by a plan to place property beyond the reach of potential future creditors, as opposed to transfers intended to defraud known or probable creditors, are entitled to protection under fraudulent transfer statutes).

37 37 6 *Del. C.* § 1304(b).

38 See, e.g., *Watkins v. Conway*, 385 U.S. 188 (1966) (one state may not deny as untimely enforcement of a sister state's judgment if it would have enforced a local judgment of the same maturity); *Matanuska Valley Lines, Inc. v. Molitor*, 365 F.2d 358 (9th Cir. 1966).

39 128 A.2d 819 (Del.1957), aff'd on other grounds sub nom. *Hanson v. Denckla*, 357 U.S. 235 (1958).

40 *Id*. at 835.

41 12 *Del. C.* § 3572(g).

42 See, e.g., *In re Brown*, 303 F.3d 1261 (11th Cir. 2002).

43 See, e.g., *Patterson v. Shumate*, 504 U.S. 753 (1992); *In re Baker*, 114 F.3d 636 (7th Cir. 1997).

44 12 *Del. C.* § 3570(11)(c).

45 *Aquilino v. United States*, 363 U.S. 509, 512-13 (1960).

46 12 *Del. C.* § 3574(f).

47 IRC § 677(a).

48 Rev. Rul. 77-378, 1977-2 C.B. 347; Rev. Rul. 62-13, 1962-1 C.B. 180.

49 See, e.g., PLR 9837007.

50 See, e.g., PLR 200148028.

51 IRC § 2036(a)(1); Treas. Reg. § 20.2036-1(b)(2).

52 PLR 200944002.

53 Id.; PLR 9141027.

54 See, e.g., PLR 9141027; TAM 8819001.

55 PLR 200715005, PLR 200647001, PLR 200637025, PLR 200612002, PLR 200502014, PLR 200247013, and PLR 200148028 (cited not as precedent but as illustrations of how the IRS might analyze the issues addressed in the rulings).

56 CCA 201208026 (Sept. 28, 2011).

57 PLR 201310002 (March 8, 2013).

58 Note that the same results were obtained in PLR 201410010 (March 7, 2014) and various subsequent rulings. One point of interest is that the 2014 ruling as well as some of the following rulings allow a non-court appointed guardian to serve on the "appointment committee" and represent the interests of minor beneficiaries.

59 13 *Del. C.* § 3570(11)(b)(2).

60 N.Y. Tax Law § 612(b)(41).

61 See, *McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001), *aff'd in part sub nom. McNeil v. McNeil*, 798 A.2d 503 (Del. 2002).

62 12 *Del. C.* § 3303(c).

63 12 *Del. C.* § 3339(a)(5).

64 In a case of first impression, the Delaware Supreme Court upheld § 3546(a). See *In re Restatement of Declaration of Trust Creating the Survivor's Trust Created Under the Ravet Family Trust Dated Feb. 9, 2012*, C.A. No. 7743-VCG (Del. Ch. 2014), *aff'd sub nom. Ravet v. Northern Trust Co. of Delaware*, No. 369, 2014 (Del. 2015) (individual who had received notice under the statute and brought a cause of action after the 120 day period was denied relief because he failed to bring his claim within the statutory period).

65 12 *Del. C.* § 3329.

66 12 *Del. C.* § 3329(b)(2).

67 See, *Morice v. Bishop of Durham*, 9 Ves. 399 (1804).

68 12 *Del. C.* § 3338.

69 12 *Del. C.* § 3338(c).

70 For clarity, the 2011 amendment to 12 *Del. C.* § 3528 added that the trustee's power to decant a trust also includes the power to create the second trust.

71 12 *Del. C.* § 3338.

72 12 *Del. C.* § 3338(e).

73 Delaware Court of Chancery Rule 101(a)(7).

74 12 *Del. C.* § 3338(a) and (b).

75 12 *Del. C.* § 3338(d).

76 See e.g., Vincent C. Thomas, *A Trustee's Modification Toolbox: Does it Really Include Non-Judicial Settlement Agreements?*, Delaware Banker, Vol. 10, No. 2, Spring 2014, for the view that the Delaware NJSA should not be used to modify a trust; But see, Michael M. Gordon and Daniel F. Hayward, *Another View: Utilizing Nonjudicial Settlement Agreements to Modify Trusts*, Delaware Banker, Vol. 10, No. 3, Summer 2014, for the view that the Delaware NJSA is one of several tools available to modify a trust in Delaware.

77 12 *Del. C.* § 3342(a).

78 *Id*.

79 12 *Del. C.* § 3325(29).

80 *In re the Ethel F. Peierls Charitable Lead Unitrust*, C.M. No. 16811-N-VCL (December 10, 2012); *In re the Peierls Family Inter Vivos Trusts*, Consolidated C.M. No. 16812-N-VCL (December 10, 2012); *In re the Peierls Family Testamentary Trusts*, Consolidated C.M. No. 16810-N-VCL (December 10, 2012).

81 *IMO Peierls Family Inter Vivos Trusts*, No. 16812 (Del. 2013); *IMO Ethel F. Peierls Charitable Lead Trust*, No. 16811 (Del. 2013); *IMO Peierls Family Testamentary Trusts*, No. 16810 (Del. 2013).

82 *In re Trust Under Will of Wallace B. Flint for the Benefit of Katherine F. Shadek,* C.A. No. 10593–VCL (Del. Ch. 2015).

83 *Mennen v. Wilmington Trust Company, George Jeffrey Mennen and Owen J. Roberts as Trustees*, C.A. No. 8432-ML, Master LeGrow (Del. Ch. December 8, 2014) (Master's Final Report), affirmed by the Delaware Court of Chancery, C.A. No. 8432-ML (August 18, 2015), *Mennen v. Wilmington Trust*, *et al*, C.A. No. 8432, affirmed by the Delaware Supreme Court (June 21, 2017).

84 Case sometimes referred to as "*Mennen v. Fiduciary* Trust International of Delaware", *Kathryn Mennen et al v. Wilmington Trust Company, George Jeff Mennen, and Fiduciary Trust International of Delaware*, C.A. No. 8432 (Motion for summary Judgment) (April 24, 2015) (Master's Final Report), affirmed by the Delaware Court of Chancery *Mennen et al. v. Fiduciary Trust International of Delaware et al*., C.A. No. 8432-VCL (February 27, 2017); affirmed by the Delaware Supreme Court, *Mennen v. Fiduciary Trust International of Delaware, et al*., 2017 WL2152478 (Del. May 17, 2017).

85 *Mennen v. Wilmington Trust* at 49.

86 *Id*. at 53.

87 *Id*. at 61.

88 *Id*. at 59.

89 *Id*. at 64.

90 *Id*. at 72.

91 *Id*. at 76.

92 *Id*. at 80.

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