THE DELAWARE ADVANTAGE



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I. Introduction. For decades, Delaware has been widely regarded as the premier jurisdiction in the United States, and indeed in the world, for settlors to create trusts and for existing trusts to transfer situs to take advantage of the modern and flexible advantages of Delaware trust law. With over 60 trust offices of nationally-recognized financial institutions located in Delaware, offering their clients the Delaware advantage, the Delaware trust environment provides consistency, reliability, flexibility and depth. Because of the sophisticated and active trust law in Delaware, Delaware boasts a strong community of trust lawyers able to assist clients with creating and relocating trusts to Delaware.

Delaware has a well-developed body of case law applicable to trusts. Delaware's case law provides certainty in determining the outcomes of conflicts. The Delaware Court of Chancery, the same court recognized worldwide for its reputation in corporate and commercial matters, is the same court with primary jurisdiction over Delaware trusts. In addition, Delaware's trust statutes have evolved as a very detailed and clear body of law concerning Delaware common law trusts. The Delaware legislature is quick to react to new developments and respond to concerns and has attempted to create flexible trust laws that are best able to effectuate the wishes of trust settlors. The Estates and Trusts Section of the Delaware State Bar Association maintains a standing legislation Committee that monitors the status of the trust laws in Delaware and other states and responds to feedback from practitioners and fiduciaries. This Committee produces new trust legislation every year which gets sponsored by the Delaware State Bar Association and is enacted into law. The Morris Nichols' Trusts, Estates and Tax Group includes three former Chairs of the Estates and Trusts Section and for decades has been integral in drafting new trust legislation. This outline contains a general overview of some of the most important features of Delaware's trust laws.

II. Advantages of Delaware Trust Law.

1. Avoiding or Minimizing Income Taxes Imposed By Other States.

A. General Delaware Income Tax Treatment.

i. **Introduction**. In general, Delaware does not impose any taxes upon trusts except in cases where one or more trust beneficiaries live in Delaware and then only upon the portion of the trust income attributable to the Delaware resident beneficiaries.

ii. **Resident Trust Definition.** A trust that is treated as a trust for federal income tax purposes, and is not a trust of which the grantor or another person is treated as the owner of the entire trust under Sections 671 through 679 of the Internal Revenue Code of 1986

(the "Code"), is treated as a "resident trust" for Delaware income tax purposes if:

a. The trust is created by the will of a decedent who at death was domiciled in Delaware; or

b. The trust is created by, or consists of property of, a person domiciled in Delaware; or

c. During more than half of any taxable year, the trust has only one trustee who is either a Delaware resident individual, or a corporation, partnership or other organization having an office for the conduct of trust business in Delaware; or

d. During more than half of any taxable year, the trust has more than one trustee and one of the trustees is a corporation, partnership or other organization having an office for the conduct of trust business in Delaware; or

e. During more than half of any taxable year, the trust has more than one trustee all of whom are individuals and one-half or more of whom are Delaware residents. 30 Del. C. § 1601(f)-(g).

A Delaware nonresident trust is any trust that is not a resident trust. 30 Del. C. § 1601(h).

iii. **Taxation of Nonresident Trusts.** Delaware nonresident trusts are only subject to Delaware state income tax to the extent that they have items of income, gain, loss and deduction derived from, or connected with, sources located within the State of Delaware. 30 Del. C. § 1639. Income of a trust is deemed to be derived from a Delaware source only if the income is attributable to:

a. The ownership of real or tangible personal property located in Delaware; or

b. A business, trade or commerce carried on in Delaware. 30 Del. C. §§ 1124 and 1639.

Intangible assets held for investment are not considered to be property employed in a business, trade or commerce. 30 Del. C. § 1124(c). Therefore, a nonresident trust conducting traditional investment activities is not subject to Delaware income taxation unless the trust owns real or tangible property located in Delaware or conducts a business or trade in Delaware.

A nonresident trust that does not have Delaware source income is not required to file a Delaware income tax return. 30 Del. C. § 1605(b)(1).

iv. **Taxation of Resident Trusts**. Delaware resident trusts are potentially subject to the Delaware income tax imposed upon individuals. However, resident trusts are allowed both an income tax deduction for the amount of their federal distributable net income that is actually distributed, 30 Del. C. § 1635, and an income tax deduction for the amount of their federal taxable income (including capital gains), as modified for Delaware purposes, that is set aside for future distribution to nonresident beneficiaries. 30 Del. C. § 1636. The practical effect of these two deductions is that a Delaware resident trust never pays any Delaware income tax if (1) the trust has no living beneficiaries who are residents of Delaware; and (2) the trust does not identify its beneficiaries by their relationship to a Delaware resident. In cases where one or more beneficiaries reside in Delaware, the portion of the trust's accumulated income and accumulated capital gains allocable to the Delaware resident beneficiaries is subject to Delaware income taxation. A resident trust which has no Delaware resident beneficiaries is not required to file a Delaware income tax return. 30 Del. C. § 1605(b)(1).

B. Avoiding Income Taxation in Other States and Jurisdictions.

i. **Introduction**. Moving a trust to a no or low tax jurisdiction or settling the trust in such a jurisdiction will avoid taxation in those high tax jurisdictions that base their income tax regime entirely upon the location of the trustee. However, a trust located in a low tax jurisdiction may still be subject to state income taxation in a high tax state based upon other contacts with the high tax state. For example, nearly half the states tax a trust's accumulated income and capital gains merely because the settlor resided in the state at some critical moment such as upon funding of the trust, when it became irrevocable or during the current tax year. Similarly, most of the same states and a few others tax trusts created or funded under the will of a resident decedent. Still other states such as New York, Massachusetts, Missouri and Ohio tax trusts created by residents if certain other contacts with the state are present, such as a resident trustee or beneficiary or if some trust administration occurs in that state. Other states, such as Delaware, tax trusts created or funded by residents only to the extent that income and capital gains accumulated in the

trust are deemed to be held for resident beneficiaries. A small number of states tax trusts if a trustee is located in the state and a similar number tax trusts if the administration of the trust occurs in the state. Finally, a few states tax trusts based solely upon the residency of the beneficiaries. It should be possible in many cases for a trust located in a low or no tax jurisdiction to avoid income taxation by high tax states through careful planning. The tax planning strategies discussed in this outline are presented solely as a possible starting point for further analysis in light of the laws of whatever high tax state may have contacts with a particular trust. Some of the strategies may work to permit trusts to avoid or reduce taxes in some states (or at least to allow the trustee to take a reasonable reporting position that no tax is due to a particular state) but not work under the laws of other states even in cases where both states tax trusts on the basis of similar factors. Other strategies mentioned here might not work under any state's laws or might be viewed as too aggressive by cautious advisers and trustees. The strategies discussed here are presented as general observations and not with the laws of any particular state in mind except to the extent that certain states are mentioned by name.

ii. **States Basing Taxation Upon Residence Of Settlor.** As was mentioned above, many states (about half) base the taxation of trusts in whole or in part upon the residence of the settlor. This raises the obvious but sometimes difficult question of who is treated as the settlor of a particular trust. For example, suppose a New York resident creates a trust and by the terms of the trust agreement grants a person who does not reside in New York a power to appoint the trust property upon further trusts. If the power is exercised, is the new trust created by the non-New York resident deemed to be created by the New York settlor of the first trust? The New York Department of Taxation has taken the position that the answer turns upon whether the power of appointment is a limited or general power. If the power is general, the powerholder is treated as the creator of the appointive trust. If the power is limited, the settlor of the first trust is treated as the creator of the new trust. N.Y. State Department of Taxation Advisory Opinion (TSB-A-03(6)I). Is the rule the same in those other states that tax trusts based upon the residency of the settlor? Is the New York Department of Taxation's position correct under New York law? What if the power of appointment, although limited, was not in the initial trust agreement but was

added by court ordered reformation at a later date? What if, as is sometimes the case under Delaware law, the reformation can be accomplished without the settlor's consent? What if the new trust is not created by the exercise of a power granted in the trust agreement, but by the action of the trustee acting under a "decanting" statute such as 12 Del. C. § 3528? What if the trust were merged into a substantially similar trust created by someone other than the settlor pursuant to a state statute or court order permitting the merger? What if the trust is created or declared by a non-resident but a resident contributes assets to the trust? Would it matter whether the trust were nominally or substantially funded by the initial non-resident settlor?

iii. **Court Ordered Change of Situs.** Some states that generally tax trusts on the basis of the residence of the settlor nevertheless do not tax trusts settled by residents following the entry of a state court order directing a change of situs from the state of the settlor's residence to another jurisdiction. Pennsylvania and Virginia appear to fall into this category. See Pennsylvania Department of Revenue PIT-01-040 (July 27, 2001); Virginia Admn-Rul, VA-Trxrptr § 202-326 (August 26, 1993). It is not clear whether this rule applies only in cases where a court order is required to move the trust. Also, it is not clear what the result would be if the trust agreement provides a means for moving the trust out of the state but the trustee nevertheless seeks such an order approving the move.

iv. **Location of Trust Beneficiaries.** The obvious question (and perhaps planning opportunity) arising in those states that tax trusts in whole or in part on the basis of the place of residence of the trust beneficiaries is how does one identify the beneficiaries and which beneficiaries are taken into account under the relevant tax statutes. For example, are discretionary distributees considered beneficiaries? If so, how would the trust be taxed if the agreement permits the trustee to make discretionary distributions to anyone in the world but only with the consent of someone who has a substantial adverse interest? Are contingent beneficiaries taken into account? California, for example, does not take into account contingent beneficiaries. What if some or all of the beneficiaries eligible to receive distributions from the trust are other trusts or entities in which residents hold beneficial or equity interests? Are persons in whose favor a power may be exercised considered beneficiaries?

v. **Location of Trustee and Place of Administration.** States that generally tax trusts based upon the location of the trustee or place of trust administration or that tax trusts on the basis of either of these factors in combination with other factors probably present the greatest planning opportunities. These states may also present some traps for the unwary. However, even in these states, questions sometimes arise concerning who is a trustee or what contacts with a state suffice to cause the trust administration to occur in the state. Can persons who are not formally designated as trustees, such as trust protectors, investment advisers or distribution advisers, nevertheless be treated as trustees? Will the performance of any traditional trustee function suffice to cause the person performing the function to be treated as a trustee? What if the function is performed in a non-fiduciary capacity under applicable law? What if such a function is performed by a committee and one or more members of the committee reside in the relevant state? What if third party advisers or agents reside in the relevant state? Does it matter whether they are selected by the trustee or named in the trust agreement? What if these advisers or agents hold discretionary powers (such as discretionary investment authority) over some or all of the trust assets? What happens if the trustee is a corporation with trust offices in several states including the potential taxing state? What happens if there are multiple trustees less than all of who reside in the relevant state?

vi. **Constitutionality**. There is disagreement among state courts as to whether the imposition of state income tax on a trust based on factors such as the domicile of the settlor or testator that created the trust, or the domicile of the beneficiaries, is constitutionally permissible. Plaintiffs that challenge the constitutionality of state laws do so under the theory that the tax violates the Commerce Clause or Due Process Clause of the United States constitution. The central issue presented in these constitutional challenges is whether the trust has a sufficient "nexus" with the taxing state to justify a tax on the entire net income of the trust.

a. **Cases Finding State Laws Unconstitutional**. Several state courts have held that it was unconstitutional for the state to impose a tax on the income of a trust where, under the circumstances, the state was deemed to have an insufficient nexus with the trust.

For example, in Potter v. Taxation Division Director, 5 N.J. Tax 399 (1983) (This case was argued together with a companion case, Pennoyer v. Taxation Division Director, 5 N.J. Tax 386 (1983), a New Jersey resident created an inter vivos trust of which the trustee, the beneficiaries and all of the assets were held outside of the State of New Jersey. Some of the contingent beneficiaries were located inside the State of New Jersey. The New Jersey Tax Court held that New Jersey's connection with the trust (i.e. the residence of the settlor and the domicile of the contingent beneficiaries) was constitutionally insufficient to permit New Jersey to tax the income of the trust.

In Blue v. Dept. of Treasury, 462 N.W.2d at 764, the Michigan Court of Appeals held that there was an insufficient connection between the trust and the State of Michigan to justify the imposition of an income tax where the trust was created under the will of a Michigan resident, and the assets, trustee and all of the beneficiaries were located outside Michigan.

In In re Swift, 727 S.W.2d 880 (Mo. 1987), the Missouri Supreme Court considered whether the State of Missouri may tax the income of testamentary trusts created by the will of a Missouri resident when the trust property, trust administration, and all beneficiaries are located outside Missouri. The court held that Missouri did not have sufficient contacts with the trusts to tax the income of the trusts. The court reasoned as follows: "An income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period. In determining whether this state has a sufficient nexus to support the imposition of an income tax on trust income, we consider six points of contact: (1) the domicile of the settlor, (2) the state in which the trust is created, (3) the location of the trust property, (4) the domicile of the beneficiaries, (5) the domicile of the trustees, and (6) the location of the administration of the trust. For purposes of supporting an income tax, the first two of these factors require the ongoing protection or benefits of state law only to the extent that one or more of the other four factors is present." Id. at 882.

In a later case, Westfall v. Director of Revenue, 812 S.W.2d 513 (Mo. 1991), the Missouri Supreme Court illustrated the limits of Swift. Westfall involved a trust created under the will of a Missouri resident. The trustee, all trust administration and primary trust beneficiaries were located outside Missouri,

however, the trust owned real property in Missouri and some of the contingent beneficiaries were located in Missouri. The court, applying the Swift test, held that the Due Process Clause of the U.S. constitution permitted Missouri to tax the trust as a resident trust due to the combination of the testator's residency, the real property located in Missouri and the fact that the trust had Missouri resident contingent beneficiaries.

b. **New York.** In Mercantile-Safe Deposit & Trust Co. v. Murphy, 242 N.Y.S.2d 26 (N.Y. App. Div. 1963), aff'd., 203 N.E.2d 490 (N.Y. 1964), the Supreme Court of New York, Appellate Division considered the constitutionality of the State of New York taxing the income of a trust created by the will of an individual domiciled in New York at his death (a resident trust under New York law) where the trustee, all of the assets and all trust administration activities were located outside of New York. The court held that the New York statutes which imposed a tax on the income of the resident trust "undertake in the circumstances disclosed here to extend the taxing power of the State to property wholly beyond its jurisdiction and thus conflict with the due process clause of the Fourteenth Amendment of the Federal Constitution." Id. at 28.

In response to Mercantile-Safe Deposit & Trust, the New York State Tax Regulations were revised to provide explicitly that no New York State income tax will be imposed on a trust that otherwise satisfies the definition of a New York "resident trust" if all of the following conditions are met:

1. all of the trustees are domiciled in a state other than New York State;
2. the entire corpus of the trust, including real and tangible property, is located outside of New York State; and
3. all income and gains of the trust are derived from, or connected with, sources outside of New York State, determined as if the trust were a nonresident trust. 20 NYCRR § 105.23.

c. **Pennsylvania**. In McNeil Trusts v. Pennsylvania, Nos. 651 F.R. 2010; 173 F.R. 2011, Judge Cohn Jubelirer (May 24, 2013), a Pennsylvania court held that the imposition of Pennsylvania's income tax on two inter vivos trusts administered in Delaware was unconstitutional under the Commerce Clause of the U.S.

Constitution. Central to the conclusion of the Court was the lack of connections the trusts had to Pennsylvania. In fact, the only two connections were the residency of the settlor when the trusts were settled and the residency of discretionary beneficiaries of the trusts. As an initial matter, the Court focused on analyzing the Trusts as separate taxpayers apart from its Settlor and beneficiaries. In respect to the Trusts, the Court found insufficient presence within Pennsylvania to create substantial nexus and allow Pennsylvania to tax the Trusts. The Court noted that the only two connections to Pennsylvania were (i) the residence of the Settlor when the Trusts were created, and (ii) the residence of the discretionary beneficiaries. The Court found it important that the Settlor retained no continuing control over the Trusts (such as a power to revoke or a power of appointment over the property of the Trusts). Moreover, the Court was persuaded by the fact that the in-state discretionary beneficiaries had no current right to receive distributions from the Trusts. The Court also found that the tax was not "fairly apportioned" because it was "externally inconsistent" – that is Pennsylvania taxed more than its share of the portion of intrastate components of the income. The parties stipulated that the Trusts derived no Pennsylvania source income and no trustee had any presence in Pennsylvania, and therefore, Pennsylvania could impose tax on little (if any) of the Trusts' income. Any attempt to tax the Trusts' income was, therefore, "inherently arbitrary" and had "no rational relationship" to the business activity that actually occurred within the state. Finally, the Court found that the tax was not fairly related to the "protections, opportunities, and services" provided.

d. **Summary**. In many cases, it should be possible for a Delaware resident trust to avoid income tax in jurisdictions other than Delaware (such as New York, New Jersey, Missouri or Michigan), so that the income accumulated in the trust entirely avoids all current state income taxes. However, in some cases it may be less clear whether a trust is subject to tax in a state other than Delaware due to the trust's nexus with that state, such as in the case of a testamentary trust subject to ongoing court supervision, or a trust that has an investment advisor, distribution advisor, protector or some other person who fulfills sufficiently substantial duties with respect to a trust.

vii. **Cases Upholding State Income Taxation of Trusts**. There are two cases that are examples of a court upholding income tax imposed on trust income under circumstances that other state courts have held to be unconstitutional. In Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999), a Supreme Court of Connecticut case, the court held that the Connecticut law which imposed an income tax on trusts based solely on the fact that the testator of a testamentary trust, or the settlor of an inter vivos trust, was domiciled in Connecticut at the time the trust was created, was constitutional. In Gavin, the court considered several testamentary trusts and an inter vivos trust with substantially similar fact patterns. For each trust, the trustee, all of the beneficiaries, the assets of the trust, and all administrative activities related to the trust were located outside of Connecticut. The trusts' only connection with Connecticut was the fact that the testators/settlor were domiciled in Connecticut at the time the trusts were created. The court held that Connecticut was constitutionally justified in taxing the income of the trusts on an ongoing basis because the trusts were initially created under Connecticut laws and the Connecticut courts were "open and available" for accounting and trust administration.

In District of Columbia v. The Chase Manhattan Bank, 689 A.2d 539 (D.C. 1997), decided a few years prior to Gavin, the District of Columbia Court of Appeals upheld as constitutional a law that permitted the District to tax the income of a testamentary trust created by the will of an individual who died while domiciled in the District, where the trustee, trust assets and trust beneficiaries were all located outside of the District. Key to the court's holding was the fact that the District's courts had a "continuing supervisory relationship" with respect to the administration of the trust. The court stated that even though another state may assert jurisdiction over the trust, the District court may nevertheless retain jurisdiction at the same time, and the District's power to exercise jurisdiction over a trust is equated with its power to tax it.

The courts in Gavin and District of Columbia essentially based their opinions on the premise that since the time when the earlier state court decisions (mentioned above) were decided, the U.S. Supreme Court had changed its method of analyzing state tax statutes under the Due Process Clause. In Quill Corp. v. North Dakota, 505 U.S. 298 (1992), the U.S. Supreme Court addressed the constitutionality of a North Dakota statute that required out-of-state retailers to collect North Dakota use tax on goods shipped to North Dakota resident

customers. The Supreme Court upheld the statute under the Due Process Clause, ruling that a state may tax a taxpayer if the taxpayer has "minimum contacts" with the taxing state. In so holding, the Court essentially imposed the same test for state taxation under the Due Process clause as it has traditionally applied to questions of state court jurisdiction over non-residents, a test which de-emphasized physical contacts with the state. Id. at 307. Hence, the court in District of Columbia equated the District's power to exercise jurisdiction over a trust with its power to tax it. The Quill approach creates an extremely broad constitutional justification for imposing state income tax on trusts.

It is unclear whether Gavin and District of Columbia correctly applied the Supreme Court's analysis in Quill to the question of state income taxation of trusts. Several commentators suggest that Gavin and District of Columbia were clearly erroneous, and that the results of their holdings were unconstitutional. See M. Read Moore & Amy L. Silliman, State Income Taxation of Trusts: New Case Creates Uncertainty, 24 Est. Plan. 200 (1997); Bradley E.S. Fogel, What Have You Done For Me Lately? Constitutional Limitations on State Taxation of Trusts, 32 U. Rich. L. Rev. 165 (1998). At this time, there are several states that have different legal precedents regarding what degree of nexus between the state and a trust is necessary in order for the state to constitutionally impose income tax on the trust's income and the constitutionality of the various court decisions has yet to be definitively resolved by the federal courts.

viii. **Conclusion**. The hodgepodge of state taxing regimes combined with the relatively high income tax rates imposed by some states, suggest that whenever one is considering the creation of a trust that will be subject to income taxation in a high tax state and whenever one encounters a trust already located in such a state, it is a worthwhile exercise to consider whether there may be an opportunity through careful and sometimes creative planning to avoid or reduce the trust's state income tax burden.

2. Directed Trusts.

A. History. Delaware has a long history of permitting directed trusts. Delaware's original directed trustee statute was enacted in 1985 and it provided: "Where one or more persons are given the authority by the terms of a governing instrument to direct, consent to, or disapprove a fiduciary's investment decisions, or proposed investment decisions,

such persons shall be considered to be fiduciaries when exercising such authority unless the governing instrument provides otherwise. Any fiduciary acting in compliance with such an authorized direction or disapproval shall not be liable individually or as a fiduciary for any loss resulting from an action taken or omitted by reason of such compliance." 65 Del. Laws, C. 422.

B. The Statute (Section 3313). Delaware's directed trustee statute is found in Section 3313 of Title 12 of the Delaware Code.

i. **What Is An Adviser (Section 3313(a))**. Section 3313(a) provides that an "adviser" may direct, consent or disapprove investment decisions, distribution decisions or any other decision of the fiduciary. It also provides that such person shall be a "fiduciary" unless the governing instrument provides otherwise.

ii. **Direction Adviser (Section 3313(b))**. Section 3313(b) of Title 12 of the Delaware Code states that if a trust instrument provides that a fiduciary is to follow the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act. The statute facilitates a wide range of planning and structuring opportunities that allow settlors and beneficiaries of trusts to accomplish their specific goals. The statute allows trustees to hold non-traditional investments, such as closely-held stock, real estate, concentrated positions, high risk investments and so forth, without risk of liability by arranging, either through drafting or modification, for the appointment of an investment adviser empowered to direct the trustee with respect to the problematic investments. Typically, the trustee manages the portion of the trust portfolio (if any) invested in traditional trust investments.

iii. **Consent Adviser (Section 3313(c))**. Section 3313(c) provides that if a fiduciary is to make decisions with the consent of an adviser, then the fiduciary shall not be liable for any loss except in cases of willful misconduct or gross negligence. Structuring a trust with a "consent adviser" is generally not recommended. The Trustee should always act either (a) solely at direction, or (b) in its sole and absolute discretion, but not with the consent or prior approval of the adviser. If the Trustee must act with the consent of an adviser, then the Trustee possesses all of the fiduciary responsibility and liability for the trust investments, yet the Trustee can only

implement its strategies and decisions after obtaining the consent of some third-party adviser who may or may not grant its consent. The result is that the Trustee must go through the administrative task of seeking, obtaining and documenting consents, and the Trustee will be responsible and liable for a portfolio that does not necessarily reflect its own decisions unless the consent adviser always agrees with the Trustee.

iv. **No Duty To Monitor (Section 3313(e))**. Section 3313(e) clarifies that a fiduciary that follows the direction of an adviser with respect to any decision shall have no duty to monitor, advise with respect to, warn or otherwise interfere with the decisions of the adviser and that any such actions taken by the fiduciary shall be presumed to be administrative actions taken solely to allow the fiduciary to perform the duties assigned to the fiduciary acting at direction. This subsection is intended to clarify the bifurcation of the investment function from the trustee's duties.

v. **Protector (Section 3313(f))**. Section 3313(f) provides that the term "adviser" shall include a "protector" who shall have any powers and authorities granted under the terms of the governing instrument and which may include but shall not be limited to the power to remove and appoint trustees or other fiduciaries, the power to modify or amend the governing instrument, and the power to modify, expand, or restrict the terms of the power of appointment granted to a beneficiary.

C. Direction In The Governing Instrument (Section 3304). Section 3304 provides that a direction to retain property in the governing instrument shall be deemed to waive any duty of diversification and shall exonerate the fiduciary from liability for retaining the property except in the case of willful misconduct. Thus, a settlor who creates a trust with a specific investment strategy in mind may effectively carry out that strategy like a directed trust using Section 3304.

D. Definition of Willful Misconduct (Section 3301). Section 3301(g) defines the term "willful misconduct" as "intentional wrong doing, not mere negligence, gross negligence or recklessness" and "wrong doing" means "malicious conduct or conduct designed to defraud or seek an unconscionable advantage."

E. Essential Elements for Effective Bifurcation.

1. A directed trust is NOT a delegation.

2. The trustee should only be liable for willful misconduct, not gross negligence or any other standard.

3. The trustee must act *solely* at direction.

4. The investment adviser provision in the trust instrument should be detailed and all-inclusive and should expressly cross-reference all of the detailed trustee powers pertaining to investments within the governing instrument.

5. The investment adviser provision should not enable the adviser to toggle between consent or direction.

6. The trustee should not remove or appoint the investment adviser.

7. The trustee should have no duty to monitor or supervise the investment adviser.

8. The direction letter must be specific and detailed.

9. Trustee should have no ability to exercise discretion with respect to the directions under the instrument or pursuant to the direction letter.

10. Directions should be delivered to the trustee in writing.

11. The direction letter should be specific and should leave no discretion to the trustee.

12. Specifically address unique issues pertaining to "Special Holdings" like closely-held companies, limited liability companies, restricted stock, real estate, life insurance, and private equity, such as valuations and entity management.

13. The direction letter should recite the provisions of § 3313 so the adviser clearly understands the bifurcation of the roles for each direction.

14. If there are documents to be signed, the direction letter should have those documents attached to it, essentially stating "sign here".

15. Identify a long term succession plan for the role of the adviser and plan for a vacancy in the role.

F. Case Law. In R. Leigh Duemler v. Wilmington Trust Company, C.A. 20033, V.C. Strine (Del. Ch. Oct. 28, 2004) (Trans.), the Delaware Court of Chancery issued an order in a bench ruling validating a statutory defense under Section 3313(b) to a breach of trust suit, providing that Wilmington Trust Company was not liable as trustee for its actions with respect to trust investments in the absence of willful misconduct. Mr.

Duemler was the investment adviser of a trust with the express power under the trust instrument to direct Wilmington Trust Company, as the trustee of the trust, with respect to all investments. Mr. Duemler was a sophisticated investment adviser who was a securities lawyer. The trust invested in "a nondiversified portfolio with extremely risky assets", the kind of portfolio "that requires the most diligent of monitoring." Wilmington Trust Company forwarded a prospectus to Mr. Duemler, while he was on vacation, with respect to which Mr. Duemler should have made an investment decision concerning one of the trust's investments. Mr. Duemler did not provide Wilmington Trust Company with any direction as to the investment and, subsequently, the investment experienced a significant drop in value. The Court stated that in these circumstances, Section 3313 requires the investment adviser to make investment decisions in isolation, without oversight from the trustee, because if the investment adviser does not make the investment decisions alone, the investment adviser's role would not work as the trustee would always "second guess" the investment adviser's decisions. Duemler at p. 11. The Court found that Wilmington Trust Company did not breach its fiduciary duty, however, Mr. Duemler did breach his fiduciary duty as investment adviser of the trust. Duemler at p. 13. Finding that Wilmington Trust Company did not engage in willful misconduct, the Court upheld a statutory defense under Section 3313(b). The Court further explained that if the trustee were liable in such situations for "the failure to provide information or to make sure that [the investment adviser] making the decision knew what they were doing" it would "gut the statute". Duemler at p. 16. Duemler is the only case in which the Court has specifically addressed the applicability of Section 3313(b). Duemler validates the standard of liability, as well as the proper course of conduct for a trustee, under Section 3313(b). The Morris Nichols' Fiduciary Litigation Group represented the Trustee in this case.

In Paradee v. Paradee, C.A. No. 4988-VCL, V.C. Laster (Del. Ch. October 5, 2010) (Mem. Op.), the Court's use of 12 Del. C. § 3313 is also worth noting. In that case, the respondents attempted to defend the trustee's conduct by arguing that he had relied on advice of counsel in the form of a letter. The Court rejected this defense for several reasons. In support of its holding, the Court mentioned 12 Del. C. § 3313: "By statute, Delaware authorizes trustees to be exculpated from liability when following the direction of an advisor. The statute does not eliminate the underlying breach, and exculpation is not available 'in cases of willful misconduct.'" Noting that 12 Del. C. § 3580 defines "good faith" to require both honesty in fact and the observance of reasonable standards of fair dealing, the

Court also said that, even if the trustee subjectively believed he was acting properly because of the advice of counsel, his actions fell short of reasonable standards of fair dealing. Finally, the Court found that the trustee failed to follow the letter's advice in one significant respect. Again citing 12 Del. C. § 3313, the Court said that the letter's advice could not exculpate the trustee's conduct since the trustee did not act in accordance with such advice. On one hand the opinion readily affirms the statute's ability, under prescribed circumstances, to exculpate trustees from liability. On the other hand, it invokes 12 Del. C. § 3313 in a context not anticipated by the language of the statute itself. By its terms, 12 Del. C. § 3313 provides that when, pursuant to the terms of a trust's governing instrument, a fiduciary is to follow the direction of an adviser, then except in cases of willful misconduct the fiduciary shall have no liability for acting in accordance with such direction. Since the statute defines an "adviser" as one "given authority by the terms of a governing instrument" to direct a fiduciary's decisions, the protection afforded by the statute has no application except in cases where an adviser's ability to direct the fiduciary is memorialized in the trust's governing instrument. Since there is no indication that the trustee's counsel served as an "adviser" within the meaning of the statute, the Court's application of the statute is somewhat ambiguous or perhaps confusing.

G. Other Statutory Approaches. Many states have adopted the Uniform Trust Code (the "UTC"), which includes a "directed trustee" section. Other states that have not adopted the UTC nevertheless have "directed trustee" statutes that function in a similar fashion to the UTC section. If a state statute follows the approach in Section 808(b) of the UTC, it provides that the trustee shall follow direction unless the exercise of the power is "manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty". Where this is the case, the trustee continues to possess the fiduciary responsibility and liability for deciding whether to follow the direction, and the trustee must still monitor the decisions of the adviser and the directions it receives. This does not effectively bifurcate the responsibilities and may inhibit the execution of the trustee powers.

H. Other Uses For A Direction Adviser. Under Section 3313, an adviser can direct the trustee with respect to any ministerial or discretionary power of the trustee. The direction adviser statute can be used to bifurcate any traditional trustee function.

i. **Distributions**. A distribution adviser or committee may be a useful strategy to provide someone with the power to make

distribution decisions other than an institutional fiduciary with knowledge of the family needs to make distribution decisions. This may be particularly useful for a special needs trust. It may also be useful to have a distribution committee of adverse persons to achieve nongrantor trust treatment.

ii. **Other Uses.** It is possible to name an adviser that shall direct the trustee how and when to provide notice and information to beneficiaries. When a trust holds a closely-held company, or a restricted entity, yet the trustee is responsible for providing accountings to beneficiaries, it may be useful to provide that the trustee shall only use valuations as directed by an adviser. Other uses for an adviser may include tax reporting, change of situs or governing law or administrative amendments to the trust instrument.

3. Creditor Protection.

A. Spendthrift Statute (Section 3536). Section 3536 of Title 12 of the Delaware Code is Delaware's spendthrift statute. It was written, and has been repeatedly revised, to afford trust beneficiaries of traditional non-self-settled trusts with near complete statutory protection from claims made against the trust or a beneficiary's interest in the trust by the beneficiary's personal creditors. This rule applies even in the case of intentional torts. Parsons v. Mumford, 1989 WL 63899 (Del. Ch. 1989); Gibson v. Speegle, 494 A.2d 165 (Del. 1984). In 2005, Delaware's spendthrift statute was amended to clearly provide that the creditors of a beneficiary (other than the settlor) of a trust with a spendthrift clause will not be able to attach the assets of the trust merely because the beneficiary possesses a testamentary power of appointment unless the power is a general power of appointment that is actually exercised in favor of the beneficiary, the beneficiary's creditors, the beneficiary's estate or the creditors of the beneficiary's estate, and then, only to the extent that the assets are actually distributed to the beneficiary, the beneficiary's creditors, the beneficiary's estate or the creditors of the beneficiary's estate. The spendthrift statute was also updated to clarify that the protection of a spendthrift clause continues to protect assets distributable to a beneficiary of a trust until the assets are actually distributed to the beneficiary. For example, if upon the occurrence of an event or condition, such as the death of a current beneficiary, the assets of a trust become distributable to a beneficiary, and there is a delay between the time of the occurrence or condition and the time that the assets are actually distributed to the beneficiary, the spendthrift clause will continue to protect the assets of the trust until the assets are actually distributed out of the trust. In 2007,

Section 3536(c) was amended to provide that a trustor's retained right to receive discretionary distributions as reimbursement for income taxes paid that are attributable to trust assets will not in and of itself subject the trustor's transferred property to the claims of his or her creditors. The new Section 3536(c) accommodates a common provision in grantor trust instruments permitting a trustee to reimburse the grantor for the payment of income taxes attributable to the trust. Section 3536(a) was also amended in 2007 and 2008: (i) to provide that a trustee may directly pay any expense on behalf of a beneficiary to the extent permitted by the trust instrument and may exhaust the income and principal of the trust for the benefit of such beneficiary, regardless of whether he or she has any outstanding creditors and without risk of liability to any creditor of the beneficiary for paying the beneficiary's expenses; and (ii) to clarify that every assignment by a beneficiary of an interest in a trust with an anti-assignment provisions by a beneficiary is invalid, including direct, indirect, voluntary and involuntary assignments (subject, however, to specific exceptions set forth in Section 3536). In 2008, Section 3536(a) was revised and reorganized in order to provide even greater protection against claims made by creditors of trust beneficiaries. As revised, the statute provides that a creditor of a beneficiary has only such rights against the beneficiary's interest as are expressly granted to the creditor by the terms of the trust instrument or Delaware law. In 2009, the statute was amended to add language to make it clear that the limitations imposed on creditors by Section 3536(a) apply generally to trusts, including, but not limited to, trusts in which a beneficiary's interest might be subject to an exercise of discretion by a fiduciary. Prior to that amendment, Section 3536(c) of Title 12 made it clear that a beneficial interest of a settlor in a spendthrift trust that he or she created is subject to the claims of his or her creditors to the extent of his or her contributions to the trust, unless Delaware's Asset Protection Trust Statute provides otherwise, or unless the trustor's sole retained beneficial interest is a right to receive discretionary distributions for reimbursement of income taxes paid on behalf of the trust. The amendment in 2009 changed the existing Section 3536(c) to 3536(c)(1) and added a new Paragraph (2). The new Paragraph (2) is an additional exception to the general rule that trusts for the benefit of a settlor do not receive creditor protection under Delaware law. New Paragraph (2) provides that property contributed to an inter vivos marital trust that is treated as qualified terminable interest property or is eligible for the marital deduction shall not be deemed to have been contributed by the settlor, even if the settlor is a potential beneficiary of the trust after the death of the settlor's spouse. Accordingly, Paragraph (2) extends the spendthrift protection afforded by Section 3536(a) to inter vivos marital trusts that may ultimately benefit the settlor in the

event that the Asset Protection Trust Statute does not otherwise provide such protection.

B. Asset Protection Trusts (Sections 3570-3576).

i. **Introduction**. Effective July 9, 1997, Delaware law allows for the creation of self-settled asset protection trusts pursuant to the Delaware Qualified Dispositions in Trust Act (the "Act"). 12 Del. C. §§ 3570-3576. The purpose of the Act, according to the synopsis, is to facilitate the establishment in Delaware of irrevocable trusts that will allow trust settlors to transfer assets from their estates, in order to reduce the federal estate taxes that would otherwise be due upon their deaths. See PLR 200944002 (July 15, 2009) (holding that transfer of assets to asset protection trust is a completed gift and that trust assets are not includible in the settlor's estate under Code § 2036 solely by reason of the trustee's discretionary power to make trust distributions to the settlor). However, beyond its utility as an estate planning device, the statute also allows for the creation of asset protection trusts that do not involve a transfer subject to gift tax.

ii. **Mechanics Of Setting Up The Trust.** The Act is triggered by a "qualified disposition," which means a disposition by or from a transferor to a trustee, with or without consideration, by means of a trust instrument. A "transferor" is defined as the owner of property or the holder of a general power or the trustee of another trust. The trustee must be either a Delaware resident individual (other than the transferor) or an entity (i) authorized by Delaware law to act as a trustee and (ii) subject to supervision by the Delaware Bank Commissioner, the FDIC, the OCC or the Office of Thrift Supervision. Except as noted below, the trust instrument must expressly incorporate Delaware law, must be irrevocable and must contain provisions barring transfers of interests in the trust. If an existing self-settled trust is transferred from another jurisdiction to Delaware and it satisfies the requirements of the Act upon the appointment of a Delaware trustee (although it need not expressly select Delaware as the governing law (see 12 Del. C. § 3570(11)d)) then there will be a qualified disposition upon the appointment of the Delaware trustee.

iii. **Ties To Delaware.** The statute provides that, at a minimum, the trustee must (a) maintain or arrange for custody in Delaware of some or all of the trust property; (b) maintain records for the trust on an exclusive or nonexclusive basis; (c) prepare or arrange for

the preparation of fiduciary income tax returns; or (d) otherwise materially participate in the administration of the trust. The trust may have non-Delaware co-trustees, investment advisers, trust protectors, distribution advisers and other advisers located outside Delaware. The settlor may act as investment adviser and may retain the power to remove and replace other trust advisers, but may not otherwise act as an adviser. However, as explained below, notwithstanding the minimum contacts described in the statute, one must be cautious regarding general conflicts of laws rules regarding choice of governing law.

iv. **Settlor's Retained Powers.** The settlor may retain various rights and powers, such as:

(1) a power to veto distributions from the trust;

(2) a testamentary special power of appointment or similar power;

(3) the potential to receive distributions of income, principal, or both, in the sole discretion of the trustee;

(4) the right to receive all of the income of the trust;

(5) the right to receive principal pursuant to an ascertainable standard contained in the trust instrument;

(6) the right to serve as investment adviser to the trust;

(7) the right to income and principal from a charitable remainder unitrust or a charitable remainder annuity trust;

(8) the right to receive income and principal from a GRAT;

(9) the right to retain a specified percentage (not in excess of 5%) of the value of the trust property each year;

(10) the right to use trust property if the right may be enjoyed only in the sole discretion of the trustee or pursuant to an ascertainable standard;

(11) the right to remove and replace trustees and other advisers;

(12) the right to reside in a residence transferred to the trust if the trust is a qualified personal residence trust described in Section 2702 of the Code;

(13) the right to retain a "qualified annuity interest" within the meaning of Treas. Reg. § 25.2702-5(c)(8);

(14) the right to be reimbursed, in the trustee's discretion, for income tax liability incurred by the settlor with respect to trust

income under the grantor trust rules of Sections 671 through 679 of the Code; and

(15) a testamentary general power of appointment exercisable in favor of the settlor's creditors or the creditors of the settlor's estate.

v. **Protection Provided**. No action of any kind may be brought for an attachment or other provisional remedy against property that is the subject of a qualified disposition, unless the action is to avoid the qualified disposition under Delaware's fraudulent conveyance law. In any such action, the creditor has the burden to prove the claim by clear and convincing evidence. Under Delaware law, as to both current and future creditors, a transfer is fraudulent if:

a. the debtor made the transfer without receiving reasonably equivalent value in exchange for the transferred property and the debtor (a) was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction, or (b) intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay; or

b. the debtor made the transfer with actual intent to hinder, delay or defraud any creditor of the debtor. As to current creditors, a transfer is fraudulent if the debtor made the transfer without receiving reasonably equivalent value in exchange for the transferred property and the transfer rendered the debtor insolvent or the debtor was insolvent at the time of the transfer ("insolvent" means debts exceed assets or generally unable to pay debts as they come due).

vi. **Limitations Period**. An action to avoid a qualified disposition must be brought (a) if the creditor's claim arose before the qualified disposition, within four years after the disposition or, if later, within one year after the disposition could reasonably have been discovered by the creditor; or (b) if the creditor's claim arose after the qualified disposition, within four years after the disposition.

vii. **Persons Not Subject To The Statute.** The following two classes of persons are not subject to the provisions of the Act:

a. any person to whom the transferor is indebted for the payment of support or alimony in favor of such transferor's spouse, former spouse, or children or for a division of property in favor of such transferor's spouse or former spouse incident to

a separation or divorce proceeding in favor of such transferor's spouse or former spouse, but only to the extent of such debt; however, for purposes of this rule, a person is treated as a spouse or former spouse only if the person was married to the transferor at, or before, the time of the qualified disposition; and

b. any person who suffers death, personal injury, or property damage on or before the date of the qualified disposition, which death, personal injury or property damage is at any time determined to have been caused by the tortious act or omission of either the transferor or by another person for whom such transferor is or was vicariously liable.

viii. **Delaware Situs Issue.** Although the Act requires minimal ties to Delaware, there are many reasons why it may be prudent to make sure that the trust has its situs in Delaware. For example, a trust with its situs in Delaware is less likely to become subject to the jurisdiction of the courts in other states, and can be governed by Delaware law with respect to issues of validity and other matters. Most importantly, under general conflicts of law jurisprudence, the enforceability of a spendthrift clause generally is determined under the law of the situs (or place of administration) of the trust. See Restatement (Second) of Conflicts of Law § 273; Bogert, Trusts and Trustees § 293; Scott, On Trusts §§ 626-628. The three most important factors Delaware courts look to in determining the situs of an inter vivos trust are the intention of the settlor, the domicile of the trustee, and the place in which the trust is administered. Lewis v. Hanson, 128 A.2d 819 (Del. 1957), aff'd sub nom. Hanson v. Denckla, 357 U.S. 235, reh'g denied, 358 U.S. 858 (1958); see also Wilmington Trust Co. v. Sloan, 54 A.2d 544, 549 (Del. Ch. 1947); Equitable Trust Co. v. Ward, 48 A.2d 519, 529 (Del. Ch. 1946).

ix. **Four Types of Asset Protection Trusts.** It is possible to create asset protection trusts with four variations of income and gift tax treatment.

a. Incomplete gift, grantor trust.

b. Completed gift, grantor trust.

c. Incomplete gift, non-grantor trust.

d. Completed gift, non-grantor trust.

x. **Transfer and Income Tax Issues.**

a. **Importance of Creditor Rights.** Under the laws of most states, if a trustee has the power, in the exercise of the trustee's sole discretion, to distribute trust assets to the settlor, the settlor's creditors may claim the trust assets in satisfaction of the settlor's debts. A number of federal tax cases and other authorities have held that, in such a case, the settlor has not made a completed gift of the trust assets or the trust assets were includible in the settlor's gross estate. In general, the reasoning has been that the settlor could borrow money or otherwise incur debt that could be satisfied out of the trust and therefore the settlor had (i) indirectly retained the power to revoke the trust (which causes estate tax inclusion under Code § 2038(a)(1)) or (ii) retained enjoyment of the trust property (which causes estate inclusion under Code § 2036(a)(1)) or (iii) failed to relinquish dominion and control over the trust property (for gift tax purposes). See, e.g., Estate of Paxton v. Commissioner, 86 T.C. 785 (1986) (estate inclusion); Outwin v. Commissioner, 76 T.C. 153 (1981) (no completed gift); Paolozzi v. Commissioner, 23 T.C. 182 (1954) (no completed gift); Rev. Rul. 76-103 (no completed gift).

b. **Absence of Creditor Rights**. There is substantial authority for the proposition that if the settlor's creditors cannot reach the assets of a trust, the settlor has made a completed gift and there is no estate tax inclusion even though the trustee has the power, in the trustee's sole discretion, to distribute the trust assets to the settlor. See, e.g., Wells v. Commissioner, T.C. Memo 1981-574 (no estate inclusion); Estate of Uhl, 241 F.2d 867 (7th Cir. 1957) (no estate inclusion); Estate of German v. United States, 85-1 U.S.T.C. 13,610 (Ct. C1. 1985) (no estate inclusion); Rev. Rul. 77-378 (completed gift); PLR 9332006 (no estate inclusion); PLR 8829030 (no estate inclusion under § 2038); TAM 8213004 (completed gift); PLR 8037116 (no estate inclusion); PLR 7833062 (completed gift). The IRS has ruled expressly that a settlor who contributed assets to an asset protection trust had made a completed gift. PLR 9837007 (June 10, 1998). Until recently, the IRS refused to rule on whether the assets contributed to such a trust would be includible in the settlor's gross estate. However, the IRS reversed its course in 2009 and has now ruled favorably on the issue. See PLR 200944002 (July 15, 2009) (holding that transfer of assets to asset protection trust is a completed gift and that

trust assets are not includible in the settlor's estate under Code § 2036 solely by reason of the trustee's discretionary power to make trust distributions to the settlor).

Some commentators have tried to make the case that the same result may not be replicated under the Delaware statute because there are limited classes of creditors under the Delaware statute who are not barred as common creditors, such as child support or property division or alimony incident to divorce from a spouse to whom the settlor was married when the trust was created. Most commentators have agreed that the same result should be produced in Delaware using the theory of "acts of independent significance." The theory of acts of independent significance is applied when determining whether the grantor retained a power which rises to the level of a power which will cause inclusion in the grantor's gross estate under Sections 2036(a)(2) or 2038 of the Code or otherwise result in an incomplete gift. If the retained power allows the grantor the ability to act in such a way so as to affect the beneficial interest of the trust, but the possibility of such action occurring is so de minimis and speculative, the power will be found to be an act of independent significance. See Estate of Tully, 528 F.2d 1401 (1976); Ellis v. Commissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; Rev. Rul. 80-25; and PLR 9141027.

c. **Avoiding Completed Gift Treatment.** In cases where the settlor wishes to avoid making a completed gift, but wishes to obtain the asset protection benefits of the Act, the settlor may (i) retain the power to veto all distributions to beneficiaries and (ii) retain a testamentary limited power of appointment. See Treas. Reg. § 25.2511-2(c) (gift is incomplete where donor reserves power to change interests of the beneficiaries among themselves).

d. **Federal Income Tax.** In general, Delaware asset protection trusts are taxed as grantor trusts because the trustee, as a nonadverse party, has the power to dispose of the beneficial enjoyment of corpus and income and to distribute the trust income to the grantor. See Code §§ 674(a); 677(a).

xi. **Creditor Rights**

a. **State Court Judgments.** Although the full faith and credit clause of the United States Constitution requires the courts

of each state to enforce the judgments of the other states, a judgment against one person is not enforceable against another person, including a trust. The issue of whether a beneficiary's interest in an inter vivos trust can be reached by his creditors is determined under the law of the state where the settlor has manifested an intention that the trust is to be administered. See Restatement (Second) Of The Law Of Conflicts § 273; Bogert, Trusts & Trustees § 293; but see In re Larry Portnoy, 201 BR 685 (S.D.N.Y. 1996) (applied New York law to Jersey (Channel Islands) trust as New York had greatest interest in the litigation and application of Jersey law would offend strong New York and federal bankruptcy policy); see also § 403 of the Restatement (3d) of Foreign Relations Law.

b. **2005 Bankruptcy Act Expressly Validates Use of Domestic Asset Protection Trusts.** The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Bankruptcy Act") was enacted into law on April 20, 2005 subject to a variety of provisions delaying the implementation of certain portions of the new law. During the course of the debate about the 2005 Bankruptcy Act, the New York Times published an article critical of domestic asset protection trusts described by the Times as a "loophole" in the bankruptcy laws used by "millionaires" to avoid their debts. Apparently as a result of the Times article or similar concerns expressed by others, Senator Schumer proposed to amend the 2005 Bankruptcy Act to permit the bankruptcy trustee to recover, for inclusion in the bankruptcy estate of the settlor, all assets in excess of $125,000 transferred to an asset protection trust within ten years prior to the bankruptcy filing. If enacted, this amendment would effectively have precluded the use of domestic asset protection trusts as a viable asset protection strategy. Senator Schumer's proposed amendment was defeated by a vote of 56 to 39. Senator Talent proposed a compromise amendment that both validates the use of domestic asset protection trusts in non-abusive circumstances such as the circumstances permitted by Delaware law and precludes the use of asset protection trusts in the abusive circumstances apparently permitted by the laws of some offshore jurisdictions. Senator Talent's amendment, which was adopted by a vote of 73 to 26 in the Senate and included in the version of the 2005 Bankruptcy Act approved in the House by a 302 to 126 vote, provides that the bankruptcy trustee may avoid any transfer made within

ten years of the bankruptcy filing if (i) the transfer is made to a self-settled trust by the debtor; (ii) the debtor is a beneficiary of the trust (this requirement seems to be subsumed within the definition of "self-settled trust"); and (iii) the debtor made the transfer with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted. Accordingly, the standard adopted for avoiding transfers to asset protection trusts under the 2005 Bankruptcy Act is identical to the existing fraudulent transfer test in Bankruptcy Code Section 548(a)(1)(A) and nearly identical to the fraudulent transfer definition appearing in the Uniform Fraudulent Transfer Act and the Delaware asset protection trust legislation (although under Delaware law creditors enjoy greater rights than under the 2005 Bankruptcy Act because, under Delaware law, a creditor may recover assets from the trust if the transfer of assets to the trust renders the settlor insolvent even in cases where the settlor did not actually intend to hinder, delay or defraud creditors). Senator Talent's amendment, codified as Section 548(e) of Title 11 of the United States Code, clarifies the relationship between the federal bankruptcy laws and the domestic asset protection legislation now in effect in Delaware and other states and, for the first time, expressly validates the utility of these trusts in asset protection planning. See Shaftel and Bundy, Impact of New Bankruptcy Provision on Domestic Asset Protection Trusts, Estate Planning Vol. 32 No. 7 (July, 2005) at 28.

xii. **Particular Uses For Delaware Asset Protection Trusts.** Beyond general creditor protection planning and sophisticated tax planning, there are certain types of trusts that practitioners routinely use for estate planning clients and, all things being equal, it makes perfect sense for those practitioners to create those trusts in Delaware, as Delaware asset protection trusts, to obtain the special advantages of creditor protection without any down-side. For example, if a client is going to use a corporate trustee for his or her GRAT or QPRT or charitable remainder trust, that client should select a Delaware trustee and utilize the Delaware asset protection trust statute to provide creditor protection over the trust. Another common use for a Delaware asset protection trust is to form the trust prior to marriage as an effective pre-nuptial planning device.

4. Dynasty Trusts.

A. Basic Structure. A dynasty trust is simply a trust that has no specific termination date identified within the document and has no rule against perpetuities applicable to it. Dynasty trusts typically are designed to accumulate trust income and principal during the settlor's lifetime. Often the trust is structured as a grantor trust for federal income tax purposes, thereby increasing the value of the gift to the trust. At the settlor's death or the death of a surviving spouse, the trust is divided into per stirpital shares for the settlor's issue. Either through the trustee's discretionary power to distribute income and principal or a series of limited powers of appointment held by trust beneficiaries or some combination of the two, the trust assets are available to be spent (rather than accumulated) by the trust beneficiaries at all times. If the beneficiaries have sufficient assets outside the dynasty trust to meet their needs, the assets in the trust will continue to grow for the benefit of future generations of the settlor's issue. Typically, ultimate charitable beneficiaries or intestate heirs are named in the event all of the settlor's issue die before the dynasty trust is exhausted. Dynasty trusts provide numerous benefits unavailable through outright gifting, such as potential state income tax savings, transfer tax savings, and creditor protection. See, generally, Pulsifer and Flubacher, Dynasty Trusts May Be Even More Powerful If Transfer Tax Laws Change, Estate Planning Vol. 34 No. 11 (November, 2007).

B. Flexibility. Because dynasty trusts are potentially perpetual in duration, and many circumstances can change regarding the tax, economic, and political environment and the specific factual circumstances of the beneficiaries over generations, it is imperative that a dynasty trust be drafted with maximum flexibility in mind. The typical structure is a discretionary sprinkle trust that divides into per stirpital shares on the death of each generation. A trust protector or the trustee can be given the power to amend the trust agreement as may be advisable for such reasons as to preserve favorable tax treatment, address changes in the law or address changing economic conditions or family circumstances among the beneficiaries. A dynasty trust may be drafted to permit the trustee to "decant" trust assets to new trusts designed to meet changing needs or circumstances. When drafting a dynasty trust, it is very important to ensure that the mechanisms for appointing the trustee, direction advisers and trust protectors will continue to operate in perpetuity as opposed to, for example, naming specific individuals with appointment powers who will not be around forever.

From the point of view of the settlor's children and more remote issue, the receipt of their inheritance in the form of a properly designed dynasty trust rather than as an outright bequest will benefit them in many ways, such as providing them with (1) control, (2) creditor protection, (3) Federal transfer tax savings, and (4) potential state income tax saving.

C. Possible Uses.

i. **Allocations of Generation-Skipping Transfer Tax Exemption.** Under the generation-skipping transfer ("GST") tax as in effect in 2013, each person has a $5,250,000 exemption available during lifetime or at death which matches the $5,250,000 exemption from the federal gift tax. Code §§ 2631; 2505. If the exemption is allocated to a transfer in trust, the trust and all transfers out of the trust are exempt from the GST tax. If a trust settlor and the settlor's spouse agree to "split" the gift, pursuant to Code § 2513, both spouses may allocate their GST tax exemption to a single trust. Code § 2652(a)(2). Thus, a $10,500,000 dynasty trust, funded by a couple, who have not made prior taxable gifts, can be entirely exempt from both the gift tax and the GST tax. Such a trust remains exempt no matter how large the corpus grows. The following chart illustrates the possible transfer tax savings, at various growth rates, attributable to a GST exempt dynasty trust when compared to a non-GST exempt trust or no trust at all:

GENERATION-SKIPPING TRANSFER TAXATION *

Value of Property in	25 Years		50 Years		75 Years		100 Years	
ANNUAL AFTER TAX GROWTH	GST EXEMPT DYNASTY TRUST	NO TRUST OR NON-EXEMPT TRUST	GST EXEMPT DYNASTY TRUST	NO TRUST OR NON-EXEMPT TRUST	GST EXEMPT DYNASTY TRUST	NO TRUST OR NON-EXEMPT TRUST	GST EXEMPT DYNASTY TRUST	NO TRUST OR NON-EXEMPT TRUST
3%	2,093,778	1,151,578	4,383,906	1,326,132	9,178,926	1,527,144	19,218,632	1,758,625
4%	2,665,836	1,466,210	7,106,683	2,149,772	18,945,255	3,152,017	50,504,948	4,621,518
5%	3,386,355	1,862,495	11,467,400	3,468,888	38,832,686	6,460,788	131,501,258	12,033,187
6%	4,291,871	2,360,529	18,420,154	5,572,097	79,056,921	13,153,095	339,302,084	31,048,261
7%	5,427,433	2,985,088	29,457,025	8,910,750	159,876,019	26,599,373	867,716,326	79,401,467
8%	6,848,475	3,766,661	46,901,613	14,187,738	321,204,530	53,440,404	2,199,761,256	201,291,903
9%	8,623,081	4,742,694	74,357,520	22,493,150	641,190,893	106,678,135	5,529,040,792	505,941,789
10%	10,834,706	5,959,088	117,390,853	35,510,733	1,271,895,371	211,611,592	13,780,612,340	1,261,012,157

* Assumes $1,000,000 initial contribution to trust and 45% estate tax imposed at *property transfer or taxable termination every 25 years (although the year 2013 top tax rate is 40%; a 45% rate is more reflective of the historical norm).*

ii. **Nonresident Alien Making Gifts To U.S. Beneficiaries.** Nonresident aliens may create GST exempt trusts for the benefit of their issue who are United States citizens. There is no limit on the amount that may be contributed to such a trust. However, such a trust may not be funded with certain types of property. I.R.C. § 2511; Treas. Reg. § 26.2663-2(b).

iii. **Non-GST Exempt Dynasty Trusts.** A transfer to a trust for the benefit of the settlor's issue including children is not subject to the GST tax because such a trust is not a "skip person." I.R.C. § 2613(a)(2)(A). Such a trust can be designed, for example, so that no taxable termination occurs until the last of the settlor's children dies. See Harrington and Acker, 850 T.M. Generation-Skipping Tax at A-18. If prior to the death of the settlor's last surviving child, the trustee makes a taxable distribution from the trust, the distribution is subject to a single GST tax, no matter how many generations are skipped. Id. at 20; I.R.C. § 2612(a). Thus, by creating a non-exempt dynasty trust of this type, it may be possible to transfer assets from the settlor through the trust to issue of the settlor born long after the settlor's death and after the deaths of all but one of the settlor's children with the imposition of only a single GST tax on the assets.

5. Delaware Court of Chancery. The Delaware Court of Chancery has primary jurisdiction over actions at equity including all aspects of trust administration and trust surcharge actions. The Court is widely regarded as among the most respected courts in the United States and the world primarily due to its expertise in corporate law. The Court, however, also has substantial experience in all aspects of trust law. Delaware has extensive common law precedent on most important aspects of trust law in addition to a comprehensive codified body of trust law. The detailed statutory and case law guidance in Delaware, together with the absence of juries, assures that, for the most part, trustees, trust beneficiaries and others having relationships with, or concerns about, Delaware trusts can predict, with a fair degree of certainty, how the Delaware courts likely will view and rule upon trust law matters.

6. "DING" Trusts.

A. Introduction. Several private letter rulings confirm that it is possible, under the laws of any state that permits the creation of so-called "asset protection trusts," to create a trust that is a non-grantor trust for purposes of Subpart E of Subchapter J of the Code and that may be funded with contributions that are not taxable gifts for federal gift tax purposes. See

PLR 200148028 (August 27, 2001); PLR 200247013 (August 14, 2002); PLR 20050214 (September 17, 2004); PLR 200612002 (November 23, 2005); PLR 200637025 (June 5, 2006); PLR 200647001 (August 7, 2006); PLR 200715005 (January 3, 2007); PLR 200731019 (May 1, 2007); PLR 2007729025 (April 10, 2007); and PLR 201310002 (Nov. 7, 2012) (cited not as precedent but as illustrations of how the IRS might analyze the issues addressed in the rulings). All PLRs after PLR 20050214 addressed the transfer tax consequences to the Distribution Committee. In Delaware, which is one of the states in which such a trust may be created, such trusts commonly are known as "DING" Trusts. The acronym stands for "Delaware Incomplete gift Non-Grantor trust." If the state in which such a trust is created also is a state that does not tax income and capital gains accumulated in the trust, the trust can be a powerful state income tax planning vehicle for settlors living in states that would not tax the trust's accumulated income and capital gains merely because the settlor resides in that state at the time the trust is created or because of some other connection between the trust and the settlor's home state. See also Flubacher and Goodwin, DINGed But Not Dented, Trusts & Estates Magazine, July 2013; Pulsifer and Flubacher, Eliminate A Trust's State Income Tax, Trusts & Estates Magazine, May 2006, at p. 30; Steiner, The Accidentally Perfect Non-Grantor Trust, Trusts & Estates Magazine, September 2005, at p. 28.

B. Importance of Creditors' Rights. A DING Trust must be created in a state that allows self-settled asset protection trusts. A DING Trust must be an asset protection trust because a trust is a grantor trust if the settlor's creditors can attach the trust's assets under Treas. Reg. § 1.677(a)-1(d).

C. Distribution Committee. Under Section 674 of the Code, a trust will also be considered a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the settlor or a nonadverse party, or both, without the approval or consent of any adverse party. The key to nongrantor trust treatment is a Distribution Committee comprised of beneficiaries who have a substantially adverse interest with respect to the settlor. In order to avoid grantor trust status, the trust agreement creates a Distribution Committee (called a "Power of Appointment Committee" in PLR 200612002), comprised of "adverse parties" within the meaning of Code § 672(a), whose consent is required in order for (i) the grantor or the grantor's spouse to receive discretionary distributions from the trust; or (ii) the trustee to accumulate income in the trust potentially subject to the grantor's testamentary limited power of appointment.

i. **Key Distribution Committee Considerations.** Some important factors to consider pertaining to the Distribution Committee's adverse interest.

a. The size of the Distribution Committee.

b. The succession of successor Distribution Committee members.

c. The power of the Distribution Committee to make distributions to themselves.

d. The nature of the beneficial interests of the Distribution Committee.

D. Overview of Requirements.

i. **Creditor Protection**. A DING trust must be an asset protection trust. Generally speaking, a grantor trust cannot be used to avoid a settlor's home state's income taxes because the settlor must report the trust's income on his or her personal state income tax return. A trust is a grantor trust if the settlor's creditors can attach the assets of the trust under Treas. Reg. § 1.677(a)-1(d). Under the laws of most states, if a trustee has the power, in the exercise of the trustee's sole discretion, to distribute trust assets to the settlor, then the settlor's creditors may claim all of the trust assets in satisfaction of the settlor's debts. Hence, self-settled trusts created under the laws of most states cannot be used to avoid the settlor's home state income taxes because the home state's version of the grantor trust rules will require the income of such trusts to be reported on the settlor's personal income tax return. By contrast, if the settlor's creditors cannot attach the assets of the trust, as is the case for a Delaware asset protection trust, then the trust would not be a grantor trust on that basis.

ii. **No Reversion**. Under Section 673 of the Internal Revenue Code (the "Code"), a trust is considered a grantor trust if the settlor retains any material reversionary interest. However, a "reversionary interest" would seem not to include the settlor's eligibility to receive discretionary distributions, a position with which the IRS has agreed.

iii. **Substantially Adverse Parties**. Under Section 674 of the Code, a trust will also be considered a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the settlor or a nonadverse party, or both, without

the approval or consent of any adverse party. Therefore, if the settlor wants to leave open the possibility of receiving distributions from the trust during his or her lifetime without triggering grantor trust status under either Section 673 or 674, then the trust should be drafted so that income and principal of the trust may only be accumulated or distributed (including distributions to the settlor) with the consent of the members of the Distribution Committee, each of whom is an adverse party within the meaning of Section 672(a). To avoid grantor trust status under Sections 676 and 677, the trust agreement should specifically provide that during the settlor's life, the trustee has no power to make any distribution of net income or principal to, or for the benefit of, the settlor or the settlor's spouse unless the distribution is made at the direction of the Distribution Committee.

iv. **Attribution of Spousal Interest Under Code Section 672(e)**. Under Code Section 672(e) any interest of the grantor's spouse is treated as being possessed by the grantor. The grantor's spouse may be a discretionary distributee during the lifetime of the settlor, so long as distributions may only be made to the spouse at any time with the consent of the Distribution Committee of adverse persons. The governing instrument should not provide for a QTIP trust after the grantor's death. Of course, because the assets of the trust will be included in the federal taxable estate of the grantor, it will often be necessary to obtain a marital deduction for the assets passing under the trust. The grantor could exercise the testamentary limited power of appointment in favor of the surviving spouse or a QTIP trust.

v. **Limited Power of Appointment**. As a Delaware asset protection trust, the settlor may retain a testamentary limited power of appointment to prevent contributions to the trust being treated as completed gifts. The settlor needs a testamentary limited power of appointment to avoid a completed gift, and this will not cause the trust to be a grantor trust. In order to avoid grantor trust treatment under Treas. Reg. § 1.674(b)-1(b)(3), the income subject to the testamentary power may only be accumulated with the consent of an adverse person. Under the most recent PLR 201310002, the settlor should also retain a lifetime blocking power and/or a lifetime limited power of appointment.

E. Gift Tax Analysis. Prior to CCA 201208026 and PLR 201310002 described below, it was thought that if the trust agreement provides the settlor with a testamentary limited power of appointment over all of the

trust property, then contributions by the settlor to the trust would not be completed gifts for federal gift tax purposes because the settlor would retain the power to change the beneficial interests of the beneficiaries of the trust. CCA 201208026 raised questions concerning this issue and PLR 201310002 appears to have resolved those issues.

F. Grantor Trust Analysis.

i. **Reversionary Interest Under Code § 673**. A threshold question that must be answered in order to determine whether it is possible to create a non-grantor asset protection trust is whether the grantor will be deemed to hold a reversionary interest in the trust for purposes of Code § 673 by reason of the grantor's eligibility to receive discretionary distributions from the trust. Code § 673 provides, in general, that a trust is a grantor trust if the grantor retains a reversionary interest having a value that exceeds five percent of the value of the trust. Query: How did the trust in PLR 200612002 avoid grantor trust status under Code § 673 despite the grantor's spouse's right to receive an outright distribution from the trust upon the grantor's death which seemingly should have been attributed to the grantor under Code § 672(e)? Code § 673(c) provides that, for purposes of determining the value of the grantor's reversionary interest, it shall be assumed that any discretion exercisable in favor of the grantor will be exercised in favor of the grantor to the maximum extent possible. In a properly drafted asset protection trust, the grantor retains no reversionary interest. The trustee's discretionary power to make distributions to the grantor should not be categorized as a "reversionary interest" within the meaning of Code § 673.

Code § 672, which provides definitions for the grantor trust provisions under subpart E, does not define "reversion" for the purposes of Code § 673. Although Code § 672 does not provide a definition of a reversion for purposes of subpart E, it seems clear that a reversion under Code § 673 cannot arise in situations other than those involving a traditional reversion. Under the traditional definition of a reversion, a reversion exists when a person having a vested estate transfers a lesser vested estate to another. See Lewis M. Simes And Allan F. Smith, The Law Of Future Interests, § 82 (2d ed. 1956) (hereinafter "Simes"); see also William Shwartz, Future Interests And Estate Planning, § 2.24 (1965) (hereinafter "Shwartz"). The interest left with the transferor, by virtue of transferring a lesser estate, is called

a reversion. Thus, the grantor of a trust retains a reversionary interest if a portion of the transferred assets will return to the grantor upon the death of a person (life estate), after a number of years (term of years), or upon the grantor's demand (tenancy at will). Under this traditional concept, if a transferor conveys all of his or her interest in property to a trust, then he or she has not retained a reversion even if he or she holds a beneficial interest (such as a right to receive distributions in the trustee's discretion). See Shwartz, § 2.27; see also PLR 9016079 (January 25, 1990) (trust held not to be a grantor trust under Code § 673 even though trustee had power to make discretionary distributions to the grantor).

ii. **Power To Control Beneficial Enjoyment Under Code § 674.** Code § 674(a) provides, in general, that a trust is a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. An asset protection trust (which by its fundamental character always permits discretionary distributions to the grantor) may avoid grantor trust status under Code § 674(a) with respect to the trustee's power to sprinkle income and principal among the grantor, the grantor's spouse and other beneficiaries by providing in the trust agreement that no such distributions may be made except with the consent of one or more members of a Distribution (or Power of Appointment) Committee comprised exclusively of persons who are themselves currently eligible to receive discretionary distributions from the trust. Each such Committee member should be deemed to be an "adverse party" within the meaning of Code § 672(a) provided that his or her interest is "substantial." An "adverse party" is defined in Code § 672(a) as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power. Plainly, any distribution from the trust to the grantor or any other beneficiary would adversely affect the interests of the Distribution Committee members not receiving the distribution. The determination of whether a party has a "substantial" adverse interest is a factual question depending on the merits of each case. Paxton v. Commissioner, 520 F.2d, 923, 925 (9th Cir. 1975). A party with a beneficial interest, or some future interest in the trust property, is not always an adverse party. If the trust agreement for a DING trust provides that all adult competent beneficiaries who are eligible to receive distributions from the trust must consent in

order for the trustee to make a distribution to the grantor or the grantor's spouse, the beneficiaries collectively should be viewed as having a "substantial beneficial interest" in the trust adverse to the exercise of the trustee's discretion in favor of the grantor because each such distribution actually made to the grantor would reduce the amount that otherwise would be available for distribution to or among them. Similarly, in PLR 9016079 (January 25, 1990) and each of the rulings pertaining to DING trusts, the IRS held that each person eligible to receive discretionary distributions from the trust had a substantial interest that was adverse, within the meaning of Code § 672, to the exercise of the trustee's discretion in favor of the grantor. See also Grantor Trusts: Sections 671-679, Tax Mgmt. (BNA) No. 858 at A-15.

iii. **Testamentary Power of Appointment Under Code § 674(b)(3).** The grantor's testamentary limited power of appointment (a requirement to avoid adverse gift tax treatment) should not cause a DING trust to be taxable as a grantor trust. Code § 674(a) does not apply to a power of appointment exercisable only by will other than a power held by the grantor to appoint income accumulated by the grantor or income that may be accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. No income can be accumulated in a DING trust without the consent of the Distribution Committee because the Committee members may, by unanimous action, appoint current and accumulated income among the trust beneficiaries (including the Committee members themselves) eligible to receive current trust distributions thereby preventing the accumulation of income subject to the grantor's testamentary limited power of appointment.

iv. **Power To Revest Property Under Code § 676.** Code § 676(a) provides that the grantor shall be treated as the owner of any portion of a trust if the grantor or a nonadverse party has the power to revest title to the trust property in the grantor. Again, the existence of a Distribution Committee comprised of adverse parties will prevent the application of Code § 676.

v. **Code § 677 Distribution Power.** Code § 677 provides, in general, that the grantor shall be treated as the owner of any portion of a trust the income from which may, without the approval of any adverse party, be distributed to the grantor or the grantor's spouse; or accumulated for future distribution to the grantor or the grantor's spouse; or applied to the payment of premiums on

insurance on the life of the grantor or the grantor's spouse. As none of these actions can occur with respect to the income of a DING trust except as a result of actions taken by Distribution Committee members, Code § 677 would not cause a carefully designed DING trust to be taxed as a grantor trust.

G. IRS News Release IR 2007-127. The IRS announced on July 9, 2007 in IR 2007-127 that it is reconsidering a series of PLRs that address DING Trusts. Those PLRs addressed, in part, the gift tax consequences applicable to the Distribution Committee under Sections 2511 and 2514 of the Code. The announcement said that it had come to the IRS's attention that the conclusions in the PLRs regarding the application of Section 2514 to the Distribution Committee members might not be consistent with Rev. Rul. 76-503, 1976-2 C.B. 275, and Rev. Rul. 77-158, 1977-1 C.B. 285. Specifically, do Distribution Committee members possess general powers of appointment? The IRS acknowledged that it received comments that the facts in the PLRs are distinguishable from the Revenue Rulings because in the PLRs, the settlor's gift to the trust is incomplete. However, the IRS referenced Treas. Reg. Sec. 25.2514-1(e), Ex. (1) and Rev. Rul. 67-370, 1967-2 C.B. 324 as possibly suggesting a contrary view. Before taking any action with respect to the PLRs, the Office of the Associate Chief Counsel, Passthroughs & Special Industries requested comments regarding whether the Distribution Committee members possess general powers of appointment under Code Section 2514. Comments were received by the IRS from the Delaware Bankers Association and Delaware Bar Association, the American Bar Association, New York Bar Association Tax Section, New York City Bar Association and others.

i. **DINGS After IR 2007-127**. The only key distinction between the DING structure in the PLRs and Rev. Rul. 76-503 and Rev. Rul. 77-158 is that with a DING, the settlor's gift to the trust is incomplete. Pending final resolution of the question, persons crafting new DING trust agreements should be familiar with IR 2007-127 and the various comment letters and take these varying viewpoints into consideration both in designing DING trusts and advising settlors and others involved in the project (including the Distribution Committee members themselves) about the potential risks and rewards of structuring and using DING trusts. It should be possible to draft a DING trust agreement that addresses the issue raised by IR 2007-127 as well as a possible grantor trust issue under Code § 674(a) raised by commentators in response to IR 2007-127.

ii. **Avoiding a Completed Gift Taxable to the Distribution Committee**. Because the Distribution Committee will always be composed of persons eligible to receive distributions out of the trust estate, the members of the Distribution Committee will have the power to distribute trust income and principal to themselves. If this power over distributions were found to be a "general power of appointment" as defined under Section 2514(c) of the Code, then the Distribution Committee's exercise or release of such power would be deemed to be a transfer of property, taxable to the Distribution Committee as a completed gift.

iii. **When setting up a Distribution Committee for a DING trust**, it's important to remember that a co-holder of a power of appointment has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, the IRS has explicitly provided that a co-holder of a power is considered as having an adverse interest to the possessor of the power where the co-holder may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Treas. Reg. § 25.2514-3(b)(2). The adverse interests inherent in a "shrinking committee" ensure that the distribution power will not rise to the level of a general power of appointment.

iv. **Alternative Approaches to Drafting**. Use of a shrinking Distribution Committee of three or four members should fall squarely within the safe harbor under Treas. Reg. § 25.2514-3(b)(2) and should address all of the concerns that the IRS raised in IR 2007-127.

v. **Other Considerations**. Although not raised as an issue by the IRS, the New York State and City Bar Associations opined that the DING trusts described in the PLRs were grantor trusts pursuant to Code Section 674(a) because, in their view, the settlor could collude with a Distribution Committee member about making a distribution to such member, and the Distribution Committee member, agreeing to such distribution, would therefore not be adverse to the settlor's supposed exercise of a distribution power. The power to make distributions is held by the Distribution Committee with the consent of the settlor, yet the New York Bar comment presumes that the settlor's ability to consent to a distribution is the same as the settlor possessing a power to actually make a distribution to the Distribution Committee member, which the member would automatically accept. The

New York State and City Bar Associations also argued that a testamentary limited power of appointment retained by the settlor is not enough by itself to cause incomplete gift treatment. They argued that the incomplete gift ruling requires one to look at the settlor's power to consent to distribution decisions made by one Distribution Committee member; if that member is adverse then there is a completed gift, but if the member is not adverse then there is no completed gift but the trust is a grantor trust.

vi. **Unlike the other comments submitted to the IRS**, they also argued that persons other than the settler of a trust can possess taxable general powers of appointment over trust assets that were never the subject of a completed gift and are includable in the settlor's estate.

vii. **Timing of IRS Pronouncement**. It does not appear that the IRS will ever address the issue raised in IR 2007-127. The personnel that were working on this issue have retired and the issue is not on the guidance plan.

H. Year 2010: Code Section 2511(c).

i. **2511(c) of the Code Was Only Effective in 2010**. In 2010, there was an outright freeze on DING Trusts when Code Section 2511(c) became effective for one year. It provided: "Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1." This provision arguably made it impossible during 2010 to create a trust that could be treated as both an incomplete gift and a non-grantor trust. It unsettled, with the rest of the tax laws related to the temporary repeal of the estate tax, on January 1, 2011. After 2010, clients again began to form DING trusts, although such trusts were less prevalent due to all of the uncertainty and changes in the law.

I. New Filing Requirement For New York Resident Trusts. On July 23, 2010, the Office of Tax Policy Analysis of the New York State Department of Taxation and Finance issued memorandum TSB-M-10(5)I, imposing new filing requirements on New York "resident trusts". For the first time, New York resident trusts that are not required to pay New York income tax are required to file a state income tax return in New York for information purposes. Prior to the 2010 memorandum, New York resident trusts not subject to taxation by New York were not required

to file a state fiduciary income tax return. The new memorandum reverses this policy, effective as of the 2010 tax year, by imposing a filing requirement on New York resident trusts for any year in which any such trust is required to file a federal income tax return, regardless of whether such trust had any New York taxable income for that year. This new filing requirement would allow New York to better quantify the amount of revenue foregone under its current tax treatment of resident trusts, including DING trusts settled by New York residents. This may have a chilling effect on DING trusts created by New York residents.

J. IRS Chief Counsel Advisory ("CCA") 201208026 (issued February 24, 2012). In this memorandum, the IRS ruled that a transfer to a trust was a completed gift for Federal tax purposes even though the donor retained a testamentary limited power of appointment over the entire trust. This memorandum immediately raised questions about whether the DING trust rulings that concluded that transfers to a DING trust are incomplete gifts for Federal tax purposes due to the retention by the transferor or a testamentary limited power of appointment. Many practitioners have taken the view that merely retaining a testamentary limited power appointment is sufficient to prevent transfers to a trust from constituting a completed gift. This raises the question: "Does the funding of a DING trust under the traditional structure give rise to a completed gift notwithstanding the PLR conclusions to the contrary?" Some commentators have suggested that the clear approach to work around this latest roadblock in the path of DING trusts is to give the trustor an inter vivos power to block distributions, an inter vivos limited power of appointment, or even an inter vivos power to make distributions pursuant to an ascertainable standard. See Estate Planning Newsletter #1937 (March 7, 2012) at http://www.leimbergservices.com Copyright 2012 Leimberg Information Services, Inc. (LISI).

K. PLR 201310002. On March 8, 2013, the IRS released PLR 201310002, another favorable ruling addressing the gift and income tax consequences of a DING trust. This ruling described a slightly different structure than that used in all of the previous rulings.

i. **Background**. In this ruling, during the settlor's lifetime, the trustee must distribute such amounts of net income and principal to the settlor and his issue as directed by the Distribution Committee and/or settlor, as follows: (1) pursuant to the direction of a majority of the Distribution Committee members, with the written consent of the settlor (the "Settlor's Consent Power"); (2) pursuant to the direction of all of the Distribution Committee members, other

than the settlor, (the "Unanimous Member Power"); and (3) such amounts of the principal (including the whole thereof) as the settlor deems advisable to provide for the health, maintenance, support and education of the settlor's issue (the "Settlor's Sole Power"). Although not explicitly stated in the PLR itself, under the facts of this case, there is no automatic replacement upon any member of the Distribution Committee ceasing to serve. It is a so-called "shrinking Distribution Committee" that satisfies the gift tax Treasury Regulations. In addition, the Distribution Committee will cease to serve if there are ever fewer than two members of the Distribution Committee. The settlor was a member of the Distribution Committee of this trust.

ii. **Income Tax Ruling**. The IRS held that (i) none of the circumstances described in the PLR would cause the settlor to be treated as the owner of any portion of Trust under Sections 673, 674, 676, or 677 of the Code, and (ii) because none of the other Distribution Committee members has a power exercisable solely by himself to vest trust income or corpus in himself, none would be treated as the owner of any portion of the trust under Section 678(a) of the Code. The IRS further concluded that none of the circumstances described in the PLR would cause administrative controls to be considered exercisable primarily for the benefit of settlor under Section 675 of the Code. The income tax ruling was made with almost no analysis of the relevant authorities cited in the ruling.

iii. **Gift Tax Rulings**. With respect to the Settlor's Consent Power, the IRS noted that under Treas. Reg. § 25.2511-2(e), a donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. The Distribution Committee members are not takers in default for purposes of Treas. Reg. § 25.2514-3(b)(2). They are "merely coholders of the power." Also, under Treas. Reg. § 25.2514-3(b)(2), a co-holder of a power is only considered as having an adverse interest where he may possess the power after the possessor's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. In this case, the Distribution Committee ceases to exist upon the settlor's death. Accordingly, the Distribution Committee members do not have interests adverse to the settlor under Treas. Reg. § 25.2514-3(b)(2) and for purposes of Treas. Reg. § 25.2511-2(e). Therefore, the settlor is considered as possessing the power to distribute income and principal to any beneficiary himself

because he retained the Settlor's Consent Power. The ruling states that: "The retention of this power causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes."

This part of the ruling is interesting because the IRS appears to apply two separate tests for adversity under the income tax laws and the gift tax laws. Under Section 674 of the Code, a trust will also be considered a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the settlor or a nonadverse party, or both, without the approval or consent of any adverse party. The IRS concluded that the trust is a nongrantor trust and, consequently, it must have necessarily concluded that the Distribution Committee members are adverse parties with respect to the settlor for grantor trust purposes, although this is only implicit in the ruling because the IRS offered no discussion or analysis of its income tax ruling. Still, the IRS expressly concluded that the Distribution Committee members do not have interests adverse to the settlor under Treas. Reg. § 25.2514-3(b)(2) and for purposes of Treas. Reg. § 25.2511-2(e).

In addition, the IRS also concluded that the Settlor's Sole Power gives the settlor the power to change the interests of the beneficiaries and, accordingly, the retention of the Settlor's Sole Power causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes under Treas. Reg. § 25.2511-2(c).

Further, just as in the previous PLRs, the settlor retained a testamentary power to appoint the property to any person or persons or entity or entities, other than the settlor, the settlor's estate, creditors, or the creditors of settlor's estate. The IRS concluded that under Treas. Reg. § 25.2511-2(b) the retention of a testamentary power to appoint the remainder of a trust is considered a retention of dominion and control over the remainder. Accordingly, the retention of the testamentary limited power of appointment causes the transfer of property to the trust to be incomplete with respect to the remainder of the trust for federal gift tax purposes.

iv. **No General Power Held by the Distribution Committee Members**. The IRS concluded that the members of the Distribution Committee do not possess general powers of appointment. With respect to the powers held by the Distribution Committee members under the Settlor's Consent Power, the IRS found that those powers are exercisable only in conjunction with

the creator, the settlor, and thus under Treas. Reg. § 2514(c)(3)(A) the Distribution Committee members do not possess general powers of appointment by virtue of possessing this power. The IRS further held that the powers held by the Distribution Committee members under the Unanimous Member Powers are not general powers of appointment because, as in the example in Treas. Reg. § 25.2514-3(b)(2), the Distribution Committee members have substantial adverse interests in the property subject to this power, because the failure of any member of the Distribution Committee to serve will leave a vacancy and there is no automatic replacement.

Finally, the IRS concluded that (i) the trust's assets are includible in the settlor's taxable estate for federal estate tax purposes, (ii) any distribution to the settlor from the trust is merely a return of the settlor's property with no transfer tax consequences, (iii) any distribution to a person other than the settlor will be a taxable gift by the settlor, and (iv) distributions by the members of the Distribution Committee are not taxable gifts made by the Distribution Committee members.

v. **Delaware Implications**. With regard to the gift tax ruling, PLR 201310002 states: "The retention of [the Settlor's Consent Power] causes the transfer of property to the trust to be wholly incomplete for federal gift tax purposes." Consequently, it seems reasonable to conclude that the Settlor's Consent Power combined with the settlor's testamentary limited power of appointment were sufficient to cause the transfers to the trust to be wholly incomplete for gift tax purposes (without the necessity of the settlor's inter vivos limited power of appointment). Under Delaware law, it is permissible for a settlor of a Delaware asset protection trust to retain a lifetime power to consent to all distributions and also a testamentary limited power of appointment under Section 3570(11)b of Title 12 of the Delaware Code. However, it is not permissible for a settlor to retain inter vivos limited power of appointment over a Delaware asset protection trust, nor is it possible for the settlor to be an actual member of the Distribution Committee, although the structure in this PLR could be otherwise replicated in Delaware, absent the inter vivos limited power of appointment.

L. Example. A simple example illustrates the utility of a DING trust: A couple residing in New York City has a sizeable portfolio of marketable securities and other intangible assets. They are concerned about liability to potential future creditors. They are in the highest federal income tax bracket and pay combined state and city income tax at an 11 percent rate.

They do not wish to make a completed gift because they do not wish to pay gift tax or use any of their gift tax exclusion amount. Within their portfolio of securities, they have $2 million of assets that they essentially hold for the benefit of their children because they do not foresee any circumstance (other than a catastrophic lawsuit or similar financial setback) in which they would expend that money during their lifetimes given the magnitude of their other assets.

A DING trust could be a powerful planning tool for this couple. As settlors of such a trust, they could retain the right to receive discretionary distributions of income and principal from the trust (subject to the consent or direction of a Distribution Committee comprised of their children who are also potential discretionary beneficiaries). This would provide the couple with a safety net against the possibility of a major financial setback. The trust also will provide creditor protection for the trust assets. At the same time, the trust's income will not be subject to New York state or city income taxation assuming the trust avoids New York source income and other contacts with New York that would subject the trust to New York income tax. The federal income tax imposed on the trust's assets would be about the same in the trust as it would be if the couple owned the assets outright.

Had the couple retained this $2 million in their own names and achieved an enviable 10 percent annual rate of return before taxes, the $2 million would grow to about $7.9 million in 20 years, assuming the earnings are comprised entirely of qualified dividends and realized capital gains. The effective rate of tax on these investment assets would be 28.8 percent (20 percent federal rate on capital gains and dividends; 11 percent New York state and city tax on all income; New York taxes deducted in computing federal taxes). By contrast, contributing the $2 million to a DING trust means the effective rate of tax is reduced to 20 percent, and the trust grows to about $9.322 million in the same time with the same rate of return. Thus, merely by creating the trust, the couple would obtain asset protection for the trust property during the entire 20-year trust period and, at the end, the value of the property would be $1.4 million greater.

M. Planning Cautions. It is possible that state taxing authorities in various states will 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, advisors should counsel their clients to avoid funding such trusts with assets likely to be sold shortly after the creation of the trust. Such a trust could be even more vulnerable

to attack if the sale were followed by the distribution of all, or a large portion, of the trust assets back to the settlor. The settlor'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.

In addition to risks under state tax laws, such a transaction could jeopardize the trust's creditor protection if there is evidence that the settlor had a prearranged agreement with the distribution committee to distribute assets back to the settlor at a particular time. Ideally, such trust should be created only with the intent to continue the trust at least for the lifetime of the settlor. Settlors should avoid transferring a proportion of their assets to such a trust that is so large that the settlor will need routine distributions from the trust to pay for living expenses. Optimally, for creditor protection reasons as well as sound tax planning, advisors 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. Also, in certain circumstances, a non-Delaware co-trustee, advisor or trust protector could subject the trust to income tax by the state of their residence.

7. Other Attractive Delaware Statutes.

A. Decanting Statute (Section 3528).

i. **The Concept**. At least eighteen (18) states have enacted so-called "decanting statutes." They are:

Alaska	Nevada
Arizona	New Hampshire
Delaware	New York
Florida	North Carolina
Illinois	Ohio
Indiana	Rhode Island
Kentucky	South Dakota
Michigan	Tennessee
Missouri	Virginia

The statutes vary in their details but the fundamental concept behind each is essentially the same in that all of the statutes permit trustees authorized to make outright distributions from a trust to

instead make such distributions in further trust. The concept is simple but the implications and opportunities are immense and complex. Delaware's decanting statute (12 Del. C. § 3528) permits trustees empowered to distribute trust principal outright to, or among, trust beneficiaries, whether the power is discretionary or exercisable pursuant to an enforceable distribution standard, to instead distribute trust assets to a different trust for the benefit of one or more of the beneficiaries to whom the trustee could have made an outright distribution. The practical opportunity (and customary use) afforded by this statute is to permit the trustee to make a distribution from a trust governed by an outdated trust instrument to a new trust governed by a modern trust instrument held upon beneficial terms substantially identical to the beneficial terms of the old trust. Thus, without in any way altering the trust's beneficial terms, a trust "trapped" in an old document can be "decanted" to a new vessel incorporating modern investment provisions, updated administrative provisions and other useful provisions without the necessity of a court-supervised modification. However, this customary use of the decanting statute is no more than the tip of the iceberg, as the possible uses of the decanting statute are as varied and numerous as the ideas that spring from the minds of thoughtful and creative trustees and their advisors.

ii. **Terminology**. For convenience and ease of understanding, the term "first governing instrument" is used throughout this outline to refer to an existing trust instrument, including a trust agreement, Will, court order or any other document that creates a trust (referred to herein as the "first trust") from which assets may be distributed in further trust pursuant to the decanting statute. The term "second governing instrument" is intended to refer to whatever document created the trust (referred to herein as the "second trust") to which assets from the first trust may be distributed pursuant to the decanting statute. The second governing instrument might be a newly minted declaration of trust made by the trustee; could be a preexisting trust instrument that created a trust already in existence prior to the decanting transaction or could be the same document, that exercises the trustee's decanting power.

iii. **Overview of How the Statute Works**. In brief, the statute simply enables the trustee to make principal distributions in further trust when and to the extent that the trustee is empowered by the first governing instrument to make principal distributions outright.

The statute does not address the possibility of decanting income so income may not be decanted as such. Of course, if the trustee is empowered to accumulate income and add it to principal, then, as a practical matter, income also may be decanted. Furthermore, if the first governing instrument requires income to be distributed, a trustee empowered to distribute principal outright could, subject to a special rule for marital deduction trusts, decant to a second trust in which the income beneficiaries of the first trust are no longer eligible to receive income.

The requirements under Section 3528 for the beneficial interests in the new trust instrument can be thought of as a puzzle that is comprised of two pieces. The first piece consists of the interests of the beneficiaries of the first trust who are currently permissible objects of an exercise of the power to distribute principal. These may be beneficiaries who are eligible to receive principal distributions in the trustee's sole discretion or pursuant to a standard. The second piece of the puzzle consists of the other beneficial interests in the original trust (e.g. presumptive and contingent remaindermen and other beneficiaries who are not presently eligible to receive distributions of principal). It is possible to alter or even eliminate the beneficial interests of the first group (including granting them a limited or general power of appointment), subject to any applicable standard applicable to the principal distributions from the first trust. However, the second group of beneficiaries must have interests in the new trust that are substantially identical to their interests in the original trust. Essentially, the beneficial interests in the new trust of any beneficiary of the original trust who is not presently eligible to receive distributions of principal must be identical to their interests in the original trust.

It is not possible to add new beneficiaries to an existing trust through decanting, as neither of the two set of criteria in the statute permits the addition of new beneficiaries. However, a beneficiary who is currently eligible to receive distributions of principal can be given an inter vivos or testamentary power of appointment that is exercisable in favor of non-beneficiaries.

As a result, the trustee and first trust beneficiaries collectively may fairly be said to possess the ability (without adverse transfer tax consequences) to cause the benefits of first trust property to be enjoyed by persons who were not beneficiaries of the first trust.

Another of the statutory rules is that the trustee may provide in the second governing instrument that, at a time or upon an event specified in the second governing instrument, the assets of the second trust shall thereafter be held for the benefit of the beneficiaries of the first trust upon terms and conditions concerning the nature and extent of each such beneficiary's interest that are substantially identical to the first governing instrument's terms and conditions concerning such beneficial interests. This means, among other things, that all of the provisions of the first governing instrument regarding beneficiaries other than those currently eligible to receive distributions (such as those who may be eligible to receive distributions in the future and remaindermen) may be preserved in the second governing instrument. However, the trustee may not add new current or non-current beneficiaries nor accelerate or otherwise alter the interests of the various non-current beneficiaries identified in the first governing instrument. So, for example, if the trustee is empowered by the first governing instrument to sprinkle distributions among the descendants of the settlor and the first governing instrument provides that the remaining trust assets pass to charity upon the death of the settlor's last living descendant, the trustee could create a second trust for the benefit of some (but less than all) of the settlor's descendants but could not provide for a distribution from the second trust to charity sooner than was permitted by the first governing trust (meaning no charity could take anything from the second trust so long as any descendant of the settlor remained living). The remaining rules are rules that prevent the trustee from (a) decanting from a revocable trust; (b) delaying the time that interests in a so-called "minor's trust" vest and become distributable; (c) decanting if the first governing instrument expressly forbids decanting; (d) reducing an income interest in a trust for which a marital deduction has been taken for federal estate or gift tax purposes; and (e) decanting property subject to a current withdrawal right held by a trust beneficiary who is the only beneficiary eligible for current distributions.

iv. **How Is Decanting Accomplished**. The Delaware statute provides that the decanting transaction whereby trust assets are distributed from one trust to another trust must be accomplished by an instrument in writing, signed and acknowledged by the trustee and filed with the records of the trust. In this instance, the statute seems plainly to refer to the records of the first trust but it seems evident the trustee (or the two trustees if the second trust's trustee

is a different trustee) for both trusts ought to keep a copy of this written instrument among the trust records. The statute mentions "acknowledgment," which means that the written instrument must be notarized. Beyond these few formalities, the trustee is left to the trustee's own devices to determine how best to arrange the mechanics of decanting transactions. There is no requirement for beneficiary consent, court approval, or even a filing with any court.

v. **When Is Decanting Permitted**. Unless the first governing instrument expressly prohibits decanting, a trustee may, under Delaware law, decant whenever the trustee has authority to make outright principal distributions whether or not the trustee's distribution power is limited by an ascertainable standard but only to the extent that trust principal is currently distributable. So, for example, if the trustee may distribute up to 5% of principal annually for the education of beneficiaries, the trustee may only decant to that extent and for that purpose.

vi. **Protecting the Trustee**. As a practical matter, decanting is far more likely to be employed and in a far more creative and potentially beneficial manner in cases where the trustee is adequately protected from potential liability for having engaged in the decanting transaction. Therefore, decanting works best when the trustee is fully protected from liability for having undertaken the decanting transaction. Under Delaware law, adult trust beneficiaries may release a trustee from liability for engaging in a decanting transaction. 12 Del. C. § 3588. Furthermore, the releases of the trust's adult beneficiaries and presumptive remaindermen generally will bind the trust's minor and unborn beneficiaries and contingent remaindermen. 12 Del. C. § 3547. Not surprisingly, trustees tend to be far more receptive to decanting opportunities when all of the current adult and presumptive remaindermen beneficiaries are prepared to consent to the transaction in a fashion that binds the other trust beneficiaries.

vii. **Ascertainable Standard**. Some state's decanting statutes appear to permit decanting only when the trustee is permitted to distribute trust principal in the trustee's sole discretion and not pursuant to an ascertainable standard. The Delaware decanting statute, however, permits decanting in every case where the trustee is empowered to distribute principal without regard to whether the trustee's distribution power is constrained by an ascertainable standard. Of course, if an ascertainable standard is imposed

upon the trustee, the trustee must abide by that standard when decanting just as would be the case if the trustee were making an outright distribution from the trust.

viii. **Governing Law Considerations.** The Delaware decanting statute provides that the use of the statute to decant shall be considered the exercise of a power of appointment (other than a power to appoint to the powerholder, the powerholder's creditors, the powerholder's estate, or the creditors of the powerholder's estate) and shall be subject to the provisions of Chapter 5 of Title 25 of the Delaware Code concerning the time at which the permissible period of the rule against perpetuities begins and the law which determines the permissible period of the rule against perpetuities. Chapter 5 of Title 25, together with the Delaware Court of Chancery's opinion in Wilmington Trust Company v. Wilmington Trust Company (26 Del. Ch. 397, 1942), makes clear that the validity of the exercise of a limited power of appointment (and, by virtue of the cross reference in the decanting statute, the validity of a decanting transaction) is governed by Delaware law whenever the trust has its situs in Delaware at the time that the power is exercised. This result is confirmed by the express provisions of 12 Del. C. § 3528(f) which was added to the statute by a 2011 amendment. Accordingly, the trustee of a trust initially created outside Delaware and governed initially by the law of some other jurisdiction, could, as a matter of Delaware law, decant pursuant to the Delaware decanting statute if the trust's situs were moved to Delaware. Thus, a trustee should be able to use the decanting statute whenever the trust is administered in Delaware even if some other jurisdiction's laws govern the trust's validity, construction and administration. It should be noted, however, that in most cases Delaware law would govern matters of administration for so long as the trust's situs is Delaware. See 12 Del. C. § 3332. Furthermore, special care should be taken to assure that Delaware's release statute (12 Del. C. § 3588) and virtual representation statute (12 Del. C. § 3547) are available in cases where Delaware law does not govern the trust's administration; otherwise, the utility of the decanting statute might be severely compromised given the understandable reluctance of trustees to decant without some assurance that the beneficiaries will not sue the trustee if the decanting turns out to produce some adverse consequence from the point of view of one or more of the beneficiaries.

ix. **Possible Uses of Decanting Statute**

a. **Alter Administrative Provisions**. Probably the most obvious and common use of decanting statutes in Delaware and elsewhere is to improve the trust's administrative provisions without altering beneficial interests in any manner. The statute can be used in Delaware, for example, to (i) add a direction or consent investment or distribution adviser to invest or participate in the investment of some or all of the trust assets or direct or participate in distribution decisions; (ii) modernize antiquated provisions; (iii) incorporate modern or more flexible investment authority; (iv) enumerate express powers useful or perhaps essential to the trustee; (v) add other advisers; (vi) add trust protectors or similar fiduciaries having special roles or powers such as the ability to oversee or remove trustees or other fiduciaries; (vii) revise provisions that otherwise might cause potential tax problems; (viii) revise standards of care or liability as appropriate to increase trust flexibility; (ix) change trustee compensation provisions; and (x) change beneficiary notice provision.

b. **Clarify Ambiguous Provisions**. Ambiguous provisions and other inartful provisions may be addressed by decanting to a second trust governed by a second governing instrument identical to the first governing instrument except to the extent necessary to resolve the ambiguity or other problematic provisions appearing in the first governing instrument. However, in such cases, if the resolution of an ambiguity even arguably alters beneficial interests, or could in any circumstance have the effect of altering beneficial interests, a prudent trustee will not generally engage in the decanting transaction unless the trustee is protected by appropriate releases binding all of the current and potential trust beneficiaries and the trustee, in consultation with competent advisers, is satisfied that the resolution does not raise material tax considerations as there are many situations in which altering ambiguous provisions could create adverse income, gift or generation-skipping transfer tax consequences.

c. **Extend the Life of Trust.** As was mentioned above, the Delaware decanting statute provides that the use of the statute to decant shall be considered the exercise of a limited power of appointment and shall be subject to the provisions of Chapter 5 of Title 25 of the Delaware Code covering the time at which

the permissible period of the rule against perpetuities begins. For the reasons explained above, Delaware law will govern this issue if the trust is located in Delaware at the time of the decanting and under a unique provision of Delaware law it is possible to commence a new perpetuities period by virtue of the exercise of a limited power of appointment. Consequently, and without regard to the law governing the validity of the first trust or whether the first trust is of limited duration, a trustee may validly decant from a first trust of limited duration to a second trust of longer duration than the first including to a second trust of perpetual duration. For creditor protection purposes, state income tax avoidance and for many other reasons, the possibility of decanting to allow assets to remain in trust for longer than permitted by the first governing instrument may be extremely advantageous. However, in any case where the first trust is exempt from generation-skipping transfer tax by reason of the effective date rules or the allocation of generation-skipping transfer tax exemption to the first trust, the second trust will be subject to the generation-skipping transfer tax, for the reasons explained below, unless (i) all of the beneficial interests in the second trust vest at the same time as the beneficial interests would have vested under the terms of the first governing instrument and (ii) the trust assets are includible in the gross estate of the beneficiaries in whom the beneficial interests vest if any of those beneficiaries die before those assets are distributed to them.

d. **Create Subtrusts**. Trustees frequently encounter material divergences in the needs and investment philosophies of a trust's beneficiaries. One solution that often ameliorates the tension sometimes caused by differing beneficiary needs and investment philosophies is to divide the assets of a single trust into separate trusts or separately invested trust shares for the appropriate beneficiaries or beneficiary groups. Decanting to separate trusts or to a second trust with appropriate subtrust or share language can often accomplish the desired result.

e. **Avoid State Income Tax.** Although the topic is beyond the scope of an outline discussing Delaware law, it appears that, pursuant to the income taxation laws of some states, trusts created by residents of the state are subject to state income taxes while identical trusts created by nonresidents of the

state are not subject to state income taxation. If so, it may be that a trust created by a decanting (in most cases the second trust to which trust assets are decanted is, at least as a matter of trust law, "created" by the trustee of the first trust) would not be subject to income taxation by a state that taxes the first trust's income because the first trust was created by a resident of the state while the second trust was not.

f. **Grant Powers of Appointment**. Although Delaware law does not permit a trustee to create new trust beneficiaries by means of a decanting (and a contrary rule, such as appears to exist in some states, may create grave public policy concerns not to mention angst among settlors), the statute does permit the trustee to grant a general or limited power of appointment over trust property to a beneficiary to whom the trustee otherwise could have appointed the property made subject to the power. This provision seems not to raise public policy concerns as it seems appropriate to permit the trustee to allow a beneficiary to decide who takes the trust property in cases where the trustee could alternatively have distributed the property to the beneficiary who could then have given the property to whomever the beneficiary wished. The difference between the two alternatives is, of course, that while both achieve the same economic result, the outright distribution and gift often will produce adverse gift tax consequences while decanting to a second trust and granting a limited power of appointment can, with proper planning, be done in many cases so as to avoid the federal gift tax. As was mentioned above, this planning opportunity likely is not available in cases where the trustee's principal distribution power under the first governing instrument is constrained by an ascertainable standard as it likely would not be possible to grant a power of appointment while abiding by the ascertainable standard.

g. **Postpone Vesting**. It is possible to postpone a beneficiary's right to receive an outright distribution from a GST tax exempt trust. Treas. Reg. § 26.2601-1(b)(4)(i)(D) provides that the modification of the governing instrument of a GST tax exempt trust (which, under applicable Treasury Regulations would include a decanting) will not cause the trust to become subject to GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons

who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest beyond the period provided for in the original trust. There have been several private letter rulings concerning modifications of GST exempt trusts that would have distributed property to a beneficiary at a certain age but instead continue to be held in trust by the trustee for that beneficiary. The Internal Revenue Service has ruled that such modifications will not cause adverse GST tax consequences if the assets will continue to be held for the exclusive benefit of that beneficiary after the designated age and the assets would ultimately be includible in the beneficiary's taxable estate as a result of the beneficiary possessing a testamentary general power of appointment and/or, in the absence of the general power of appointment or in the absence of its exercise, the assets would pass to the beneficiary's estate. See PLR 200752018, PLR 200736008, PLR 200608001, PLR 200520023, PLR 200308045, and PLR 200231011.

h. **Creditor Protection**. Some trusts lack a spendthrift clause which protects the interests of beneficiaries from the claims of their creditors and prevents beneficiaries from transferring their interests to others. A decanting can be used to add a spendthrift provision to the new trust, to protect the assets from beneficiaries' creditors or claims of a spouse pursuant to a divorce. It is also possible to decant an existing self-settled trust into a new trust with terms that qualify as an asset protection trust. An irrevocable self-settled trust may have been created in a jurisdiction that does not permit asset protection trusts, or at a time before domestic asset protection trusts existed. Such a trust could be decanted in a jurisdiction that permits self-settled asset protection trusts to a new trust that includes provisions that conform with the requirements of the applicable asset protection trust statutes. Such a decanting should cause the new trust to be treated as an asset protection trust at the time of the decanting.

x. **IRS Notice 2011-101**. The IRS has recognized that decanting is an emerging issue with tax consequences that are not entirely clear under current law. In 2011 decantings were added to the "no ruling list" pursuant to Rev. Proc. 2011-3. The Internal Revenue Service issued a notice (IRS Notice 2011-101) requesting comments on the tax implications of trust decantings that result in a change

in the beneficial interests in the trust. Several organizations, including the American College of Trust and Estates Counsel, the American Bar Association, the New York State Bar Association, and the Delaware Bar Association, have filed responses to IRS Notice 2011-101.

xi. **Gift and Estate Tax Considerations**. It is worth noting a few general principals concerning the gift tax consequences of decanting. If the trustee has no beneficial interest in the trust then decanting should not be treated as a taxable gift. See Treas. Reg. § 25.2511-1(g)(1). A distribution by the beneficiary/trustee should not be a taxable gift if it is made pursuant to a power the exercise or non-exercise of which is limited to an ascertainable standard. See Treas. Reg. § 25.2511-1(g)(2).

xii. **Generation-Skipping Transfer Tax Considerations**. There are two GST tax safe harbors that potentially apply to decanting under the Treasury Regulations.

a. **Discretionary Distribution Safe Harbor** (Treas. Reg. 26.2601-1(b)(4)(i)(A)). This safe harbor applies when, at the time the trust became irrevocable, either the terms of the trust instrument or local law authorized distributions in further trust without the consent or approval of any beneficiary or court; and the resulting trust does not extend the time for vesting of any interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, beyond the longer of (a) lives in being plus 21 years, or (b) 90 years.

   There were no statutes in existence at the time that trusts became grandfathered (Sept. 25, 1985). The New York statute was the first and it came into effect in 1992. Thus, the only option under this safe harbor is a decanting pursuant to the terms of the governing instrument. You can change whatever you want, just don't extend the perpetuities period beyond the federal rule against perpetuities period.

b. **Trust Modification Safe Harbor** (Treas. Reg. 26.2601-1(b)(4)(i)(D)). This safe harbor applies when the distribution does not cause a beneficial interest to be shifted to a beneficiary in a lower generation, and the governing instrument of the resulting trust does not extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust instrument.

Example (2) appearing in Treas. Reg. § 26.2601-1(b)(4)(i)(E) expressly addresses the fact pattern that appears to be applicable in every case where assets held in a first trust that is exempt from the generation-skipping transfer tax by reason of the effective date rules (that is, the first trust is a "grandfathered" trust) are decanted to a second trust. The Example posits a scenario in which assets are decanted from a grandfathered trust to another trust pursuant to a state decanting statute that was not in existence at the time the grandfathered trust became irrevocable. As no decanting statutes existed prior to the advent of the current generation-skipping transfer tax regime, it appears that all decantings from grandfathered trusts made pursuant to a state decanting statute are covered by Example (2). The Example concludes that the decanting constitutes a "modification" governed by Treas. Reg. § 26.2601-1(b)(4)(i)(D). This conclusion seems plainly correct because that regulation covers all modifications not described in paragraphs (b)(4)(i)(A), (B) or (C).

It is worth noting, however, that a trust, exempt from generation-skipping transfer tax by reason of the allocation of generation-skipping transfer tax exemption, which was created in a state that permits decanting and was created after the enactment of that state's decanting statute apparently is covered by paragraph (A) as the IRS has repeatedly ruled, in the private letter ruling context, that the regulatory principles concerning grandfathered trusts should apply with equal force to trusts exempt from the generation-skipping transfer tax by reason of the allocation of generation-skipping transfer tax exemption. The IRS has stated: "No guidance has been issued concerning the GST tax consequences of the modification of a trust created after September 25, 1985. At a minimum, it seems appropriate to conclude that a change that would not affect the exempt status of a trust that was irrevocable on September 25, 1985 would similarly not affect the exempt status of such a trust." See Priv. Ltr. Rul. 200822008, see also Priv. Ltr. Rul. 200743028.

In any case, the aforementioned "straightjacket" of Treas. Reg. § 26.2601-1(b)(4)(i)(D), apparently applicable to all grandfathered trusts, provides, in substance, that the decanting will not cause the second trust to be subject to the generation-skipping transfer tax provided that (i) the decanting could not (under any circumstance) shift a beneficial interest in the trust

to a beneficiary who occupies a lower generation (as defined in Code Section 2651) than the person or persons who held the beneficial interest prior to the decanting and (ii) the decanting does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the first trust. As a result, great care must be taken in decanting assets from a grandfathered trust. However, it plainly is permissible to extend the duration of the trust so long as there is no delay in the vesting of interests.

B. Unitrust Statute (Section 61-106). In 2000, Delaware enacted the very first total return unitrust statute in the country. Delaware has both a general unitrust statute (12 Del. C. § 61-106) that permits a traditional income trust to be converted to a unitrust, in a manner sanctioned by the applicable Treasury Regulations, and an express unitrust statute (12 Del. C. § 61-107) designed to comport with the Treasury Regulations addressing that type of trust. Converting an income trust to a total return unitrust helps avoid the need for the trust portfolio to be heavily weighted in bonds to provide enough income to the trust's current beneficiary. This provides trustees with a better opportunity to invest trust funds for both a reasonable current return for income beneficiaries and reasonable prospects of growth in the trust portfolio. The Unitrust Statute also permits a trustee to reconvert a total return unitrust to an income trust, change the percentage used to calculate the unitrust amount (between 3% and 5%), or change the method used to determine the fair market value of the assets of the trust. The general unitrust statute is designed so that trusts administered outside Delaware may, in most cases, avail themselves of the statute if the situs of the trust is changed to Delaware. The statute requires various methods of converting a traditional income trust to a total return unitrust. If there is at least one adult beneficiary in each class of necessary notice recipients, then a trust may be converted to a unitrust with the adoption of a unitrust policy by the trustee, and delivery of written notice to each adult beneficiary, along with a copy of the statute and the unitrust policy. Each person receiving notice of the conversion has thirty (30) days following receipt of the notice in which to object to the conversion of the trust to a total return unitrust, by written instrument delivered to the trustee. The unitrust conversion generally can be completed without any court intervention.

C. Principal and Income Act (Chapter 61). The Delaware Principal and Income Act (Chapter 61 of Title 12) enacted in 2009 adopts much of the Uniform Principal and Income Act. However, the Delaware Principal and Income Act is crafted to retain the prior law feature granting trustees broad

latitude in making allocations of receipts and expenditures to principal or income so that trustees may make appropriate allocations informed by the needs and interests of the trust beneficiaries, tax considerations and other relevant considerations without being constrained by regimented rules that might compel allocations contrary to the interests of the beneficiaries or good tax planning. The relevant provision of the Delaware Principal and Income Act is § 61-103(a)(2) which provides, in relevant part, that in allocating receipts and disbursements to or between principal and income, a fiduciary may administer a trust by the exercise of a discretionary power of administration, which shall include a power to allocate between principal and income given to the fiduciary by the terms of the trust or by local law, even if the exercise of the power produces a result different from a result required or permitted by the Principal and Income Act. The term "discretionary power of administration" includes the power granted to virtually all Delaware trustees by 12 Del. C. § 3325(23) meaning that virtually all Delaware trustees may allocate receipts and disbursements between principal and income in the manner deemed best by the trustee notwithstanding the remaining provisions of the Principal and Income Act. Accordingly, § 61-103(a)(2) in effect permits trustees to override all of the other provisions of the Principal and Income Act when the trustee determines it is appropriate to do so.

D. **Power To Adjust (Section 61-104).** Delaware has a detailed and flexible power to adjust statute (12 Del. C. § 61-104) designed to satisfy the applicable Treasury Regulation requirements while granting broad latitude to trustees to allocate receipts and expenditures between income and principal in a manner calculated to address the needs and wishes of the trust beneficiaries in light of tax consideration and other relevant facts.

E. **Enforceability Statute (Section 3303).** Section 3303 of Title 12 of the Delaware Code provides broadly that any provision included in a trust instrument is enforceable as written so long as the provision does not by its terms, or in operation, have the effect of exculpating a fiduciary from liability for willful misconduct or preclude the removal of a fiduciary for willful misconduct. This statute helps assure trust settlors that if they elect to create a trust in Delaware, under Delaware law, virtually any provision they wish to include in the trust instrument will be enforced as written, subject to the outer bounds of public policy. Among other topics expressly addressed by the statute, the statute provides that the settlor may include a provision limiting the right of a beneficiary to be informed of the beneficiary's interest in the trust for a period of time.

F. Silent Trusts (Section 3303). Section 3303 of Title 12 of the Delaware Code provides that the terms of a trust instrument may expand, restrict, eliminate, or otherwise vary the rights and interests of beneficiaries, including, but not limited to, the right to be informed of the beneficiary's interest for a period of time. This statute is frequently used by settlors who wish to restrict beneficiaries' rights to notice and information or accountings for a period of time. For example, the settlor of a very large trust may not wish for the beneficiaries to become aware of the trust until they reach a suitable age, in order to foster productive lives, careers and education and prevent the beneficiaries from becoming dependent upon the trust. This statute is also useful to validate so-called "blind trusts" for politicians and public officials.

G. Enforcement of Charitable Trusts (Section 3303). In 2005, Section 3303 was amended to add a provision that enables a settlor of a charitable trust, or one or more designees of the settlor, to enforce the purpose of the charitable trust. The settlor may designate individuals, or create a mechanism for selecting individuals, who may enforce the charitable trust even after the settlor is no longer living. In the absence of a statute like Section 3303, only the Attorney General's Office has standing to enforce a charitable trust. Section 3303 provides trust settlors with a greater voice in their own charitable legacy. Often, a deviation from a charitable trust's purpose is not brought to the attention of the Attorney General's Office and no interested person is aware of a deviation from a charitable trust's purpose or is inclined to seek to enforce the trust's purpose. This addition to Delaware trust law provides settlors with a useful mechanism for enforcing charitable trusts in situations where a trustee or even an Attorney General's Office attempts to deviate from the trust's purpose or where the trust's purpose is unclear. This attractive new feature of Delaware law should help resolve situations such as those which arose in infamous cases such as the In re Milton Hershey School Trust case and The Barnes Foundation case and should make settlors more inclined to consider creating charitable trusts in Delaware.

H. Purpose Trusts (Section 3555). Delaware has enacted two statutes designed to allow for the creation of so-called "purpose trusts." At common law, trusts generally may be created only for the benefit of living persons and charity. Therefore, at common law, it is not clear whether one may create a trust for a non-charitable purpose in cases where the trust has no identifiable living (or unborn) beneficiaries. The first of the two Delaware statutes (12 Del. C. § 3555) permits the creation of trusts for the care of animals. The second statute (12 Del. C. § 3556) broadly permits the creation of trusts for any purpose not impossible

of attainment. Both statutes permit the settlor to identify one or more persons having standing to enforce the trust.

I. **Abuse of Discretion Standard (Section 3315).** Under Delaware law, the trustee's exercise of discretion may be overturned by a court if there is evidence of an abuse of discretion. Section 3315(a) of Title 12 of the Delaware Code (effective August 1, 2008) provides: "Where discretion is conferred upon the fiduciary with respect to the exercise of a power, its exercise by the fiduciary shall be considered to be proper unless the court determines that the discretion has been abused within the meaning of § 187 of the Restatement (Second) of Trusts, not §§ 50 and 60 of the Restatement (Third) of Trusts." Several Delaware cases decided prior to the enactment of Section 3315 address the abuse of discretion standard. They generally hold that in analyzing whether a trustee properly has exercised its discretionary powers, a Delaware court will not substitute its own judgment for that of the trustee, unless the court finds that the trustee acted in bad faith or in an arbitrary or unreasonable manner. In the Matter of Barker Trusts, C.A. 20455, V.C. Lamb (Del. Ch. Feb. 7, 2005) (Mem. Op.); see also Wilmington Trust Company v. Coulter, 200 A.2d 441 (Del. 1964). It remains to be seen how the Delaware court may, if at all, conclude that Section 3315 overrides the standard expressed in those cases. Section 3315 makes an unusual and interesting distinction between the Restatement (Second) of Trusts and the Restatement (Third) of Trusts which invites further examination. The Section instructs us to disregard the standard set forth in the more recently adopted Restatement and apply the older Restatement (Second) of Trusts standard instead. As it turns out, the legislature has done this to make it clear that when a trustee has absolute discretion not limited by a standard, the court should not evaluate the reasonableness of the exercise of discretion but rather, it should limit the analysis to whether the trustee acted dishonestly or with an improper motive. Section 187 of the Restatement (Second) of Trusts provides that "[w]here discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of his discretion." Restatement (Second) of Trusts § 187 (1959); see Merrill Lynch Trust Company, FSB v. Mary F.C. Campbell, et al., C.A. 1803-VCN, V.C. Noble (Del. Ch. September 2, 2009) (Mem. Op.) at 23. Comment e of Section 187 of the Restatement provides in part: "If discretion is conferred upon the trustee in the exercise of a power, the court will not interfere unless the trustee in exercising or failing to exercise the power acts dishonestly, or with an improper even though not a dishonest motive, or fails to use his judgment, or acts beyond the bounds of a reasonable judgment. The mere fact that if the

discretion had been conferred upon the court, the court would have exercised the power differently, is not a sufficient reason for interfering with the exercise of the power by the trustee." Comment i of Section 187 of the Restatement (Second) of Trusts provides that where the trustee's discretion is not limited by a standard, then the court will only interpose if the trustee acts dishonestly or from some improper motive. Comment j of Section 187 of the Restatement provides that the settlor of a trust may manifest an intention that the trustee's discretion need not be exercised reasonably, even where there is a standard by which the reasonableness of the trustee's conduct may be judged, by the inclusion of a provision in the governing instrument that the trustee shall have "absolute" or "unlimited" or "uncontrolled" discretion. For this reason, it is advisable to ensure that the governing instrument consistently grants "sole and absolute discretion." It appears that in applying the Restatement Section 187 rule, trustees shall be deemed to have abused their discretion only if they have acted dishonestly, with improper motive, or beyond the bounds of a reasonable judgment.

Section 60 of the Restatement (Third) of Trusts only discusses an abuse of discretion by a trustee in the context of whether discretionary distributions can be compelled by a beneficiary's transferee or creditors. Section 50(2) of the Restatement (Third) of Trusts, along with its comments, offers a court greater leeway than Restatement (Second) of Trusts to determine that a power exercised by a trustee constitutes an abuse of discretion. Specifically, Section 50(2) of the Restatement (Third) of Trusts provides that "the benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor's purposes in granting the discretionary power and in creating the trust." Restatement (Third) of Trusts § 50(2) (2001). Section 50(1) of Restatement (Third) of Trusts provides that "[a] discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee." Comment b of Section 50 of the Restatement (Third) of Trusts sets forth a series of requirements and standards for reviewing discretion. It provides in part:

> "A court will not interfere with a trustee's exercise of a discretionary power when that exercise is reasonable and not based on an improper interpretation of the terms of the trust.... On the other hand, a court will not permit abuse of discretion by the trustee. What constitutes an abuse of discretion depends

> on the terms of the trust, as well as on basic fiduciary duties and principles. Of particular importance are the purposes of the power and the standards, if any, applicable to its exercise and the extent of the discretion conferred upon the trustee. Relevant fiduciary principles include (i) the general duty to act, reasonably informed, with impartiality among the various beneficiaries and interests and (ii) the duty to provide the beneficiaries with information concerning the trust and its administration.... Absent language of extended (e.g., "absolute" or "uncontrolled") discretion, a court will...intervene it if finds the payments made, or not made, to be unreasonable as a means of carrying out the trust provisions.... It is not necessary...that the terms of the trust provide specific standards in order for a trustee's good faith decision to be found unreasonable and thus to constitute an abuse of discretion."

Thus, Section 3315(a) expressly rejects the additional requirements and standards described above in Section 50(2) of the Restatement (Third) of Trusts, in favor of the more restricted standard of review found in Section 187 of the Restatement (Second) of Trusts. Consequently, a trustee who exercises its power in an honest and good faith manner, and did not act dishonestly or with an improper motive, should not be deemed to have abused its discretion under Delaware trust law. One final observation bears noting. If the trustee simply abdicates its duties and acts solely upon the request of someone else, then this potential failure to exercise any discretion concerning the action could result in an abuse of discretion. See Campbell at 23. In other words, the trustee cannot abandon its discretion and follow the suggestion or instructions of another. Additionally, consistent with the analysis in the Campbell decision, the trustee should be sure to follow its established policies and procedures for making such decisions.

The Campbell decision has important implications for trustee accounting actions, particularly where the court reviews a trustee's investment decisions. The opinion places great emphasis on the terms of the trust's governing instrument in evaluating the trustee's investment strategy and demonstrates the importance of the factual record in evaluating the potential abuse of trustee discretion. The trust instrument granted the trustee sole discretion over investment decisions and, consistent with longstanding Delaware law, the Court held that "its exercise is not subject to control by the court, except to prevent an abuse by the trustee of [its] discretion." Notably, the Court held: "Had [the Trustee] abdicated its duties and acted solely upon Campbell's request, [the Trustee's] failure to

exercise any judgment concerning the shift in investment strategy would have been an abuse of its discretion." The Court's analysis demonstrates that where a trustee capitulates to a current beneficiary's requests with respect to investment decisions, without exercising independent discretion, the Court may find an abuse of discretion. This case demonstrates the Delaware Court of Chancery's restraint in interfering with a trustee's exercise of discretion, respect for good faith reliance by the trustee on the terms of the governing instrument, contextual view of trustee duties and asset diversification, and application of the prudent investor rule. With respect to the abuse of discretion analysis, it is frequently the case that the current beneficiary of a trust applies pressure on the trustee to remain invested in one or more stocks to which the beneficiary may be attached, or to adopt a certain investment approach. The Court's analysis in this case demonstrates that if a trustee simply follows a current beneficiary's requests, without exercising independent discretion, the Court may find an abuse of discretion and hold the trustee liable for surcharge. This case highlights the need for trustees to establish a record that supports their due diligence and independent decision-making process when exercising investment discretion. It also illustrates the importance to trustees of express language in the governing instrument concerning fiduciary releases and accountings, and related expenses being payable from the trust fund.

J. Trustee Compensation (Sections 3561 and Court of Chancery Rule 132). In the absence of a provision in the governing instrument or a valid agreement fixing the compensation of a trustee, Court of Chancery Rule 132 and 12 Del. C. § 3561 can be used to determine an amount of trustee fees that will generally be deemed to be reasonable. Section 3561 of Title 12 of the Delaware Code provides that unless the trust instrument specifically states the trustee must serve without compensation, if a trust instrument does not fix the amount of compensation to be paid to a trustee, the trustee is entitled to "reasonable compensation". The amount of a corporate trustee's fees that will be deemed "reasonable compensation" is defined in 12 Del. C. § 3561 as an amount determined under the trustee's compensation schedule which has been filed with the Register in Chancery and which has been provided to the settlor of a revocable trust or the income beneficiaries of every other type of trust for which the trustee seeks to be allowed compensation. Consequently, a corporate trustee's fees will be considered "reasonable" if such trustee charges compensation in accordance with (or, at least, not more than) its published compensation schedule if the schedule has been (i) filed with the Register of Chancery and (ii) provided to the settlor of a revocable trust or the income beneficiaries of every other type of trust. Section

3561(b)(2) provides that "reasonable compensation" shall, with respect to individual trustees, be set by the rules promulgated by the Delaware Court of Chancery from time to time. Court of Chancery Rule 132 provides that subject to the provisions of a valid agreement, and further subject to increase or decrease by the Court of Chancery for cause, an individual trustee shall be entitled to the schedule of fees set forth in Rule 132. Rule 132 provides the following schedule for income commissions and annual principal commissions that a trustee may charge:

Income Fees

6% on the first $20,000 of income;

3.5% on the next $10,000 of income;

3% on the next $270,000 of income;

2% of all income over $300,000.

Principal Fees

5/10 of 1% on the first $100,000 of principal;

3/10 of 1% on the next $100,000 of principal;

2/10 of 1% on the next $500,000 of principal;

1/10 of 1% on all principal over $700,000.

Rule 132 further provides that in the discretion of the Court of Chancery, additional and special commissions may be allowed for unusual and extraordinary services. Additionally, for any trust with a fair market value greater than $1 million and which has limited diversification, meaning three-fourths or more of the fair market value is invested in not more than two blocks of stocks and/or bonds, the income commission set forth in the schedule above shall be reduced by 25%. Paragraph (h) of Rule 132 provides that when two or more trustees are serving, they shall be allowed compensation under the Rule as the court shall in its discretion determine, considering the amount and character of the trust property, the extent of the risk and responsibility of each trustee, the character of the services rendered by each trustee, the degree of difficulty in administering the trust, the skill and success of the administration and any other relevant and material circumstances.

K. Delaware Tax Trap. Sections 2041(a)(3) of the Internal Revenue Code relating to the estate taxation of powers of appointment and 2514(d) of the Code relating to lifetime transfers are colloquially known as the "Delaware tax trap" because they were enacted in order to prevent estate and gift tax avoidance through the use of Delaware trusts. When the provisions were enacted in 1942, most states, including Delaware, applied the common law rule against perpetuities, which limited a trust's duration to lives in being when the trust was created plus 21 years. Where a trust instrument included a power of appointment, and the power-holder exercised the power, most state laws required that the perpetuities measuring period relate back to the time the trust was originally created. Delaware, however, had a rule that when a power of appointment (whether general or special) was exercised, a new period for measuring the rule against perpetuities commenced upon the exercise of the power. Thus, for example, suppose that under Delaware law, a grantor created a trust with income to his son for life, and thereafter as the son might appoint. The son could appoint by granting his daughter income for life and granting her a power to appoint the remaining trust property upon her death, she could do the same for her child, and so on. Each exercise would start a new perpetuities period running, so that (absent Code § 2041(a)(3) and before the present Delaware rule against perpetuities), a Delaware trust could have lasted forever and not be subject to federal estate taxation. To deal with this Delaware problem, Congress enacted a rule embodied in Sections 2041(a)(3) and 2514(d) which stated that if a power-holder exercises a power of appointment created after October 21, 1942 by creating another power of appointment which under the applicable local law (i.e., Delaware) can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the creation of the first power, then the property subject to the power is includible in the gross estate of the person who creates the second power. Thus, looking at the law in Delaware at the time when the Delaware tax trap legislation was enacted, if a holder of a testamentary special power of appointment exercises that power to create another power of appointment, then upon the holder's death the entire trust corpus would be includible in the holder's gross estate for federal estate tax purposes.

Under current Delaware law, it is generally possible to exercise a limited power of appointment in a manner that will cause the property subject to the power to be included in the power-holder's federal gross estate under the Delaware tax trap. Under Delaware law, a person can exercise a limited power of appointment in favor of a further trust which contains a limited

power of appointment that can be exercised so as to postpone the vesting of the trust property for a period determined without regard to the date of the creation of the first power. Under Section 2041(a)(3) of the Code, if someone exercises a power of appointment in this fashion, the exercise will cause all of the assets subject to the exercised power of appointment to be included in the estate of the power-holder. The beneficiary would exercise his or her power of appointment in favor of a further trust which contains a second power of appointment. This second trust could be written to last only a short period of time, such as six months, in order to trigger the Delaware tax trap and then distribute the assets to the beneficiaries' issue. In some instances, it may be an advantageous tax planning strategy to cause some or all of those assets to be included in the beneficiary's taxable estate. If such trusts are settled in Delaware, the power-holders may, for example, elect to cause trust property to be included in their gross estates in order to avoid the imposition of the generation-skipping tax in cases where the power-holder's estate tax rate is below the generation-skipping tax rate. It is also always possible to exercise the limited power of appointment in a fashion that does not cause the property subject to the power to be included in the power-holder's federal gross estate. The assets subject to a power will not be includible in the power-holder's taxable estate if the power-holder either (1) does not exercise the power, (2) exercises the power but does not create another power of appointment, or (3) exercises the power so as to create another power of appointment, where the second power of appointment relates to the date of creation of the first power. Thus, for example, a power-holder can obviously avoid estate taxation by not exercising his or her power over the assets that he or she does not want included in his or her estate. The power-holder could also avoid estate taxation while exercising his or her power by exercising the power to create a further trust which does not contain a power of appointment. If desired, the power-holder could design the new trust so that the trustee or trust protector of the new trust holds the powers that otherwise would have been given to a beneficiary power-holder. Finally, the power-holder could exercise the power in a fashion that creates a second power, however, he or she could provide in the instrument effecting the exercise that every estate or interest in property created through the exercise of the second power shall vest within a specified time period measured from the date of creation of the first power (for example, within 100 years following the creation of the first power). The Treasury Regulations expressly provide that property subject to a special power is includible in the power-holder's gross estate under Code Section 2401(c)(3) only if the second power created by the exercise of the first power can, under the terms of the instrument exercising the first power and applicable local law, be validly exercised so

as to postpone vesting of the property for a period ascertainable without regard to the date of creation of the first power. Treas. Reg. § 20.2041-3(e)(1)(ii). Therefore, in any case where the instrument exercising the first power expressly provides that all property subject to the second power must vest within a specified time period measured from the date of creation of the first power, it is clear that the property subject to the first power is not includible in the power-holder's gross estate under Code Section 2041(c)(3). The ability to utilize a limited power of appointment to either cause or avoid estate taxation can be a very useful tax planning opportunity because it provides a beneficiary with maximum flexibility in deciding exactly what amount of the assets in a trust shall be includible in his or her estate by purposely "triggering the trap" over the portion of assets that the beneficiary wants to have included in his or her estate for tax planning purposes. This flexibility in Delaware's law does not exist under the laws of any other state.

Effective July 6, 2000, the Delaware tax trap statute was amended to preclude a power-holder from exercising a limited power of appointment over a trust exempt from the generation-skipping tax in a fashion that would cause the trust property to be includible in the power-holder's gross estate. 72 Del. Laws c. 397 (amending 25 Del. C. § 504). Power-holders still have the flexibility to determine whether or not to exercise their powers in a fashion that will cause estate inclusion when the power relates to property held in a trust subject to the generation-skipping tax.

L. Virtual Representation (Section 3547). In Delaware, virtual representation is an important tool for the efficient resolution of trust matters before the Delaware Court of Chancery and nonjudicial matters such as beneficiary consents and releases. In its most basic form, virtual representation allows certain parties to represent and bind the interests of other parties. The underlying theory behind virtual representation is that, if the economic interests of the representative and the person being represented are substantially the same, and such interests would be affected in the same way by the proposed action, then the presence of the representative can be relied upon to raise any potential issues that the person represented would have made (or in the case of a consent, acquiring the representative's consent can insure that the proposed action would not have adversely affected the person being represented).

Though Delaware enacted its first virtual representation statute in 2000, the concept of virtual representation can trace its origins back to eighteenth century England. While the "necessary parties rule" generally required all persons with an interest in an action before the

English Court of Chancery to be joined as a party in the interests of justice; there was also an "impossibility exception." This exception was used in cases where (i) the interested parties were so numerous that joining all parties was not a practical possibility or (ii) the identity of one or more parties was unknown. Representation was necessary to bind such absent parties. In the late nineteenth century United States, this theory expanded through the common law to permit representation of unborn persons. By the 1930s, the doctrine was familiar enough to be included in the first Restatement of Property which, among other things, specifically allowed for a presumptive taker of an interest to represent a person who was not a presumptive taker. Since then, the Uniform Probate Code and the UTC have further developed the doctrine to allow parents, in certain instances, to represent their minor children. This newsletter will spotlight the types of interests that can be represented under Delaware's virtual representation statute, 12 Del. C. § 3547 (the "Virtual Representation Statute").

The Virtual Representation Statute, when enacted in 2000, basically consisted of what is currently subsection (a) of the statute. A minor, incapacitated, unborn, or unascertainable person (defined as a person whose identity or location is unknown and not reasonably ascertainable) may be represented by an adult and competent person who has a substantially identical interest with respect to the particular question or dispute—but only to the extent that there is no material conflict of interest with respect to the particular question or dispute. Thus, as long as there is a substantially identical interest and no material conflict exists with respect to the proposed action, this subsection can eliminate the need for a court to appoint a guardian ad litem to represent the interests of minor, unborn, or unascertained beneficiaries.

The Virtual Representation Statute became a much more useful tool after amendments made in 2007. The original Virtual Representation Statute became subsection (a), and subsections (b) and (c) were then added. Subsection (b) permits presumptive remainder beneficiaries to represent and bind successor remainder beneficiaries, including adults and charities, for the same purposes, in the same circumstances and to the same extent that an adult and competent beneficiary may bind minor, unborn and unascertainable beneficiaries under subsection (a). A successor remainder beneficiary is defined as either (i) a beneficiary who, but for the exercise of any power of appointment, would receive income or principal of the trust if the trust were to terminate or (ii) if the trust does not provide for its termination, a

beneficiary who would receive or be eligible to receive distributions of income or principal of the trust if all of the current beneficiaries were deceased.

The addition of subsection (c) in 2007 provided, in many cases, a backstop to situations where a minor or incapacitated beneficiary cannot be virtually represented under subsections (a) or (b). Subsection (c) permits the surviving and competent parent or parents or custodial parent (in cases where one parent has sole custody of the beneficiary) or guardian of the property of the beneficiary to bind such a beneficiary (and in some cases, his or her unborn descendants), provided that (i) there is no one else to virtually represent the beneficiary and (ii) there is no material conflict of interest between the beneficiary and either of the beneficiary's parents with respect to the particular question or dispute. Thus, subsection (c) often eliminates the need for the court to appoint a guardian ad litem to represent minor beneficiaries in situations where such beneficiaries could not have been represented under the original Virtual Representation Statute. In 2011, Section 3547(c) was amended to clarify that if a minor or incapacitated beneficiary has two parents that are living and competent, then both parents are required to represent the beneficiary, unless only one parent is the sole custodial parent.

In 2009, subsection (d) was added to the Virtual Representation Statute, clarifying two procedural issues. First, subsection (d) provides that the virtual representation afforded under the statute may be used in any judicial proceeding and for any nonjudicial matter, unless otherwise so provided in the governing instrument. Second, it makes clear that the Virtual Representation Statute will be applicable in any proceeding before a Delaware court or administrative tribunal, even if such proceeding involves a trust that is governed by the laws of another state. Thus, as a matter of Delaware law, the Virtual Representation Statute is available for use in consent petitions, releases, ratifications, and other trust-related matters even if the law of some other jurisdiction governs the trust's validity, construction and administration.

In 2013, Subsection (e) was added to Section 3547 to create three factual scenarios where a material conflict of interest between the purported representative and beneficiary will be presumed. These three scenarios track language that is part of Court of Chancery Rule 100 regarding consent petitions. First, a material conflict of interest will be presumed if the purported representative will be appointed to a fiduciary or non-fiduciary role with respect to the trust, unless the

representative already serves in such a role and will not receive greater authority, broader discretion, or increased protection as a result of the judicial proceeding or nonjudicial matter. Second, a material conflict of interest will be presumed if the purported representative currently holds a fiduciary or non-fiduciary office and will receive greater authority, broader discretion, or increased protection by reason of the judicial proceeding or non-judicial matter. Third, a material conflict of interest will be presumed if the purported representative has any other actual or potential conflict of interest with the represented trust beneficiary with respect to the particular question or dispute to be resolved, such as a conflict resulting from different investment horizons or different interests in present income and capital growth such as the conflict that commonly exists between current income beneficiaries (who prefer income) and remainder beneficiaries (who prefer preservation of principal).

The use of the Virtual Representation Statute can eliminate considerable time and expenses that would otherwise be incurred in a judicial proceeding, or nonjudicial matter, while still insuring that all interests in a proposed action are adequately represented. Especially with recent additions to the statute, trust proceedings in Delaware can be resolved on a much more efficient and cost-effective basis.

M. Statutory Tenancy By The Entireties Property In Trust (Section 3334). In 2010, Delaware introduced a new form of creditor protection for property titled as tenants by entireties when contributed to Delaware revocable trusts and asset protection trusts. Generally, a debt of one spouse may not be enforced against property titled as tenants by the entireties and therefore such property will be protected from creditors. Some commentators have observed that there may be creditor concerns if the tenancy by the entireties is severed when those assets are contributed to a Delaware revocable trust or a Delaware asset protection trust. Section 3334 of Title 12 provides that, unless otherwise provided by the governing trust instrument, when a husband and wife make a contribution to a revocable trust of property titled under applicable law as tenants by the entireties, the property and any accumulation thereto shall, while held in trust during the lifetime of both spouses, be treated as though it were tenancy by the entireties property and be dealt with in a manner consistent with that applicable law, but in every other respect shall be dealt with in accordance with the terms of the trust instrument. Section 3334 further provides that in any action

regarding whether a creditor of either or both spouses may recover the debt from the trust, the sole remedy available to the creditor with respect to tenancy by the entireties property shall be an order directing the trustee to transfer the property to both spouses as tenants by the entireties. In addition, new Section 3574(f) of Title 12 provides for the same treatment when tenancy by the entireties property is transferred to a Delaware asset protection trust. The purpose of the statute is to permit married couples to contribute tenancy by the entireties property to a revocable trust without losing whatever creditor protection they enjoyed when holding the property as tenants by the entireties. In 2011, Section 3334 was revised to make it clear that the two spouses may contribute their respective joint interests in the property to different revocable trusts, as is commonly done in estate planning, without losing the creditor protection afforded by the statute.

N. Nonjudicial Consent Settlement Agreements. The 2013 Trust Act added new Section 3338 to Title 12 of the Delaware Code to permit the use of nonjudicial settlement agreements in Delaware. The new statute is substantially similar to the version in the UTC that has been adopted in at least 26 other states and the District of Columbia. The new statute provides settlors, beneficiaries, and fiduciaries an additional option under Delaware law for the resolution of matters arising with respect to the administration of a trust without the time and expense of court involvement. Subsection (b) of Section 3338 provides that, except as provided in Subsection (c), interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust with one exception. The exception relates to charitable trusts and noncharitable purpose trusts described in Section 3541. Subsection (d) of Section 3338 provides a list of six matters that may be resolved by a nonjudicial settlement agreement: (1) interpreting or construing the terms of a trust; (2) approving the report or accounting of a trustee; (3) directing a trustee to refrain from exercising a power or granting a power to a trustee; (4) resignation, appointment, or determination of compensation of a trustee; (5) transferring the principal place of administration of a trust; and (6) determining the liability of a trustee for an action relating to the trust.

For a more detailed discussion of Delaware's nonjudicial consent settlement agreement statute, see the discussion dedicated to this subject under Section V below.

III. How To Create A Delaware Trust.

1. Inter Vivos Trusts.

A. Execution Requirements (Section 3545). Delaware has a statute that sets forth the execution requirements for a trust agreement. It provides that the creation, modification or revocation of a trust whereby a person other than the trustor acquires or is divested of an interest in the trust the possession or enjoyment of which is contingent upon surviving the trustor shall be void unless such creation, modification or revocation be: (1) in a writing executed by the trustor and witnessed by at least 1 disinterested person or 2 credible persons, or (2) in a writing executed by a trustee who is a disinterested person. The second of these two options preserves the ability to create a trust by declaration of trust executed by the trustee.

B. Delaware Trustee Requirement. In order to create a Delaware inter vivos trust, meaning an inter vivos trust governed by Delaware law, it is important that the initial trustee or one of the initial co-trustees be located in Delaware and perform its role in the administration of the trust in Delaware (although this does not preclude the Delaware trustee from retaining agents located outside Delaware to assist the Delaware trustee in the performance of the Delaware trustee's duties). In cases where the Delaware trustee is serving as a co-trustee, it also is advisable to, pursuant to the express terms of the trust's governing instrument, assign discrete administrative duties solely to the Delaware co-trustee.

Traditional conflicts of law analysis for trusts divides the topic into three separate (although sometimes overlapping and indistinct) categories. These categories generally are described in the case law as questions of trust validity, construction and administration. Trust settlors have wide and perhaps unfettered latitude in selecting which jurisdiction's laws govern questions of trust construction and administration. However, the laws of some states, including Delaware, probably require that in order for a trust settlor to select that state's laws to govern trust validity (which would include the applicable perpetuities period and other important matters), the trust's initial situs must be located in that state. Subject to various exceptions and limitations, a similar rule appears to apply to the choice of law to govern the nature and extent of creditor rights against the trust.

The conservative approach to planning and designing trusts intended to be governed by Delaware law in all respects (including with respect to

questions of trust validity) is to make certain that Delaware is the initial situs of the trust. This, in turn, leads directly to a consideration of the Delaware Supreme Court's opinion in Lewis v. Hanson. Trusts designed to satisfy the Lewis v. Hanson test described below will unquestionably be found by the Delaware courts to be governed by Delaware law. Furthermore, it seems improbable that courts located elsewhere would reach a contrary conclusion.

C. Lewis v. Hanson Test. In determining which state's law governs the validity of a trust, to date the Delaware courts have considered the following factors: (i) the intention of the settlor of the trust; (ii) the domicile of the trustee of the trust; and (iii) the place where the trust is administered. See Lewis v. Hanson, Del. Supr., 128 A.2d 819, 826 (1957), aff'd sub nom. Hanson v. Denckla, 357 U.S. 235, reh'g denied, 358 U.S. 858 (1958) (hereinafter "Lewis v. Hanson"); see also Wilmington Trust Co. v. Wilmington Trust Co., Del. Supr., 24 A.2d 309 (1942); Wilmington Trust Co. v. Sloane, Del. Ch., 54 A.2d 544, 549 (1947).

The "settlor's-intent" factor may be satisfied with a clear and express provision in the trust instrument stating that the settlor intends for Delaware law to govern the validity, construction and administration of the trust.

With respect to the "trust-administration" factor of the Lewis v. Hanson test, the investment advisory function apparently is not included among the tasks considered to comprise "trust administration." In Lewis v. Hanson, the Delaware Supreme Court stated that the trust in question was administered "wholly within Delaware." See Lewis v. Hanson, Del. Supr., 128 A.2d 819, 825 (1957). However, the investment advisory function was performed outside of Delaware. In the opinion rendered by the Delaware Court of Chancery in the case, the Court indicated both (i) that the initial investment advisor for the trust was the settlor's husband; and (ii) that the settlor was at no time domiciled in Delaware. See Hanson v. Wilmington Trust Company, Del. Ch., 119 A.2d 901 (1955), aff'd sub nom. Lewis v. Hanson, Del. Supr., 128 A.2d 819 (1957), aff'd sub nom. Hanson v. Denckla, 357 U.S. 235, reh'g denied, 358 U.S. 858 (1958). As it seems reasonable to assume that the domicile of the trust settlor's husband was identical to the domicile of the trust settlor, it appears that the initial investment advisor of the trust was not domiciled in Delaware. Thus, it may reasonably be inferred from the Court's statement that the trust was wholly administered in Delaware that the Court views the investment advisory function as being outside of the scope of "trust administration" for purposes of the Lewis v. Hanson test.

Although the precise scope of the term "trust administration" for purposes of the Lewis v. Hanson test is not entirely clear, the following factors, which were discussed in Lewis v. Hanson, are probably relevant in ascertaining where a trust is "administered":

i. Location of trust's various accounts and tangible personalty;

ii. Location where trust records are maintained;

iii. Location of trustee's offices responsible for the administration of the trust;

iv. Location where trust reviews and trust account transactions occur;

v. Location from which correspondence and other communications concerning the trust with the settlor, beneficiaries, and unrelated third parties originate;

vi. Location of trust officers responsible for the administration of the Trust;

vii. Location where trust accountings, reports, and other communications with the settlor, beneficiaries, and unrelated third parties are prepared and reviewed;

viii. Location where documents relating to the trust are executed on behalf of the trust;

ix. Location at which trust income and contributions are received and from which trust expenditures and distributions are disbursed;

x. Location of trust officer meetings concerning the trust;

xi. Location of documents evidencing ownership of trust property;

xii. Location to which trust account inquiries are directed;

xiii. Location where tax reports are prepared and reviewed and tax compliance reviews and audits are performed and reviewed;

xiv. Location where the trust agreement is executed by the trustee;

xv. Location where trustee's trust committee meetings and trust reviews occur; and

xvi. Location where decisions are made concerning when to make discretionary distributions and the amounts of such distributions.

This suggests that in cases involving co-trustees located outside Delaware, the "trust administration" factor of the Lewis v. Hanson test would likely be satisfied if duties of the sort described above were assigned to the Delaware co-trustee either by the terms of the governing trust instrument or by the terms of an enforceable delegation by the non-Delaware co-trustees of these duties to the Delaware trustee.

With respect to the "trustee-domicile" factor of the Lewis v. Hanson test, the domicile of the trustee would plainly be Delaware in cases where the sole initial trustee is a Delaware institutional fiduciary or a Delaware resident individual.

It is less clear how the domicile of a trustee should be determined in cases where the trust instrument names two or more co-trustees. One possible approach that the courts might follow in such cases would be to treat the location where the trust is being administered as the trustee's domicile for purposes of applying the Lewis v. Hanson test. The Delaware Supreme Court may have taken that view when considering which state's law governed the validity of a trust. Wilmington Trust Co. v. Wilmington Trust Co., 24 A.2d at 312 ("the domicile of the trustee and the place of administration of the trust - quite generally the same place - are important factors; and the intent of the donor, if that can be ascertained, has been increasingly emphasized."). This is also the approach taken in a leading treatise on trusts, which indicates that the domicile of a trustee is ordinarily the place in which the trust is to be administered. See Austin Wakeman Scott and William Franklin Fratcher, The Law of Trusts, § 598 (4th ed. 1989).

D. Administrative Trustee. It seems clear, as a matter of Delaware law, that the Lewis v. Hanson test would be satisfied in a case where the trust's settlor clearly selects Delaware law to govern trust validity, construction and administration and the Delaware co-trustee's duties are limited to administrative duties of the type listed above, meaning that the other co-trustees alone would bear responsibility for the performance of the other trustee functions. In fact, Delaware trusts tied to the State solely by the involvement of a Delaware administrative trustee have been common in Delaware at least as far back as the 1950's. The recent and widely publicized McNeil Trust litigation involved such a trust.

2. **Testamentary Trusts and Trusts Holding Real Estate.** It should be noted that the foregoing discussion concerning choice of law applies only to inter vivos trusts funded with intangible assets. Different rules may apply to trusts funded in whole or in part with real estate or tangible property located outside Delaware. Similarly, different rules apply to trusts created under the will of a decedent residing outside Delaware at the time of death. It often is possible to create trusts holding direct or indirect interests in real estate and testamentary trusts governed by Delaware law. However, in such cases, the law of the place where the real estate is located or the law of the place where the decedent resided at death, as the case may be, needs to be carefully considered to assure that the laws of that jurisdiction would recognize the selection of Delaware law to govern the trust's validity.

IV. How To Move A Trust To Delaware and/or Modify an Irrevocable Trust.

1. **Trust Situs Defined.** The term "trust situs" means different things in different contexts. For example, a trust's situs for state income tax purposes may be different from the trust's situs for conflicts of law purposes or for purposes of determining which state's courts have primary, or perhaps exclusive, jurisdiction over various internal governance matters concerning the trust (such as supervision over surcharge actions). Situs identification issues are sometimes analyzed and decided differently under different state's laws.

2. **Approach to Changing Situs.** In order to be confident that the situs of a trust has been moved from one jurisdiction to another jurisdiction, it is important to (i) first determine, under the laws of the transferor jurisdiction (which might be a state or foreign jurisdiction), what contacts with the transferor jurisdiction are currently causing the trust's situs to be in the transferor jurisdiction for whatever purposes (taxation; governing law; court supervision; creditor rights; administration; etc.) are relevant in the particular case; (ii) then determine how, again under the laws of the transferor jurisdiction, the trust's contacts with the transferor jurisdiction may be severed to the extent necessary so that the trust's situs no longer is in the transferor jurisdiction for relevant purposes; (iii) next determine what contacts, under Delaware law, are necessary to cause Delaware to become the trust's situs for relevant purposes; and (iv) finally determine how, under both the laws of the transferor jurisdiction and Delaware, the requisite contacts with Delaware may be established.

3. **Significance of the Location of the Trustees.** Subject to exceptions and limitations far too numerous to mention, it generally is true under the laws of many transferor jurisdictions for many purposes (with income

taxation being a major and frequent exception and testamentary trusts often constituting a second major exception) that the situs of a trust may be moved out of the transferor jurisdiction if the trust's trustees located in the transferor jurisdiction are replaced by trustees located outside the transferor jurisdiction. However, it frequently is possible to change a trust's situs through less drastic measures (such as adding one or more new trustees, particularly administrative trustees located outside the transferor jurisdiction, or even simply arranging for the current trustees to administer the trust, or perform some aspects of the trust's administration, outside the transferor jurisdiction).

4. **Transferor Jurisdiction Law Governs.** The process for changing a trust's situs is governed in large measure by the law of the transferor jurisdiction as that jurisdiction's law likely govern virtually every aspect of the trust's existence at least until the change of situs project is successfully completed.

5. **Altering the Trustee Composition.** Sometimes and for some purposes, the laws of the transferor jurisdiction will require that all of the trustees located in the transferor jurisdiction be replaced by trustees located elsewhere. In some cases, it is only necessary to add a co-trustee (perhaps only as administrative trustee who does not participate in investment or distribution decisions) located outside the transferor jurisdiction. Sometimes, particularly if the trust was created under the will of the decedent who resided in the transferor jurisdiction at the time of death, it is also necessary or advisable to obtain an appropriate order transferring situs from a court in the transferor jurisdiction or revoking letters of trusteeship.

6. **Trust Agreement Provisions.** Often, particularly in the case of inter vivos trusts governed by trust agreements that include modern flexible language regarding changes of trust situs and the removal and appointment of trustees, the situs of a trust may be changed pursuant to the trust agreement without court involvement or any other supporting actions.

7. **Transferor Jurisdiction Court Involvement.** Sometimes, even if it is permissible under the trust's governing instrument and the laws of the transferor jurisdiction to change trustees, it nevertheless will be necessary to obtain an order from the appropriate court in the transferor jurisdiction in order to change the trust's situs. In some cases, in order to obtain such an order from the transferor jurisdiction's courts, it is necessary to obtain a companion order from the Delaware Court of Chancery. See Trust U/W of William Rockefeller, 773 N.Y. S.2d 529 (Surrogate's Court of New York County, December 19, 2003) (the case helps one understand the odd situation in New York law, in which it is possible for a trust's sole trustee to be

in Delaware without changing the trust's situs from New York to Delaware). It is particularly likely that assistance from the courts in the transferor jurisdiction will be required or advisable if the trust was created under the will of a decedent who resided in the transferor jurisdiction at the time of death or if the trust is under the ongoing supervision of the courts in the transferor jurisdiction (for example, if the trust is required by the laws of the transferor jurisdiction to file periodic court-reviewed accounts). In some cases, although an order from a court in the transferor jurisdiction may not be required to change the trust's situs, such an order may be beneficial. For example, some states that generally tax trusts on the basis of the residence of the settlor nevertheless do not tax trusts settled by residents following the entry of a state court order directing a change of situs from the state in which the settlor resided at the time the trust became irrevocable to another jurisdiction. Pennsylvania and Virginia appear to fall into this category. See Pennsylvania Department of Revenue PIT-01-040 (July 27, 2001); Virginia Admin-Rule, VA-Taxrptr § 202-326 (August 26, 1993).

8. **Automatic Change of Governing Law.** In many cases, a change of trust situs raises collateral issues such as what state's laws govern various aspects of the trust relationship. In general, the law governing the trust's validity and construction should not change as a result of a change of situs but the law governing various aspects of trust administration may change. Under 12 Del. C. § 3332, unless the governing instrument or a court order provides otherwise, Delaware law governs trust administration while the trust situs is Delaware but the law governing validity and construction of the trust does not change by reason of changing the trust's situs to Delaware. Section 3332 also provides that the duration of a trust and time of vesting of interests in the trust property shall not change merely because the place of administration of the trust is changed from some other jurisdiction to this State.

V. Trust Modification.

1. **Overview of Trust Modification.** In many cases, it may be advisable to modify the choice of law or situs provisions of a trust instrument, or make other modifications to a trust, such as converting the trust to a directed trust, when the trust is migrated to Delaware. Of course, in many circumstances it will be possible to simply remove a trustee and appoint a successor in Delaware, and many trust instruments provide flexible provisions that allow for the change of situs and governing law or even administrative amendments to the governing instrument. However, in many cases, this flexibility is not available and it is important to note that under the laws of many states, modifications to the trust can be accomplished before or contemporaneously with the migration of the trust. If it is not possible

to accomplish a modification to the trust under the laws of the original jurisdiction, then it may be possible to move the trust to Delaware and then utilize one of the tools available under Delaware law to modify a trust. In either case, whether using the laws of the original jurisdiction or the laws of Delaware, the techniques available to modify the terms of a trust may include: decanting, merger, judicial modification, or nonjudicial modification or consent settlement agreement.

2. **Decanting.** It may be possible to migrate a trust to Delaware and modify its terms at the same time by decanting the existing trust from a different jurisdiction into a new Delaware trust. Eighteen (18) states have enacted specific decanting legislation and at least two other states have proposed statutes. The States that currently have decanting statutes are:

Alaska	Nevada
Arizona	New Hampshire
Delaware	New York
Florida	North Carolina
Illinois	Ohio
Indiana	Rhode Island
Kentucky	South Dakota
Michigan	Tennessee
Missouri	Virginia

The two states where decanting statutes have been proposed are: South Carolina and Colorado. A trustee of one trust can decant into a new trust located in Delaware, governed by Delaware law and subject to modified administrative provisions.

It may be possible for an existing trust to migrate to Delaware and then affect a modification by decanting under the Delaware decanting statute, as provided in the Section above describing Delaware's decanting statute. In order to decant an existing trust under the Delaware statute, one must carefully analyze the conflicts of laws issues to ensure that the Delaware statute applies to that particular set of facts. Additionally, the trustee will need to consider whether the release and virtual representation statutes of Delaware or another state apply.

In order to decant a trust, one must analyze the trustee's power to distribute principal and assess whether applicable law empowers the trustee to decant. If a decanting can be accomplished, then the trustee of the original trust will need to perform a risk assessment and determine whether it can become comfortable exercising the discretion to decant the original trust to the new

Delaware trust. The exercise of discretion will likely be analyzed under an abuse of discretion standard. The trustee of the original trust will also need to consider whether it will require releases from the beneficiaries and how virtual representation may bind the minor and unborn beneficiaries. All of this may be analyzed under the laws governing the original trust and will pertain to the non-Delaware trustee, or perhaps it may be analyzed under Delaware and performed by the Delaware trustee if the situs and law governing administration can first be moved to Delaware. The parties will need to consider whether the trust instrument for this new trust will be a declaration of trust or a trust agreement, and who (if anyone) will be the nominal grantor of the new trust). Alternatively, the decanting instrument could simply set forth that the new trust shall be governed by the terms and conditions of the original instrument, subject to a series of changes set forth therein. The parties should also consider all income and transfer tax issues. The new Delaware trust could be a Delaware directed trust, the administration of which is governed by Delaware law or could take advantage of any of the other advantages of Delaware trust law and the Delaware jurisdiction.

3. **Trust Merger (Section 3325(29)).** The ability to merge trusts can be a very attractive strategy for migrating a trust from another state to Delaware. Under Section 3325(29) of Title 12 of the Delaware Code, a trustee of a Delaware trust has the power to: "Merge any 2 or more trusts, whether or not created by the same trustor, to be held and administered as a single trust if such a merger would not result in a material change in the beneficial interests of the trust beneficiaries, or any of them, in the trust." This can be a very useful tool for combining substantially similar trusts to achieve economies of scale. It can also be an effective strategy to migrate an existing non-Delaware trust into Delaware, by merging the existing trust with and into a new Delaware trust. The surviving Delaware trust could be administered under Delaware law and could include some administrative differences from the original trust, such as including a directed trustee provision. This should be possible, even if the original trust is generation skipping transfer tax exempt because there is a safe harbor in the Treasury Regulations for a trust merger. See Treas. Reg. § 26.2601-1(b)(4)(E) Example 6.

Section 417 of the UTC provides trustees with the power to merge and combine trusts. It states: "After notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust."

Including Delaware, there are thirty-six (36) states plus the District of Columbia that authorize trust mergers by statute without court approval.

Those states are:

Alabama	New Hampshire
Arizona	New Mexico
Arkansas	North Carolina
Delaware	North Dakota
District of Columbia	Ohio
Florida	Oregon
Illinois	Pennsylvania
Indiana	South Carolina
Iowa	South Dakota
Kansas	Tennessee
Louisiana	Texas
Maine	Utah
Massachusetts	Vermont
Michigan	Virginia
Minnesota	Washington
Mississippi	West Virginia
Missouri	Wyoming
Nebraska	

Additionally, there are six (6) other states that allow mergers with some level of court intervention. Those states are California, Colorado, Georgia, Maryland, Montana, and Rhode Island.

Generally, the statutes allow a merger with another trust so long as there is no material change in the beneficial interests of the trust beneficiaries. Many trust instruments include express merger provisions and this is also generally true of such provisions. Consequently, it should be possible to merge an existing trust into a new Delaware trust, the administration of which is governed by Delaware law and which includes changes to various administrative provisions, to take advantage of beneficial Delaware laws.

Three (3) states (Connecticut, New York, New Jersey) allow a trustee to hold two or more trusts as a single trust (essentially to merge) in the case of trusts created under the same governing instrument. Those statutes are not helpful with respect to migrating trusts to Delaware. The remaining states (Alaska, Hawaii, Idaho, Kentucky, Louisiana, Nevada, Oklahoma, and Wisconsin) appear to have no statutory merger power available to trustees.

The process for a trust merger involves several steps. First, one must ensure that the existing trust instrument or current governing law of the original trust enable the trustee to merge the trust. If this can be accomplished, then

the trustee of the original trust will need to perform a risk assessment and determine whether it can become comfortable with exercising the discretion to merge the original trust with and into the new Delaware trust. The exercise of discretion will likely be analyzed under an abuse of discretion standard. The trustee of the original trust will also need to consider whether it will require releases from the beneficiaries and how virtual representation may bind the minor and unborn beneficiaries. All of this will generally be analyzed under the laws governing the original trust and will pertain to the non-Delaware trustee, or perhaps it may be analyzed under Delaware and performed by the Delaware trustee if the situs and law governing administration can first be moved to Delaware. There will also need to be a new valid and existing Delaware trust, governed by Delaware law, which will be the survivor of the merger. The parties will need to consider whether the trust instrument for this new trust will be a declaration of trust or a trust agreement, and who (if anyone) will be the nominal grantor of the new trust. The parties should also consider all income and transfer tax issues. Once each of these steps has been accomplished, the trustee of the original trust will need to merge that trust with and into the new Delaware trust pursuant to some written instrument memorializing the exercise of discretion to merge. The new Delaware trust could be a Delaware directed trust, the administration of which is governed by Delaware law or could take advantage of any of the other advantages of Delaware trust law and the Delaware jurisdiction.

4. **Nonjudicial Modification.** Twenty-four (24) States plus the District of Columbia have enacted the UTC which includes provisions for the nonjudicial modification of trusts. Those States are:

Alabama
Arizona
Arkansas
District of Columbia
Florida
Kansas
Maine
Massachusetts
Michigan
Missouri
Nebraska
New Hampshire
New Mexico
North Carolina
North Dakota
Ohio
Oregon
Pennsylvania
South Carolina
Tennessee
Utah
Vermont
Virginia
West Virginia
Wyoming

In addition, the UTC has been introduced in 2013 in Montana and New Jersey. There are also other states, such as Illinois, that have not enacted the UTC but do have nonjudicial settlement agreement statutes that permit trust modification.

5. **Delaware Nonjudicial Consent Settlement Agreements.** Effective August 6, 2013, Delaware added new Section 3338 to Title 12 of the Delaware Code to permit the use of nonjudicial settlement agreements in Delaware. The new statute is substantially similar to the version in the UTC. The new statute provides settlors, beneficiaries, and fiduciaries an additional option under Delaware law for the resolution of matters arising with respect to the administration of a trust without the time and expense of court involvement.

   A. **Consent of Interested Persons.** Section 3338 requires the consent of all "interested persons" to enter into a nonjudicial settlement agreement. Subsection (a) 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 currently permit various matters involving trusts to be addressed through the filing of a consent petition with the Court of Chancery. Subsection (a)(7) of Rule 101 provides that all whose interest in the trust is affected by the relief requested in the petition must consent to the requested relief. Subsection (a)(7) of Rule 101 further provides that such persons include, but are not limited to: (i) trustees and other fiduciaries, (ii) trust beneficiaries with a present interest in the trust or whose interest would vest if the present interests in the trust terminated, (iii) the settlor 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. Accordingly, for purposes of entering into a nonjudicial settlement agreement under the new statute, interested persons include, at minimum, all of those persons identified in Subsection (a)(7) of Rule 101. Delaware's virtual representation statute, Section 3547, should be available for purposes of binding those interested persons who are minor, unborn, unascertainable or contingent successor remainder beneficiaries.

   B. **Matters That May Be Resolved.** Subsection (b) of Section 3338 provides that, except as provided in Subsection (c), interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust with one exception. The exception relates to charitable trusts and noncharitable purpose trusts described in Section 3541. Subsection (d) of Section 3338 provides a list of six matters that may be resolved by a nonjudicial settlement agreement: (1)

interpreting or construing the terms of a trust; (2) approving the report or accounting of a trustee; (3) directing a trustee to refrain from exercising a power or granting a power to a trustee; (4) resignation, appointment, or determination of compensation of a trustee; (5) transferring the principal place of administration of a trust; and (6) determining the liability of a trustee for an action relating to the trust. A comment to the UTC version of subsection (d), which is identical to Delaware's version, provides that this is a "nonexclusive list" of matters that can be resolved by a nonjudicial settlement agreement. Since the terms of Subsection (d) of Section 3338 track the UTC version and expressly provides that it may be used to enter into an agreement with respect to "any" matter involving a trust, Subsection (d) plainly provides a nonexclusive list and, as such, Section 3338 is a useful new tool for addressing a wide variety of matters related to the administration of trusts. Subsection (c) of Section 3338 provides certain limitations for the subject matter of a nonjudicial settlement agreement. Subsection (c) provides that a nonjudicial settlement agreement is valid only to the extent that 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. The term "material purpose" is not defined in new Section 3338 or in the UTC, but is generally understood to require an assessment of the purposes of the trust from the perspective of the intent of the settlor at the time the trust was created.

C. **Court Involvement.** Subsection (e) of new Section 3338 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. Subsection (e) expressly provides that such a proceeding may include seeking a determination that virtual representation under Section 3547 was proper. Subsection (e) of Section 3338 departs from the UTC version, which simply provides that an interested person may request court approval of a nonjudicial settlement agreement. The broader scope of Subsection (e) of Section 3338 reflects the Court of Chancery's plenary power over matters involving trusts.

6. **Delaware Consent Petitions.** For over a decade, a practice has developed whereby all of the beneficiaries of a trust and the trustees of a trust may file a consent petition with the Delaware Court of Chancery to move the situs of a trust to Delaware and to make certain modifications to the governing instrument.

A. **Court of Chancery Rules 100 – 104.** On April 12, 2012, Chancellor Leo E. Strine, Jr. enacted Court of Chancery Rules 100 through 103, which

took effect on May 1, 2012. These new Rules required material changes to Delaware Court of Chancery consent petitions for trusts. The Rules created additional requirements designed to assure that the Court is fully apprised of the nature of the relief sought and all facts and circumstances relevant to the Court's determination as to whether that relief is advisable and appropriate. Then on October 31, 2012, Chancellor Strine signed Amendments to Court of Chancery Rules 101 and 104, which took effect on December 1, 2012. Court of Chancery Rules 100 through 104 address additional procedures and requirements for the Delaware trust consent petition practice and, following these amendments, also apply to any other action, including contested trust litigation, involving the modification of a trust.

ii. **Situs and Governing Law.** Under Rule 100(b)(3), every petition to modify a trust must address the basis for the Court of Chancery's jurisdiction over the trust and, to the extent jurisdiction is based on Delaware being the principal place of administration, must include a description of the administrative tasks and duties carried out by the Delaware trustee or other Delaware fiduciaries and a comparison of those tasks and duties to those entrusted to the fiduciaries or proposed fiduciaries domiciled outside of Delaware. Historically petitions have generally stated that the Court of Chancery has jurisdiction over the trust and cited the existence of a Delaware trustee administering the trust in Delaware as the basis for the Court's jurisdiction. However, Rule 100 requires a description of the actual administrative tasks and duties being carried out by the Delaware trustee and a comparison of those tasks with those being performed by fiduciaries or proposed fiduciaries outside of Delaware.

iii. **Issues To Be Addressed with Particularity.** Rule 100(c) states that every petition to modify a trust must address nine specific areas "with particularity". Many of those areas can be easily addressed or have historically been covered with a sufficient degree of particularity under the consent petition practices that have been followed by many Delaware lawyers in the past. However, some of the matters that must be addressed under Rule 100 will require additional due diligence. For example, Rule 100(c)(2) requires the petition to address with particularity any prior determination or judgment on the merits in any action, suit, or proceeding involving any living person (but not institutional fiduciaries) who is either a petitioner or a person who will serve as a fiduciary if the relief requested in the petition is granted, resulting in a criminal

conviction, an adjudicated breach of the fiduciary duty of loyalty, or a determination reflecting on the honesty or integrity of such person. It would be impracticable for counsel in the matter affirmatively to verify that no such prior determination or judgment in fact exits on any court's docket. Consequently, counsel and the parties to the petition will likely have to rely on affidavits or similar statements by proposed fiduciaries and petitioners. Rule 100(c)(5) requires the petition to state with particularity how the proposed relief will affect the interests of current, vested future, and contingent beneficiaries. In some cases, this will likely require a detailed description of matters such as investment objectives and horizons, changes in fiduciary fees, changes in the rights and interests of the beneficiaries, changes in the qualifications, capitalization or expertise of advisers in fiduciary roles, and how the relief requested might affect the interests of the beneficiaries in various possible circumstances. For example, careful thought should be devoted to the disclosure of how the petition will affect the interests of beneficiaries if the relief requested includes a change of the trust's governing law. Rule 100(c)(6) states that the petition must address with particularity any personal interest of any petitioner, or person who will serve as a fiduciary if the relief requested in the petition is granted, creating an actual or potential conflict between the interests of such person and the interests of the current, vested future, or contingent beneficiaries relating to the relief requested in the petition. Such a conflict may include, but is not limited to, conflicts relating to differing investment horizons, an interest in present income versus capital growth, or any limitation on, exculpation from, or indemnification for any existing or potential future liability. This requirement applies even in cases where no person is consenting on behalf of another through the use of virtual representation under Section 3547 of Title 12 of the Delaware Code. This requirement mandates disclosure of any actual or potential conflict of interest between any petitioner or person to be appointed as a fiduciary and any beneficiary of the trust. Thus, for example, if an individual who is a beneficiary of the trust is to be appointed as an investment adviser, that person would be deemed to have a conflict of interest with other beneficiaries under this Rule and that conflict will need to be disclosed with particularity in the petition. The petition must fully disclose all such conceivable conflicts. Rule 100(c)(7) requires the petition to state with particularity whether any petitioner or beneficiary has a familial, personal, or financial relationship with any person who will be appointed to a fiduciary or non-fiduciary role or will receive greater authority, broader

discretion, or increased protection, including but not limited to, any limitation on, exculpation from, or indemnification for existing or potential future liability. It seems that a non-fiduciary role would include those who, in a non-fiduciary capacity, possess a power such as the power to appoint or remove a trustee or adviser. The description of the relationships between all beneficiaries and petitioners and any person who will possess any fiduciary or non-fiduciary role with respect to the trust will require a detailed and careful analysis and presentation to the Court. For example, if the petition seeks the appointment of an investment adviser who is a family member or friend of any beneficiary, or who has any type of business relationship with any beneficiary, those connections will need to be disclosed with particularity. Rule 100(d)(4) states that any petition which seeks to confirm a change of situs of a trust or the application of Delaware law to a trust despite a choice of law provision selecting the law of another jurisdiction, shall address whether Delaware law governs the administration of the trust, and, if so, why. If the petition relies upon the domicile of the trustee as support for a determination that the trust situs is Delaware or that Delaware law governs the administration of the trust, the petition must explain why Delaware is the place of trust administration, taking into account the administrative tasks and duties that will be carried out by the trustee, any tasks and duties assigned to the advisers, trust protectors, or other persons, and any other factors counting in favor of or against Delaware jurisdiction, such as the ability of the Delaware trustee to resign automatically or under specific circumstances.

iv. **Blackline of Modifications and Clean Reformed and Restated Trust Instrument**. Rule 101(a)(3) requires the attachment of a blacklined version of the proposed modified trust instrument. Historically petitions for modifications of trusts would sometimes set forth the requested modifications as a part of the petition, without a restatement of the trust with a blacklined version of the requested changes. Occasionally, counsel would file a blacklined version as an exhibit to the petition if the changes were numerous and were more easily presented to the Court in the form of a blacklined version of the document. However, this requirement under Rule 101 requires a blacklined version of the proposed modified trust instrument. Under Rule 101(a)(4), the party submitting a consent petition must include a clean version of the proposed modified trust instrument as it will read if the relief requested in the consent petition is granted.

v. **Trustor's Consent**. Rule 101(a)(6)(iii) requires that the consent or non-objection of the trustor of the trust, if living, be annexed to the petition.

vi. **Virtual Representation**. Rule 103(b) states that any consent involving Delaware's virtual representation statute, Section 3547, must certify that no material conflict of interest exists between the consenting party and the persons represented, including any of the factors set forth in subsection (c) of Rule 103, and must describe the relationship between the person signing the consent and the persons represented. Rule 103(c) states that any petition involving virtual representation shall contain a certification, signed by the senior Delaware attorney involved in the matter and the senior out-of-state attorney, if any, involved in the matter, certifying to the best of their knowledge that, after good faith investigation, the person purporting to consent for others by representation: (1) will not, as a result of the relief sought in the petition, be appointed to a fiduciary or non-fiduciary office or role relating to the trust; (2) if already serving in a fiduciary or non-fiduciary office or role relating to the trust, will not as a result of the relief sought in the petition receive greater authority, broader discretion, or increased protection, including but not limited to any limitation on, exculpation from, or indemnification for any existing or potential future liability; and (3) does not have an actual or potential conflict of interest with those persons represented relating to the relief sought in the petition, including but not limited to, conflicts relating to differing investment horizons or an interest in present income over capital growth. Rule 103(c) notably requires a certification made by attorneys after a "good faith investigation". Such an investigation will presumably involve more than relying on verbal statements from a family representative or attorney. The attorneys will be required to perform adequate due diligence to establish that the facts satisfy these requirements. It seems clear that no person may consent on behalf of any other person using virtual representation if the consenting person will either be appointed as an adviser or will individually, or as a member of class, hold a non-fiduciary role such as holding the power to remove and appoint the adviser or trustee. Thus, for example, if a petition seeks the addition of a direction adviser and the adviser may be removed or appointed by a majority of the trust's adult beneficiaries, it would appear that none of the adult beneficiaries may virtually represent minors and unborn beneficiaries, who will not hold that power upon the entry of the order. Rule 103(a) also

states that when virtual representation is used, the petition must address with particularity the process used to obtain the required consents, including the information provided to the parties giving the consent. Traditionally, consents, along with copies of the petition and exhibits, have been sent to the beneficiaries for signature without the attorneys necessarily having personal knowledge of the process used to obtain the consents or all information provided to the parties giving consent. The Rule requires inquiry into and disclosure of all of the information that was or was not shared with the consenting beneficiaries and the facts and circumstances surrounding the process used to obtain the consents. So, for example, if someone related to the consenting beneficiary had a private conversation with that beneficiary that persuaded him or her to sign the consent, that communication should be disclosed in the petition and the petitioner and petitioner's counsel therefore ought to inquire into such matters.

vii. **Separate Orders Required**. Under Rule 104(a), the party submitting a consent petition is required to file a separate proposed form of order for each item of relief requested. The Rule expressly prohibits orders for multiple individuals, multiple beneficiaries, or other interested parties, and now requires a separate proposed order for each individual, beneficiary, or interested party. The Rule also states that each such separate proposed order submitted with a consent petition will be charged a filing fee equal to the fee charged for filing one proposed order. This Rule brings the requirements that were first introduced in a Standing Order dated October 7, 2012 into the Court of Chancery Rules.

viii. **Application of Rules To Any Matter Involving a "Modification of a Trust"**. Rule 104(b) states that Rules 100 through 104 shall apply to any matter before the Court of Chancery in which the relief sought includes the modification of a trust. The Rule expressly applies to all relief involving the modification of a trust, whether by means of a consent petition, civil action (i.e. contested litigation), court approved settlement or otherwise. However, the Rule states that "modification of a trust" does not include the severance or division of a trust, the merger of a trust, a distribution from a trust, or the appointment of a fiduciary of a trust if the action is permissible without court intervention under the terms of the agreement or under applicable law, unless the parties seek court approval of such action. In general, Rule 104(b) expands the scope of Rules 100 through 104 to contested civil litigation. Rules 100 through 104, which took effect on

May 1, 2012, established many detailed requirements applicable to the consent petition practice in the Court of Chancery and applied initially to only the consent petition process. However, because of the amendment to Rule 104(b), litigants involved with trust litigation involving the modification of a trust will need to carefully consider all of the additional requirements of Rules 100 through 104.

7. Peierls Decisions.

On October 4, 2013, the Delaware Supreme Court issued three related en banc opinions in the Peierls consent petition matters which were the subject of three notable Court of Chancery decisions near the end of 2012. See IMO: Peierls Family Inter Vivos Trusts, No. 16812 (Del. Oct. 4, 2013); IMO: Ethel F. Peierls Charitable Lead Trust, No. 16811 (Del. Oct. 4, 2013); and IMO: Peierls Family Testamentary Trusts, No. 16810 (Del. Oct. 4, 2013). These landmark opinions have a significant impact on the field of Delaware trust law, clarifying when Delaware law governs the administration of trusts migrating to Delaware, the Delaware court's jurisdiction and its role with respect to trust modifications, instructions and other matters. Most notably, the Court held that absent evidence that a settlor intended that the laws governing the administration of a trust at its inception shall always govern administration, a settlor's choice of governing law is not absolute and unchangeable. Under the Peierls decisions, Delaware law will govern the administration of any trust that allows for the appointment of a successor trustee without geographic limitation once the Delaware trustee is appointed and the trust is administered in Delaware, unless a choice of law provision expressly provides that another jurisdiction's laws shall always govern.

A. Background. These opinions resulted from the appeal of three opinions of the Delaware Court of Chancery issued in connection with consent petitions filed for seven testamentary trusts (the "Testamentary Trusts"), a charitable lead unitrust (the "Charitable Trust"), and six inter vivos trusts (the "Inter Vivos Trusts"). Each of the uncontested consent petitions requested that the Court (i) approve the resignation of individual trustees, and in the case of the Inter Vivos Trusts and Charitable Trust only, replace a corporate trustee; (ii) confirm the appointment of a Delaware trust company as successor corporate trustee; (iii) determine that Delaware law governs administration of the trust; (iv) confirm Delaware as the trust situs; (v) reform the trusts to modify the administrative provisions and create the positions of Investment Direction Adviser and Trust Protector; and (vi) accept jurisdiction over the trust. The Court of Chancery denied all of the requested relief and set forth analysis concerning when Delaware law will govern the administration of existing trusts that migrate to Delaware.

The Delaware Court of Chancery analyzed Delaware's long-standing case law concerning the application of Delaware law to trusts and found that where the settlor chooses a governing law, that choice is dispositive and the settlor need not deploy "talismanic language" or specify a litany of trust issues to be governed by the chosen law in order to prevent the law governing administration from changing when the place of administration changes to Delaware. The Court explained that the settlor's intent to choose a particular law may be implied from the trust document as a whole and when a settlor has selected a governing law, the power to appoint a successor trustee in and of itself is insufficient to override this intent, unless the trust document expressly provides for such a change. The Court held that the appointment of a successor trustee combined with a change in situs will change the law governing administration only if the trust document so provides or can be construed to contemplate such a change. Those decisions were overturned by the Delaware Supreme Court.

B. Delaware Law Governing Administration. One of the most significant holdings of the Delaware Supreme Court in these opinions was its decision with respect to the application of Delaware law governing administration of the trusts. The Court's analysis of those issues primarily appears in the opinion addressing the Inter Vivos Trusts, and the opinions addressing the Testamentary Trusts and the Charitable Trust referenced and incorporated that analysis.

There were several sets of governing law provisions among the Inter Vivos Trusts. The Inter Vivos Trusts created in 1953 contained a provision that stated: "all questions pertaining to its validity, construction, and administration shall be determined in accordance with the laws of the State of New York". The Inter Vivos Trust created in 1957 contained a provision that stated its "validity and effect [are] determined by the laws of the State of New Jersey". The Inter Vivos Trusts created in 1975 contained a provision that stated that the trusts: "shall be governed by and [their] validity, effect and interpretation determined by the laws of the State of New York". Relevant to the Court's analysis, all of the trust instruments permitted the appointment of a successor trustee without any geographic limitation.

The Court recognized that Delaware has a choice of law statute, namely 12 Del. C. § 3332. That Section provides that "[e]xcept as otherwise expressly provided by the terms of a governing instrument or by court order, the laws of this State shall govern the administration of a trust while the trust is administered in this State." However, the Court noted that for all of the trusts in this matter, the Delaware trustee was appointed

on a conditional basis, subject to judicial approval. The Court found that because the Delaware trustee has not yet assumed its role, Delaware is not yet the place of administration and Section 3332 does not apply to this analysis. Consequently, the Court did not engage in an analysis of Delaware's Section 3332, but instead turned to an analysis of Delaware's conflicts of laws jurisprudence.

The Court quoted Lewis v. Hanson, 128 A.2d 819, 826 (Del. 1957) for the proposition that "a creator of an inter vivos trust has some right of choice of selection of the jurisdiction, the law of which will govern the administration of the trust". The Court elaborated on this principal by stating that a settlor may "designate, either expressly or implicitly within the trust instrument, the law governing the trust's administration." The Court expressed that when confronted with a choice of law issue, Delaware courts adhere to the Restatement (Second) of Conflicts of Laws (the "Restatement"). The Court entered into an extensive analysis of Section 272 of the Restatement. Most importantly, the Court addressed whether the law governing a trust's administration changes following a change of situs. The answer to this question depends "upon the terms of the trust, express or implied." The Supreme Court agreed with the Vice Chancellor's conclusion that in the absence of a choice of law provision, the settlor implicitly intended to allow a change in the law governing administration by allowing the appointment of a successor trustee in another jurisdiction. However, the Supreme Court disagreed with the Vice Chancellor's conclusion that the law governing administration can only be changed in those limited circumstances. The Court stated: "Without evidence that the settlor intended for the law governing administration of the trust at its inception to always govern the trust, a settlor's initial choice of law is not absolute and unchangeable."

The crux of the Court's holding was that a trust instrument may implicitly authorize a change in the law governing the administration of the trust "such as when the trust instrument contains a power to appoint a trustee in another named state." Even a simple power to appoint a successor trustee may be construed to include a power to appoint a trust company or individual in another state. Regardless of whether the trust instrument expressly or implicitly authorizes a change in the trust's administrative law, "the law governing the administration of the trust thereafter is the local law of the other state and not the local law of the state of original administration." That rule applies even when the trust instrument contains a choice of law provision. The Court disagreed with the Vice Chancellor's conclusion that a choice of law provision governing a trust's administration reflects a settlor's intent that a particular state's

law will always govern a trust's administration, irrespective of whether the beneficiaries validly exercise a power to appoint an out-of-state trustee. The Court concluded: "when a settlor does not intend his choice of governing law to be permanent and the trust instrument includes a power to appoint a successor trustee, the law governing the administration of the trust may be changed".

As applied to the Peierls trusts, the Court agreed with the Vice Chancellor that at the time of the creation of the trust, the settlor's intent was that the law of the original jurisdiction would govern administration. However, the Court disagreed with the Vice Chancellor's conclusion that a valid appointment of a trustee in another state would effect a change in the law governing administration only "if the settlor has not selected a particular law to govern the trust." The Court reached this conclusion even in the case of the 1953 Inter Vivos Trusts which included a choice of law provision stating that the "validity, construction and administration shall be determined in accordance with the laws of the State of New York". The Court stated: "we adopt the Restatement's enlightening commentary concerning testamentary trusts, namely, that a change in the place of administration resulting from the valid appointment of a successor trustee will result in a change of the law of administration, unless the change would be contrary to the testator's intent. Such a circumstance could arise 'when [the testator] has expressly or by implication provided in the will that the administration of the trust should be governed by the local law of the state of his domicil[e] at death, even though the place of administration should be subsequently changed.'" None of the Inter Vivos Trusts include any language suggesting that the law governing the trust's administration must always remain the law of the original jurisdiction. Accordingly, the Court held that the settlors "implicitly permitted the law of administration to change with a change in the place of administration" and the settlors manifested that intent by permitting the appointment of a successor trustee without geographic limitation. The Court concluded for all of the Inter Vivos Trusts, that the "law of administration would change with a change in the place of administration."

C. Explanation of Delaware's Conflicts of Laws Cases. Delaware has a fairly well-developed common law history concerning conflicts of laws of trusts. The Vice Chancellor interpreted some of the important cases in this body of law to reach its conclusions. The Supreme Court considered each of those cases and articulated a more constrained interpretation of their application. First tackling the admittedly confusing series of Wilmington Trust v. Wilmington Trust cases, the Court stated: "We read the Wilmington Trust trilogy to stand for the narrow proposition that a

trust instrument, through a power to appoint a trustee combined with 'to the same effect as though now named herein' language can reflect a settlor's intent to allow a beneficiary to reestablish a trust in a different state." Then the Court read Wilmington Trust Co. v. Sloane to hold "that a settlor can permit a beneficiary to exercise a power of appointment over the trust's assets to create a new trust in another state." Finally, the Court read Annan v. Wilmington Trust Co. as "supporting the proposition that a choice-of-law provision concerning the law governing a trust instrument's construction will remain effective even if the trust's place of administration is changed." The Court explained that none of those cases supports the Vice Chancellor's conclusion that "[w]hen a settlor has selected a governing law, the power to appoint a successor trustee in and of itself is insufficient to override this intent, unless the trust document as construed by the Court expressly provides for such a change."

D. Validation of Change of Governing Law and Situs Provisions. The governing instrument of the Charitable Trust included flexible change of situs and change of governing law provisions, and the Court upheld the application of those provisions. With regard to situs, the governing instrument provides: "The situs of the trust shall, as to personal property, be (i) the location of the main business office of the Trustee who then has custody of the trust records, wherever the Trustee may locate that office, or (ii) any other situs (designated by the Trustee in a writing filed with the trust) that has sufficient contact with the trust to support jurisdiction of its courts over the trust." The Court confirmed the validity and effect of this provision, stating that it would appear that upon the appointment of a corporate trustee in Delaware with custody of the trust records, the situs of the trust would automatically move to Delaware under the express terms of the trust instrument. The Court continued, stating that if the petitioners are not convinced of this, the trustee may file a written election with the trust records. The governing law provision designated Washington law to govern administration but provided that the law would change to the jurisdiction where situs is located. The Court concluded that the settlor's intent was clear that the law governing administration will change with the situs of the trust.

E. Court Jurisdiction. The Court found that all of the matters before it pertained to matters of administration and, consequently, the question of whether the Delaware courts have jurisdiction over the trusts required the Court to address which courts have jurisdiction over administration of the trusts. In the opinion addressing the Testamentary Trusts, the Court cited Section 267 of the Restatement for the proposition that

"[w]here the trustee has qualified as trustee in a particular court, that court usually has a continuing jurisdiction over the administration of the trust." Furthermore, "[e]ven though the trustee has qualified as trustee in a court, its jurisdiction is not exclusive and the courts of other states may exercise jurisdiction in proper cases if they have jurisdiction over the trustee, or if they have jurisdiction over trust assets insofar as interests in those assets are concerned." The Court noted that all interested parties consented to the Court of Chancery's jurisdiction and, having obtained jurisdiction over the trustees, the Court of Chancery had jurisdiction to adjudicate issues of administration of the trusts under the Restatement test adopted by the Court.

The issue of whether the Court of Chancery had jurisdiction to evaluate the petitions is distinct from the issue of whether the Vice Chancellor should have exercised jurisdiction to do so. This question, according to the Supreme Court, is largely one of which court has "primary supervision" over the trusts. The Court held that "[i]f the court in which the trustee has qualified 'does not exercise active control over the administration of the trust,' then the court of the place of administration 'may exercise primary supervision.'" The Court found that the record reflects that the Superior Court of New Jersey continues to supervise the 1960 Testamentary Trusts and, consequently, it is for the New Jersey courts, and not Delaware, to exercise jurisdiction as to all questions which may arise in the administration of the trust. With respect to the 1969 Testamentary Trusts migrating from Texas, the Court noted that there is no record of interaction with the Texas courts after 2001 and the Texas courts did not appear to exercise active control over the trusts. The Court concluded that because the Texas Probate Court's jurisdiction over the 1969 Testamentary Trusts is not exclusive, and because of the absence of evidence that any court retains primary supervision over the Trusts, no interstate comity concerns prevents the Court of Chancery, which has personal jurisdiction over the trustees, from having jurisdiction over the 1969 Testamentary Trusts and addressing the petitions. The 1957 Inter Vivos Trust was subject to ongoing supervision of the New Jersey courts. The Court concluded that the Petitioners should first seek the permission of the New Jersey Superior Court to terminate its supervision over the trust before it would become subject to Delaware court supervision.

F. Trust Modification. The Court's orders analyzed the necessary conditions for judicial modification of a trust. In the Charitable Trust opinion, the Court highlighted the semantic confusion between the use of the word "reformation" as opposed to "modification" to describe the relief sought in the petitions. A traditional reformation action, of

course, has its own set of common law doctrines and criteria, whereas modification merely seeks an exercise of equitable power to modify the terms of a trust instrument based upon the consent of all interested parties. In the Charitable Trust opinion, the Court held that substituting the word "modify" for "reform" would not lead to a different result. In either instance, the Petitioners seek to have the court invoke its equitable powers to change the terms of a trust instrument. In all three opinions, the Court held that "the Court of Chancery's power to reform a trust depends on which state's law governs the administration of the trust." In other words, if the laws of a state other than Delaware govern the administration of a trust, then parties to a petition for modification or reformation must address reformation or modification under the laws of that state to satisfy the burden. Of course, the holdings in Peierls regarding the change of law governing administration will pave the way for reformation or modification matters to be addressed by Delaware law after a Delaware trustee is appointed. But prior to Peierls, parties routinely petitioned the Court of Chancery for modification, and obtained Court orders granting the relief they were requesting regardless of the governing law, based on the premise that the Court had jurisdiction over the trust and could exercise its equitable powers to modify the terms of the trust instrument. The Court's holdings in Peierls will likely have an impact on the trust modification petition practice in Delaware. With respect to the Peierls trusts, the Court declined to address the issue because Delaware law did not yet govern the administration of the trusts because of the conditional appointment of the Delaware trustee and the issue was not briefed under the laws of the other jurisdictions.

G. No Advisory Opinions. The Court concluded that the Vice Chancellor properly declined to approve the resignation and appointment of trustees of the Inter Vivos Trusts, Charitable Trust and Testamentary Trusts because the trust instruments expressly authorize the resignation and appointment of trustees without court approval. The Court concluded that any judicial ruling on this issue would be an impermissible advisory opinion and that no actual controversy exists (even though the trustees made the resignation and appointment of successor trustee conditioned upon the court order and "essentially attempted to create their own controversy"). This holding will also have a material impact on the trust consent petition practice in Delaware. In the past, there has been a practice in Delaware of seeking judicial approval or instructions concerning certain actions that do not necessarily require judicial approval, and in light of Peierls, that practice now appears to be halted.

H. Conditional Appointment and Acceptance of Delaware Trustee. In the past, parties sometimes conditionally appointed a Delaware trustee, effective upon the entry of a Delaware court order modifying the trust and granting relief similar to that requested in the Peierls matters. For example, parties who desire to convert a trust to a so-called "directed trust" would sometimes seek a judicial modification of the trust, and the Delaware trustee would be appointed conditionally effective upon the Delaware court's order modifying the trust, so that the Delaware trustee would become a directed trustee from the outset. The Peierls decisions seem to make it clear that it is no longer a viable practice to appoint a successor Delaware trustee, conditioned upon obtaining an order of the Delaware Court of Chancery granting the types of relief requested in the Peierls matters. First, the Court will not grant relief if it is possible for the parties to achieve the same result without judicial intervention because it is an advisory opinion, and this includes approval of the appointment of the Delaware trustee. Under Peierls, it now seems clear when Delaware law will govern administration and when the Delaware court will take jurisdiction over a matter, and confirmation of those items may now be viewed as advisory opinions. If a Petitioner seeks a judicial modification of a trust on the basis of a conditional appointment of the Delaware trustee, and consequently Delaware law does not yet govern administration, the parties will now be required to brief the modification issue under non-Delaware law. Consequently, the conditional appointment of a Delaware trustee, subject to obtaining a Delaware court order, has effectively been halted by Peierls.

I. Conclusion. The Delaware Supreme Court's Peierls opinions have important implications on the Delaware trust industry. The opinions clarify when Delaware law will govern matters pertaining to trust administration, court jurisdiction, judicial modification, and the parameters of the issues traditionally addressed by Delaware trust consent petitions. These decisions may even have implications beyond Delaware, as the conflicts of laws issues addressed by Peierls have not been so clearly articulated in a court's decisions elsewhere in the nation, and certainly not by a court with the stature and reputation of the Delaware Supreme Court. These decisions should help bring clarity to the confusing field of conflicts of laws associated with the inter-state migration of trusts.

Most significantly, the Peierls decisions make it clear that Delaware law will govern the administration of any trust that allows for the appointment of a successor trustee without geographic limitation once a Delaware trustee is appointed and the trust is administered in Delaware,

unless the choice of law provision expressly provides that another jurisdiction's laws shall always govern the administration even if the place of administration or situs changes. According to the Court, the ability to appoint a trustee in Delaware reflects the settlor's implied intent that Delaware law will govern the administration of the trust following such appointment. This is the result where the trust instrument is silent as to governing law, or even where the trust instrument provides that some other jurisdiction's laws shall govern the validity, construction and administration of the trust. Based on this holding, the two situations where Delaware law would not govern the administration of a trust of which a Delaware trustee has been appointed are either (1) where the governing law provision expressly states that the law the original jurisdiction will continue to always govern administration even if a successor trustee is appointed in another jurisdiction, or (2) where the governing instrument does not provide any ability to appoint a successor trustee or the ability to appoint a successor trustee is limited to one located in the original jurisdiction.

Once a Delaware trustee is appointed and Delaware law governs administration, a trust can avail itself of all of the advantages of Delaware law that pertain to administration including, without limitation: decanting (although the decanting statute expressly provides that it would already be available to any trust administered in Delaware), trust merger, general trustee powers, trustee releases, virtual representation, nonjudicial consent settlement agreements, the prudent investor rule, permissible affiliated investments, trustee compensation, total return unitrust conversions, and the trustee's power to adjust.

In a nutshell, the Peierls decisions held the following:

- **Choice of Law.** Absent evidence that the settlor intended that the laws governing administration at a trust's inception shall always govern administration, a settlor's choice of governing law is not absolute and unchangeable. A settlor manifests an implied intent to change the law governing administration by permitting the appointment of a successor trustee without geographic limitation. Delaware law will govern the administration of any trust that allows the appointment of a successor trustee without geographic limitation once the Delaware trustee is appointed and the trust is administered in Delaware unless a choice of law provision expressly provides that another jurisdiction's laws shall always govern administration.

- **Explanation of Delaware's Line of Conflicts of Laws Cases.** The Court elucidated the seminal cases found in Delaware's long-standing conflicts of laws case law.

- **Court Jurisdiction.** The Court noted that all interested parties consented to the Court of Chancery's jurisdiction and, having obtained jurisdiction over the trustees, the Court of Chancery had jurisdiction to adjudicate issues of administration of the trusts under the Restatement test that was adopted by the Court. However, if another court has retained primary jurisdiction over a Trust (as with the 1960 Testamentary Trusts) then the Delaware court will not take jurisdiction to address questions pertaining to administration. But where another court has not retained ongoing or primary jurisdiction, then the Delaware courts can exercise jurisdiction.

- **Conditional Appointment and Acceptance of Delaware Trustee.** The practice of conditioning a Delaware trustee's appointment upon the entry of a Delaware court order has effectively been halted.

- **Trust Modification.** The issue of whether the Court can modify or reform a trust is a question to be determined by the law that governs administration. The Court denied the modifications in Peierls because Delaware law did not yet govern administration and the parties did not brief the issue of modification or reformation under applicable law. Apparently modification is not an exercise of equitable powers that the Court of Chancery can simply exercise based on the consents of all parties, without regard to the law that governs administration.

- **No "Advisory Opinions".** The Court will not enter an order with respect to any matter that can be accomplished without court approval because that is an advisory opinion.

- **Validation of Change of Situs and Governing Law Provisions.** The Court validated the effectiveness of change of situs and change of governing law provisions often found in trust instruments.

Morris Nichols
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