

IMO Daniel Kloiber Trust U/A/D December 20, 2012

Client Alert

10.01.2014

INTRODUCTION

The Delaware Supreme Court recently issued an order denying an interlocutory appeal of the opinion of Delaware Court of Chancery (the “Chancery Court”) in IMO Daniel Kloiber Trust U/A/D December 20, 2012 (“Kloiber”). In August of this year, the Chancery Court issued an opinion addressing the meaning of the term “exclusive jurisdiction” found in Section 3572(a) of Delaware’s Qualified Dispositions in Trust Act (the “Act”), which states that the Chancery Court shall have exclusive jurisdiction over any action brought with respect to a “qualified disposition”, and when the Chancery Court shall be deemed to have “primary jurisdiction” over Delaware trusts.

BACKGROUND

Glenn F. Kloiber (“Glenn”) created a trust (the “Trust”) in 2002 pursuant to an irrevocable trust agreement (the “Trust Agreement”) and initially funded the Trust with \$15,000. In 2003, Glenn’s son, Daniel Joseph Kloiber (“Dan”) sold 99.45% of his shares of Exstream Software, Inc. (“Exstream”) to the Trust for an unsecured promissory note with a face value of \$6 million. In 2007 and 2008 respectively, the Trust sold 80% of its Exstream holdings for \$250 million and its remaining Exstream holdings for \$60 million. Since those sales, the assets of the Trust have consisted of cash, marketable securities, and interests in closely held entities, including interests in single-member limited liability companies (the “LLCs”).

The Trust is governed by the Trust Agreement dated December 20, 2002 between Glenn and a corporate predecessor to PNC Delaware Trust Company (“PNC”). PNC is the current trustee of the Trust (in such capacity, the “Trustee”). The Trust Agreement selected Delaware as the situs and law governing the administration of the Trust, and further provided that Delaware law governs the validity, construction and effect of the provisions of the Trust Agreement.

Dan is the primary beneficiary of the Trust. Dan has the power to withdraw up to five percent of the value of the Trust annually. He also has both inter vivos and testamentary limited powers of appointment over the Trust exercisable in favor of his “wife”, his issue, his siblings, the issue of his siblings, and charities. Additionally, the Trustee can make distributions to Dan for his health, education, support and maintenance.

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Beth Ann Jenkins (“Beth”) is a beneficiary of the Trust if she qualifies as Dan’s wife. The Trust Agreement defines Dan’s wife to mean during Dan’s lifetime, the person to whom Dan is legally married and with whom Dan is cohabiting. Beth and Dan were married and cohabitating at the time of the creation of the Trust, but they separated in April 2010.

The Trust Agreement created various office holders which are “advisers” under Section 3313 of Title 12 of the Delaware Code with the power to direct the Trustee to exercise certain trustee powers. Most notably, the Trust Agreement creates the office of “Special Trustee”. Dan was named as the initial Special Trustee. The Special Trustee has the power to direct the Trustee with respect to the investment of trust assets, and with respect to discretionary distributions. The Special Trustee can also remove and replace the Trustee.

PREVIOUS PROCEEDINGS IN KENTUCKY

Daniel and Beth are legally separated and have been embroiled in divorce proceedings in the Fayette Family Circuit Court in Kentucky (the “Kentucky Court”). In 2011 and 2012, the Kentucky Court issued status quo orders (“Status Quo Orders”) intended to prevent the parties from dissipating marital assets before the Kentucky Court was able to determine ownership and equitably divide such assets. Because the Kentucky Court had personal jurisdiction over Dan, the Kentucky Court had the power to restrain Dan’s activities, individually and in his capacity as Special Trustee of the Trust and as sole manager of the LLCs. When the Status Quo Orders were entered, the Trustee and Trust were not parties to the Kentucky divorce proceeding, but by restricting Dan as Special Trustee, the Kentucky Court restricted the Trust. Beth initiated a plenary action in a Kentucky Circuit Court in an effort to void Dan’s transfer of Exstream stock to the Trust, alleging that they were fraudulent transfers. The Kentucky divorce proceeding was tried from June through August 2013 and the Kentucky Court entered a further status quo order to keep the earlier Status Quo Orders in effect until the entry of a final decree. As with the earlier orders, the Trustee and the Trust were not parties to these further status quo orders. On March 27, 2014, the Kentucky Court informed the parties that it was planning to add the Trust as a party to the divorce proceeding and on April 28, 2014, Beth sought to add PNC as a party.

On May 15, 2014, Dan resigned as Special Trustee of the Trust and resigned as sole manager of the LLCs on May 29, 2014. He appointed William Nicholas Kloiber (“Nick”) as Special Trustee. As Special Trustee, Nick took actions that were arguably contrary to the Status Quo Orders. Consequently, after additional proceedings, the Kentucky Court issued a rule to show cause (the “Rule to Show Cause”) why Nick should not be held in contempt.

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DELAWARE PROCEEDINGS

The procedural history in Delaware, like in Kentucky, is quite complicated. On May 22, 2014, two days after receiving Nick's instruction as Special Trustee that arguably violated the Status Quo Orders, PNC filed a petition seeking instructions and declarations from the Chancery Court. That petition, with subsequent amendments, sought declarations that (1) the Court of Chancery has exclusive jurisdiction over the Trust and the Kentucky Court improperly asserted jurisdiction over the Trustee, Special Trustee and Trust, (2) Beth's fraudulent transfer claims are time-barred, (3) the Kentucky Court's orders are not enforceable against PNC or the Trust, and (4) the Chancery Court has primary jurisdiction over the Trust and must intervene to curb the activities of the Kentucky Court over the Trust. Nick responded to the petition, admitting all of PNC's allegations with the one exception that Nick denied that the transfer of Exstream stock to the Trust was a qualified disposition under the Delaware Act. Nick also sought a temporary restraining order ("TRO") preventing Beth from seeking to enforce the Status Quo Orders. Nick's and PNC's actions were consolidated and the Chancery Court's opinion addressed Nick's application for a TRO.

The Chancery Court denied Nick's request for a TRO for a number of reasons. Notably, the Chancery Court found that Nick lacked a colorable claim that the Kentucky Court is interfering with the Chancery Court's exclusive jurisdiction or primary jurisdiction over the Trust. The Chancery Court separately found that Nick's TRO should be denied because he would not suffer irreparable harm without the TRO.

EXCLUSIVE JURISDICTION

PNC argued that the Act applies to the Trust and, pursuant to Section 3572(a) of Title 12 of the Delaware Code, the Chancery Court has exclusive jurisdiction over the Trust and the Chancery Court could issue injunctive relief to protect such exclusive jurisdiction. Section 3572(a) of the Act provides in relevant part that the Chancery Court "shall have exclusive jurisdiction over any action with respect to a qualified disposition". As the Chancery Court describes PNC's argument, it was argued that Section 3572(a) of the Act permits the Chancery Court to assert exclusive jurisdiction to the exclusion of all other courts in the world, including the Kentucky Court.

The Chancery Court interpreted the terms "exclusive jurisdiction" in the Act to mean that when such a matter is heard before a Delaware Court, it is the Chancery Court rather than any other Delaware court that shall have jurisdiction over such matters. The Chancery Court noted that there are several Delaware statutes that provide a specific court in Delaware Morris Nichols Trusts, Estates and Tax Group 3 has "exclusive jurisdiction" over claims brought under such statute. Thus, according to the Chancery Court, when the General Assembly uses the phrase "exclusive jurisdiction", it is making it clear which of Delaware's trial courts will handle identified matters. According to the Chancery Court, such an indication is particularly important in Delaware because the Chancery Court has residual

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equitable jurisdiction over all matters that the General Assembly has not removed from the Chancery Court. The Chancery Court held that when a Delaware statute assigns exclusive jurisdiction to a particular Delaware court, the statute is allocating jurisdiction among the Delaware courts.

The Chancery Court further concluded that the State of Delaware could not preclude a court in another state from hearing a matter pertaining to Delaware law under the Supremacy Clause of the United States Constitution and the federal diversity statute, 28 U.S.C. § 1331. Under the Full Faith & Credit Clause of the United States Constitution, state courts must respect the laws of sister states and entertain claims under their laws. The Chancery Court held that even if the Delaware General Assembly wanted to unilaterally restrict courts in other states from hearing claims with respect to Delaware asset protection trusts, the General Assembly could not do so in a constitutionally permissible manner. The Chancery Court distinguished the situation involved with a trust from the situation where parties have agreed voluntarily by contract to an exclusive forum.

PRIMARY JURISDICTION

Nick and PNC additionally argued that the Kentucky Court's Status Quo Orders interfered with the Chancery Court's "primary jurisdiction" over the Trust. Here the Chancery Court examined the concept of primary jurisdiction, distinguishing the historical, supervisory role that a court might traditionally play with respect to a trust (noting judicial accountings as a primary example) from the Trust Agreement, which was drafted in a manner to ensure that "no court would exercise meaningful supervision over the Trust." To support this conclusion, the Chancery Court cited provisions in the Trust Agreement authorizing the Trustee to act without court authorization, providing that the Trustees have no duty to account to any court, and authorizing account statements to be delivered to Dan or the Trust Protector that can be settled without court approval. The Chancery Court appears to have tied a lack of judicial supervision over the administration of the Trust to the Chancery Court lacking primary jurisdiction over the Trust.

Additionally, the Chancery Court focused on the provisions of the Trust Agreement related to situs and governing law. The Chancery Court emphasized that the Trust Agreement authorized the situs of a Trust to be changed by the Trust Protector. Further, the Trust Protector could, upon a change of situs, elect that the Trust be administered exclusively under the laws of the state where the Trust was then situated. The Chancery Court noted that Dan could also elect another jurisdiction's laws to govern the Trust by appointing the assets of the Trust during his life or after his death in favor of a new trust. In the Chancery Court's view, both the situs and governing law of the Trust were "impermanent".

Based on these provisions, the Chancery Court concluded that, under the Delaware Supreme Court's recent Peierls decisions, only at such time that Nick and PNC filed the petitions did the Chancery Court obtain the ability to exercise jurisdiction over the Trust (but the Chancery Court also noted its

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jurisdiction is not mandatory in that the Chancery Court could decline to exercise jurisdiction). Moreover, in the view of the Chancery Court, other courts could exercise jurisdiction over the Trust so long as it does not constitute “undue interference” with the Chancery Court’s primary jurisdiction. The Chancery Court dismissed the argument that the Kentucky Court unduly interfered with the Chancery Court’s jurisdiction, noting that (i) the Chancery Court had not exercised any supervisory jurisdiction over the Trust, (ii) the terms of the Trust Agreement minimize opportunities for judicial supervision, (iii) the connection of the Trust to Delaware was “ephemeral”, and (iv) the Chancery Court lacked any supervision over the Trust at the time that the Kentucky Court issued the Status Quo Orders.

IRREPARABLE HARM

The Chancery Court concluded that Nick was not entitled to a TRO, as he had not demonstrated he would suffer irreparable harm without the TRO. In the Chancery Court’s view, Nick had an adequate remedy at law, as he could respond to the Rule to Show Cause in the Kentucky Court with the assistance of counsel and receive a decision from the Kentucky Court with respect thereto. Moreover, Nick would be entitled to judicial review by Kentucky appellate courts. Moreover, the Chancery Court rejected Nick’s claim that there is a jurisdictional conflict that may result in a “collision course” between Morris Nichols Trusts, Estates and Tax Group 4 the Delaware and Kentucky court proceedings. The Chancery Court found no “near-term” threat of collision, as it is not clear that the Kentucky Court would reach a conclusion as to various issues of administration of the Trust (such as whether Dan’s resignation and Nick’s appointment as Special Trustee were valid) in issuing an order with respect to the Rule to Show Cause. Moreover, the Chancery Court indicated that there was no “long-term” threat of a collision course. Rulings on the validity of Dan’s resignation and Nick’s appointment as Special Trustee would help, rather than hinder, the Kentucky divorce proceeding and, moreover, resolution of such issues by the Chancery Court would not resolve the question of whether those actions violated the Status Quo Orders. Additionally, the Chancery Court emphasized that, only after the Kentucky divorce proceeding is completed and results in a final, non-appealable judgment that the judgment holder seeks to enforce, would the Chancery Court be asked to resolve issues of Delaware law.

QUESTIONS TO CONSIDER

The facts surrounding the Trust in Kloiber raise several perplexing questions that call into question whether this case ought to be relevant to Delaware asset protection trusts. The Chancery Court acknowledged that there are several reasons why the Act (and its exclusive jurisdiction provision) might not be applicable to this matter. The Chancery Court indicated that Nick and Dan (but not PNC) argued that Dan’s sale of the original Exstream shares in exchange for an unsecured promissory note from the Trust in the amount of \$6 million was an arm’s length, third-party sale and not a qualified disposition under the Act. It appears that this argument was raised to defend against any

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claim by Beth that the transfer was a fraudulent conveyance because Dan received adequate consideration for his Exstream shares - that is the Exstream shares were worth the same amount as the unsecured promissory note he received in exchange. Presumably, that was Dan's estate planning goal when he sold the stock to the Trust created by his father. If this is true, then the Trust would not be a so-called self-settled trust with respect to Dan and the Act would have no application in this matter. If Dan is indeed only a beneficiary of the Trust and sold the stock without contributing value to the Trust, then Beth's rights should be determined under Delaware's spendthrift statute, Section 3536 of Title 12 of the Delaware Code, and applicable Delaware common law. Only if it was determined that Dan made a contribution to the trust that constituted a "qualified disposition" within the meaning of Section 3570 of the Act would the meaning of "exclusive jurisdiction" have application to Dan and Beth.

Second, the Chancery Court noted that Beth argued that under Garretson v. Garretson, 306 A.2d 737, 740 (Del. 1973), a wife seeking maintenance from a husband may be treated as a creditor under certain circumstances. The Court also noted that under Subsection 3573(1) of the Act, a transferor is not protected from certain spousal claims incident to a judicial proceeding with respect to a separation or divorce. Because Beth and Dan were married at the time of the creation of the Trust and at the time of Dan's transaction with the Trust, Beth was a "spouse" within the meaning of the Act and such claims by Beth presumably would not be limited under the Act.

There are other problems with this case that the Chancery Court did not raise which call into question whether the exclusive jurisdiction argument is even applicable. The Trust Agreement grants Dan certain powers that the Act does not expressly allow to be retained by the transferor of a Delaware asset protection trust. The Act did not permit a transferor of a Delaware asset protection trust to retain an inter vivos limited power of appointment until February 25, 2014, yet Dan possessed one since the creation of the Trust. Additionally, Dan served as the Special Trustee and, in such capacity, could direct the Trustee with respect to distributions. Under Section 3570(8)d of the Act, the transferor of a Delaware asset protection trust cannot serve as a trustee and cannot direct distributions. Consequently, the purported transfer to the Trust by Dan would not have met the requirements for a "qualified disposition" under Section 3570(7) of the Act. Given all of these concerns, it is somewhat confusing why the parties argued that the "exclusive jurisdiction" language found in Section 3572(a) of the Act is applicable to the Trust.

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PRACTICE AREAS

Trusts & Estates/Private Client

