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Estate Planning After the Fiscal Cliff: Did We Survive the Fall?

Thomas W. Abendroth
Schiff Hardin LLP
233 S. Wacker Drive, Suite 6600
Chicago, IL 60606
(312) 258-5501
tabendroth@schiffhardin.com

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THOMAS W. ABENDROTH is a partner in the Chicago law firm of Schiff Hardin LLP and practice group leader of the firm's Private Clients, Trusts and Estates Group. He concentrates his practice in the fields of estate planning, federal taxation, and business succession planning. Tom is a 1984 graduate of Northwestern University School of Law, and received his undergraduate degree from Ripon College, where he currently serves on the Board of Trustees. He co-authored a two-volume treatise entitled *Illinois Estate Planning, Will Drafting and Estate Administration*, and a chapter on sophisticated value-shifting techniques in the book, *Estate and Personal Financial Planning*. He was co-editor of *Estate Planning Strategies After Estate Tax Reform: Insights and Analysis* (CCH 2001). Tom has contributed numerous articles to industry publications, and serves on the Editorial Advisory Board for *ABA Trusts & Investments* Magazine. He is a frequent speaker on tax and estate planning topics at banks and professional organizations. In addition, he is a co-presenter of a monthly telephone briefing series on trust and estate planning issues, presented by the American Bankers Association. Tom has taught at the American Bankers Association National Graduate Trust School since 1990. He is a Fellow of the American College of Trust and Estate Counsel.

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PLANNING FOR THE "NEW" MEDIUM SIZED ESTATE

I. Introduction

A. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (hereinafter the "Tax Relief Act of 2010" or the "2010 Act") changed the dynamics of transfer tax planning for the vast majority of wealthy taxpayers by increasing the exemption amount for estate, gift and generation-skipping tax purposes to $5,000,000. A 2010 Congressional Research Service Report noted that, with a $5,000,000 exemption, the number of taxable estates measured as a percentage of deaths on an annual basis is projected to be 0.14% (citing projections based on U.S. Census Bureau data). This far below the recent historical levels of having estate taxes paid by 1% to 2% of decedent's estates.

B. That 0.86% to 1.86% of estates that are not taxable as a result of the 2010 Act are the estates of the under $10 million client. Many of those estates will become taxable again if the transfer tax provisions of the 2010 Act sunset.

C. The current transfer tax law, and the uncertainty over its future, leaves the under $10 million client with a number of difficult issues.

1. Is transfer tax planning necessary at all, or will the high exclusions and portability eliminate the need for tax planning altogether?

2. If marital/nonmarital planning still is advisable, what is the best way to utilize the applicable exclusion amount, especially given uncertainty over the size of the exclusion?

3. What is the best way to do generation-skipping transfer ("GST") tax planning given uncertainty over the amount of the GST exemption?

4. If the $5,000,000 exclusion is extended, how can the clients use some of that exclusion amount for gifts, without compromising their financial well-being?

II. A Short History of the Estate Tax Exclusion and Planning to Utilize It[1]

A. Key Developments in the Unified Transfer Tax System

1. Since enactment of the Tax Reform Act of 1976, the federal estate and gift taxes have been assessed using a single tax rate table under which all lifetime taxable transfers and all taxable transfers at death are considered together. The 1976 Act also added Section 2010 to the Internal Revenue

[1] Portions of this outline are based on "Portability: The New Estate Planning Wonder Drug?" presented by Thomas W. Abendroth at the 46th Annual Heckerling Institute on Estate Planning, and is used with the permission of the University of Miami.

Code (the "Code") creating a unified credit against the estate and gift taxes that exempts a certain amount of property from the tax. The credit is now identified in the Code as the applicable credit amount. The amount sheltered by the credit is the applicable exclusion amount. IRC § 2010(a), (c).

2. The Economic Recovery Tax Act of 1981 brought about the unlimited marital deduction, in effect enacting a policy that the federal government would expect payment of estate tax only once for a married couple. A couple could choose to defer estate tax until the death of the survivor by leaving property at the death of the first spouse to die to the surviving spouse.

3. These two changes to the estate tax system left married couples with a choice. They could take the easy route, leave all property at the first death to the surviving spouse, and defer but not necessarily avoid or minimize estate tax. Or they could create a separate credit shelter trust to utilize the first spouse's exclusion amount. Most couples with knowledgeable counsel chose the latter option. The A/B estate plan with an optimum marital deduction, as we know it today, became an integral part of estate planning.

4. In separate property states, the retitling of assets in order to use the exclusion regardless of the order of deaths also became part of planning. It was less of an issue at first because of the size of the exclusion. With increases to the exclusion over time, it has become an increasingly challenging part of marital planning.

5. From 1977 to 2001, the applicable credit and effective exclusion amounts changed as follows:

Year	Applicable Credit Amount	Applicable Exclusion Amount
1977	$30,000	$131,000
1978	34,000	144,333
1979	38,000	157,666
1980	42,500	172,666
1981	47,000	187,666
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987-1997	192,800	600,000
1998	202,050	625,000

Year	Applicable Credit Amount	Applicable Exclusion Amount
1999	211,300	650,000
2000-2001	220,550	675,000

6. The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for a further increase of the applicable credit amount from $345,800 to $1,455,800, followed by suspension of the estate tax in 2010. The Tax Relief Act of 2010 brought the final changes to the amounts through 2012.

Year	Applicable Credit Amount	Applicable Exclusion Amount
2002-2003	$345,800	$1,000,000
2004-2005	555,800	1,500,000
2006-2009	780,800	2,000,000
2009	1,455,800	3,500,000
2010 (opt-out)	No tax	No tax
2010 (opt-in)	1,730,800	5,000,000
2011	1,730,800	5,000,000
2012	1,772,800	5,120,000

B. Traditional Planning Challenges

1. Resistance to A/B estate plans and the use of credit shelter trusts has not been a major issue for estate planning professionals. For the most part, clients accept the concept, and readily grasp the benefits of credit shelter trusts, both the tax benefits and the general planning advantages of a trust that can benefit both spouse and descendants while insulating the property from misuse.

2. Many clients are reluctant to retitle assets to accommodate future use of the exclusion, however. In community property states, the operation of those laws often provides an automatic solution. Asset titling remains a regular issue in separate property states. There are two overlapping challenges in convincing clients that a more equal division of assets is worthwhile.

   a. First, the spouse with the larger estate may not want to give assets to his or her spouse for personal reasons. These doubts may arise from concern over possible divorce, the spouse's spending habits, or for other reasons.

   b. Second, the couple may strongly oppose the administrative inconvenience of creating additional accounts.

3. Estate planning professionals have many options in responding to the concerns of clients. The responses each have their own drawbacks, however.

C. Retained Controls on Assets

1. Lifetime QTIP Trust. In situations where the wealthier spouse wants to retain control, a lifetime QTIP trust can be used. A gift to a lifetime QTIP trust qualifies for the marital deduction. The trust gives the donee spouse assets that will be included in his or her estate and that can be sheltered with that spouse's applicable exclusion.

   a. The spouse must receive all of the trust income from a QTIP trust, but the spouse's access to principal can be controlled by the trustee, or denied entirely. Most important, as with a testamentary QTIP trust, property held in a lifetime QTIP ultimately passes at the death of the spouse as the donor of the property prescribes.

   b. A lifetime QTIP trust can give the donor spouse an interest in the trust after the donee spouse's death, assuming the donor spouse survives. The QTIP regulations state that a trust interest for the donor spouse after the donee spouse's death will not cause the trust to be included in the donor's estate under Section 2036(a). Reg. § 25.2523(f)-1(d) and (f), Examples 9, 10 and 11.

   c. Perceived drawbacks of a lifetime QTIP are that it grants the donee spouse an income interest that cannot be terminated in the event of divorce, it requires a separate trust and trust account, and in many cases, the donor spouse should not act as trustee.

2. Joint Trust. One technique used by some practitioners in separate property states to solve the problem of providing each spouse with an estate at least equal to the applicable exclusion amount is the joint revocable trust. This is a revocable living trust created by husband and wife together and funded with all the couple's property. It is similar to the form of trust routinely used in community property states. The trust agreement can provide that all of the couple's property held in the trust will be treated as owned one-half by each, with each spouse having separate control over that share. If the total property in the trust exceeds twice the applicable exclusion amount, each spouse will have property with a minimum value equal to the applicable exclusion amount.

   a. An alternative is to provide that at the death of the first spouse to die, that spouse will have some form of general power of appointment over all or substantially all the trust property that causes inclusion of the property in that spouse's estate. A portion of that property is then used to fund the non-marital trust.

Regardless of which spouse dies first, the applicable exclusion amount can be allocated to the non-marital trust.

b. From a control standpoint, the wealthier spouse may feel comfortable with joint ownership through a joint trust. The less wealthy spouse still must have authority over his or her share of the trust, including power to withdraw that property, but day-to-day administration can be handled largely by one spouse.

c. The joint trust may be undesirable to the client because the wealthy spouse does not want to grant any authority to the less wealthy spouse. The attorney also may be uncomfortable with drafting a joint trust in a separate property state.

3. Revocable Trust With Testamentary Power of Appointment Given to Less Wealthy Spouse. Letter Rulings 200604028 (January 27, 2006) and 200403094 (January 16, 2004) have described a variation on the joint trust approach and a novel solution to the problem of control while still using the less wealthy spouse's applicable exclusion amount. In the rulings, husband created a revocable trust and transferred property held in his separate name to the trust. He retained the power to amend or revoke the trust and to withdraw assets until his death. He then proposed to give his wife, if she predeceased him, to have a testamentary general power to appoint assets of the trust equal to the value of her remaining applicable exclusion, less any property she separately owned.

a. First, the IRS concluded that, despite the fact that the transfer will occur at the moment of the wife's death, the amount over which the wife exercises her testamentary power will be treated as a gift from her husband that will qualify for the marital deduction.

b. The IRS then confirmed that wife's general power of appointment would cause those assets subject to the power to be includable in her gross estate, and thereafter those assets would be treated as coming from her. Therefore, the assets could pass to a non-marital trust for the benefit of the husband and descendants. The husband would not be treated as having a retained interest in the non-marital trust (even though the assets were his until the moment of his wife's death). In addition, the husband would not be treated as making any gifts to his descendants by virtue of their interests in the non-marital trust.

c. If husband died first, his revocable trust contained provisions for setting aside his applicable exclusion amount in a non-marital trust for the wife and descendants, with the remainder passing as marital deduction property. Thus, the proposed trust would allow

whichever spouse died first to fully use his or her applicable exclusion amount.

d. Practitioners have been reluctant to rely on this option based on these two isolated private rulings.

D. Asset Retitling

1. Tenancy-in-common ownership. For couples who favor joint ownership and do not want to create separate accounts to ensure use of their applicable exclusion amounts, one possible solution is to change the title of assets from joint tenancy with right of survivorship to tenancy-in-common. Both forms of ownership allow husband and wife to own the property jointly, with each having an undivided one-half interest. However, property owned tenancy-in-common does not pass by operation of law to the survivor. Instead, the deceased spouse's one-half will pass under his or her estate plan.

EXAMPLE: Martin and Marian have assets of $7,000,000, with a majority of the property owned either by Martin or by Martin and Marian as joint tenants. Their assets include a $2,000,000 home and a $1,000,000 bond account, both owned in joint tenancy. They change title on both assets to tenancy-in-common. Marian now has an additional $1,500,000 that can pass under her estate plan.

a. When recommending title changes like this, the estate planning professional should be sure the clients understand what happens at the first death. If Marian dies first and one-half of the home passes to a credit shelter trust for Martin, he may react adversely to not owning 100% of the home himself.

b. Many financial institutions accommodate estate planners and clients by providing the alternative of a tenancy-in-common account between the couple's revocable trusts. This allows the couple to hold investments in one account, in a form that will avoid probate. Each trust owns an undivided one-half interest in the account. At one spouse's death, one-half the assets from the account are segregated in a separate account and then used to fund the marital and nonmarital trusts.

2. Holdings Trust. When there are assets for which a tenancy-in-common account is not feasible, an alternative is for the husband and wife, as trustees of their revocable trusts, to create a "holdings trust" that in effect acts as a nominee title holder for the other two trusts.

a. The holdings trust is a simpler alternative to using a traditional business entity, such as a partnership or LLC. Unlike a limited partnership or LLC, the trust does not have to be organized through

the state Secretary of State's office, and it is not subject to annual filings with the state. Because husband's and wife's revocable trusts each are grantor trusts, the holdings trust can also be treated as a grantor trust and no separate tax reporting is necessary.

b. The holdings trust provides a useful solution where the couple is using an investment manager or custodian who is not able or willing to create tenancy-in-common accounts. It also is attractive for privacy purposes. Many institutions today request a full copy of an individual's revocable trust in order to create an account in the trust name. If the trust is a simple holdings trust created by the spouses as trustees of their revocable trusts, the clients do not have to make available the documents that contain the specifics of their estate plan.

III. Portability Provisions

A. Basic Provision and Scope

1. Section 2010 of the Code, as amended by Sections 302(a)(1) and 303(a) of the Tax Relief Act of 2010, creates portability by introducing the concept of "deceased spousal unused exclusion amount" ("DSUEA").[2] Section 2010(c)(2) defines the applicable exclusion amount as "the sum of (A) the basic exclusion amount, and (B) in the case of a surviving spouse, the deceased spousal unused exclusion amount."

2. The JCT Technical Explanation for the 2010 Act describes the new provision as follows:

   "Under the provision, any applicable exclusion amount that remains unused as of the death of a spouse who dies after December 31, 2010 (the 'deceased spousal unused exclusion amount'), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount."

   Staff of the Joint Committee on Taxation, 111th Cong., 2d Sess., "Technical Explanation of the Revenue Provisions Contained in the 'Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010' Scheduled for Consideration by the United States Senate," (JCX-55-10) pgs. 51-52 (Dec. 10, 2010) ("JCT Technical Explanation").

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[2] In temporary regulations published on June 18, 2012 (T.D. 9593), the IRS chose to use the term "DSUE amount" rather than "DSUEA." The temporary regulations are effective June 15, 2012. See Temp. Reg. §§20.2010-1T to -3T; 25.2505-1T to -2T.

EXAMPLE: Janet Jones dies in 2011, and a total of $500,000 of assets pass under her estate plan to a nonmarital trust for her husband, John Jones. Janet's executor elects to have her $4.5 million of unused exclusion amount transferred to John. If John took no further action and died in 2012, he would have a total of $9.5 million of applicable exclusion amount that could shelter property from estate tax.

3. Portability is available without regard to the size of the estate of the decedent or the reason for the decedent having unused exclusion amount.

    a. A decedent with a $2 million estate, all left in taxable form, leaves $3 million of exclusion that is portable.

    b. A decedent with an $18 million estate, who leaves $2 million to his children and $16 million to his spouse and charity, also leaves $3 million of unused exclusion that is portable.

4. The definition of applicable exclusion amount also applies for gift tax purposes. The 2010 Act amended Code Section 2505 (Unified Credit Against Gift Tax) to define the credit for gift tax purposes by reference to "the applicable credit amount in effect under section 2010(c) which would apply if the decedent died as of the end of the calendar year." Thus, a surviving spouse may use his or her enhanced applicable exclusion amount for gifts.

5. Portability does not apply to the GST exemption. Section 2631(c), as amended by the 2010 Act, defines the GST exemption amount as equal to "the basic exclusion amount under section 2010(c)."

6. The basic exclusion amount is $5,000,000 and is adjusted for inflation beginning in 2012. IRC § 2010(c)(3). The basic exclusion amount in 2012 is $5,120,000. The examples and discussion of portability in these materials will ignore the inflation adjustment to the basic exclusion amount.

B. <u>Deceased Spousal Unused Exclusion Amount</u>

1. Section 2010(c)(4) defines the deceased spousal unused exclusion amount as the lesser of (i) the basic exclusion amount, and (ii) the unused portion of the basic exclusion amount of the last deceased spouse of such surviving spouse.

2. Once transferred to the surviving spouse, the DSUEA is not adjusted for inflation.

3. The statute limits the surviving spouse to use of the unused exclusion of his or her <u>last deceased spouse</u>. This limitation applies regardless of whether the last deceased spouse has any unused exclusion or whether the

last deceased spouse's executor makes or fails to make a timely election. See JCT Technical Explanation, pg. 52, note 57 (Dec. 10, 2010).

4. The JCT Technical Explanation provides the following two examples to illustrate portability and the application of the "last deceased spouse rule":

"Example 1: Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount or unused exemption. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's exemption is $7 million (her $5 million basic exemption plus $2 million of Husband 1's unused exemption), which she may use for lifetime gifts or for transfers at death."

Example 2: Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's unused exemption. Although the combined amount of unused exemption of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exemption is available for use by Wife because the unused exemption is limited to the lesser of the basic exemption ($5 million) or the unused exemption of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exemption). Thereafter, Wife's exemption amount is $6 million (her $5 million basic exemption plus $1 million of Husband 2's unused exemption), which she may use for lifetime gifts or for transfers at death."

5. The last portability example in the JCT Technical Explanation indicates that a surviving spouse who remarries can pass his or her full unused applicable exclusion amount, including any portion that is DSUEA, to a surviving spouse of the remarriage. The example provides as follows:

"Example 3: Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's exemption is $7 million (her $5 million exemption plus $2 million unused exemption from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's unused exemption, which is $4 million (Wife's $7 million exemption less her $3 million taxable estate). Under the provision, Husband 2's exemption is increased by $4 million, the amount of Wife's unused exemption."

6. The statutory language itself (Code Section 2010(c)(4)) does not support this interpretation. Rather, it is written as if only the spouse's unused basic exclusion amount is portable:

   "the term 'deceased spousal unused exclusion amount' means the lesser of:

   (A) the basic exclusion amount, or

   (B) the excess of (i) the **basic exclusion amount** of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse."

7. The limitation under Section 2010(c)(4)(B) refers to the deceased spouse's **basic exclusion amount** not to his or her **applicable exclusion amount**.

8. The Joint Committee stated that the reference in Section 2010(c)(4)(B) to basic exclusion amount is an error:

   "The provision adds new section 2010(c)(4), which generally defines 'deceased spousal unused exclusion amount' of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. A technical correction may be necessary to replace the reference to the basic exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the provision."

   Joint Committee on Taxation, 111th Cong., 2d Sess., ERRATA – General Explanation Of Tax Legislation Enacted In The 111th Congress, (JCX-20-11) p. 1 (March 23, 2011) ("JCT ERRATA") (emphasis added).

9. The IRS has treated the statutory reference as an error in its temporary regulations. The regulations define DSUEA by reference to the excess of the decedent's **applicable exclusion amount** over the exclusion amount otherwise used. See Temp. Reg. §20.2010-2T(c)(1).

C. Order of Use of Exclusion

1. Because the IRS interpreted Section 2010 consistently with Example 3 in the JCT Technical Explanation, the IRS could have decided that the question of the order in which a surviving spouse uses her applicable exclusion amount is irrelevant. It should not be necessary to separately track use of the surviving spouse's basic exclusion amount and DSUEA.

EXAMPLE: In Example 3 in the JCT Technical Explanation, Wife had exclusion of $7 million, consisting of her $5 million basic exclusion amount and $2 million DSUEA from Husband 1. If Wife makes a $3 million taxable gift, she has unused exclusion of $4 million remaining. If she makes a $5 million gift, she has exclusion of $2 million remaining. The source of the exclusion is not relevant.

2. Nevertheless, the Treasury created a rule on the order in which exclusion amounts are used. Pursuant to Temp. Reg. §25.2505-2T(b), a surviving spouse who makes a taxable gift will be considered first to use the DSUEA of the last predeceased spouse before his or her own applicable exclusion amount.

   EXAMPLE: Same facts as prior Example, with Wife possessing $7 million of exclusion, $2 million of which is DSUEA. Wife makes a $3 million taxable gift. She is assumed to use her DSUEA first, so she has $4 million of basic exclusion amount remaining after the gift. If Wife dies and leaves her entire estate to Husband 2, her executor can elect to pass her $4 million of applicable exclusion to Husband 2.

3. In addition, if a surviving spouse has used DSUEA of predeceased spouse for lifetime gifts, and then has a subsequent predeceased spouse, the subsequent predeceased spouse's DSUEA is not reduced or impacted by the DSUEA already used by the surviving spouse. The commentary to the regulations puts it this way:

   "Thus, a spouse who has survived multiple spouses may use each last deceased spouse's DSUE amount before the death of that spouse's next spouse, and thereby may apply the DSUE amount of multiple deceased spouses in succession. However, this does not permit the surviving spouse to use the sum of the DSUE amounts of those deceased spouses at one time, and a surviving spouse may not use the remaining DSUE amount of a prior deceased spouse following the death of a subsequent spouse."

   EXAMPLE: Same facts as prior Example, with Wife possessing $7 million of exclusion, $2 million of which is DSUEA. Wife make a $3 million taxable gift, which is treated under the regulation's ordering rule as using H1's $2 million of DSUEA and $1 million of her own exclusion. Wife has remarried and H2 now dies before her, leaving $4 million of DSUEA. Based on the regulation, if Wife makes a $4 million gift after H2 dies, it uses his $4 million of DSUEA, and she still has her own basic exclusion amount.

D. Triggering Event for Change in DSUEA

1. It seems fairly clear that the event that causes a surviving spouse's DSUEA to change is the death of subsequent spouse, not remarriage or other intervening events.

2. Nevertheless, the regulations make clear that the identity of the last deceased spouse does not change due to a subsequent marriage. Temp. Reg. §20.2010-3T(c)(3).

   EXAMPLE: Husband received $2 million of DSUEA from Wife 1, who predeceased him. Husband previously made $5 million of taxable gifts. Husband marries Wife 2. While Wife 2 is alive, Husband may use the $2 million DSUEA to shelter additional taxable gifts.

3. The result should be the same regardless of Wife 2's available applicable exclusion. The fact that Wife 2 may have used all $5 million of her exclusion is not relevant. Husband and Wife 2 could divorce or Wife 2 could survive Husband. In either case, Husband's DSUEA will be the DSUEA from Wife 1.

E. Election

1. The surviving spouse may use the unused exclusion amount of a deceased spouse only if the executor of the deceased spouse timely files a Form 706 for the deceased spouse and elects to make that spouse's unused exclusion portable. IRC § 2010(c)(5). The regulations make clear that the return must be filed by the nine month due date unless an extension request is timely made. Temp. Reg. §20.2010-2T(c)(1). However, in Notice 2012-21, the IRS granted relief to estates of decedents who died in the first half of 2011, allowing the extension request to be filed up to the day of the 15-month due date for filing returns on extension.

2. The election is irrevocable and must be made on a timely filed, complete estate tax return.

3. Notice 2011-82, 2011-42 I.R.B. 516 (September 29, 2011), contained the Service's initial guidance on the election. The temporary regulations supplement this guidance.

   a. The executor of the deceased spouse must file a complete Form 706 within the time prescribed by law (including extensions) even if a return is not otherwise required.

   b. The regulations state the IRS will consider the election automatic if the Form 706 is filed. The regulations stated that the IRS eventually would revise the Form 706 to expressly contain a computation of the unused exclusion amount.

c. If the executor chooses not to make the portability election, the executor may do this by (1) not filing a Form 706 if the return is not otherwise required or (2) following the instructions on the Form 706 that describe the steps for not electing portability. See Temp. Reg. §20.2010-2T(a)(3).

d. The 2011 Form 706 instructions (for 2011 decedents) states that the election not to grant portability can be made (1) by attaching a statement to the Form indicating that the election is not being made, or (2) by writing across the top of the first page of the form "No Election Under Section 2010(c)(5).

4. The Service issued a new Form 706 for 2012 decedents in August of 2012, with a new Part 6 for the portability election.

   a. The new Form includes a section for opting out of portability.

   b. The Form provides sections for calculating the DSUEA of the decedent first spouse to die, and for the DSUEA available for a decedent who is the surviving spouse.

5. The IRS will not produce a more abbreviated Form 706 for estates in which the only purpose of filing is to make the election.

   a. However, the temporary regulations state that an executor of an estate that is not otherwise required to file a Form 706 because of the filing threshold does not have to report on the return the value of certain property that qualifies for the marital or charitable deduction. Temp. Reg. §20.2010-2T(a)(7)(ii).

   b. An executor who uses this rule must provide a statement with an estimate of the total value of the estate (within a range of dollar values) to verify that it falls below the filing threshold. Line 23 of Part 5 of the new Form 706 is where the executor reports marital and charitable property that is subject to this rule.

   c. This exception would allow an executor to file a return that reports only the estimated total estate value if all the decedent's property passes to the surviving spouse. Or, for example, if the decedent and surviving spouse own their residence jointly, it would not be necessary to formally value that property for the return.

6. The Act provides that, if the portability election is made, there is no statute of limitations for examining the predeceased spouse's Form 706. The waiver of the statute is limited to determining the amount of unused exemption available to the surviving spouse. IRC § 2010(c)(5)(B), as added by Act § 303(a). Thus, if the normal statute of limitations under Code Section 6501 has expired, the IRS will not be able to adjust the

deceased spouse's return and increase the tax due. It could, however, make adjustments to the return, such as by modifying the amount of adjusted taxable gifts, including additional assets or changing the valuation of certain assets, for the purpose of reducing the DSUEA.

7. There are many practical questions about the IRS statutory right to examine, after the limitations period has expired, the Form 706 of a predeceased spouse with respect to the amount of DSUEA claimed.

   a. It is conceivable that DSUEA might not be claimed until 20, 30 or even 50 years or more after a spouse died. Even if a full, very complete Form 706 was filed, the ability of the parties to provide additional support or proof for their positions will be hampered by the passage of time.

   b. The assignment of burden of proof, and the presumption of correctness, if any, assigned to a filed Form 706, will take on a great deal of importance.

IV. <u>Planning With Portability</u>

A. <u>Planning Through 2012</u>

1. One of the only certainties about portability is that no married couple should rely on it for planning purposes while it still is possible that the provision will expire. Right now that uncertainty lasts through December 31, 2012. But no one should completely discount the possibility of Congress enacting another temporary extension of the transfer tax provisions, thereby extending the period during which portability should not be relied on.

2. Some practitioners have raised the question whether expiration of the portability provisions at the end of 2012 would clearly eliminate the DSUEA already obtained by a surviving spouse from a predeceased spouse who died before 2013.

3. Absent action by Congress, the sunset of the provisions of the Tax Relief Act of 2010 will eliminate DSUEA, except in cases where both spouses are deceased in 2011 or 2012.

   a. Section 304 of the Tax Relief Act of 2010 applies the sunset provision of EGTRRA to Section 301 to 303 of the 2010 Act, the estate and gift tax provisions, including portability.

   b. Under the sunset section, the Code provisions added or extended by the 2010 Act will not apply to estates of decedents dying, or

gifts made, after December 31, 2012, and the Code will be administered as if the provisions had never been enacted.

4. Even though portability may expire, it would not be wise to ignore it, and fail to advise the executors and surviving spouses about using unused exclusion at the first death.

   a. Clearly the portability election should be recommended for estates where the couple is above or near the threshold for incurring tax.

   b. The decision whether to elect portability will be more difficult for estates well under the likely threshold for taxation. The up-front cost of preparing a Form 706 to make the election is not insignificant (although the temporary regulations may reduce that cost in many cases). It always is possible that assets might appreciate significantly during the surviving spouse's life, or that the surviving spouse will benefit from a major inheritance, or win the lottery. But in many cases, the realistic odds of such an event are minimal.

   c. If the deceased spouse lives in a state with a low state death tax threshold (e.g., New York or New Jersey) the estate may be filing a return anyway, and the incremental cost of preparing the federal return is minimal. Absent this situation, the client will need to weigh the pros and cons and decide.

B. <u>Portability versus Credit Shelter Trust Planning – General Conclusions</u>

1. If portability is made permanent, it will provide a simple alternative to traditional estate planning designed to fund a credit shelter, or nonmarital, trust at the death of the first spouse to die. In most cases, however, it will prove to be an inferior alternative. Most well-drafted estate plans will continue to use nonmarital trusts and practitioners will work with clients on asset titling to facilitate the funding of those nonmarital trusts.

2. Portability would provide an excellent back-up to planned use of the applicable exclusion amount. In the frequent situations where a couple fails to fully implement asset retitling, or the size or nature of the assets prevents full use of the applicable exclusion amount at the first death, an election to use portability can save applicable exclusion that otherwise would be lost.

   EXAMPLE: John and Janet Jones have $11.5 million of total assets. John owns $9 million of the total, Janet has $500,000, and they own their home, personal belongings and bank accounts, totaling $2 million, in joint tenancy. The Jones' attorney advises John to shift some assets to Janet's name. John moves an investment account and a parcel of undeveloped land he owns, but those assets total only $1.5 million. Janet dies

unexpectedly. There are $2 million of assets in her name that can pass to the nonmarital trust. John could disclaim joint assets but does not want to create a probate or have their home pass other than to him. Janet's executor files a Form 706, and $3 million of DSUEA passes to John.

C. Advantages of Credit Shelter Trust Planning

1. Shelter of Appreciation and Income. The DSUEA is not indexed for inflation. A credit shelter trust creates the opportunity for future appreciation and income to increase the value of assets outside the estate.

EXAMPLE: Assume the same facts as the preceding example, except that John did transfer an additional $3 million of assets to Jane. At her death, her estate has $5 million of assets, all of which fund the nonmarital trust. John lives another 15 years, during which time the appreciation and retained income from the nonmarital trust average 4% per year. At John's death, the additional $3 million in the nonmarital trust grows to $5,402,830. Full use of the nonmarital trust has sheltered an additional $2,402,830 from estate tax.

2. Generation-Skipping Tax Planning. There is no portability of GST exemption. A couple who wants to maximize the amount of property held in long-term trusts for descendants will want to use credit shelter planning.

3. Impact of Remarriage. A risk with portability is that the surviving spouse will lose some or all of the DSUEA if he or she remarries and the second spouse also predeceases him or her. In addition, DSUEA is not cumulative. By contrast, the surviving spouse's remarriage does not impact the benefits of a credit shelter trust and the surviving spouse can accumulate multiple credit shelter trusts.

EXAMPLE: John has survived Jane and is now a beneficiary with his children of a credit shelter trust holding $3 million. He also has $2 million of DSUEA from Jane. John marries Mary. Mary also predeceases John and leaves her entire $5 million estate to a trust for her family. John's DSUEA becomes -0-. The credit shelter trust is unaffected.

EXAMPLE: Same facts as the preceding example except that Mary leaves her $5 million to a credit shelter trust for John and his children. John and his children are now beneficiaries of two credit shelter trusts funded initially with $8 million.

4. Protective Benefits of a Trust. A trust of course provides all the spendthrift protections that are at the core of estate planning. The trust assets are insulated from claims of creditors, are more protected if the surviving spouse remarries, and are better protected from misuse or misappropriation by the children.

a. A decedent can achieve many of these benefits by creating a marital trust for the surviving spouse, who still can claim DSUEA.

b. But if the taxpayer is going to the trouble of creating a trust under the estate plan, why not use a nonmarital trust, or at least a QTIP eligible trust for which no election would be made?

5. Avoiding Potential Audit Issues. If the credit shelter trust is funded with non-publicly traded assets that are difficult to value, the family can avoid risk of audit at the second death.

a. The credit shelter trust also allows a family that owns a closely-held business to isolate voting control outside the estate, or divide a controlling interest so voting control does not end up in the hands of the surviving spouse.

EXAMPLE: John owns a business that continues to do well and increase in value. Several years ago, John recapitalized the business and created classes of voting stock and nonvoting stock. He transferred 20% of the voting stock to an irrevocable trust and 40% to Jane. Jane dies. Her estate plan leaves her voting stock to a credit shelter trust, of which John is trustee. At John's death, he is not considered to have voting control for estate tax purposes.

b. Finally, if the deceased spouse's estate is under the threshold for filing an estate tax return, but contains non-marketable assets, the value of which could be subject to question, the estate can avoid a potential audit by not filing the Form 706, as otherwise would be required to elect portability.

D. Advantages of Portability

1. Simplicity. As previously discussed, the main advantage of portability is simplicity. It allows a married couple to prepare a simple estate plan that leaves all property to the surviving spouse, while still preserving the deceased spouse's applicable exclusion amount.

2. Additional Basis Step-Up. The primary benefit of portability after simplicity is that assets passed to the surviving spouse will receive another step-up in basis at the surviving spouse's death, something not available for assets in a credit shelter trust.

a. The basis step-up is not a meaningful benefit in larger estates that otherwise are subject, or potentially subject, to estate tax. By definition, a large unrealized capital gain means significant appreciation. If portability was elected instead of using a credit shelter trust, that appreciation could result in making the estate of the surviving spouse taxable, or increasing the overall estate tax.

b. In estates of couples that clearly will be less than twice the applicable exclusion amount, the basis step-up has more appeal.

EXAMPLE: John and Jane each have estates of $3 million. If John dies and leaves his $3 million in a credit shelter trust for Jane, the trust assets will not receive a step-up in basis at Jane's death. John can leave the $3 million directly to Jane, and his executor can elect portability to avoid estate tax at Jane's death. All unrealized gain on the assets will be eliminated at Jane's death.

c. The problem with examples of the potential benefits of this second step-up is that they assume that the asset or assets that pass to the credit shelter trust or surviving spouse are retained for the life of the surviving spouse.

d. This is likely to be true only if the assets are closely-held stock in a family business or real estate . These are exactly the type of assets that are difficult to value and subject to significant potential appreciation, both of which factors favor creation of a credit shelter trust.

e. By contrast, a portfolio of marketable securities in a credit shelter trust is likely to turn over during the surviving spouse's life. It may appreciate significantly during the life of the surviving spouse, but the unrealized gain at the surviving spouse's death may be a fraction of the appreciation.

f. In addition, practitioners already are exploring ways to draft credit shelter trusts to facilitate opportunities to obtain a basis step-up at the surviving spouse's death for appreciated assets in the trust (see the discussion in VI.B. below).

3. Use With Depreciating Assets. If the decedent's estate contains assets that likely will depreciate in value, then passing those assets to the surviving spouse is preferable to using them to fund a credit shelter trust. If most of the decedent's estate consists of these assets, then electing portability could be preferable to using a credit shelter trust.

a. This scenario is most likely to occur in an estate that consists mainly of retirement assets. Because the assets are income in respect of a decedent ("IRD"), they will shrink by the income taxes incurred as distributed, and they likely will need to be distributed more rapidly under the minimum distribution rules if allocated to a credit shelter trust.

b. The preferred disposition for many married couples is to leave retirement assets to the surviving spouse. A typical beneficiary designation names the spouse as primary beneficiary and the

participant's revocable trust as contingent beneficiary. The spouse then can disclaim a portion of the retirement assets if they are needed to fund the credit shelter trust and the spouse and his or her advisors decide that increasing the funding is worth foregoing the income advantages of rollover by the spouse.

c. With portability, the surviving spouse can avoid the choice between maximizing estate tax benefits and maximizing income tax benefits.

EXAMPLE: John has a $5 million estate, with $3 million consisting of several rollover IRA accounts. John designates Jane as beneficiary of the IRA accounts. At his death, $2 million passes to a credit shelter trust, and the remaining $3 million of IRA accounts to Jane. John's executor elects portability. Jane dies with a separate estate of $6 million, including $2.5 million remaining in the IRAs (a decrease due to minimum distributions). She has applicable exclusion of $8 million consisting of her $5 million and $3 million of DSUEA from John.

E. Impact of State Death Taxes

1. States that have a separate death tax or state estate tax tied to the old federal state death tax credit have not enacted portability for state tax purposes.

2. If the state has an exclusion amount, a couple will forego use of that exclusion at the first death if they are relying entirely on portability.

EXAMPLE: John and Jane are Illinois residents. Illinois has a $2 million exclusion amount in 2011. John has $6 million of assets and Jane has $3 million of assets. Their assets are not increasing in value and they want their estate plan to be as simple as possible. Pursuant to their estate plan, all of John's assets pass to Jane at his death in 2011. His executor elects portability and passes John's $5 million DSUEA to Jane. At Jane's death, her estate is $9 million. It is sheltered by her $10 million applicable exclusion amount. However, Jane's estate is subject to Illinois estate tax of $801,049.

John's estate plan instead creates a $2 million credit shelter trust, a $3 million QTIP eligible trust for which state QTIP is elected but not federal QTIP, and a $1 million QTIP marital trust. At Jane's subsequent death, her estate for federal tax purposes consists of the $1 million QTIP marital trust and her separate $3 million. This is sheltered by her applicable exclusion amount and she owes no federal estate taxes. Her Illinois taxable estate also includes the $3 million state-only QTIP trust. The Illinois estate tax on her estate is $565,603.

3. In the foregoing example, the lack of Illinois exclusion planning has a cost of about $235,000. Portability may enable some simplification in this situation, though. John's estate plan could create the $2 million credit shelter trust, and leave the remaining $4 million to a QTIP trust for, or outright to, Jane. His executor then could elect portability and pass $3 million of DSUEA to Jane. Jane has an estate of $7 million and has $8 million of exclusion amount. The Illinois estate tax would be $565,603.

V. Predictions for a Portable Exclusion World

A. Changes Will Not Be Significant

1. For reasons discussed in the preceding pages, if portability is made permanent, it is unlikely to change estate planning for married couples in major ways.

2. It will be most attractive in smaller estates where the assets are unlikely to exceed twice the applicable exclusion amount.

    a. A couple in this demographic may wish to leave all the assets of the first spouse to die to the survivor, and rely on portability to avoid estate tax.

    b. The more important factor influencing a movement to simpler plans will be the size of the applicable exclusion amount. If it remains at $5 million, then just one exclusion amount will shelter the vast majority of estates even if there is no credit shelter planning. Couples can rely on portability to cover unanticipated increases in the value of the estate after the first spouse's death.

    c. Consider, however, whether married couples and their advisors should become comfortable with the assumption that the exclusion will remain at a higher level. If the surviving spouse lives many years, there is an increasing likelihood of federal, or state, tax law changes that could negatively impact the surviving spouse's estate, but which would not impact a credit shelter trust.

    EXAMPLE: John dies in 2012 with an estate of $3 million. Jane also has an estate of $3 million. John dies at age 72, leaves all his estate to Jane and his executor elects portability. Jane now has $6 million of assets and $10 million of applicable exclusion amount. Sixteen years later, when Jane is 88, Congress reduces the base exclusion amount to $2 million and increases estate tax rates. Jane's estate is now taxable.

3. Clients whose estates will be taxable even with a $5 million exclusion should continue to use credit shelter planning, for the reasons previously discussed. Portability will provide a safety net to save any applicable exclusion amount of the first spouse to die because he or she lacks separate assets to fully use it.

B. Additional Flexibility for Credit Shelter Trusts.

1. Estate planning professionals are exploring ways to draft credit shelter trusts to capture some of the basis step-up that otherwise is available with portability at the surviving spouse's death.

2. This planning is not motivated by portability but primarily by the higher applicable exclusion. The higher exclusion will increase the number of situations where the surviving spouse's taxable estate will be significantly less than the exclusion. If assets from the credit shelter trust could be included in the spouse's estate without exceeding the exclusion, the additional basis step-up will reduce capital gains tax.

3. A number of papers and articles contain detailed discussions of the alternatives available for enabling the taxation of appreciated credit shelter trust assets in the estate of a surviving spouse. See, e.g., Zaritsky, "Portability: Getting Ready for Game Time," ACTEC 2011 Summer Meeting, at 10-21. Zaritsky suggests four options:

   a. Power in an independent trustee to make discretionary distributions from the credit shelter trusts to the spouse for the purpose of reducing income taxes.

   b. Discretionary power in a disinterested fiduciary to grant the spouse a general power of appointment over certain trust assets.

   c. An automatic grant of a general power of appointment by means of a formula.

   d. A grant of a non-general power of appointment in the surviving spouse trust that the spouse can exercise in a way to trigger Code Section 2041(a)(3) (the "Delaware tax trap").

4. As Zaritsky discusses in detail, all the options present certain challenges and disadvantages. Not the least of the disadvantages is that a power granted to save income taxes ends up being used by a trustee or surviving spouse in a way to divert assets away from the decedent's intended beneficiaries.

VI. Use of Optimum Marital Deduction Planning

John and Janet Jones are both in their 60's. They have Wills that are thirty years old. The Wills leave all the decedent's assets to the survivor, otherwise to trusts for their children which terminate when each child reaches age 21. These three children are now adults. John and Janet understand that their estate plan should now provide estate tax minimization planning given the significant wealth they have accumulated over the last three decades. John recently retired as a Senior Vice President of Acme Industries and has accumulated a significant amount of Acme stock during his many years at the company. Their assets are as follows:

	John	Joint	Janet
Residence		$ 1,000,000	
Cash accounts	$ 100,000	100,000	$ 5,000
Acme stock	3,600,000		
Other Marketable Securities		1,000,000	100,000
Life Insurance	300,000		
Retirement Accounts/IRAs	1,500,000		100,000
Personal Property	0	100,000	20,000
	$5,500,000	$2,200,000	$225,000

Life insurance and retirement accounts are payable to the spouse.

A. Optimum Marital Estate Plan

1. For years, the standard approach for a married couple like the Jones has been to recommend an optimum marital deduction estate plan, using an explanation such as the following:

   a. The marital deduction is unlimited in amount, and can be used to avoid all federal estate tax if the spouse survives the decedent. But, it is rarely desirable for an individual to use the "maximum" marital deduction.

   b. Section 2010 of the Code provides a credit against the estate and gift tax (the "applicable credit amount" or "unified credit"), which allows an individual to make tax-free transfers irrespective of the transferee of the property. The applicable credit amount is $1,730,800 in 2011 and $1,772,800 in 2012. The 2012 credit amount permits a person to transfer up to $5,120,000 of property, tax-free. The amount that can be transferred tax-free is referred to as the "applicable exclusion amount."

2. The optimum marital plan uses the marital deduction only to the extent necessary to reduce taxes and avoid using it to the extent of the decedent's remaining applicable exclusion amount.

EXAMPLE: An individual with an estate of $7,000,000 dies in 2012 and leaves the entire amount to her husband. Her estate will pay no estate tax, because of the unlimited marital deduction. However, (absent portability) if at the husband's subsequent death in 2012 he has no estate other than the $7,000,000 he received from his wife, his estate will exceed his applicable exclusion amount of $5,000,000 by $2,000,000, which will generate total estate taxes of $700,000.

On the other hand, if, at the time of her death, the individual had left $5,000,000 for the benefit of her husband in a nonmarital trust and had given the remaining $2,000,000 to him outright, her estate still would owe no estate tax. The $5,000,000 left in trust would be sheltered by her applicable credit amount and the $2,000,000 given outright to the husband would be sheltered by the marital deduction. Upon the husband's subsequent death, the trust would not be taxable and the $2,000,000 he received from his wife could be left to the children tax-free, by virtue of his applicable credit amount assuming it had not increased in value.

B. Under Optimizing the Marital Amount

1. There traditionally were two reasons an estate planning attorney might under-utilize the marital deduction and deliberately leave more property in a taxable form at the first death.

2. First, in a second marriage situation, with children from the prior marriage, factors other than estate tax planning might dictate the estate plan. For example, the decedent may want to leave only 30% of his or her estate to his or her surviving spouse and 70% to the children from the prior marriage, even if this resulted in a taxable estate greater than the applicable exclusion amount.

3. Second, prior to the 2001 Tax Act, planners also might consider creating a taxable estate when both spouses' estates were very large, in order to use low estate tax brackets. In an optimum marital plan, at the surviving spouse's death, the surviving spouse's taxable estate will include the full value of the marital property as well as any separately owned property. If this caused marital property to be taxed at the top marginal estate tax bracket (55% before 2002), a benefit might be gained from reducing the amount of property passing to the surviving spouse at the death of the first spouse to die and leaving it instead in a taxable form. This goal was to increase the first spouse's taxable estate to use his or her lower marginal estate tax brackets below 55%.

4. As a result of the 2001 Tax Act, use of low bracket planning effectively has disappeared. When the applicable exclusion amount rose to $2,000,000 in 2006, any federal tax benefit disappeared because there no

longer were any graduated tax rates. The tax applicable to amounts over $2,000,000 is assessed at a flat rate.

C. Over-Optimizing—Reserving more for the surviving spouse

1. The changes brought about by the 2001 Tax Act and then the Tax Relief Act of 2010 may have the opposite impact on the use of the optimum marital deduction, depending on a client's views on how much property should be set aside solely for the benefit of a surviving spouse.

2. A flexibly drafted estate plan often will provide that the beneficiaries of a nonmarital trust are the spouse and children, or spouse and descendants. This enables use of the nonmarital trust for other family members if the spouse's own assets and the marital gift are sufficient to provide for him or her.

3. Before 2002, if the residuary estate of the first spouse to die exceeded $1,350,000, the marital trust would be the larger trust. In this situation, most couples were very comfortable with the allocation between a nonmarital trust for spouse and descendants and a marital disposition solely for the spouse. The surviving spouse would have assets or a trust of significant size for his or her own benefit. The nonmarital trust would be available as a safety net for the spouse, but, most likely, the nonmarital trust assets could be left to accumulate, or used to some extent for children or descendants.

   EXAMPLE: John dies with an estate of $5,500,000 in 2001. Under an optimum marital deduction plan, $675,000 was allocated to a nonmarital trust and $4,825,000 to a marital trust for Janet. The marital trust and Janet's own assets would be sufficient to provide for her. The income from the nonmarital trust could be distributed annually to the children and the remaining growth in value of the trust is left to accumulate.

4. As the higher applicable exclusion amounts have phased in, a much larger portion of estates that use an optimum marital formula will produce an allocation that sets aside little or no property solely for the spouse. In the example above, if death occurred in 2007 or 2008, the marital trust for Janet would receive $3,500,000 and the nonmarital trust would receive $2,000,000. In 2009, the marital trust would receive only $2,000,000. In 2011 or 2012, the marital trust would receive $500,000. All the remaining assets would be allocated to the nonmarital trust.

   a. This could leave the surviving spouse feeling insecure. It also may create undue pressure on the spouse if there are adult children who are actively encouraging their parent not to invade the nonmarital trust or to use more of it for the children.

b. The attorney may be able to address these concerns by making the spouse the sole beneficiary of the nonmarital trust or by clearly prioritizing the spouse's need in the terms of the nonmarital trust.

c. Another option is to create a single QTIP eligible marital trust that will receive all the residue of the decedent's estate. The decedent's executor can use a partial QTIP election to utilize the decedent's applicable exclusion amount.

EXAMPLE: John dies in 2012 with an estate plan that passes his entire $5,500,000 estate to a QTIP trust for Janet. The executor of John's estate elects marital deduction only for 9.09091% of the trust ($500,000). The remaining portion ($5,000,000) is non-elected QTIP. It can be segregated in a separate trust for Janet, and it will not be included in Janet's estate at her death.

d. If these alternatives are not sufficient to give the clients comfort, the attorney can modify the optimum marital formula. For example, the formula could place a cap on the amount of property allocated to the nonmarital trust.

EXAMPLE: John has a $5,500,000 estate. John and Janet were satisfied with an optimum marital formula allocation under the old rules, but believe it will leave too little for Janet in light of the increases in the applicable exclusion amount. To address this concern, the attorney drafts the marital formula to allocate to a marital trust "the smallest amount necessary to produce the least federal estate tax payable by reason of my death...but not less than forty percent of the property available for allocation under this Article." John dies in 2011, with an estate still worth $5,500,000. Even though the applicable exclusion amount is $5,000,000, the credit shelter trust will receive only $3,300,000 (60%) and the marital trust will receive $2,200,000 (40%).

5. In situations such as this, the marital disposition always should be to a qualified terminable interest property QTIP marital trust. An election can be made to treat only a portion of the property in the marital trust as qualifying for the marital deduction, so that the applicable exclusion amount of the first spouse to die is utlizied.

EXAMPLE: The formula in John's estate plan allocates $3,300,000 to the credit shelter trust and $2,200,000 to a QTIP marital trust. At John's death, his full $5,000,000 applicable exclusion amount is available. The executor for John makes a partial QTIP election for the marital trust and then exercises the power under the estate plan to allocate the non-elected portion to a separate trust. When John's estate plan is fully implemented,

there is a $3,300,000 credit shelter trust, a $1,700,000 Non-Elected Marital Trust and a $500,000 Marital QTIP Trust.

D. Impact of State Death Taxes

1. Since the 2001 Act phased out the state death tax credit, many states that previously assessed a pick-up tax based on the credit let their estate taxes lapse. A number of other states passed legislation to tie their state estate tax to the state death tax credit as it existed in 2001 or before. These "decoupled" states, together with states that assess an independent estate or inheritance tax, currently total 22 (including the District of Columbia). Many of the decoupled states have thresholds for taxation that are lower than the federal applicable exclusion amount:

State	**Type of Tax**	**2012 Estate Tax Filing Threshold**
Connecticut	Stand-Alone Estate	$2,000,000
Delaware	Estate	$5,120,000
District of Columbia	Estate	$1,000,000
Hawaii	Stand-Alone Estate	$5,120,000 (post 1/25/12 deaths)
Illinois	Estate	$3,500,000
Indiana	Inheritance	
Iowa	Inheritance	
Kentucky	Inheritance	
Maine	Estate	$1,000,000
Maryland	Estate and Inheritance	$1,000,000
Massachusetts	Estate	$1,000,000
Minnesota	Estate	$1,000,000
Nebraska	County Inheritance	
New Jersey	Estate and Inheritance	$675,000
New York	Estate	$1,000,000
North Carolina	Estate	$5,120,000
Ohio	Stand-Alone Estate	$338,333
Oregon	Estate	$1,000,000
Pennsylvania	Inheritance	
Rhode Island	Estate	$892,865
Tennessee	Inheritance	
Vermont	Estate	$2,750,000
Washington	Stand-Alone Estate	$2,000,000

2. The increase in the applicable exclusion amount to $5,000,000 creates an even greater number of estates where the only death tax payable is state inheritance or estate tax. In Illinois, a 2012 decedent with a $5 million estate would pay $352,158 of Illinois estate tax.

3. The largest estates of decedents in decoupled states would pay combined federal and state estate tax at a top rate of 44% to 45.4%, depending on whether the state calculates its tax taking into account the deduction for state estate taxes (some states recognize the federal deduction for state estate taxes in calculating the state tax due, while others do not).

Top Marginal Estate Tax Rates			
	Federal	**State**	**Total**
2009			
"Coupled" State	45%	0	45%
Ordinary "Decoupled" State	38.8%	13.8%	52.6%
"Decoupled" State/No Deduction	37.8%	16%	53.8%
2010-2012			
"Coupled" State	35%	0	35%
Ordinary "Decoupled" State	30.2%	13.8%	44.0%
"Decoupled" State/No Deduction	29.4%	16%	45.4%
2013			
All States (Under Current Law)	39%	16%	55%

4. In planning for a married couple, the professional is left with several choices for dealing with state estate tax at the death of the first spouse to die. The availability of these options will vary from state to state depending on that state's law.

5. The nonmarital trust can be funded only with the amount of the state exclusion amount, in order to avoid state estate tax. For example, in Illinois, the estate plan could allocate only $3.5 million to the nonmarital trust. In New York or Minnesota, only $1 million would be allocated to the nonmarital trust. The remaining assets, if any, would pass to a marital trust or the spouse.

   a. This may be adequate in smaller estates, where the additional assets passing to the surviving spouse would not cause his or her estate to be taxable for federal estate tax purposes.

   b. If portability survives, the under-utilized federal exclusion at the first death can be transferred to the surviving spouse.

   c. In larger estates, foregoing full use of the $5 million federal exclusion is a steep price to pay for avoiding a relatively modest state estate tax at the first death.

6. If the state allows a state only QTIP election, it can be used to avoid state estate tax at the first death, while fully using the federal exclusion amount. Decoupled states that allow a state only QTIP election include Illinois, Maine, Maryland, Massachusetts, Oregon and Rhode Island. In DC,

Minnesota, New Jersey, New York, North Carolina and Vermont it is either not permitted or limited.

EXAMPLE: John and Janet live in Illinois where the applicable exclusion amount for state law purposes is $3.5 million. John's estate plan contains an allocation formula that funds the marital trust with the smallest amount necessary to minimize federal and state estate taxes. Under this formula, the credit shelter trust will receive $3,500,000, and the marital allocation is $2,000,000. John's executor then would divide the marital portion into a $500,000 Marital QTIP Trust and a $1,500,000 Marital State-Only QTIP Trust. For the $1,500,000 Trust, John's executor would elect QTIP for Illinois purposes but not for federal purposes. The Marital State-Only QTIP Trust would be included in Janet's gross estate at her death for state purposes only.

7. The third option is to pay the state estate death at the first death and allocate all $5 million to the nonmarital trust. As noted previously, this would cost $352,158 of state estate tax in a state like Illinois that calculates the tax taking into account the federal deduction for state estate taxes paid.

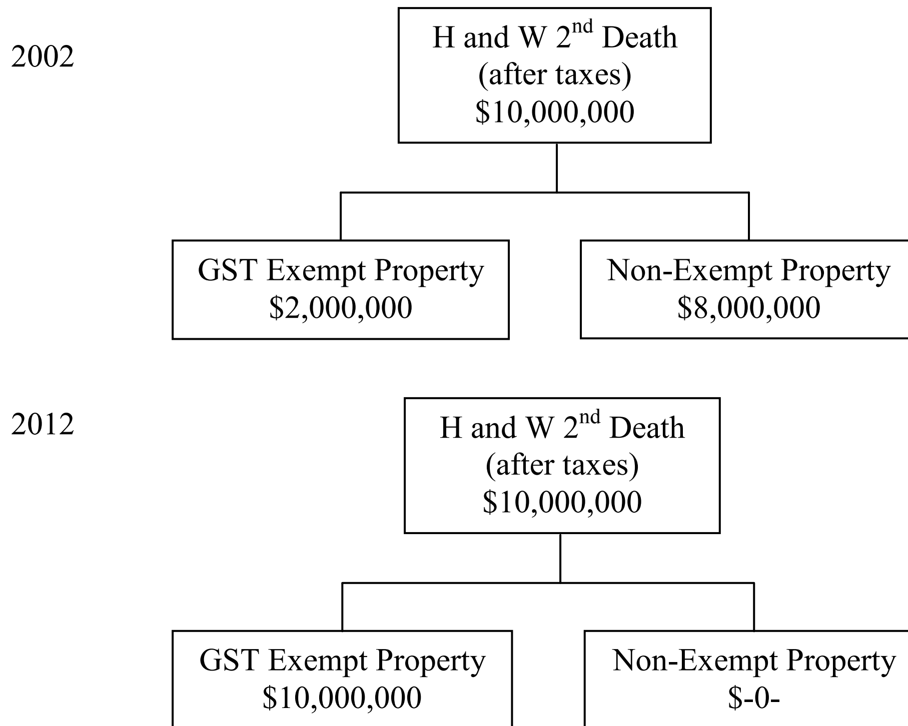
VII. Modifications To GST Planning

A. A common plan for wealthier clients is to provide that all assets that can be sheltered from GST tax at the surviving spouse's death will be retained in trusts for the children and their families, while all other assets will be distributed to the children.

1. There are numerous variations on the plan. The non-GST share may be distributed outright to the children, or it may be held in trusts over which each child has withdrawal rights at designated ages. The non-GST share may remain in longer-term trusts, but each child designated as trustee and given substantial discretionary authority.

2. The GST exempt portion may be held in a one-pot dynasty trust or allocated among separate trusts, one for each child and his or her descendants. Some clients by-pass the children entirely and direct that the GST exempt property be allocated among trusts for grandchildren.

B. With the increase in the GST exemption to $5,000,000, formula allocations that are based on the maximum amount of GST exempt property available in many cases will no longer carry out the clients' expectations.



1. If the higher GST exemption is allowed to sunset, then the allocation would shift back – approximately $2,800,000 to the GST exempt share and $7,200,000 to the non-exempt share. The allocation between children and long-term trusts is unpredictable.

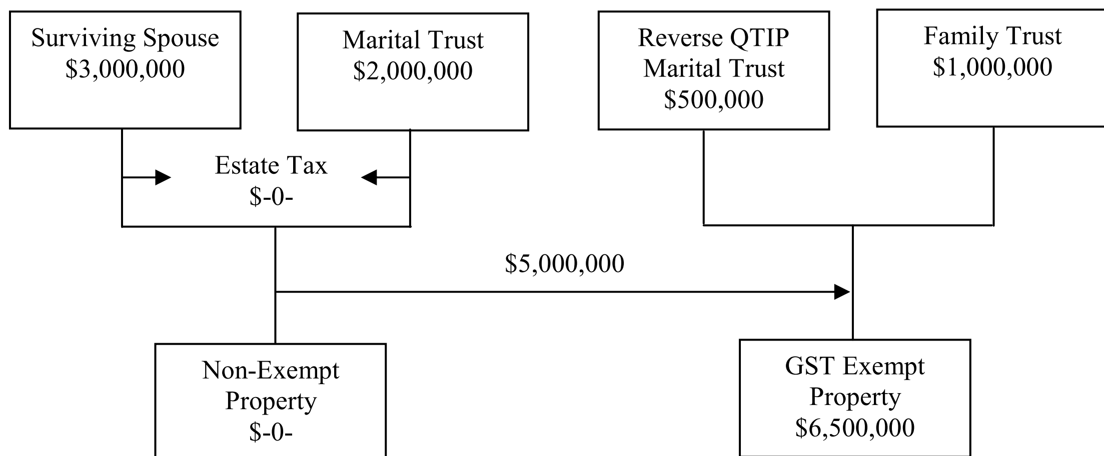
2. To address the shift in favor of GST exempt property, many clients will want to define the second death allocations by referring to the lesser of a designated percentage and the amount of GST exempt property rather than solely by reference to GST exempt and non-exempt property. For example, an allocation that capped the GST exempt trusts at 70% would limit the allocation in 2011 in the above example to $7,000,000. There would be $3,000,000 in the "non-exempt" share.

3. If the clients do not want to change the allocation language in response to the increasing GST exemption, it is advisable to obtain written confirmation of that fact. In the example above, the parents may be comfortable with the allocation of all of their wealth to long-term trusts, but the children may not believe it.

C. The impact of an increasing GST exemption also should be reviewed in estate plans where one spouse already has died. Consider the common situation where

the first spouse died five or more years ago, and his estate plan resulted in the funding of a Marital Trust, a Reverse QTIP Marital Trust (GST exempt) and a Family Trust (GST exempt). The estate plan provides that, at the second death, the non-exempt Marital Trust will reimburse for the estate taxes attributable to both marital trusts. Then the Family Trust, Reverse QTIP and GST exempt property from the surviving spouse will be held in long-term generation-skipping trusts. The non-exempt property will be distributed outright to the children. Compare what happens if the spouse dies in 2005 with the spouse dying in 2012.

2012



1. If the surviving spouse has testamentary powers of appointment, he or she can correct any perceived inequities by exercising the power to adjust the allocation. The spouse also could alter his or her own estate plan to favor the children, rather than take full advantage of his or her own GST exemption.

2. There may be situations in which the surviving spouse does not have powers of appointment and lacks sufficient separately owned property to make a sufficient adjustment. A court reformation proceeding, or family settlement agreement, may be worth considering. It generally will be better to pursue these courses of action while the spouse is alive and can exercise some influence on the family and, more importantly, provide testimony as to the intent of the estate plan when originally put in place.

VIII. <u>Lifetime Giving in 2012</u>

A. For 2012, the general advantages of lifetime gifts are enhanced by higher exclusion. It is a benefit that should not be recaptured if the system reverts to prior law (but see the discussion below about "clawback").

B. An individual who does not act this year may forgo the opportunity to transfer up to $4,120,000 out of the transfer tax system without ever being subject to transfer

tax ($5,120,000 exclusion for 2012 less the $1,000,000 exclusion that would be available if 2001 law applies in 2013). This is a potential tax savings in addition to any savings from future appreciation of the property.

> **EXAMPLE.** John has an estate of $15,120,000. In 2012, he makes a taxable gift of $5,120,000 to an irrevocable trust for the benefit of his descendants. John dies in 2014. At that time, the estate tax law has reverted to 2001 rules, with a $1,000,000 applicable exclusion amount, a top estate tax rate of 55% for assets over $3,000,000, and 5% surtax for assets over $10,000,000 but less than $17,184,000. Assume that the assets John transferred by gift have not changed in value. The following compares the tax calculation for John's estate to the calculation if John had made a gift of only $1,000,000.

Taxable Estate	10,000,000	14,120,000
Taxable Gifts	5,120,000	1,000,000
Total	15,120,000	15,120,000
Tentative Tax	8,212,800	8,212,800
Less Gift Tax Payable	(2,111,000)	-0-
Less Unified Credit	(345,800)	(345,800)
Estate Tax	5,756,000	7,867,000

1. In the foregoing example, the savings from the additional gift taking advantage of the increased 2011-12 exclusion amount is $2,111,000.

2. This example assumes that Congress does not "recapture" the benefit of lifetime gifts using the higher exclusion amount. This has commonly been referred to in the tax literature as "clawback." It is not anticipated that clawback will occur. But there is a residual concern about it because the current estate tax calculation (which was not written in contemplation of an applicable exclusion amount that would be reduced) would cause clawback to occur.

C. Many couples with estates under $10 million cannot afford to make significant taxable gifts (or believe they cannot afford to). They may be willing to take partial advantage of the higher exclusions this year, if they still have access to the property.

1. For example, H could make a $4 million gift to an irrevocable trust for W and descendants. W's beneficial interest in the trust gives her a safety net, and H shares in that safety net for as long as W is alive and they stay married.

2. H may be unwilling to make so large a gift, because of the possibility of divorce or W's premature death. Instead, H and W would prefer to each

make a $2 million gift in trust, with the non-grantor spouse and descendants as beneficiaries.

D. Reciprocal Trusts. If two parties create identical trusts for each other, the IRS will recharacterize the trusts and treat them as if each party created a trust for himself or herself. At the death of one of the grantors, the trust created by the deceased grantor's spouse will be recharacterized as a self-settled trust and included in his or her estate under Section 2036. This is known as the reciprocal trust doctrine.

1. The two-prong test for determining if reciprocal trusts were established was set forth in United States v. Grace, 395 U.S. 316 (1969). Under Grace, the doctrine applies when the following two conditions are met: (1) the trusts are "interrelated," and (2) the arrangement, to the extent of mutual value, leaves the grantors in the same economic position as they would have been in had they created the trusts for themselves.

   a. In Grace, a husband and wife created irrevocable trusts two weeks apart. The trusts contained nearly identical terms. Each spouse's trust named the other spouse as income beneficiary. At the husband's death, the IRS asserted that his wife's trust should be included in his estate.

   b. The Supreme Court agreed with the IRS that the trusts were interrelated. The Court's analysis was brief. It noted that the trusts had substantially identical terms and were created at the same time. This appeared to be enough for the Court in the case before it. But it left much uncertainty about what minimum facts had to exist for trusts to be considered interrelated.

2. There have been several subsequent cases interpreting and applying the doctrine, some interpreting the tests quite narrowly, and some very broadly.

   a. In Estate of Levy v. Commissioner, 46 T.C.M. 910 (1983), husband and wife had created trusts on the same day and funded them with an identical number of shares of stock of the same corporation. Each was a life beneficiary and trustee of the other's trust. Both trusts named the couple's son as the remainder beneficiary. The Tax Court concluded that the trusts were not interrelated because husband's trust granted wife an inter vivos limited power of appointment, and wife's trust did not contain a comparable provision.

   b. The Tax Court in Estate of Bischoff v. Commissioner, 62 T.C. 32 (1977), applied the reciprocal trust doctrine to trusts in which neither spouse had any economic interest as a beneficiary.

Husband and wife had created identical irrevocable trusts for their grandchildren. Each named the other as trustee. The court treated the trusts as if each spouse had named himself or herself as trustee and therefore had retained a § 2036(a)(2) right to designate the persons who would enjoy or possess the trust property.

c. This broader application of the doctrine was rejected by the Sixth Circuit in Estate of Green v. United States, 68 F.3d 151 (6th Cir. 1995). In Green, the husband created a trust for one granddaughter, with the wife as trustee, and the wife created an identical trust for another granddaughter, naming husband as trustee. The court ruled that the couple's powers as trustees did not constitute a retained economic benefit, so the reciprocal trust analysis did not apply.

d. The latest reflection of the IRS' point of view can be found in Letter Ruling 200426008. Husband and wife each created an irrevocable insurance trust, and named the other as trustee. The trusts contained significantly similar language but differed in several important respects. The husband's trust gave the wife several additional powers, including lifetime and testamentary powers of appointment. In addition, in the wife's trust, the husband did not become a beneficiary unless he was living three years after the wife's death, and he had a right to distributions only if his net worth or income fell below certain levels. The IRS decided that these differences were sufficient to prevent the trusts from being interrelated.

3. Because the tests are subjective in nature, there is no clear line demarking when husband and wife each can create irrevocable trusts for the other without invoking the doctrine.

a. The standard guidance is that husband and wife should not create the trusts at the same time, as part of one plan, with identical provisions for each other.

b. To be in the best position to avoid application of the doctrine, one of the trusts should not benefit the other spouse at all.

c. Beyond these two guideposts, there is a large grey area.

4. The first step in avoiding the reciprocal trust doctrine is for husband and wife to create the trusts at different times. If the clients do not want to leave one spouse out as a beneficiary of the other's trust, then one spouse's trust should give the other beneficial interests that are meaningfully different. For example, assume wife is a discretionary beneficiary of

income and principal in husband's trust, pursuant to an ascertainable standard. The wife's trust could do one or more of the following:

a. Make the husband a discretionary beneficiary of income only.

b. Allow distributions to the husband only in the discretion of an independent trustee.

c. Allow distributions to the husband only if his income or net worth falls below a certain level.

d. Limit the husband's interest to a 5 and 5 withdrawal power.

E. Conclusions Regarding Lifetime Giving

1. For 2012, clients with under $10 million of assets first must determine how much, if anything, they are comfortable giving away. A married couple should make this determination taking into account the ability to name a spouse as beneficiary of the donee trust.

2. If clients who have their full lifetime exclusion amounts are not willing to transfer more than $2 million ($1 million for a single client), the case for needing to act in 2012 is far less compelling.

3. Clients who are comfortable giving away more should act now, with their counsel assisting to structure the donee vehicles in a way that both accomplishes the transfer tax goals and ensures the clients' financial security.

THE ILLUSORY ASSET PROTECTION OF LLCs AND THE ERODING ASSET PROTECTION OF TRUSTS

I. Introduction

A. Asset protection has been part of estate planning for as long as there has been an estate planning discipline. After all, trusts for family members are created in most instances to preserve and protect property for the future use and benefit of family members. The third party created trust has been a cornerstone of asset protection planning for, literally, hundreds of years.

B. With increasing accumulation of wealth comes increasing concern about losing that wealth. As a result, the emphasis on asset protection has increased over the past twenty years. There is no doubt that the interest of clients has been fed by the legal and financial professions. Anyone who focuses his or her practice on asset protection needs to generate business. Anyone who simply speaks or writes on the topic tries to justify its importance. The result is a certain amount of engagement by the professionals in "fear tactics". For example, consider the following quote from the Illinois Institute of Continuing Legal Education (IICLE) book "Asset Protection Planning":

> "Over the past 20 years, however, various societal factors have unleashed many new threats against personal wealth. There has been an exponential rise in the number of lawsuits filed. New subjective injuries such as emotional and psychological distress. Juries are also more willing to impose punitive damages than in the past. . . ."
>
> "As asset protection planning has become more common and is viewed in a more favorable light, a number of commentators have suggested that the pendulum of public opinion may swing completely to the other side and estate planning attorneys may now have a duty to include asset protection planning as a standard part of the services they provide to their clients. Once commentator has gone as far as to state that the "failure to so advise a wealthy or at risk client may constitute malpractice if the client's assets are needlessly exposed to a subsequent judgment or other legal claim" (Mario A. Mata, *Asset Protection Planning for the Family Business Owner*, ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER (ALI-ABA July 2005), ..."

C. The fervent selling of the need for asset protection is one discussion point in the larger debate about the proper role of asset protection in clients' estate plans and whether certain planning techniques are being overused or incorrectly relied on by attorneys and clients alike.

D. These materials explore these questions with respect to two distinct aspects of estate and asset protection planning - the use of Limited Liability Companies ("LLCs") as an asset protection device and the protection provided by third party created trusts in divorce.

II. Limited Liability Companies

A. Most business entities available under U.S. law are designed to limit the liability of owners in certain ways, but only one puts that purpose in its name - the Limited Liability Company, or LLC.

B. The LLC was developed as an alternative to the limited partnership, and the two remain closely connected - indeed for federal income tax purposes, they are identical, both being taxed as partnerships.

1. The limited partnership developed as an attractive form of doing business because it combined the following features:

a. Limited liability of its limited partners - limited partners could not be liable for the debts and obligations of the entity.

b. Flow-through income tax treatment; no double taxation as with C corporations.

c. No limitations on the persons or entities that can own interests, unlike an S corporation.

2. The drawback of a limited partnership is that it requires a General Partner, and the General Partner does not have limited liability. This means a limited partnership must either have one or more individuals willing to accept the potential liability of being a General Partner, or a second entity (typically a corporation) must be created to act as General Partner.

C. The LLC first became available in Wyoming in 1977. Every state now has a separate LLC statute. It provides all the favorable attributes of a limited partnership, without the need for a General Partner. In effect, all the LLC members are limited partners. It also provides more flexible options for management and control. An LLC can be managed by the Members or one or more Managers (who may or may not be Members). Members can be given voting or non-voting status, and can (but are not required to) have the power to remove and replace the Manager.

D. Initially, there was some reluctance to use LLCs, not only because statutes had not been enacted in every state but because of uncertainty about federal tax status.

1. In 1988, the IRS first publicly ruled that an organization formed as an LLC was properly classified as a partnership for federal income tax purposes. See Rev. Rul. 88-76, 1988-2 C.B. 360.

2. It is now clear that LLCs (other than single member LLCs) can elect treatment as a partnership for federal tax purposes as the default, without concern about challenge from the IRS. See Treas. Reg. §§ 301.7701-1 to 301.7701-6.

E. LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

1. A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;

2. An assignee will not become a member of the LLC without the unanimous consent of the other members; and

3. An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.

F. The LLC plays two distinct roles in asset protection planning.

1. Internal - the LLC is designed to trap business or asset liabilities inside the entity, so that a member does not become personally liable for such liabilities.

2. External - the LLC insulates its assets from the creditors of individual members, and can serve a purpose in protecting the assets of the members.

III. Misconceptions About Internal Liability Protection of LLCs

A. With respect to internal liabilities, the LLC is like any other commonly used business entity (corporation or limited partnership). If properly operated, and absent other contractual obligations entered into by the members, the members of an LLC will not be liable for debts and liabilities of the LLC.

EXAMPLE: George has purchased both a small apartment building and two single family residential lots, each with a small bungalow on it. He plans to renovate the apartment building and rent the units. He also plans to tear down the two homes and build one larger home on the lots, which he then will sell. George's attorney advises him to create two LLCs, one to own the apartment building and one to own the two lots. Each LLC will borrow funds if necessary, enter into contracts with contractors and other vendors, and for the apartment building enter into leases with tenants. Any liability related to debts, injury or

damage during construction, or injury to a tenant or visitor to the property should be trapped in the LLC.

EXAMPLE: Jane opens a children's clothing store. On the advice of her attorney, she creates an LLC to own the business. The LLC enters into the lease for the store and contracts with wholesalers of the clothing. The LLC employs the store employees. Any liabilities of the business, including claims of an employee, vendor, or customer, should not reach Jane personally.

B. The liability protection provided by an LLC in these situations is important. But in practice it often is not as complete as one would hope.

1. Banks and other financial institutions that lend to the LLC often will demand personal guarantees from the principal member or all the members.

2. A claim against the LLC may also involve a claim against the member. For example, George may be accused of negligence in personally buying shoddy materials, or Jane may be accused of negligently failing to do a proper background check on an employee, who then harms a customer.

C. Many professional advisers gloss over these distinctions in recommending LLCs for the assets of wealthy clients.

1. An LLC clearly is appropriate for business activities, activities that involve employees, or for ownership of assets that inherently involve risk.

2. A client that acquires an airplane or a large yacht that will have a crew should acquire and hold the asset in an LLC. For the yacht, for example, the LLC should both own the boat and employ the crew.

3. Likewise, rental properties or other non-personal use real estate should be owned by LLCs. For example, a client that owns rural property that he uses for hunting, where he allows friends and colleagues to use the property, would be well-advised to own it in an LLC.

D. In other situations, the LLC sounds like a good idea but is likely to provide little or no protection.

EXAMPLE: Paul and Pricella purchased a vacation home on a lake last year. They are in the process of acquiring a jet ski to use on the lake and two snowmobiles to use on the property during the winter. They are advised to place ownership of each item in a separate LLC in order to protect them from liability should there be an accident with any of the items.

1. The use of LLCs in this instance may do nothing more than create a false sense of security. Any liability arising from use of the jet ski or a snowmobile is almost certainly going to be based on the alleged negligent

operation of the vehicle by Paul, Pricella, one of their family members, or someone who is using the vehicle with their permission. The LLC will not provide any protection against claims of negligent operation or negligence in failing to supervise the person who was operating it.

2. Proper asset protection planning in these situations should involve counseling on adequate insurance coverage, and, if necessary, advice on ground rules for use and operation of the vehicles.

IV. External Liability Protection Provided by LLCs

A. Both an LLC and a limited partnership provide protection against creditors of a member or partner who are seeking assets to satisfy a debt or judgment. The protection derives from the limited rights granted to the assignee of a member or partner. The protection is largely based on state statutes.

B. For a limited partnership, almost every state enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"), which was promulgated by the National Conference of Commissions on Uniform State Laws in 1976 and amended in 1985. RULPA restricted the rights of a creditor of a limited partner by limiting the remedy available to that creditor.

1. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. An assignment does not dissolve the limited partnership or entitle the assignee to become or exercise any of the rights of a limited partner.

2. Under RULPA, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides:

> On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This [Act] does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest.

C. The creditor protection provisions of the Revised Uniform Limited Liability Company Act ("RULLCA") were patterned after RULPA, but with greater detail.[1] Section 503 of RULLCA provides as follows:

> SECTION 503. CHARGING ORDER.
>
> (a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor.
>
> (b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:
>
> (1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and
>
> (2) make all other orders that the circumstances of the case may require to give effect to the charging order.
>
> (c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to Section 502.
>
> (d) At any time before foreclosure, the member or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

[1] The National Conference on Uniform Laws replaced RULPA with a new Uniform Limited Partnership Act in 2001. The new Act in turn incorporated much of the more detailed provisions of RULLCA, including the specific provisions about foreclosure on a transferee interest. The new ULPA has been adopted in whole or in part in 18 states and the District of Columbia. Illinois is one of those states.

> (e) At any time before foreclosure, a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.
>
> (f) This [act] does not deprive any member or transferee of the benefit of any exemption laws applicable to the member's or transferee's transferable interest.
>
> (g) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment out of the judgment debtor's transferable interest.

D. Most state LLC statutes contain charging order sections similar to that found in the RULPA or the RULLCA. The Illinois charging order statute is below:

> <u>Illinois (805 ILCS 180/30-20)</u>:
>
> "(a) On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's share of profits and right to distributions with payment of the unsatisfied amount of the judgment with interest. To the extent charged, the judgment creditor has only the rights of an assignee. This Article shall not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company.
>
> (b) A charging order constitutes a lien on the judgment debtor's distributional interest. The court may order a foreclosure of a lien on a distributional interest subject to the charging order at any time. A purchaser at the foreclosure sale has the rights of a transferee.
>
> (c) At any time before foreclosure, a distributional interest in a limited liability company that is charged may be redeemed:
>
> (1) by the judgment debtor;
>
> (2) with property other than the company's property, by one or more of the other members; or
>
> (3) with the company's property, but only if permitted by the operating agreement.

(d) This Act does not affect a member's right under exemption laws with respect to the member's distributional interest in a limited liability company.

(e) This Section provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor's distributional interest in a limited liability company.

E. Arizona's LLC statute provides as follows:

Arizona (Ariz. Rev. Stat. § 29-655)

Rights of judgment creditors of a member

"A. On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's interest in the limited liability company with payment of the unsatisfied amount of the judgment plus interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's interest.

B. This chapter does not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company.

C. This section provides the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the judgment debtor's interest in the limited liability company."

F. Delaware also follows the general approach of the Uniform Act, but with a very important change. In Delaware, there is no right to foreclose on the interest under the statute. The charging order is the exclusive remedy. Several other states have followed this approach.

Delaware (Del. Code tit. 6, §18-703):

"(a) On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the limited liability company interest of the judgment debtor to satisfy the judgment. To the extent so charged, the judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled in respect of such limited liability company interest.

(b) A charging order constitutes a lien on the judgment debtor's limited liability company interest.

(c) This chapter does not deprive a member or member's assignee of a right under exemption laws with respect to the judgment debtor's limited liability company interest.

(d) **The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest.**

(e) No creditor of a member or of a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

(f) The Court of Chancery shall have jurisdiction to hear and determine any matter relating to any such charging order."

G. The statutory limits on remedies for a creditor of an LLC provide several clear advantages.

1. The creditor is only an assignee of the member's interest and has no right to participate in the management of the entity or to vote.

2. The effect of the charging order is that a member's creditor will only receive those LLC distributions which, absent the charging order, would have been distributed to the debtor member.

a. Of course, if the debtor is a member in a widely-held LLC that makes regular distributions, the charging order may be an effective means for a creditor to collect upon a judgment.

b. However, in a family or other closely-held LLC in which a relative of the debtor has control over distributions and in which distributions may be made infrequently and in very modest amounts, the creditor may find the charging order to be an unattractive remedy.

3. A charging order is a lien only on partnership distributions. Some commentators point out that it may be possible to enable the debtor member, or other family members to pull cash or assets out of the entity through loans, salary, or guaranteed payments, without including the judgment creditor. See, e.g. Stein, "Practical Primer and Radical

Approach to Asset Protection" 38 Estate Planning No. 6, at 25 (June 2011). Certain commentators go further and state that the agreement could permit distributions that are not proportionate to the ownership interests. Id. at 26.

4. The foreclosure remedy granted in LLC statutes is unattractive because the purchaser obtains only the assignee interest, and therefore no greater rights than the creditor had. The creditor will not receive much for the interest. Id. at 25.

5. Delaware and several other states have eliminated the foreclosure remedy and provided that the charging order is the sole and exclusive remedy available to a judgment creditor.

6. In a family entity, the family can build on the unsatisfactory nature of the charging order remedy by including provisions in the agreement that trigger purchase options in the other members when one member's interest becomes subject to a charging order or that member declares bankruptcy. Typically, the purchase options are at a deep discount from the net asset value of the LLC interest. This allows the member to take the creditor out of the picture entirely, while preserving the underlying LLC assets to the maximum extent possible.

7. The tax treatment of a charging order also may discourage a creditor from going after an LLC interest. Many tax practitioners believe that the income tax effect of a creditor obtaining a charging order is to cause the creditor to become liable for that LLC interest's share of the LLC income, even if no distributions actually are made by the LLC. See Rev. Rul. 77-137, 1977-1 C.B. 178 (assignee of limited partner's entire interest is taxed on distributive share of partnership income even if not a substituted limited partner).

   a. Some commentators have questioned whether a creditor with a charging order can be equated with an assignee of an entire partnership or LLC interest. Local law may determine how the holder of the charging order is to be treated for tax purposes.

   b. In family situations in states in which the law is not clear, the manager could take the position that the charging order does burden the creditor with a share of the taxes, in order to encourage the creditor to accept a reduced amount in satisfaction of the debt.

H. Clearly, these attributes provide significant benefits in negotiating with the creditor of an LLC member. Plaintiff's attorneys acknowledge that they do not like to expend time and energy going after illiquid and difficult to collect assets.

1. In fact, plaintiff's attorneys say that tort and professional malpractice judgments rarely result in collection of significant amounts from a

defendant's personal assets. They are interested primarily in the insurance. In both pre-trial settlement and post-judgment settlement, the availability of insurance will dictate the amount collected in the majority of suits.

2. Is it true that the threat of going after one's personal assets is used all the time – as a negotiating tactic and a way to gain leverage against the insurance carrier (the party that usually is running the defense) and its lawyers. The actual incidence of verdicts that seriously threaten one's personal wealth is greatly exaggerated according to the plaintiff's bar.

3. Thus, in some respects, LLC structures may be protecting against a threat that does not exist or is far less significant.

I. Moreover, as with professional advice on the internal liability protection of an LLC, the professional who emphasizes only the favorable attributes discussed above and touts the LLC as a cure-all for asset protection does the client a disservice. In fact, too much reliance on the LLC for asset protection could make it less effective not more.

1. There are significant practical consequences to having a judgment creditor make a legal claim against a member's LLC interest.

2. There also are aspects of the law that are not favorable to LLCs. The asset protection features of an LLC do not work in all legal forums. Not surprisingly, courts sometimes do not follow the strict letter of the statutory law, in particular where the court decides it would create an inequitable result.

J. Practical Consequences of a Charging Order Against An LLC Interest

EXAMPLE: Samuel, his wife, Wanda, created an investment LLC for the family 15 years ago. They contributed several rental properties owned by the family and significant marketable securities. When a trust created by Samuel's parents terminated several years ago, he convinced his children to contribute the assets they received outright, consisting of marketable securities and a family vacation home, to the LLC. As a result of these contributions and a gifting program by Samuel and Wanda, the children each own a 22% in the LLC outright. Samuel and Wanda own about 10% and the remaining 24% is held by various irrevocable trusts. The family administers the LLC with great care and follows the advice of their professional advisers. For example, they have a rental arrangement for the vacation home; no one in the family receives free use of it.

Samuel's son, Baxter, started his own investment firm several years ago. Things went badly for Baxter, and he committed some major mistakes in trying to keep the firm solvent. The firm failed, he was indicted by the federal government for securities violations and numerous claims were brought against him by individual investors. Assume that Baxter's

judgment creditors now have judgments against him and several are seeking satisfaction in part from his LLC interests.

1. The creditors who obtain a charging order against Baxter's LLC member interest become assignees only and will receive only that member interest's share of those distributions which the LLC decides to make.

    a. What if the LLC was planning on a significant distribution because of needs of certain other LLC members?

    b. What if the LLC routinely makes annual distributions of the income from the rental properties?

2. The income tax consequences of holding the assignee interest and being allocated a share of the LLC income each year are unattractive to a creditor. They are equally unattractive to the other LLC members, who may have become dependent on tax distributions from the LLC.

    a. Suppose that the LLC interest is the only asset held in one or more of the irrevocable trusts and that one or more of the trusts are separate taxpayers, not grantor trusts. The only source of cash for tax payments for those trusts is the LLC.

    b. Assume that Baxter's violation of the federal securities laws allowed the federal government to seize assets, and it has the charging order on Baxter's LLC interest. The government will not care about the income tax consequences of the charging order. It may not be compelled to negotiate a quick and favorable buy-out to liquidate its claim.

3. Purchase options that are triggered upon the involuntary transfer of Baxter's interest do provide a way for the family to terminate the interests of the assignees.

    a. The discounts at which the LLC allows the family to purchase the interests may be significant. This clearly is a benefit. But the discounts will not be 100%, and in most instances they do not exceed 50%, because no family member at the time of formation wants to see their equity investment lost for too low a price.

    b. The purchase option solution does not protect Baxter's assets and may not protect all the assets of the LLC. If the purchase options are exercised, Baxter will have lost his interest in the LLC, and, because it was purchased at a discount by the LLC or other family members, his remaining judgment debt remains higher. The LLC may have to liquidate some investments to accomplish the buy-out.

c. Samuel and Wanda could take steps in their estate plan to try to restore what Baxter lost, but, as a practical matter, it seems unlikely that either Samuel and Wanda, or Baxter's siblings will feel much sympathy for Baxter. Most siblings will not be interested in having their future inheritances reduced to restore a sibling's lost wealth.

4. The other members could use loans from the LLC to deal with cash flow issues. But, the family must be conscious of the estate planning purposes of the LLC. The frequent use of loans may weaken arguments for valuation discounts for federal estate and gift tax purposes. For the same reason, the idea of amending the agreement to permit disproportionate distributions may be a non-starter.

K. Federal Bankruptcy Law

1. The benefits that an LLC might provide in dealing with a judgment creditor do not carry over completely to a bankruptcy situation. If the judgment debtor declares, or is forced into, bankruptcy, then several protective measures may not be available.

2. The charging order is a remedy imposed by state law. Commentators have said that the public policy behind the remedy is to "balance a judgment creditors rights against the desire to avoid a disruption or liquidation of the LLC's business." Forsberg "Asset Protection and the Limited Liability Company" Probate & Property, 39, 40 (Nov./Dec. 2009). This public policy balancing has a slightly different tilt in bankruptcy.

3. In one bankruptcy case, In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz 2005), an LLC member who owned less than all of the LLC declared bankruptcy. The trustee sued the LLC, claimed that the LLC was diverting and misapplying assets, and sought to be treated as a substitute member.

a. The court held that the bankruptcy trustee had all the rights and powers of that the debtor/member had at the commencement of the case. The trustee took the debtor's full membership interest.

b. The court also held that § 541(c)(1) of the Bankruptcy Code negated the provision of Arizona law and the operating agreement that would take away the trustee's non-economic rights and treat the trustee as an assignee. The court appointed a receiver and stated that the receiver could, if necessary cause the LLC to be dissolved and liquidated in order to satisfy the claims of creditors.

4. Similarly, in In re Smith, 185 B.R. 285 (Bankr. S.D. Ill. 1995), the court held that a bankruptcy trustee assumed all the rights of the bankrupt

limited partner, and therefore could maintain a suit to dissolve the partnership on the grounds that it was not carrying on a business.

5. The Bankruptcy Code provision referred to above, § 541(c)(1), provides as follows:

> "Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2) or (a)(5) of this section, notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law –
>
> (A) that restricts or conditions transfer of such interest by the debtor; . . . ."

a. This provision can negate a term in the LLC operating agreement that purports to convert a member's interest to an assignee interest upon the filing of a bankruptcy petition. It also could prevent a purchase of the interest under a purchase option provision.

b. These provisions will be negated unless the operating agreement is treated as an "executory" contract. In federal bankruptcy law, a contract is treated as executory when "the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other." Forsberg, supra, at 41, quoting Countryman, Executory Contracts in Bankruptcy, 57 Minn L. Rev. 439 (1973).

c. Most courts conclude that an LLC operating agreement or limited partnership agreement is not executory. See In re the IT Group, Inc., 302 B.R. 483 (D. Del. 2003); In re Smith, 185 B.R. 285 (Bankr. S.D. Ill. 1995); In re Garrison-Ashburn, LC, 253 B.R. 700 (Bankr. E.D. Va. 2000); In re Cutler, 165 B.R. 275 (Bankr. D. Ariz. 1994).

L. Legal Relief Granted in Judgment Creditor Cases Involving Partnerships and LLCs

1. If the LLC is not in states such as Delaware, Nevada or Alaska, the foreclosure remedy may be available to the creditor. It should be noted that courts have allowed foreclosure in some partnership cases, even though the applicable partnership act did not specifically provide for it.

2. In two California cases, courts provided authority that a creditor could foreclose upon an interest in a partnership, thereby causing its sale.

a. In Crocker National Bank v. Perroton, 208 Cal. App. 3d 311, 255 Cal. Rptr. 794 (Cal. App. 1st Dist. 1989), the court permitted the sale of a limited partnership interest to satisfy the claim of a judgment creditor. The court based its opinion on California Corporations Code § 15028(1), which provides that the court "may ... make all other orders, directions, and inquiries which the circumstances of the case may require" and refers to a possible court ordered sale of a partnership interest which is subject to a charging order. However, the facts in the case indicate that it may be of limited use to a creditor because the other partners consented to the sale of the limited partnership interest. (In a family partnership situation, this is unlikely to happen, absent bad blood among the family members.)

b. A similar but more far-reaching result was reached in Hellman v. Anderson, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (Cal. App. 3d Dist. 1991), which involved the sale of a general partnership interest. The Hellman court emphasized that the consent of the nondebtor partners did not necessarily have to be obtained in every case in which a forced sale was sought. However, it added that before authorizing the foreclosure of a charged partnership interest, the trial court must determine that a foreclosure of the charged partnership interest will not unduly interfere with partnership business.

3. In one Connecticut case, Madison Hills Limited Partnership II v. Madison Hills, Inc., 644 A.2d 363 (Conn. App. 1994), the court went one step further than the courts in Hellman and Crocker. The court held that a charging creditor may enforce its charging order not only through a forced sale but also through "strict foreclosure" (i.e., the vesting of title of the partnership interest absolutely in the charging creditor, on default in payment, without any sale of the property).

M. Single Member LLCs

1. One should anticipate that a single member LLC will not receive the same protections as a multi-member LLC in a judgment creditor case. The public policy factors behind the desire to avoid disruption of the LLC business are based in part on the desire not to adversely impact the other business participants. That factor is not present in a single member LLC.

2. In Olmstead v. Federal Trade Commission, 44 So. 3d 76 (Fla. 2010), the Florida Supreme Court determined that a charging order was not the exclusive remedy for the judgment creditor of the owner of a single member LLC.

a. The case arose out of a judgment the Federal Trade Commission had obtained against two individuals, Olmstead and Connell, for unfair and deceptive trade practices in a consumer credit card scheme. The FTC judgment included $10 million in restitution. The FTC had obtained a preliminary order under which several of the defendant's interests in single-member LLCs were frozen and placed in receivership.

b. After the defendants appealed to the 11th Circuit Court of Appeals, the Court of appeals certified the following question to the Florida Supreme Court: "Whether, pursuant to F.S. § 608.433(4), a court may order a judgment-debtor to surrender all 'right, title and interest' in a debtor's single member limited liability company to satisfy an outstanding judgment?" (The charging order statutory provision)

c. The Florida Supreme Court broadened the question and phrased it in terms of whether Florida law allowed such actions.

d. The Court concluded that the Florida LLC Act had not specifically displaced other remedies available to judgment creditors and looked specifically to the more general creditor's remedy of levy and sale under F.S. § 56.061. The Court held that the sale and levy remedy authorized transfer of all the LLC member's right, title and interest in the LLC to the judgment creditor.

e. The Court did focus on the lack of exclusivity language in the Florida LLC statute. It noted that both the Florida Revised Uniform Partnership Act and Florida Revised Uniform Limited Partnership Act contained exclusive remedy language, and stated that this showed that the legislature's failure to include such language in the LLC statute was not inadvertent.

f. In response to the decision in Olmstead, the Florida legislature modified § 608.433 of the Florida statutes to make clear that the holding in Olmstead does not apply to multi-member LLCs, and that the sole and exclusive remedy for a judgment creditor of a member of a multi-member LLC is a charging order. The legislation was effective May 31, 2011.

3. In In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003), the court held that the bankruptcy filing transferred the debtor's entire interest as sole member and manager of a Colorado LLC to the bankruptcy trustee. The court noted that there were no non-debtor members whose rights needed protecting.

N. LLCs as the Primary Vehicle for Asset Protection

1. These practical and legal issues can arise in any situation in which an LLC member is subject to creditors claims. But they are likely to be magnified in those situations in which an individual has created the LLC for the sole and exclusive purpose of providing asset protection.

   EXAMPLE: Mark has a business that entails a significant amount of risk, and is fearful that, despite his best efforts, a disastrous event could occur someday that would result in significant liability against him. His net worth currently exceeds $50 million. He reads an on-line advertisement that says he can put all his assets in LLCs and that, because he no longer owns the assets, they are not attachable in the event of a judgment against and everything will be protected. He visits the attorney who placed the advertisement and sets up a separate LLC to own each of his two homes and one to hold his investment assets. The LLC holding the investment assets is structured with an S corporation as manager and 1% member. That corporation has a 10% Class A voting interest and a 90% Class B voting interest that is converted to nonvoting at the election of the holder of the Class A interest. Mark gives the 10% Class A interest to his mother and retains the 90% Class B interest himself. In addition at the recommendation of the lawyer, he creates an irrevocable trust for the benefit of his mother, sister and any future descendants of his and makes a gift of 1% interest in the LLC to the trust. Mark now sleeps well at night, knowing all his assets are protected from creditors.

2. For the reasons described in the preceding pages, Mark has been lulled into a false sense of security. The LLC holding his investment assets may in fact provide some benefits in the case of a judgment against him. However, even in the best circumstances, the judgment creditor will obtain a charging order against it and he or the LLC will have to negotiate a settlement or buy-out the interest to eliminate the creditor as an owner.

3. If Mark has done nothing more than put his homes in single-member LLCs, they likely will provide little or no protection. There is no apparent business purpose to the entities. Mark lives in each residence, and keeps his personal belongings there. If he pays bills related to their upkeep, and pays for improvements from time to time from his separate funds, there is a significant chance they would not be respected by a court and afforded whatever more limited protections single member LLCs might have.

4. Because Mark has placed virtually all his liquid assets in an LLC structure, he may find he actually has reduced its effectiveness as an asset protection device.

   a. First, if Mark has limited assets outside the LLC, a major judgment creditor will likely devote more effort to breaking through the LLC structure to obtain some recovery.

b. In settlement discussions before a trial, the complete commitment to the LLC structure may have a negative effect. Prior to judgment, the plaintiff's counsel is not focusing on the nature of the assets of the defendant. Discovery regarding the defendant's assets does not occur at this stage. Counsel is preparing his or her case, and probably negotiating with opposing counsel to determine if an acceptable settlement is available, not trying to learn about the defendant's assets. If the defendant is too tied to the idea that he or she has no attachable assets, and therefore offers little in settlement, the motivation of the plaintiff in fact may be to take the case to trial.

c. A court also may be less sympathetic to Mark than it would to someone who had some assets in an LLC but had not committed to what clearly appears to be an attempt to protect everything and make himself "judgment proof."

5. Finally, Mark's total commitment to the LLC makes it inherently more difficult for Mark to adhere to the formalities of the structure.

EXAMPLE: Mark keeps a separate bank account in his individual name. His salary from his business and business distributions are deposited in this bank account. Mark uses it for his personal living expenses. From time to time the account builds up excess cash, which Mark deposits in the LLC investment account. There also are occasional larger expenses, including quarterly estimated tax payments. Mark transfers funds from the LLC investment account to his personal account to pay these expenses.

a. In the foregoing example, Mark is required to maintain strict discipline in tracking contributions to the LLC (and valuing LLC assets at the time of contribution) and both tracking distributions and making sure they are pro rata to all the LLC members. He may need to have some contributions run through the S corporation acting as Manager, if he wants to maintain its 1% interest in the LLC.

b. In some cases, the professionals who create the structure fail to advise the client on the importance of maintaining these formalities. In most cases, the client probably is not disciplined enough to do it. This exposes the client to assertions that the structure lacks economic substance and should be ignored.

V. Practical Asset Protection For the Successful Professional

A. LLCs can and do play an important role in financial planning and asset protection. Reliance on them as the primary means to achieve asset protection is misplaced. It can create a false sense of security. As one writer pointed out:

> "If removing assets from the debtor's balance sheet is desirable, only an irrevocable trust will accomplish that. With a trust, the debtor can declare that he or she owns no assets without perjuring oneself . . . . Contrast that with a transfer of assets to an LLC where the debtor changes the asset he or she owns (i.e., converts real estate into an LLC interest) but still owns the asset."
>
> Stein, "Asset Protection," supra at 27 and note 51.

B. Reliance on any one technique to provide asset protection is not the wisest course of action. In asset protection planning, like other aspects of estate planning diversification often best serves the clients' needs. Clients crave easy solutions, and long to hear that there is a single solution that will solve all their problems. That is rarely the case. Part of the attorney's role as counselor is to educate the client in a realistic way.

C. An educated client will realize that a great deal of asset protection planning can be accomplished as part of the normal estate planning process, and without turning to more exotic or complex structures.

EXAMPLE: Peter and Penny Plum are successful professionals. Peter is a surgeon and Penny left a high level job with an investment firm two years ago to join with several colleagues in starting a private investment fund. They have accumulated $10 million of investment assets, own a $1.75 million home and a $750,000 condominium in Colorado.

The Plums are increasingly worried about the impact that a lawsuit could have on their wealth and their lifestyle. Neither has any lawsuits pending against them, nor any potential claims they are aware of. But both of them obviously are in high risk professions. One of Peter's colleagues tells him that his accountant recently attended a seminar promoting offshore trust planning. The colleague says that based on the recommendations of the seminar sponsor, his accountant is working with attorneys (affiliated with the seminar sponsor) to transfer virtually all of his assets to an offshore trust where, he is told, it will be completely protected from future creditors. Peter is interested in the same thing. He and Penny would like to transfer their $10 million portfolio, and their Colorado condo to an offshore trust. They want to know if they can transfer their primary residence also.

D. The Plums need advice on two important aspects of asset protection planning. The first area is the many practical asset protection solutions that can be implemented with less cost and as part of the normal estate planning process. The second aspect is the great danger of trying to go too far with a technique like offshore trust planning. More so than almost any other part of estate planning, offshore planning is an area that illustrates the maxim that "pigs get fat and hogs get slaughtered."

E. There are several asset protection solutions that the Plums should consider before exploring offshore trusts. For a couple where only one spouse is in an at-risk profession, that spouse should consider giving property outright to the other spouse. This solution is not appropriate for the Plums, and it may not be appropriate for many couples because of divorce concerns. This is where irrevocable trusts can be used very effectively.

F. Transfers in Trust. Trusts may be the most important regularly used and accepted asset protection tool available. A trust can be used to alleviate a client's concerns about imprudent use of the property, or to control the property in case of later divorce.

EXAMPLE: Peter transfers $1,000,000 to an irrevocable gift trust for Penny and their children. Peter names Penny as trustee. She can distribute property to herself and the children for health and support and to the children for their education. The trust provides that if Peter and Penny divorce, then Penny automatically ceases to be trustee and all her interests in the trust terminate. The gift does not generate gift tax because of Peter's gift tax applicable exclusion amount.

1. Peter also could use a lifetime QTIP trust to transfer property to Penny. The possible drawback of a QTIP trust is that Penny must receive all the income for life, even if there is a divorce. If this is not a concern, however, the QTIP trust can be a very useful asset protection device. It can be created without gift tax consequences in any amount because transfers to it qualify for the marital deduction. It both removes the assets from the reach of Peter's future creditors and protects the assets for Penny. A judgment creditor of Penny could go after her income interest in the trust but not the principal.

2. In addition, it is possible to give Peter an interest in the trust if Penny predeceases him. The marital deduction regulations permit a settlor to create a lifetime QTIP trust in which the settlor has a contingent trust interest if the donee spouse predeceases the settlor. After the donee spouse's death, that spouse will be treated as the transferor of the trust property. See Treas. Reg. §25.2523(f)-1(d) and (f), Examples 9, 10 and 11. Therefore, the original settlor's contingent interest will not be treated as a retained interest under Section 2036 of the Code.

   a. For asset protection purposes, the settlor should not actually have a contingent beneficial interest in the trust. This may place the property within the reach of creditors for state law purposes.

   b. However, it should be possible to give the donee spouse a testamentary power of appointment that would allow the donee spouse to create a trust for the settlor if the donee spouse dies first.

EXAMPLE: Peter creates both a $1 million irrevocable trust for Penny and their children and a $1 million lifetime QTIP trust for Penny. Penny finally frees up some time in her busy schedule to discuss further planning. She also would like to create an irrevocable trust – identical to the one Peter created for her and the children. In addition, as the family member in charge of investments, she would like to minimize the number of investment accounts they are creating.

G. Reciprocal Trusts. If two parties create identical trusts for each other, the IRS will recharacterize the trusts and treat them as if each party created a trust for himself or herself. At the death of one of the grantors, the recharacterized trust he or she created will be included in his or her estate under Section 2036. This is known as the reciprocal trust doctrine.

1. The two-prong test for determining if reciprocal trusts were established was set forth in United States v. Grace, 395 U.S. 316 (1969). Under Grace, the doctrine applies when the following two conditions are met: (1) the trusts are "interrelated," and (2) the arrangement, to the extent of mutual value, leaves the grantors in the same economic position as they would have been in had they created the trusts for themselves. There have been numerous cases interpreting and applying the doctrine, some interpreting the tests quite narrowly, some very broadly.

2. Because the tests are subjective in nature, there is no clear line demarking when husband and wife each can create irrevocable trusts for the other without invoking the doctrine. The standard guidance is that husband and wife should not create the trusts at the same time, as part of one plan, with identical provisions for each other. To be in the best position to avoid application of the doctrine, one of the trusts should not benefit the other spouse at all. In between these two guideposts, there is a large grey area.

3. Peter and Penny Plum already have one fact in their favor – Peter already created his irrevocable trust and now Penny is considering one for the first time. The prudent approach would be not to make Peter a beneficiary of Penny's trust. If that is not possible, then Penny's trust should give Peter beneficial interests that are different from Penny's rights in Peter's trust. For example, assume Penny is a discretionary beneficiary of income and principal in Peter's trust, pursuant to an ascertainable standard. Penny's trust could do one or more of the following:

   a. Make Peter a discretionary beneficiary of income only.

   b. Allow distributions to Peter only in the discretion of an independent trustee.

c. Allow distributions to Peter only if his income or net worth falls below a certain level.

d. Limit Peter's interest to a 5 and 5 withdrawal power.

H. Consolidating Investments. Peter and Penny should consider forming a family investment entity – a limited partnership or LLC, to hold their investment assets. This would allow them to invest on a consolidated basis as they create various trusts. It also may give them an opportunity to claim valuation discounts. For example, assume that, prior to Penny creating her irrevocable trust, Peter, Penny, Peter's irrevocable trust and Peter's lifetime QTIP trust contribute a total of $10 million to an LLC. Peter and Penny are voting members of the LLC. Most of the member interests are non-voting member interests. Penny then transfers non-voting member interests to an irrevocable trust she creates. Even using a relatively modest 20% valuation discount, her $1 million gift transfers underlying net asset value of $1,250,000.

I. Personal Residences. Peter and Penny own both their homes as joint tenants with right of survivorship. As a next step in asset protective planning, the Plum's attorney suggests changing title to tenancy by the entirety. Tenancy by the entirety is a special type of joint tenancy which is only permitted between a husband and wife.

1. Under common law, a tenancy by the entirety was not severable by the husband or wife. In states which follow the common law rule, consequently, the creditor of one spouse cannot seize or obtain a lien on property held in tenancy by the entirety.

2. If Peter and Penny have a mortgage on one or both of their residences, payment of the mortgage balance would in essence convert the amount paid into a protected asset.

J. Life Insurance. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a dependent. See 735 ILCS 5/12-1001(f). Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

EXAMPLE: Penny purchases a variable life insurance policy into which she pays $500,000 over a three-year period. The policy offers investment of cash value in a selection of mutual funds. The policy is payable to Peter, otherwise trusts for their children. Under state law, this policy is protected from creditors.

K. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. See 735 ILCS § 5/12-1006. The Supreme Court ruled in Rousey v. Jacoway that rollover IRAs should be treated like ERISA plan accounts under federal law, and therefore can be claimed as exempt assets in bankruptcy. In the Bankruptcy Abuse Preservation and Consumer Protection Act of 2005, Congress provided a specific exemption for IRAs, with no dollar limitation for rollover accounts, and a $1 million limitation for other IRA account balances. 11 U.S.C. §522(d)(12). Another simple asset protection step for Peter and Penny is to take maximum advantage of opportunities to contribute to qualified retirement plans. It turns out they already have a combined $500,000 in such plans.

L. By taking the relatively straight-forward steps just described, the Plums have provided significant insulation from creditors for the following assets:

Peter's irrevocable trust	$1,000,000
Peter's lifetime QTIP trust	1,000,000
Penny's irrevocable trust	1,250,000
Primary residence	1,750,000
Colorado condominium	750,000
Penny's life insurance	500,000
Retirement assets	500,000
	$6,750,000

If the irrevocable trusts have Crummey powers, they can make annual exclusion gifts on an ongoing basis to one of the irrevocable trusts. They may find that these steps are more than sufficient to provide them with the protection they seek.

M. Determining the Right Amount of Asset Protection Planning.

1. Even if the Plums would like to do more, they may be well-advised not to. The most effective means for a creditor to attack an asset protection plan is use of the fraudulent conveyance laws. Fraudulent conveyance provisions exist under both the federal Bankruptcy Code and state law. Most states have adopted a version of the Uniform Fraudulent Conveyances Act ("UFTA"). In Illinois, it is found at 740 ILCS 160. These provisions must be considered any time one engages in any asset protection planning that involves transferring property to a third person, including the trustee of an irrevocable trust (offshore or onshore). The more one commits assets to asset protection strategies, especially ones that do not have significant purposes other than asset protection, the more likely it is that a creditor may be able to plead facts that could establish a fraudulent conveyance. Even if the Plums are "clean" they may appear not to be if they go too far.

2. Fraudulent Conveyances as to Existing Creditors. Under the UFTA, a transfer made or obligation incurred by a debtor is fraudulent as to a

creditor whose claim arose before the transfer was made or the obligation was incurred if:

a. The debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation, UFTA § 5(a); or

b. The transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent, UFTA § 5(b).

3. Fraudulent Conveyances as to Future Creditors. A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose after the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation:

a. with the actual intent to hinder, delay or defraud any creditor of the debtor, UFTA § 4(a)(1); or

b. without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business of transaction; or intended to incur, or believed or reasonably should have believed that he would incur debts beyond his ability to pay as they became due.

4. Although the UFTA does not distinguish between different classes of future creditors, courts have created a distinction between future creditors that the debtor can reasonably foresee and those that the debtor cannot reasonably foresee. Under this distinction, actual intent to defraud can exist as to the former but not as to the latter. For example, in Hurlbert v. Shackleton, 560 So.2d 1276 (Fla. 1st Dist. 1991), a Florida court held that a physician who transferred assets to his wife after his insurance policy was canceled did not have actual intent to defraud one of his existing patients because the patient was not a reasonably foreseeable creditor at the time of the transfer.

5. Determination of Actual Intent - Badges of Fraud. In determining whether a debtor had actual intent to defraud creditors and therefore made a fraudulent conveyance as to foreseeable future creditors, the so-called "badges of fraud" are to be assessed. The badges of fraud, with respect to a transfer, include:

a. The transfer was to an insider (e.g., a relative of the debtor or a corporation in which the debtor is the person in control);

b. The debtor retained possession or control of the property transferred after the transfer;

c. The transfer was not disclosed or was concealed;

d. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

e. The transfer was of substantially all the debtor's assets;

f. The debtor absconded;

g. The debtor removed or concealed assets;

h. The value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

i. The debtor was insolvent or became insolvent shortly after the transfer was made;

j. The transfer occurred shortly before or shortly after a substantial debt was incurred; and

k. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor. UFTA § 4(b).

6. Solvency. The debtor's solvency before and after a transfer is probably the most important factor in determining whether the transfer was fraudulent. Usually, absent actual intent to defraud, a transfer is not considered fraudulent if, following a transfer, the debtor retained sufficient non-exempt assets to satisfy the claims of creditors. It is for this reason that a transfer of nearly all of one's assets to an offshore trust or other asset protection devise runs an increased risk of being ineffective. The client should retain sufficient assets to remain clearly solvent.

7. Offshore Assets, Onshore Person. Some taxpayers who have established offshore trusts have discovered the hard way that moving almost all their assets offshore does not magically make creditors go away. The fundamental problem is that a U.S. resident who moves assets to an offshore trust is still personally subject to the jurisdiction of U.S. courts. As in the Florida bankruptcy case, In re Lawrence, 251 B.R. 630 (S.D. Fla. 2000), the court may have little sympathy for someone who has, in its view, "stashed" funds offshore. The same issue could arise in onshore planning.

a. On January 8, 1991, Stephen Lawrence established an offshore trust in the Jersey Channel Islands with an initial contribution of $7 million. This trust was established two months prior to the conclusion of a 42 month arbitration dispute with Bear Stearns and Company that resulted in a $20.4 million award in favor of Bear Stearns. On February 7, 1991, the trust was amended to add specific spendthrift language and to move the property to Mauritius. On January 23, 1993, the trust was amended so that the settlor's powers could not be exercised under duress or coercion and that Lawrence's life interest would terminate in the event that Lawrence became bankrupt.

b. Lawrence subsequently declared bankruptcy. On August 26, 1999, the bankruptcy court ordered Lawrence to turn over the trust assets to satisfy partially a judgment obtained by Bear Stearns. On September 8, 1999, the bankruptcy court held Lawrence in contempt for failing to turn over the assets, and ordered him to be jailed. The court said that because the trust was his own creation, the debtor could not avail himself of the impossibility defense. The court also stated that it tortured reason and abandoned common sense that Lawrence would transfer $7 million to a trust and release all control. Lawrence appealed to the district court.

c. The district court supported the bankruptcy's court's conclusion that Lawrence set up the trust for his own benefit. Moreover, it found that Lawrence effectively had dominion over the property in the trust and that the spendthrift provisions were not enforceable as a shield against creditors. It found that Lawrence's attempt to use an offshore trust contravened the clear public policy against allowing a debtor to shield money placed in a trust for his or her own benefit from creditors, defied common sense, and was undermined by language in the trust that gave Lawrence the power to remove and appoint trustees.

d. Upon review, the district court found that the order of incarceration for Lawrence should be upheld. The district court cited the Ninth Circuit's holding in Federal Trade Commission v. Affordable Media, LLC., 179 F.3d 1228 (9th Cir. 1999). Affordable Media involved an attempt by a couple, the Andersons, to hide money in an offshore trust based in the Cook Islands. Under the terms of that trust, if an event of duress occurred, the Andersons were removed as co-trustees and the Cook Island trustee was prohibited from repatriating assets. In a contempt proceeding at the District Court level, the Andersons had argued that they could not comply with the court order to repatriate the assets because to do so was impossible. The District Court was not impressed and held the

Andersons in contempt. The Ninth Circuit upheld the contempt finding.

e. In late 2006, the District Court ordered Lawrence's release since Lawrence's incarceration was no longer fulfilling its coercive purpose.

VI. Introduction to Trusts and Divorce

A. One does not plan for divorce, at least not in the same sense as one plans his or her estate by creating a Will, Revocable Trust, and other estate planning documents. The incidence of divorce may be high, but it is far from inevitable; and certainly any person's hope is that it does not happen. The distinction is subtle but important because it leads to the first important principle in planning in this area. One should not let the possibility of divorce at some unknown time in the future dictate a person's financial affairs. In other words, the divorce tail should not wag the financial dog.

1. However, steps that can be taken to protect a client's separate assets if there is a divorce, without substantially altering his or her life or financial affairs, are important to consider.

2. If divorce becomes a real possibility in a client's life or the life of a client's child, then financial and estate planning decisions should be made with the divorce implications specifically in mind.

B. The best protective steps one can take are like any other type of insurance against a possible, but not certain, detrimental event. The most effective protection must be in place before the event occurs. You cannot buy car insurance to cover an accident that already has occurred.

C. The rules governing the treatment of property in a divorce, and the actions that may be taken to affect the treatment of that property, are very state law-specific. These materials discuss both specific aspects of state law and the general legal concepts that tend to be relevant in most jurisdictions. The materials also examine the emerging differences under state law in the treatment of trusts in divorce. It is very important that any advice to a specific client be provided with the assistance of legal counsel who practices in and is familiar with the applicable state law.

VII. Dividing the Economics Upon Divorce

A. When a person goes through a divorce, his or her financial resources will be subject to division in one or all of the following three ways: (1) the couple's property will be divided between them as part of the property settlement, (2) one spouse may be obligated to make payments to the other spouse for support or

maintenance, and (3) if there is a minor child, there may be child support payments.

B. The first step in property division is to determine what is property of the marriage, to be divided between husband and wife, and what is separate property of either, usually to be retained entirely by him or her.

1. In community property states (including the marital property system in Wisconsin), the property ownership laws that exist throughout the marriage dictate the categorization.

a. For all ownership purposes, property acquired or accumulated during the marriage is treated as community property that is owned one-half by each spouse, regardless of how title is held. Specific exceptions are carved out for certain categories of property, such as property owned before the marriage and property received by one spouse by gift or inheritance.

b. Specific states may have other exceptions to the standard definitions. For example, under Texas law, separate property includes recovery for personal injuries sustained during marriage in addition to property owned before marriage and property acquired by gift or devise during marriage. Tex. Fam. Code Ann. § 3.001. Texas community property is all property acquired by either spouse during the marriage that is not separate property. *Id.* at § 3.002. Upon dissolution, a spouse can only overcome the presumption that property in a spouse's possession is community property with clear and convincing evidence of separate ownership. *Id.* at § 3.003.

2. In states that are not community property states, actual ownership governs for most property law purposes; the concept of "property of the marriage" or "marital property" is relevant only in divorce. The process of dividing property in a divorce starts with a determination of whether the property is marital property or separate (nonmarital) property.

3. The predominate statutory approach starts with a legislative preference for treating property as marital property. Many statutes define marital property as all property acquired after the marriage and before divorce, unless the property falls into one of a number of list exceptions.

4. Illinois follows this approach. Section 503(a) of the Illinois Marriage and Dissolution of Marriage Act (750 ILCS 5/503) provides:

> "(a) For purposes of this Act, "marital property" means all property acquired by either spouse subsequent to the marriage, except the following, which is known as "non-marital property":

(1) property acquired by gift, legacy or descent;

(2) property acquired in exchange for property acquired before the marriage or in exchange for property acquired by gift, legacy or descent;

(3) property acquired by a spouse after a judgment of legal separation;

(4) property excluded by valid agreement of the parties;

(5) any judgment or property obtained by judgment awarded to a spouse from the other spouse;

(6) property acquired before the marriage;

(7) the increase in value of property acquired by a method listed in paragraphs (1) through (6) of this subsection, irrespective of whether the increase results from a contribution of marital property, non-marital property, the personal effort of a spouse, or otherwise, subject to the right of reimbursement provided in subsection (c) of this Section; and

(8) income from property acquired by a method listed in paragraphs (1) through (7) of this subsection if the income is not attributable to the personal effort of a spouse."

5. New York also follows this approach. Section 236 Part B of New York's Domestic Relations Law provides:

> "c. The term 'marital property' shall mean all property acquired by either or both spouses during the marriage and before the execution of a separation agreement or the commencement of a matrimonial action, regardless of the form in which title is held, except as otherwise provided in agreement pursuant to subdivision three of this part. Marital property shall not include separate property as hereinafter defined.

d. The term separate property shall mean:

(1) property acquired before marriage or property acquired by bequest, devise, or descent, or gift from a party other than the spouse;

(2) compensation for personal injuries;

(3) property acquired in exchange for or the increase in value of separate property, except to the extent that such appreciation is due in part to the contributions or efforts of the other spouse;

(4) property described as separate property by written agreement of the parties pursuant to subdivision three of this part."

6. The presumption in favor of marital property takes precedence over the actual form of ownership. In addition, if non-marital property is transferred into co-ownership between the spouses, it then is presumed to be marital property. In Illinois, the party seeking to have property categorized as non-marital property bears the burden of proof, by clear and convincing evidence. Hofmann v. Hofmann, 94 Ill. 2d 205, 446 N.E. 2d 499 (1983).

7. Illinois also adopts an approach that does not allow property to be classified as partially marital and partially non-marital. It must be classified as entirely marital or entirely non-marital. See In re Marriage of Komnick, 84 Ill. 2d 89, 417 N.E. 2d 1305 (1981); Bentley v. Bentley, 84 Ill. 2d 97, 417 N.E. 2d 1309 (1981). The question of one estate contributing to another is dealt with by the right of reimbursement in § 503(a)(7) of the Marriage and Dissolution of Marriage Act.

8. The three most significant categories of separate, or non-marital property are (i) property acquired by gift or inheritance, (ii) property acquired before the marriage, and (iii) property acquired in exchange for such property. The key in establishing that property falls into one of these categories is keeping it separate. Because of the presumptions that exist, if the separate property is commingled with marital property, there is a strong possibility that it will be treated as marital property. See, e.g. In re Marriage of Orlando, 218 Ill. App. 3d 312, 577 N.E. 2d 1334 (1st Dist. 1991) (wife did not overcome marital property presumption when inherited property placed in joint tenancy with her husband).

C. States take a wide variety of approaches as to whether increases in the value of separate property, or income from the separate property, after the marriage will be treated as marital property. See Chorney, "Interests In Trust In Divorce: What the Settlor Giveth The Divorce Court May Taketh Way," 40th Annual Heckerling

Institute on Estate Planning (2006), for a more comprehensive review, from which some of the summaries of state law below were taken.

1. Illinois treats increase in the value of separate property as separate property. As noted above, if the increase in value is in part due to a contribution of marital property, or the personal efforts of the other spouse, a right of reimbursement may be created. However, the character of the property does not change. Income from separate property is separate property "if the income is not attributable to the personal effort of a spouse." 750 ILCS 5/503(a)(8). For example, dividend income from a business asset may be marital property if it is due to the efforts of the spouse and he is not being adequately compensated for those efforts in the form of salary.

2. New York treats appreciation from separate property as separate property. However, increases in value due to the contributions of the other spouse may be marital property. Thus, property may end up as mixed marital and separate property. See N.Y. Dom. Rel. Law §236-B1.d.

3. Florida's statute defines nonmarital assets to include "all income derived from nonmarital assets during the marriage unless the income was treated, used or relied upon by the parties as a marital asset." Fla. Stat. §61.075(6)(b). Appreciation of nonmarital assets also should be nonmarital. However, like New York, "enhancement in value and appreciation of nonmarital assets resulting from the efforts of either party during the marriage or from the contribution to or expenditure thereon of marital funds or other forms of marital assets or both" will be marital assets. Id. §61.075(6)(a)(1).

    a. Enhancement of value due to contributions of the other spouse is not limited to direct contributions to the value of the property by that spouse. Courts can take a much more expansive view.

    b. For example, if a nontitled spouse's indirect contribution as a homemaker and parent aids and makes it possible, at least in part, for a titled spouse to devote time and effort to a separate property interest, then appreciation in the interest due to the titled spouse's effort is marital property. Price v. Price, 503 N.E.2d 684, 689 (N.Y. 1986) (appreciation of husband's interest in family company was marital property where wife had raised the couple's two children, conferred with business customers, entertained husband's business associates, and attended business conventions with her husband); *cf.* Rubin v. Rubin, 105 A.D.2d 736, 739 (N.Y. App. Div. 1984) (wife in seven year childless marriage who "devoted a great deal of her time and energies during the marriage to the leisure pursuits of bridge and tennis" made no indirect contribution to husband's interest in closely held company).

c. In Dunagan v. Dunagan, 664 So. 2d 68, 68 (Fla. Dist. Ct. App. 1995), the appreciation of the husband's interest in the family business was marital property because while he worked for his father, the wife "took care of the home, the husband, and the children." Even though his father was the decision maker, the husband ran the day-to-day business and therefore his marital labor contributed to its overall success. *Id.*

d. In Oxley v. Oxley, 695 So. 2d 364, 367 (Fla. Dist. Ct. App. 1997), the appreciation on assets held in husband's revocable trust, which was established before the marriage, was not marital property. Other people's business decisions and management led to the increase in value; "the husband's only active role was deciding to maintain the trust and trustee, and to permit the trustee to take his father's and brother's advice and to continue to manage the corpus, and retained income, for his benefit." *Id.*

4. Colorado provides that increases in value and income from separate property occurring after the date of marriage or of acquisition of the property is marital property. See C.R.S. §14-10-113(4).

5. A minority of states, which includes Connecticut, Indiana, Massachusetts, and Oregon, allow the courts to determine an equitable division of all assets, including separate property, such as inherited assets. See, e.g., Conn. Gen. State Ann. §46b-81; Ind. Code Ann. §31-15-7-4; Mass. Gen. Laws Ann. Ch. 208, § 34; Or. Rev. Stat. 107.105(1)(f).

6. The variety of approaches carries over to community property states. See Reinecke, "Community Property Issues for Non-Community Property Practitioners", 28 ACTEC Journal 224 (2002).

a. Income from separate property retains its separate property character in Arizona, California, New Mexico, Nevada and Washington. Such income is community (marital) property in Idaho, Louisiana, Texas and Wisconsin.

b. California provides that each spouse retains his or her separate property, and divides community property equally. Ca. Fam. Code §2550. Washington allows an equitable division based on a global consideration of the assets, both separate and community. Wash. Rev. Code Ann. §26.09.080.

D. Even if state statutory law places limits on how property is categorized, a court often can address perceived inequities in its allocation of the marital property. Many states follow the approach of the Uniform Marriage and Divorce Act, which provides for an equitable division (not necessarily an equal division) of marital property in a divorce.

1. Section 503(d) of the Illinois Marriage and Dissolution of Marriage Act embodies this equitable division approach, and sets forth a variety of factors for the court to consider (many similar to the factors relevant in determining maintenance), including "the value of [non-marital] property assigned to each spouse; . . ." See also In re Marriage of Joynt, 375 Ill. App. 3d 817, 874 N.E. 2d 916 (3rd Dist. 2007).

2. Thus, if one spouse has significant separate property, the issue of whether the increase in value or income of that property may not be dealt with specifically; instead, the court can adjust for this factor by awarding more of the marital property to the other spouse.

E. A court will determine support or maintenance based on a variety of factors.

1. For example, the Illinois statute (750 ILCS 5/504) states:

> "(a) In a proceeding for dissolution of marriage or legal separation or declaration of invalidity of marriage, or a proceeding for maintenance following dissolution of the marriage by a court which lacked personal jurisdiction over the absent spouse, the court may grant a temporary or permanent maintenance award for either spouse in amounts and for periods of time as the court deems just, without regard to marital misconduct, in gross or for fixed or indefinite periods of time, and the maintenance may be paid from the income or property of the other spouse after consideration of all relevant factors, including:
>
> (1) the income and property of each party, including marital property apportioned and non-marital property assigned to the party seeking maintenance;
>
> (2) the needs of each party;
>
> (3) the present and future earning capacity of each party;
>
> (4) any impairment of the present and future earning capacity of the party seeking maintenance due to that party devoting time to domestic duties or having forgone or delayed education, training, employment, or career opportunities due to the marriage;
>
> (5) the time necessary to enable the party seeking maintenance to acquire appropriate education,

training, and employment, and whether that party is able to support himself or herself through appropriate employment or is the custodian of a child making it appropriate that the custodian not seek employment;

(6) the standard of living established during the marriage;

(7) the duration of the marriage;

(8) the age and the physical and emotional condition of both parties;

(9) the tax consequences of the property division upon the respective economic circumstances of the parties;

(10) contributions and services by the party seeking maintenance to the education, training, career or career potential, or license of the other spouse;

(11) any valid agreement of the parties; and

(12) any other factor that the court expressly finds to be just and equitable."

2. The Florida statute (Fla. Stat. Ann. § 61.08) states:

"(1) . . .

(2) In determining whether to award alimony or maintenance, the court shall first make a specific factual determination as to whether either party has an actual need for alimony or maintenance and whether either party has the ability to pay alimony or maintenance. If the court finds that a party has a need for alimony or maintenance and that the other party has the ability to pay alimony or maintenance, then in determining the proper type and amount of alimony or maintenance under subsections (5)-(8), the court shall consider all relevant factors, including, but not limited to:

> (a) The standard of living established during the marriage.
>
> (b) The duration of the marriage.
>
> (c) The age and the physical and emotional condition of each party.
>
> (d) The financial resources of each party, including the nonmarital and the marital assets and liabilities distributed to each.
>
> (e) The earning capacities, educational levels, vocational skills, and employability of the parties and, when applicable, the time necessary for either party to acquire sufficient education or training to enable such party to find appropriate employment.
>
> (f) The contribution of each party to the marriage, including, but not limited to, services rendered in homemaking, child care, education, and career building of the other party.
>
> (g) The responsibilities each party will have with regard to any minor children they have in common.
>
> (h) The tax treatment and consequences to both parties of any alimony award, including the designation of all or a portion of the payment as a nontaxable, nondeductible payment.
>
> (i) All sources of income available to either party, including income available to either party through investments of any asset held by that party.
>
> (j) Any other factor necessary to do equity and justice between the parties."

3. Not stated specifically, but underlying factors such as these, is the public policy that divorce not leave one spouse in significant financial distress if there are sufficient resources to avoid that. In Illinois, the policy also is to allow a former spouse to live in approximately the same standard of living the couple had during the marriage, if the payor spouse's finances permit it. See In re Marriage of Chapman, 285 Ill. App. 3d 377, 674 N.E. 2d 432 (3d Dist. 1996).

4. A goal of the Illinois Act is to satisfy the future needs of both parties primarily through the division of marital property. In re Marriage of

Brackett, 309 Ill. App. 3d 329, 722 N.E. 2d 287 (2d Dist. 1999). However, if this not possible, a court may take additional steps toward creating an equitable result through granting maintenance.

F. That obligation to support of course extends to minor children. The wealthier spouse can expect to have the major share of the obligation to support the children.

G. The categorization of property received by inheritance or gift as separate property is not dependent on the use of a trust. However, because of the presumption in favor of marital property and the rules regarding commingling and rights of reimbursement, the traditional estate planning advice to a parent in a wealthy family is that property should be left in trust for the children, in order to protect it in case of divorce. The trust serves to keep the property separate. Equally important, the trust provides a legal barrier to division because of the spendthrift protection that trusts created by a third party can provide.

1. The spendthrift concept dates back to English common law, and generally provides that a judgment creditor cannot reach property held in trust for a judgment debtor if the trust was created, in good faith, by a person other than the judgment debtor.

2. The rule is well established in the United States, see 3 Scott and Ascher on Trusts §15.2 (5th ed., 2006), although with numerous variations and special rules and exceptions that differ from state to state. Many states have enacted statutes that embody the rule. For example, the Illinois statute provides:

> "2-1403. Judgment debtor as beneficiary of trust. No court, except as otherwise provided in this Section, shall order the satisfaction of a judgment out of any property held in trust for the judgment debtor if such trust has, in good faith, been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor."

735 ILCS 5/2-1403. The exception "otherwise provided in this Section" is for collecting unpaid child support obligations.

3. State law often is reinforced by the provisions of the trust itself. A spendthrift provision in the trust agreement might state:

> "To the maximum extent permitted by law, (i) no power of appointment or power of withdrawal shall be subject to involuntary exercise, and (ii) no interest of any beneficiary shall be subject to anticipation, to claims for alimony, maintenance, or support, to voluntary transfer without the written consent of the independent trustee, or to involuntary transfer in any event."

4. Absent extraordinary circumstances, this protection will prevent a divorcing spouse from claiming trust assets to satisfy divorce obligations. Moreover, the trust property cannot be subject to division with the spouse, since the beneficiary spouse does not own it, and if it is a spendthrift trust, cannot transfer it. The trust interest is even better protected than separate property of the spouse.

5. For a wealthy family, long-term trusts for the children can provide much of the protection that otherwise would need to be accomplished through a prenuptial agreement. It is protection that a child cannot provide for himself or herself, except possibly through careful use of offshore trusts or trusts set up in domestic asset protection jurisdictions like Delaware, Alaska, or South Dakota.

H. There is no reason to abandon the traditional advice. However, it often is not as simple as telling the client that property left in trust will be fully protected in the case of a divorce. Moreover, as discussed in the following sections, the development of the law in some states has significantly weakened the protection traditionally provided by trusts.

EXAMPLE: John is 45, and has been married 15 years, with two minor children. He and his wife have about $2 million of assets, most of which they accumulated during their marriage. The assets include a limited partnership interest in an investment partnership created by John's family, held solely in his name, and acquired by John through gifts from his parents during the marriage. The LP interest has a current value, based on underlying net asset values, of $500,000. The value of the interests at the time of the gifts totaled about $300,000.

John also is a beneficiary of a "family trust" created at his mother's death 10 years ago. His father is trustee and primary beneficiary. He and his 3 siblings are also permissible beneficiaries. At the death of John's father, the trust property will be distributed in equal shares to trusts for those of John and his 3 siblings who are then living (with living descendants of any deceased child receiving their parent's share). Each child has a full withdrawal right at age 40. The trust was funded with $1 million 10 years ago and currently holds $1.4 million.

Finally, John is a beneficiary of a long-term generation-skipping trust created by his grandfather. The current beneficiaries are John's father, John and his siblings, and all of their descendants. It is currently a one-pot trust with broad spray provisions. At the death of John's father, subject to the power of appointment his father has, separate trusts will be created each of John and his siblings and their descendants. John will be co-trustee of his trust, with a corporate co-trustee. The trustees have broad discretion to make distributions among John and his descendants, The trust will last for John's life. At John's death, John has a power of

appointment that allows him to distribute the property among descendants, charities, or a trust for his spouse (remainder to descendants). Absent exercise of the power, continuing identical trusts will be created for each of John's children and their descendants. Based on current values, if John's father does not exercise his power of appointment, John's separate trust will received about $2.5 million.

John's wife files for divorce.

VIII. Treatment of Trusts in Divorce in States Like Illinois

A. Any property interests that John is deemed to have in the family trust created by John's father and the GST trust created by his grandfather would be treated as separate property in Illinois.

B. Although the trust property cannot be accessed by a divorcing spouse or the court, and while a court in Illinois probably would not ever contemplate seeking to do so, the court could take the trusts into account in the property division.

1. The trusts do represent a possible source of income for John, and, in the case of the family trust, a future expectancy of property. Therefore, they may be relevant in the division of property between John and his wife.

2. A divorcing spouse should not expect that the trusts will remain secret. Many states' laws require extensive financial disclosure in divorce proceedings. In Illinois divorce proceedings, for example, mandatory disclosure of financial information is the norm. Although the rules differ from county to county and are based on local circuit court rules, almost all circuits in Illinois have some form of mandatory disclosure.

a. In Cook County, each party is required to provide the other with a completed disclosure statement of income, expenses and assets, and with the last two years of filed tax returns. See Cook County Circuit Court Rules 13.3.1 and 13.3.2.

b. The Disclosure Statement form includes a category for trust income, and a category for "All Other Property." Courts are liberal in granting discovery requests seeking information about trusts.

C. Income is given a broad definition in Illinois. Distributions from a trust would fall into the definition, regardless of their tax or accounting categorization.

D. If the spouse who is a beneficiary was receiving regular distributions for a family trust, it is likely that a court would presume those distributions will continue, and likely would take them into account in making an equitable division of marital property or an award of maintenance.

E. It also is possible that a court might set a time for reconsideration of the amount of a maintenance award if the time period when a trust might terminate is nearer. For example, if a trust for John lasted until he turned 48, a court could decide to revisit maintenance, especially if it had struggled with an equitable division satisfactory to it at the time of divorce.

F. Less likely, but probably arising on occasion is the question of rights of reimbursement or even transmutation of the property. For example, suppose the trust held real estate that the beneficiary actively managed, but for which he or she took a nominal salary. The court might order reimbursement for this activity, because it was "marital energies" that enhanced the properties' values. The reimbursement could not occur from the trust assets. The spendthrift rules would prevent this. But the court could require the beneficiary/spouse to make it out of other assets.

G. The decision as to what constitutes an equitable division of the marital assets could necessitate consideration of the "value" of John's trust interests, which brings into play the terms of the trust including the distribution provisions and how long they will last.

H. Note also that John's wife is unlikely to attack LP interest, if it is categorized as separate property. But its existence might influence the division of marital property.

EXAMPLE: In John's divorce, the court determines John's LP interests are his separate assets, and have a value of $450,000. The marital assets are $1.6 million. John's income is deemed to include the annual distributions he receives from the LP and the family trust, about $7,000 per year total. Taking into account John's total financial resources, including the interests in the trusts, the court awards John $600,000 of the marital property and awards the remaining $1,000,000 to his wife.

IX. Treatment of Trusts in Divorce in Other Jurisdictions

A. In Illinois, the interests John has in the two trusts may impact the division of marital property or play a role in the maintenance John is required to pay. However, the trusts themselves are not directly part of the property division. This is not the case in all states. The law governing the division of property in a divorce has developed in several jurisdictions in ways that threaten the long-standing traditional protection provided by trusts.

1. In some states, courts treat trust interests as property that can be considered as part of the pool of assets to be divided.

2. There is no uniformity as to the types of trust interests that may be subject to division. In some jurisdictions, courts have determined that a remainder interest that will be distributed outright to the spouse if he or she reaches a

certain age is property subject to division. An outright remainder interest contingent only upon the remainder beneficiary surviving the income beneficiary also may fall in this category. Some courts treat any interest in the trust, current, vested or contingent, as property to be considered. See Chorney, "Interests In Trust In Divorce: What the Settlor Giveth The Divorce Court May Taketh Way," 40th Annual Heckerling Institute on Estate Planning (2006), for a thorough discussion of the legal trends.

3. The courts are not invalidating spendthrift statutes in taking these steps. In general, they do not, and cannot, order the trustee to distribute trust property or assign trust interests. Some courts also have included in the property settlement decree an obligation on the beneficiary spouse to transfer trust property to the other spouse when received.

B. As explained in the preceding section VII.C., Colorado is one state that treats the increases in value and income from separate property during the marriage as marital property. Courts in the state have taken the further step of treating interests in many trusts as property subject to division in divorce, even if the trust interest is not possessory. Several cases illustrate this trend.

1. In In re Balanson, 25 P.3d 28 (Colo. 2001), the Colorado Supreme Court held that a wife's remainder interest in a trust constituted "property" for purposes of property division in a dissolution of marriage case. Id. at 32-33.

   a. The trust was created by the wife's parents during the Balansons' marriage. The father, as the surviving grantor, was the current beneficiary, with both an income interest and a right as trustee to invade principal.

   b. The court treated the value of the trust at time of its creation as a gift to the wife during her marriage, and, under Colorado law, her separate property.

   c. The court held, however, that any appreciation on the trust property constituted marital property, which would be taken into account in determining the division of property. Id. at 40-43.

2. In In re Marriage of Dale, 87 P.3d 219 (Colo. Ct. App. 2003), the court included in the division of property a wife's interest in a trust created by her grandparents. The wife's father was the current beneficiary. At the father's death, one-half of the trust would be distributed to the wife and her three siblings. The remaining one-half would be retained in trust for the wife's mother, and then distributed to the children in the same manner at the mother's death.

   a. The trust was significant. It had a value of over $6.6 million at the time of the divorce.

b. The court treated the appreciation in the wife's interest during the marriage as marital property, and valued that interest at $313,962. The husband was awarded one-half.

c. The court further ordered that one-half of the amount awarded to husband be paid within 60 days of the father's death, and the other one-half following the mother's death. In other words, the court in effect ordered the wife to turn over part of the trust property to the husband upon receipt.

d. Note that Section 1041 of the Code, which treats transfers between spouses in connection with a divorce as non-taxable exchanges, applies only if the transfer occurs within up to six years after the cessation of the marriage. IRC § 1041(c). The transfers in this case conceivably could occur well after that, leaving the question of whether the beneficiary spouse also incurred capital gain in complying with the order if it was satisfied in kind.

C. Similar results have occurred in other states.

1. In Zuger v. Zuger, 563 N.W.2d 804 (N.D. 1997), the husband was an outright remainder beneficiary of a trust created by his father. His mother was the mandatory income beneficiary. The mother also had an annual right to withdraw the greater of 5% of trust or $5,000. The husband had three siblings who would share in the trust when it terminated.

a. The court determined that the husband's trust interest was a property interest subject to division. It decided that awarding specific dollar amount to the wife based on the possible future trust value was too uncertain.

b. The court ordered that the husband should pay the wife one-half of the husband's share of the trust when it terminated.

2. In Fox v. Fox, 592 N.W.2d 541 (N.D. 2001), the court treated an income interest of one of the spouse's as part of the marital estate. N.D. Cent. Code 14-05-24 treats all property of the couple as subject to equitable division.

3. In Davidson v. Davidson, 474 N.E.2d 1137 (Mass. App. Ct. 1985), the husband was the remainder beneficiary of a testamentary trust for the primary benefit of his mother. The trustees had broad discretion to invade the trust for the mother.

a. The court found that husband's interest in the trust was "at the outer limits" of what constituted a divisible property interest. However, notwithstanding the uncertainty over its value and the

inalienability of the interest, the court concluded it could be considered as part of the property subject to division. Id. at 1144.

b. Recall that Massachusetts is one of the states that allows an equitable division of all assets. Once that trust interest is included as "property," the entire interest (at whatever value the court determines) is subject to division.

4. Oregon, like Massachusetts and North Dakota, considers all property subject to division. In Becker v. Becker, 858 P.2d 480 (Ore Ct App. 1993), court determined that the wife's interests in several trusts were subject to division. The court awarded the husband a share of the interests in the form of a note payable in installments and a balloon payment payable when one trust ended. Id. at 480-82.

5. The court treated a vested remainder interest in a trust as marital property in Buxbaum v. Buxbaum, 692 P.2d 411 (Mont. 1984).

6. One example of terrible facts creating a bad precedent is Ruml v. Ruml, 738 N.E. 2d 1131 (Mass. App. Ct. 2000). The husband in this divorce had considerable resources, had abandoned the wife and children, and refused to participate in the divorce proceeding. The wife and children were beneficiaries of a trust husband had created, over which he held a non-general but broad power of appointment. The court awarded all of the trust property to the wife, in effect forcing the husband to exercise the power of appointment. It is unclear how the award was enforced.

X. Estate Planning Responses

A. The foregoing cases illustrate that, in several jurisdictions, trust property is not fully insulated in the case of divorce. It is important to keep this in mind even if the client does not live in one of these jurisdictions. For example, the fact that one is planning for an Arizona or Illinois client, using local situs trusts, may not matter to a court in Colorado or Massachusetts that is handling the divorce of a family member who is trust beneficiary. It is the law of the jurisdiction governing the divorce that will control (1) the categorization of property subject to division and (2) whether trust interests are considered property of the beneficiary.

EXAMPLE: John is living in Massachusetts at the time of his divorce. The court treats John's interest in the family trust as property subject to division. Because of uncertainty about possible dissipation of the trust during the life of John's father, the court orders John to pay his ex-wife one-half of the trust property he receives on termination of the trust.

B. The case law in divorce cases should lead practitioners to consider several options to provide further protection for trust interests.

1. Powers of appointment can provide several benefits in preventative planning in case of the divorce of a trust beneficiary.

2. If the current income beneficiary has a power of appointment over the trust, this may prevent the trust property from being considered in a divorce of a remainder beneficiary.

   a. In In re Balanson, 25 P.3d 28 (Colo. 2001), there was no attempt to treat any interest in a marital trust for the wife's father as marital property in the divorce, apparently because the father held a general power of appointment over the trust.

   b. In D.L. v. G.L., 811 N.E. 2d 1013 (Mass. App. Ct. 2004), the court concluded that father's testamentary power of appointment over a trust caused husband's remainder interest to be "the equivalent of an expectancy under a will." Id. at 1028.

3. The power of appointment also can be used to alter a future beneficiary's interest in response to a pending or completed divorce proceeding.

   a. For example, if John's father had a power of appointment over the family trust, he could exercise it to cause the share for John to continue in trust for John and his descendants, rather than terminate and distribute outright to John at his father's death.

   b. John's father could craft a provision that tries to directly address the impact of a divorce and any order in the divorce proceeding impacting the trust. This could be accomplished for example with a provision that would delay or cancel the otherwise designated termination date of a trust:

      "If the trustee determines that principal which is otherwise required to be distributed outright to a beneficiary could, after receipt by such beneficiary, be subject to claims of creditors, to claims for alimony, maintenance, or support, or to any involuntary transfer to a third party, whether or not such claims have been asserted or are then prospective, the trustee shall withhold such principal in accordance with this paragraph. The trustee shall retain any principal so withheld in a separate trust named for the beneficiary, and shall apply as much of the net income and principal of the trust as the trustee determines from time to time to be required for the best interests of the beneficiary, adding any undistributed net income to principal from time to time, as the trustee determines. The trustee shall make no distribution to satisfy any legal obligation of the beneficiary, including any obligation to support or educate any person. The trustee may invest the property of such trust in assets that will be held for the

beneficiary's use rather than for investment purposes, including, but not limited to, automobiles, furniture and hobby equipment, and may pay directly any costs of taxes, insurance, maintenance, repairs and necessary improvements for such assets or other property owned by the beneficiary, if the trustee determines that such use is necessary for the beneficiary's health, support, education and best interests. If the beneficiary dies before complete distribution of the trust, the trustee shall distribute the remaining principal to such one or more persons or organizations (other than the beneficiary, his or her estate and the creditors of either) as the beneficiary may appoint by will, or, in default of effective appointment, to the beneficiary's then living descendants, per stirpes."

4. A discretionary spray trust that lasts for the child's lifetime, rather than terminates upon the parent's death should not be treated as a divisible property interest. At a minimum it would be treated as having a significantly reduced value in a property division.

5. Powers to alter the trust terms also could be vested in a trust protector or other third party. For example, the trust could allow a trust protector to suspend or take away a power of withdrawal that the beneficiary has if the beneficiary gets divorced.

XI. Prenuptial Agreements

A. One of the most effective ways to protect a person's assets in a marriage is to enter into a prenuptial, or premarital, agreement. A prenuptial agreement is an agreement between the parties to be married, entered into before the marriage, that determines their respective property rights. It can control their rights in case of death, in case of divorce, or in both cases. It can apply to all property or only to certain property interests.

B. Historically, prenuptial agreements were not favored by the courts. Courts often concluded that the agreements were against public policy and void, if they waived or reduced a duty of support.

1. During that time period, it typically was a duty of the husband to support the wife after divorce; for example, in invalidating a prenuptial agreement in Warner v. Warner, 235 Ill. 448, 85 N.E. 630 (Ill. 1908), the Illinois Supreme Court said that it is the duty of a husband to support his wife and children "according to his ability and status in life."

2. In most jurisdictions, prenuptial agreements are now valid, and in fact may even be specifically sanctioned by statute (in Illinois, the Uniform Premarital Agreement Act, 750 ILCS 10/1, et seq.); however, the

historical animosity survives in the form of a judicial presumption that the agreements should be strictly and narrowly interpreted.

C. Within this context of narrow interpretation, however, a properly drafted agreement may alter or eliminate any of the rights that otherwise might exist as a result of the marriage, except one. Those rights include:

1. The right to temporary or permanent maintenance;

2. The categorization of property as marital property, or the exclusion of certain property from division upon divorce;

3. The right to claim contribution to separate property or a right of reimbursement from separate property;

4. The right to treat jointly owned property as marital property;

5. The right to a homestead exemption;

6. The right to a spouse's award, an intestate share of the estate, or to renounce a spouse's will and take an elective share; and

7. The right to act as personal representative of the estate, or to designate the person who will act.

D. The one right that generally cannot be waived or altered is the right to child support. In Illinois, for example, the Illinois Uniform Premarital Agreement Act specifically states that a prenuptial agreement may not waive child support. 750 ILCS 10/4(b).

E. The validity of a prenuptial agreement is determined under the same rules that apply to contracts generally. However, as noted above, courts are generally more willing to exercise their equitable powers over prenuptial agreements for public policy reasons. The following requirements for valid prenuptial agreements are found in most jurisdictions:

1. <u>Written and signed</u>. The agreement should be in writing and signed by both parties. Some courts have enforced an agreement against the one party who signed it, even if the other did not. However, it should never be the plan to have just one party sign.

2. <u>Voluntary</u>. Clearly, there should be no question that each party is voluntarily entering into the contract. There can be no duress or coercion. These factors can arise more frequently in prenuptial agreements than in other contracts. This is understandable given the emotional and social pressures.

a. If the agreement is presented to one spouse shortly before the wedding, and/or delivered with an ultimatum that the wedding will not happen unless the agreement is signed, the stage is set for invalidating the agreement.

b. To avoid this possibility, the agreement should be dealt with as far in advance of the wedding as possible. It should not be a afterthought.

3. Consideration. Prenuptial agreements are somewhat unique in that no special consideration in the form of money or actions is needed to make them valid. The pending marriage is sufficient consideration.

a. As a result, the lack of equality in what is being promised or given up in the agreement does not impact the adequacy of consideration.

b. Inequality may be a factor supporting invalidity on other grounds, such as duress or fairness, discussed below.

4. Fairness. Fairness is the catch-all that allows courts to exercise their equitable powers and not enforce an agreement that the court believes is fundamentally unjust. This is most likely to occur where the agreement leaves one spouse impoverished following the divorce. Courts have invalidated agreements that leave one spouse with a significantly lower standard of living than the couple enjoyed during the marriage. See, e.g. Warren v. Warren,169 Ill. App.3d 226, 523 N.E.2d 680 (5th Dist. 1988).

a. This is a critically important fact in counseling wealthy clients about premarital agreements. If they go too far in trying to protect their wealth, and do not provide some reasonable financial accommodation for the less wealthy spouse in case of divorce, they put the validity of the agreement at risk.

b. A variety of other factors may impact the fairness of the agreement, including the ages of the couple, their business and financial sophistication, and the amount of time they had to review and consider the agreement terms.

c. Under the laws of many states, it is not an absolute requirement that each party be represented by a lawyer. However, having separate legal representation for each spouse is the best way to deflect later attempts by one party to invalidate the agreement, based on claims of lack of fairness, coercion, or lack of understanding of the implications of the agreement.

5. Disclosure. One of the most important prerequisites for a prenuptial agreement is that there be full disclosure by each of the parties of their

wealth and income. It is a factor that goes to the fairness of an agreement, and in some jurisdictions, it may constitute an independent requirement.

a. The position of many courts is that a person cannot give up marital rights to property if he or she does not know the value of the rights being given up.

b. This does not necessarily mean that each spouse must provide a detailed, exhaustive list of his or her assets, although it is preferable to do so. It may be sufficient to provide general descriptions that give the other party an understanding of the nature and extent of the assets.

c. For example, for an individual with an interest in a family business, it may be sufficient to describe it as a "__% interest with an estimated value in excess of $5 million." Whether the exact value is $5 million or $10 million may not be critical. (However, if its value is $50 million, the estimate may be insufficient.)

d. If the wealthier party conceals assets of meaningful value, he or she is giving the court an excellent reason to invalidate the agreement.

e. The sophistication level of the parties, and the nature of the legal representation they receive are factors that may impact the level of disclosure required.

F. Planning Considerations

1. With prenuptial agreements, one size does not fit all. The role an agreement will play in a person's financial planning will depend on the circumstances and the nature of the relationship with the future spouse.

2. For an older couple, each with separate assets and children from a prior marriage, an agreement that keeps all assets separate and in which they each waive all spousal rights might make sense. The goal for such a couple is often to preserve each one's own property for his or her own children and to minimize financial ties between the new spouse and children. They are in full agreement that it is best to start with the presumption that their assets will be separate. They can choose to place some property in joint ownership during the marriage, but this will not impact the treatment of their other property.

3. In the same situation, but where one spouse has significantly less assets and would not be able to support himself or herself following a divorce or death, the type of agreement described above could fail. A court might invalidate it as unfair. It is better to deal with the need to provide support for the less wealthy spouse head-on, and provide very specific terms in the

agreement. That means less for the children from the first marriage, but more certainty. More certainty hopefully means less conflict.

4. Another common situation in which prenuptial agreements are used is for a young couple, first marriage, where the family of one of the couple has significant wealth.

   a. If the wealth is tied up in a family owned business, one approach is to use the agreement only to protect the family business assets.

   b. It may be that the primary goal of the agreement is to prevent the poorer spouse from claiming significant maintenance in the event of a divorce (especially after a shorter marriage) based on the much higher living standard of the wealthy family. Provisions limiting the spouse's rights at death may not be necessary because the wealthier spouse intends to treat his or her spouse in the usual way if they are married at death. Instead, trusts can be used to protect the assets for children of the marriage or that spouse's collateral relatives.

5. In a marriage of two professionals, one may be giving up a career to start a family and be the stay-at-home parent. That person may be foregoing significant financial opportunity. She or he may be in a profession where there are barriers to re-entry after a few years off. If a prenuptial agreement is used in this situation, it needs to recognize this reality. A court will, and it will make sure the stay-at-home spouse receives adequate support in the event of a divorce. If the agreement goes too far in limiting the spouse's rights, there is a risk the court may invalidate it.

XII. Post-Nuptial Planning

A. There of course are many circumstances in which a prenuptial agreement is advisable, but is not used. Even if both parties were willing to consider it, they did not make it a priority, and it was not addressed before the wedding.

B. In many jurisdictions, an agreement still can be entered into after the marriage. There are some unique factors that come into play, however.

C. The basic requirements for a post-nuptial agreement are similar to the requirements for a valid prenuptial agreement. The agreement generally should be in writing and must be entered into voluntarily, without duress or coercion. There should be full disclosure of assets. Separate legal counsel may not be mandated in every jurisdiction, but it is strongly encouraged to eliminate possible claims of unfairness or duress.

D. Unlike a prenuptial agreement, adequacy of consideration is an issue in post-nuptial agreements. The contemplated marriage is no longer available as the

consideration. The mutual release of property rights may constitute adequate consideration; however, if there is significant disparity of wealth, it may not be sufficient. To avoid any issue, it usually is advisable for the wealthier spouse to make some type of present payment to the other spouse. This may be in the form of a cash transfer, or a transfer of property into the other spouse's name.

E. The other unique issue that can arise is whether the agreement will be interpreted as made in contemplation of a divorce. If so, it may come under an entirely different set of rules applicable to court-approved divorce settlements. A discussion of this, which is another area where the law can vary from jurisdiction to jurisdiction, is beyond the scope of these materials.

F. In the absence of any agreement, a person who wishes to preserve the status of his or her separate property should be very careful to keep all such property interests separate, in his or her own name.

  1. One of the better ways to do this is to transfer separate property to a revocable trust before or soon after the marriage.

  2. It may even be advisable to name a bank or trust company or another family member as trustee or as a co-trustee. Another option is to name a co-trustee and provide that the grantor can amend or revoke the trust only with the consent of another family member.

  3. These steps will help ensure that the person's separate property is not unintentionally mixed with separate property.

  4. The trust then needs to be administered in light of state law concerning appreciation and income from the property. If state law would treat the income as marital property, then it should be distributed out of the trust and kept separate from the underlying separate property.

G. If one of the assets of separate property is an interest in a family business in which the spouse is active, it might be best to keep this interest separate from passive investment assets that are separate property. The trustee also may want to obtain an appraisal of the business to establish a value before the spouse's efforts on the behalf of the business during the marriage start. This all is designed to keep a certain amount of value as separate property, if a court later finds that appreciation in the business is a marital asset. This will help ensure that interests are not unintentionally mixed with marital property.

XIII. <u>Specific Estate Planning Changes and Specific Assets</u>

A. Once it becomes clear that an individual is heading toward divorce, he or she should have his or her estate plan reviewed and, most likely, modified.

B. In most states, a spouse named in a Will automatically is deemed to have predeceased the testator once a divorce decree is entered. Some states have statutes that apply the same rule to revocable trusts. For example, Illinois law provides that "[u]nless the governing instrument or the judgment of judicial termination of the marriage expressly provides otherwise, judicial termination of the marriage of the settler of a trust revokes every provision which is revocable by the settlor pertaining to the settlor's former spouse in a trust instrument or amendment thereto..." 760 ILCS 35/1.

C. The same rule generally does not apply to an irrevocable trust, such as an irrevocable life insurance trust. In that case, the terms of the trust should explicitly be made part of the settlement negotiations or court proceedings. The settlor of the trust will want to make sure that the former spouse's interests in the trust are taken into account in the division of property.

1. The former spouse could renounce his or her interests in the trust in exchange for other property interests as part of the settlement.

2. The settlor may want the spouse to agree to resign as trustee of irrevocable trusts as part of the settlement agreement.

D. While the parties are separated, but before the divorce becomes final, a wealthier spouse's ability to modify the estate plan may be more limited.

1. He or she can amend the Will or Trust to remove the other spouse as a fiduciary.

2. The wealthier spouse also can modify the estate plan, which often makes the spouse the primary beneficiary. In most states, however, the wealthier spouse probably will not be able to completely eliminate the other spouse's interests before the divorce is final.

a. Even if the couple is separated, each spouse still has the right to elect against the Will.

b. The majority of states have adopted the augmented estate approach for the spousal election, so the wealthier spouse may not have any ability to shelter assets from the election right.

c. Nevertheless the individual may want to write the spouse completely out of the estate plan, and force that spouse to exercise the renunciatory rights if the individual dies before the divorce is final.

E. A spouse with an IRA can remove the separated spouse as a beneficiary. However, spousal consent is needed to change the beneficiary under an ERISA-qualified plan. A spouse with life insurance can remove the separated spouse as a

beneficiary. For both life insurance and an IRA, the augmented estate rules may impact the effectiveness of these steps.

F. Each party also probably will want to consider executing new powers of attorney for property and health care, to name someone other than the spouse as agent.

G. Retirement Assets

1. The division of retirement assets can be a contentious issue in divorce. In general, value attributable to funds in a qualified plan or IRA before the marriage remains separate property, but contributions during the marriage, and the appreciation thereon usually are treated as marital assets. There can be significant disputes over determining those proportions. There also can be valuation issues in determining the value of future pension rights or unvested benefits.

2. At the same time, a significant interest in a separate account plan or IRA often is a useful asset for satisfying one spouse's obligations to the other. The division can be accomplished tax-free, with the former spouse receiving a separate account, or rolling the proceeds over into his or her own IRA. The former spouse then assumes the tax obligation as funds are withdrawn.

3. A tax-free division of a retirement plan or IRA must be accomplished through a Qualified Domestic Relations Order (QDRO). The Code defines a QDRO as a domestic relations order

> "(i) which creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan...."

and which meets additional detailed requirements set forth in the Code and the regulations. IRC § 414(p).

a. The "alternate payee" is most often the spouse; however, it can be a child or other dependent. IRC § 414(p)(9).

b. The order cannot alter the form or timing of payment of the benefits. For example, it cannot require distribution of benefits that are not yet distributable under the plan.

H. Non-qualified stock options and deferred compensation

1. A transfer of a non-qualified stock option or deferred compensation rights to a former spouse in connection with a divorce is excepted from the general rule requiring the employee to recognize income upon a transfer.

2. When the former spouse exercises the option, or receives the deferred compensation, he or she will recognize income, not the employee spouse. See Rev. Rul. 2002-22, 2002-1 C.B. 849.

XIV. Special Planning Considerations For Business Owners

A. In the family business situation, the owner who may face divorce can have any number of roles in the business. He or she may be the founder of the business, or a child or grandchild who is a principal in the business, or a family member who is a passive owner. It may be that both spouses are active in the business. In each situation, the impact of divorce on the business will be different.

B. The issue of whether some of the value of a business should be treated as marital property is a complex one. As noted previously, even if the ownership interests in the business are the separate property of one spouse initially, increases in value during the marriage might create a right if reimbursement or convert some of the value to marital property if due to the efforts of one or both of the spouses. In a business, this can occur in a number of ways.

1. The spouse may assert that she or he supported the other spouse's business activities, through entertainment or otherwise, and that her or his role as the primary parent and manager of the household allowed the spouse to devote more time to increasing the business value.

2. The spouse could argue that the business unreasonably accumulated earnings in lieu of paying the owner-spouse a salary commensurate with his or her contributions.

3. Or, the non-owner spouse actually may have participated in the business and not been adequately compensated.

C. These issues often can be deflected if the owner-spouse is adequately compensated for his or her efforts devoted to the business. The compensation will be marital property even if the business is one spouse's separate property, and it can be adequate renumeration for the efforts of both spouses in supporting the business.

D. Prenuptial agreements can be especially effective in protecting interests in a family business. A prenuptial agreement can be used to carve out the business interests, and all appreciation of those interests, as separate property. This avoids having to deal with issues of contribution, compensation, and valuation in the property settlement.

1. If the primary goal is to make sure that the business interests stay in the family in the event of a divorce, then consideration should be given to limiting the agreement to accomplishing that one goal.

2. Too often, the owner of the interest, or others in the family, also try to keep all distributions from the business as separate property, or greatly limit the spouse's rights to other property in case of death or divorce. This can detract from the primary goal. If the agreement tries to do too much, there is a risk that a court might invalidate it.

3. By contrast, a single purpose prenuptial agreement, designed to keep the stock in the family business as separate property, but otherwise not altering the spouses' rights with respect to other property, should not be easily challenged.

E. If the business is part of the property being divided by the court, then the valuation of the business is likely to be at issue. This can add significantly to the cost of the divorce. Each side will need experts to value the business, and the lawyers will spend significantly more time preparing the experts and understanding their opinions.

F. Although a business can add to the complexity of a divorce, the business interests also can be used in a positive way to settle property and maintenance obligations.

1. If the divorcing spouse will be awarded some stock, the company can create a class of non-voting stock for that purpose. Call features could be added to allow the company to liquidate the spouses' interest at a future date. Or, the company could issue debt to the spouse.

2. If the owner-spouse will have significant ongoing financial obligations to the other spouse, it may be possible to use a debenture issued by the company, or preferred stock, to fund those obligations.

3. If the business has an ESOP, it could be used to purchase the interests of a spouse who acquired stock in the divorce.

G. It is not uncommon for the non-family member spouse to be employed by the family business. For example, the father might employ son-in-law in the business. When daughter and son-in-law separate, a natural initial reaction is to fire son-in-law. This may not be a wise move. Many business owners have found that it is best to retain the divorcing spouse as an employee, especially where he or she is working in a key capacity. It not only is better for the business, but it gives that spouse a steady income that may help in the financial settlement in connection with the divorce.

H. Of course, some divorces degenerate into events worse than firing a soon to be ex-son-in-law. One author reported the story of a California man who sought a divorce from his wife but was desperate to avoid having her receive an interest in his $10 million company. He decided the solution was to hire a hit man to kill his wife. Unfortunately for the husband (and fortunately for the wife), the hit man was an undercover San Jose police officer. The man didn't have as much use for

the business after he was convicted of solicitation to murder. Roger Fritz, Wars of Succession, 231 (1997).

XV. Conclusion

A. Any individual favors the simple solution, and estate planning clients are no different than anyone else in that regard. Certainly any estate planning professional should endeavor to craft an estate plan that is not unnecessarily complex.

B. Part of an attorney's duty is to educate the client on alternatives available and the implications of those alternatives. That duty includes the obligation to be forthright with the client in explaining that some problems or issues cannot be fully addressed with one simple solution.

C. Asset protection is one of those issues for which there is not one simple solution. For a client who wants to take steps to help preserve assets in case of future claims or a divorce, the professional's job is to both craft solutions that the client can live with and educate the client on the limitations of those solutions.

ADMINISTERING CONCENTRATED STOCK POSITIONS IN TRUSTS

I. The Tension Between Concentrated Stock Positions and Diversification

"Go for a business that any idiot can run – because sooner or later, any idiot is probably going to run it."

-Peter Lynch

"Wide diversification is only required when investors do not understand what they are doing."

-Warren Buffet

A. One of the most vexing investment challenges for a trustee is how to handle a concentrated position in a single stock. The situation can arise in the context of a decedent or settlor who leaves a large stock position in trust without specific directions, or where the decedent or settlor has included trust terms addressing retention of a particular stock.

1. The retention of a concentrated stock position flies directly in the face of the Prudent Investor Rule's duty to diversify.

2. However, where the decedent or settlor has left directions regarding retention of the stock, the trustee must balance the duty to diversify with the duty to carry out the settlor's intent.

B. The mandate to diversify is an integral part of the Prudent Investor Rule, found in the Restatement Third of Trusts, issued by the American Law Institute in 1990, and the Uniform Prudent Investor Act, issued by the National Conference of Commissioners on Uniform State Laws in 1994.

1. The Restatement is not law. It is intended to reflect the emerging legal trends in many jurisdictions and act as a guide for further development of the law consistent with those trends.

2. 45 states have adopted the Prudent Investor Rule in some form or another. 38 states and the District of Columbia have adopted the Uniform Prudent Investor Act while 7 states have adopted the provisions of the Third Restatement.

C. The Prudent Investor Rule affords more latitude for exercise of discretion and judgment by trustees than was permitted under the former rule. In addition, the Prudent Investor Rule focuses on the trust's portfolio as a whole and the investment strategy on which that portfolio is based, instead of evaluating the propriety of specific investments in isolation. The Prudent Investor Rule incorporates principles of modern portfolio theory, including the relationship of risk to return on investment and the risk to return posed by inflation.

D. The Third Restatement's Prudent Investor Rule requires trustees to invest and manage trust funds as prudent investors would under the circumstances and in light of the purposes of the trust. The Prudent Investor Rule incorporates five "Principles of Prudence." These are:

1. Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer;

2. **Diversification is fundamental to risk management and is ordinarily required of trustees;**

3. The fiduciary duty of impartiality requires a balancing of the elements of return between production of current income and the protection of purchasing power against the effects of inflation;

4. Trustees have a duty to avoid fees, transaction costs and other expenses that are not justified by needs and realistic objectives of the trust's investment program; and

5. Trustees may have a duty, as well as having the authority, to delegate investment decisions to third parties as prudent investors would.

(Introduction to Third Restatement, emphasis added).

E. The following concepts are necessary to an understanding of the Prudent Investor Rule's requirement of risk management and diversification.

1. Total Return.

The price of an asset is affected by (1) the anticipated return, and (2) the risk that the return will fall short of the anticipation. The anticipated return includes not only cash flow from interest or dividends, but also the expected appreciation in market price. Therefore, return means total return from both ordinary income and capital gains. (See Martin, "A Preface to the Prudent Investor Rule," Trusts & Estates, November, 1993).

2. Market Risk or Compensated Risk.

Market risk affects all investments of a particular type. All common stocks are affected by the risk of a rise or fall generally in the stock market. Similarly, commercial rental real estate has a risk element attributable to the type of investment. This form of risk is taken into account in the pricing of an asset (i.e. it is compensated risk because it is reflected in the price of the asset). It is quantified in the equity security markets under the so-called "beta" ratings. The stock market as a whole is given a beta of 1. Individual stocks are given beta ratings to indicate the

range within which they are likely to move as the stock market generally rises or falls. (Id.)

EXAMPLE: A stock with a beta of 2 would rise and fall twice as much as the market generally; a stock with a beta of .5 would rise and fall only 50% as much as the market generally. The former stock has a much greater compensated risk than the latter.

3. Specific Risk or Uncompensated Risk.

Specific risk is the possibility that events may adversely affect one asset or group of assets without affecting other assets of the same type of investment in the same degree or in the same manner. The market does not compensate the buyer for specific risk. The price of an asset offers no protection against specific risk. (Id.)

EXAMPLE: Adverse weather and destructive storms cause high losses for insurance companies and therefore reduce their stock price. The same event results in large profits for manufacturers of building materials causing the price of those stocks to increase.

4. Diversification.

Since the uncompensated risk is the uneven effect that events may have on different assets, protection can be obtained by trying to purchase assets that will or are likely to react to external events in different ways. Assets that may react negatively need to be balanced by assets that are likely to react positively. The purpose of this type of diversification is not to acquire a greater number of assets, but to acquire assets whose responses to potential events or influences will somewhat offset each other. (Id.)

EXAMPLE: A trustee invests in the stock of chemical, automotive, and airline companies. Although the trustee may have selected an appropriate level of market risk for the trust assets, the trustee has failed to minimize uncompensated risks through diversification because all the stocks held by the trust are similarly sensitive to fluctuations in the price of oil.

5. Efficiency of Markets and Passive Investment Strategy.

a. The Third Restatement, or at least its Reporter, Professor Edward Halbach, accepts the proposition that the major capital markets in the United States are highly efficient. They process and disseminate information very rapidly; as soon as information is available, it is communicated to all investors. Therefore, the market price of publicly traded securities reflects the new information almost immediately. "As a result, fiduciaries and other investors are confronted with potent evidence that the application of expertise, investigation, and diligence in efforts to

'beat the market' in these publicly traded securities ordinarily promises little or no payoff, or even a negative payoff after taking account of research and transaction costs." (§ 227, Reporter's General Note on Comments *e* through *h*).

b. In other words, if one assumes that the market is perfectly efficient, then there are no underpriced stocks. The price of each stock is a correct price because all information is known and fully reflected in that price. If there are no underpriced stocks, it doesn't make any sense to spend money to look for them. In this situation, a passive investment strategy, such as buying an index fund that reflects the market as a whole, pays off. Achieving diversification through investment in mutual funds may also reduce a trustee's chances of violating its duty to minimize investment costs. While expressing a preference of passive investment strategies, the Third Restatement recognizes that more active strategies are appropriate under some circumstances.

EXAMPLE: Because venture capital and real estate markets are less efficient than the securities markets, "expert analysis is essential to those trustees who seek to exploit opportunities in [those markets]." (§ 227, Reporter's General Note on Comments *e* through *h*).

c. While the Restatement does not reject active investment management in the securities markets, the views expressed in the Reporter's Notes and the comments are in conflict with the philosophy behind most of the investment management industry and, to a lesser degree, with the investment strategy of many fiduciaries.

F. Diversification is fundamental to the management of specific or uncompensated risk and is *ordinarily required of trustees*. The Prudent Investor Rule states: "In making and implementing investment decision, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." (§ 227(b)). This principle from the Restatement is directly incorporated into many state statutes. See, e.g., Illinois Trusts and Trustees Act, 760 ILCS 5/5(a)(3).

1. The duty to diversify applies unless the duties of prudent risk management and of impartiality can be satisfied without diversifying, or special circumstances make diversification undesirable. (§ 227, Comment *g*). The Restatement recognizes a number of circumstances that might justify forgoing or delaying diversification:

a. Retention of appreciated assets used originally to fund the trust to defer recognition of capital gain;

b. Inability to realize full value of trust property in a sale (for instance, because of market conditions); or

c. The trust property bears special relation to settlor's objectives (stock in a family business).

2. The duty to diversify is not based only on the trustee's duty of caution (the duty not to take risks greater than those suitable to the trust's purposes), but is predicated on the duty to exercise care and skill and to minimize uncompensated risk.

3. There is no defined set of asset categories to be considered by trustees. Nor does a trustee's general duty to diversify assume that all basic categories of assets are to be represented in each portfolio. In general, the Restatement takes the position that passive investment strategies, such as investing in mutual funds, provide greater diversification at less cost than selecting individual securities in a combination that reduces specific risk. (§ 227, Comment *h*).

G. Of course, the settlor's specific expressed intent as reflected in the trust agreement supersedes almost any duty that may exist at common law or by statute, including the duty to diversify. If the settlor directs the trustee not to diversify, or authorizes the trustee to retain a concentrated stock position, that direction by the settlor is the starting point of any analysis of the trustee's actions.

H. The challenge is that a decedent's or settlor's direction usually is not absolute. In most cases, the trustee is not directed to retain the stock in all events. Nor is the trustee relieved of the power to sell the stock. The trustee must determine its obligations in light of a permissive direction.

II. Impact on Traditional Trustee Duties

A. A trustee is under a duty to act for the benefit of the trust estate and its beneficiaries. A list of a trustee's traditional duties as defined by common law would include the following:

1. The duty to administer the trust,

2. The duty of loyalty,

3. The duty not to delegate the administration of the trust,

4. The duty to furnish information to the beneficiaries,

5. The duty to exercise reasonable care and skill in selecting trust investments,

6. The duty to take and keep control of trust property,

7. The duty to preserve the trust property for the benefit of the beneficiaries,

8. The duty to make the trust property productive, and

9. The duty to deal impartially with beneficiaries.

B. The Prudent Investor Rule and its specific duties regarding investments impact these traditional duties only slightly.

1. The primary impact is on duty #3, the duty not to delegate, and its ancillary impact on duty #5. The Prudent Investor Rule promotes delegation for investment purposes in many circumstances, and, in that context, applies the trustee's duty to exercise reasonable care and skill to the selection of investment managers, instead of the selection of investments.

2. The Prudent Investor Rule reinforces the duty of impartiality, commenting on how to achieve that from an investment standpoint.

3. The Rule also arguably expands the meaning of the duty to preserve trust property by emphasizing that the duty includes preservation of the real value of the property in light of inflation.

III. Case Law on Retention of Concentrated Stock Positions

A. A review of recent case law provides ample evidence of the consequences of failure to balance the trustee's duties with the settlor's implied or expressed intent regarding a concentrated stock position.

B. Matter of Dumont,[1] Trustee sued for retention of Eastman Kodak stock.

1. In his will, Charles G. Dumont directed that the residue of his estate be retained in trust for the benefit of his daughter and her descendants. At the death of the descendants, the remaining property was to pass to designated charities. The trust was funded in 1958 almost entirely with shares of Eastman Kodak Company. The final paragraph of the will specifically discussed the retention of the Kodak stock:

"It is my desire and hope that [the Kodak stock] will be held by my said Executors and by my said trustee to be distributed to the ultimate beneficiaries under this Will, and neither my Executors nor my said trustee shall dispose of such stock for the purpose of diversification of investment and neither they or it shall be held liable for any diminution in the value of such stock."

[1] 26 A.D.3d 824, 809 N.Y.S.2d 360, 2006 N.Y. Slip Op. 866 (2006).

2. In a subsequent provision, which became the focus of the litigation, the will also included an exception to the retention provision, as follows:

   "The foregoing provisions shall not prevent my said Executors or my said Trustee from disposing of all or part of the stock in Eastman Kodak Company in case there shall be some compelling reason other than diversification of investment for doing so."

3. In 1997, an attorney for Mr. Dumont's grandchild (who was at that time the sole income beneficiary of the trust following her mother's death) approached the Bank regarding the potential sale of the Kodak stock. An agreement between all parties to sell the Kodak stock was pursued but never finalized. In 1997, following a request by the income beneficiary's lawyer to do so, the trust officers (for the first time) requested an in-house legal opinion regarding the terms of the trust and the construction of the exception clause. Although the trust officers promptly received a legal analysis, the trust officers took no action regarding the sale of the Kodak stock and the matter was dropped.

4. A few months later, a compulsory accounting proceeding was brought by the income beneficiary and her sole living child (the presumptive remainderman) seeking damages in excess of $39 million because of the Bank's alleged improper retention of an almost 100 percent concentration of Kodak stock and overall mismanagement of the trust.

5. In December 2001, the Bank determined that a compelling reason existed to sell the Kodak stock based on Kodak's lack of a presence in the digital market. The Bank recommended sale of 95 percent of the Kodak stock spread over three tax years to minimize the substantial capital gains tax, but the actual sale of the Kodak stock was expedited and took place over nine months.

6. The income beneficiary's sole living child died in 2002, during the litigation, at which time the three charities that were the takers in default under the Will (the University of Rochester, Rochester Institute of Technology, and the American National Red Cross) became the presumptive remaindermen and joined the suit (along with the New York Attorney General).

7. In the lower court opinion,[2] the Surrogate extensively criticized the Bank's conduct in support of its conclusion that the Bank had breached its fiduciary duty, including:

[2] Dumont, 4 Misc. 3d 1003(A), 791 N.Y.S.2d 868, 2004 N.Y. Slip Op. 50647U (2004).

- Failure to obtain a legal opinion (or a judicial decision) on the interpretation of the will, and failure to have a uniform interpretation of the will followed by the succession of trust officers responsible for the trust.

- Lack of documentation of the investment strategy for the trust or the performance of the Kodak stock.

- Inexperience of trust officers assigned to the account.

- Lack of meaningful investment review and oversight beyond a "rubber stamp" process.

- Lack of "triggers" in place for review of Kodak stock in the event of significant declines in stock values.

- Inadequate communication with and disclosure to beneficiaries.

- In a footnote, the Surrogate criticized the Bank for routinely using payment of its own fees as a compelling reason to sell the Kodak stock to generate funds to pay the fees.

8. The Surrogate concluded that despite the finding of breach of duty, under the terms of the will, there could be no liability by the Bank unless there had been a "compelling reason" to sell the Kodak stock other than diversification, thereby triggering the exception to Mr. Dumont's direction to retain the Kodak stock. The Surrogate rejected the Bank's argument that any sale would result in diversification prohibited under the will, and drew a distinction between diversification and a sale to preserve the trust corpus and to remedy a suffered loss (even though such a sale could result in diversification). The Surrogate defined a "compelling reason" as:

   "[A]ny factor which should indicate to the fiduciary that the interest of any beneficiary is not being reasonably maintained or protected by the trust, or that the interest of any beneficiary would not continue to be reasonably maintained or protected by the trust, if the trustee were to continue to retain the stock."

9. The Surrogate rejected the beneficiary's position that the large concentration of Kodak stock itself was a compelling reason to sell the stock, citing Mr. Dumont's family history and affection for Kodak, and that such an interpretation would render the retention clause in the will meaningless. The Surrogate also rejected the beneficiary's attempt to preclude the Bank by estoppel from arguing that the retention of the Kodak stock was prudent, citing a prior decision against the Bank finding

that the Bank as executor of another estate should have sold a large concentration of Kodak stock on or before August 1, 1973.[3]

10. The Surrogate concluded that a compelling reason did not exist to sell the Kodak stock on January 31, 1973, in light of the retention clause and the high value of the stock. The Surrogate, however, concluded that a compelling reason existed to sell the Kodak stock on January 31, 1974 because of (1) absence of previous praise for Kodak in the January 11, 1974 independent investment report and (2) declines in stock value throughout 1973.

11. The Surrogate also found that the low income yield of the Kodak stock created a compelling reason to sell the stock. The Surrogate disagreed with the Bank's argument that the low income did not create a compelling reason in light of the beneficiary's significant other assets and income, stating that "[t]he law protects the wealthy no less than the poor" and that the "duty to produce reasonable income is a duty to the trust itself, not the income beneficiary." The Surrogate stated that the low yield should have triggered a more thorough review of the Kodak stock, which did not occur.

12. The Surrogate held that the Bank should have sold 95 percent of the Kodak stock on or before January 31, 1974. After factoring in capital gains taxes, dividends received by the beneficiaries, statutory compounded interest, and the actual sales proceeds of the Kodak stock when sold in 2001, the Court surcharged the Bank for just under $21 Million, and also ordered the Bank to forfeit its commissions, with interest, for a total surcharge of over $24 Million.

13. The Bank appealed the decision to the Fourth Department, Appellate Division of the New York Supreme Court. In a unanimous memorandum opinion issued on February 3, 2006, the Appellate Division reversed the decision of the Surrogate's Court.

14. The Appellate Division affirmed the Surrogate's rejection of the claim that a compelling reason existed to sell the Kodak stock on January 31, 1973 based on low income yield combined with the risk to the remainder beneficiaries from the concentration of the stock itself. The Appellate Division, however, held that the Surrogate erred by going beyond the beneficiary's objections to determine that a compelling reason existed to sell the stock on January 31, 1974 on the basis that (1) the date was not pled by the beneficiaries in their objections and (2) the court's basis for the decision was not pled by the beneficiaries. The Appellate Division cited prior case law for the principle that "[a] surcharge may not be predicated on a ground neither alleged nor proved."

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[3] Janes, 165 Misc. 2d 743, 630 N.Y.S. 2d 472 (1995).

15. The Appellate Division then proceeded, in what might be characterized as *dictum*, to conclude that (even if the issue were properly before the Surrogate) there was no evidence that the Bank acted imprudently in failing to sell the Kodak stock based on price reductions of the stock, stating that "the Surrogate's determination that the trustee should have sold the stock on January 31, 1974 is impermissibly based on nothing more than hindsight."

16. The Appellate Division noted the history of success of the stock, favorable Valuline reports, and the retention clause in support of its conclusion, and rejected the Surrogate's reliance on there being "less praise" on the 1974 Valuline report. The Appellate Division also flatly rejected the Surrogate's reliance on the low income yield as a basis for finding a compelling reason to sell the Kodak stock, stating that:

    "The dispositive test is whether the income was reasonable in view of the needs and interests of the income beneficiary…and not whether a certain percentage yield was being met. The income yield of a stock is not determinative, nor indeed is it relevant to, the determination of reasonable income. Rather, the determinative factor is the amount of income paid to the income beneficiary viewed in light of her overall financial circumstances."

17. Accordingly, the Appellate Division reversed the entire order of the Surrogate surcharging the Bank. Interestingly, the Appellate Division did not address the multiple criticisms of the Bank's conduct and procedures (or lack thereof) during the administration of the trust. New York's highest court, the Court of Appeals, denied the motions for leave to appeal the decision of the Appellate Division.[4] The Appellate Division's rebuke of the Surrogate on the merits is not essential to the decision (the procedural failings dispose of the entire matter), and a future court may be tempted to discount the balance of the decision as *dictum*.

C. In Wood v. U.S. Bank, N.A.,[5] the Trustee was sued for failure to diversify out of a significant holding of First Star stock

    1. John Wood II, a prominent Cincinnati attorney whom the court mentions had "estate-planning experience," created a trust worth over $8 million, naming his wife as a beneficiary. During his lifetime, Wood served as trustee, naming Star Bank (which later became U.S. Bank) as successor trustee. FirstStar stock constituted nearly 80 percent of the assets of the trust. FirstStar was the successor to Star Bank before its U.S. Bank incarnation. The remainder consisted of predominantly stock in

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[4] Dumont, 7 N.Y.3d 824, 855 N.E.2d 1167 (September 12, 2006).

[5] 828 N.E.2d 1072 (Oh. Ct. App. 2005).

Cincinnati Financial Corporation. Though the court did not provide the provision in its entirely, a relevant section of the trust document specifically gave the trustee the power:

"[t]o retain any securities in the same form as when received, including shares of a corporate Trustee, even though all of such securities are not of the class of investments a trustee may be permitted by law to make and to hold cash uninvested as they deem advisable or proper."

2. Relying on that provision, the trustee did not endeavor to diversify the trust assets. In fact, shortly after the grantor's death, when the trust officers met with the beneficiaries to discuss selling some of the stock to pay the debts and expenses of the estate (pursuant to the grantor's direction), they recommended sale of two-thirds of the *minor* stock position (Cincinnati Financial stock), and only ten percent of the Firstar stock. This was premised on the Firstar stock's "strong earnings momentum." As the court noted, the plan was actually one of "reverse diversification," raising the percentage of total assets in Firstar stock to 86%.

3. The court in Wood listed 7 factors a trustee should consider in diversifying: 1) the purposes of the trust; 2) the amount of the trust estate; 3) financial and industrial conditions; 4) the type of investment, whether mortgages, bonds, or shares of stock; 5) distribution as to geographical location; 6) distribution as to industries; 7) the dates of maturity.

4. Interestingly, Firstar stock did substantially increase in value, rising from $21 per share in October 1998 to nearly $35 per share in early 1999 due to the bank's merger. In April of 1999, the court noted that the beneficiaries requested that the trustee sell some of the stock and diversify, though the requests were not in written form. No stock was sold by the trustee as a result of the requests.

5. In the middle of 1999, Firstar's stock price plummeted. By mid-2000, it was valued at $16 per share. Around this time Firstar decided to make the final distribution to the beneficiaries. Expert testimony approximated that the failure to diversify cost the plaintiff $771,099.

6. In analyzing the trust document, the court concluded that the language was "unambiguous." It granted the trustee the power to retain its own stock even though it ordinarily wouldn't have been permitted to do so. However, the court stated that the retention clause "merely served to circumvent the rule of undivided loyalty. The trust did not say anything about diversification." Moreover, the court noted that the retention clause "smacked of the standard boilerplate that was intended merely to circumvent the rule of undivided loyalty, no more, no less." As the court

noted, broad or general authorizations are not enough to relieve the trustee of her duty to diversify.

7. While the court noted that there were indeed factors that justified retaining the stock (specifically, the significant tax consequences), the court stated that after the grantor's death, such justifications were absent. In construing the grantor's intent in the trust document, the court opined that had he wanted to circumvent the diversification requirement, he could have said so. Thus the court explicitly held that "*the language of a trust does not alter a trustee's duty to diversify unless the instrument creating the trust clearly indicates an intention to do so.*" (emphasis added) In order to abrogate the duty to diversify, a trust document must contain "specific language authorizing or directing the trustee to retain in a specific investment a larger percentage of the trust assets than would normally be prudent."

8. Nevertheless, the court did identify a single exception to the statutory duty to diversify: as the statute itself provides, a trustee is relieved of the duty when the trustee "reasonably" determines that there are "special circumstances" for retaining the assets. The only way for Firstar to have been relieved of its duty to diversify, the court reasoned, was to have identified special circumstances which after the grantor's death justified retaining the stock. As the court noted, such "special circumstances" generally refer to "holdings that are important to a family or a trust," such as a family farm or a closely-held corporation.

D. May and Emanuel Rosenfeld Foundation Trust.[6] Individual co-trustees surcharged over $1 million in for failure to diversify Pep Boys stock.

1. Emanuel Rosenfeld, the founder of Pep Boys, created a perpetual charitable trust in 1952. Mr. Rosenfeld's son Lester, his daughter Rita, Lester's son Robert, and Wachovia Bank (and its corporate predecessors) were serving as co-trustees. Lester worked for Pep Boys his entire life. He served as vice president of the company until his retirement and thereafter was a consultant to the company and a member of the board, eventually moving to emeritus status.

2. Rita began pressuring for the diversification of the Pep Boys stock in 1997. Around the same time, the bank attempted unsuccessfully to arrange a meeting with the co-trustees to discuss diversification. Rita and the bank favored the sale of the stock, and Lester and Robert opposed it. Lester and Robert refused to participate in conference calls to discuss the sale. In September 1997, the bank sent a letter to the co-trustees expressing concern about the poor performance of the stock compared to

[6] 2006 WL 3040020, 29 Fiduc. Rep. 2d 271 (Pa. Com. Pl. July 31, 2006).

the S&P 500 and recommended reducing the stock concentration to below 10 percent. Lester refused to consider a sale, despite information he received as a director about the company's difficulties and declining performance. Notwithstanding his conflict as a member of the board, Lester refused to abstain on the issue of the sale of the stock and refused to sell the Pep Boys stock "at any time."

3. In 1999, the bank again recommended diversification and requested that the co-trustees indemnify the bank with respect to the stock concentration. None of the co-trustees agreed to the indemnification. By a subsequent letter, the bank stated that it was imprudent for the trustees to hold the stock concentration. Lester responded to the bank's letter by suggesting that the bank resign as co-trustee. The bank continued to actively monitor the stock. Robert was only passively involved as co-trustee and refused to disagree with his father because of his concern about being disinherited.

4. Lester and Robert finally agreed to sell some of the stock in 2001, at which time the stock had significantly declined in value. In 2002, Rita sued the co-trustees seeking surcharge based on the failure to diversify the trust's 100 percent concentration of Pep Boys stock. All three co-trustees moved for summary judgment. Summary judgment was granted in favor of Wachovia Bank only.

5. Following trial of the matter, the trial court found that Lester and Robert had breached their fiduciary duties as co-trustees for their refusal to work with Rita and the bank concerning trust investments. The court held that the stock retention clause did not protect Lester and Robert from liability because a majority of the co-trustees had not approved the retention of the stock. The trial court awarded damages against Lester and Robert in the amount of $593,546, calculated from the date that Rita and the bank voiced their objection to the retention of the stock. The trial court approved the reasonableness of the bank's attorneys' fees and surcharged Lester and Robert for all of the bank's $425,507 in attorneys' fees.

E. Matter of Knox.[7] Trustee found negligent for retaining concentrated positions in its own stock and Woolworth, and for making additional investments at the request of the settlor.

1. This case concerned a trust created by Seymour Knox II (Mr. Knox) in 1957 for the benefit of his son Seymour Knox III (Seymour), with a predecessor to HSBC Bank as sole trustee. The Knox family had long been involved with the bank, and both Mr. Knox and his son Northrup headed the bank for many years. The Knox family was one of the bank's

[7] 2010 NY Slip Op 52234U (February 24, 2010); Matter of Knox, 2010 NY Slip Op 52251U (November 24, 2010).

most important clients and among the founders of the modern version of the bank.

2. The trust provided for discretionary income and principal distributions among Seymour's children and more remote descendants on a *per stirpes* basis, with the goal of treating Seymour's children equally. The trust was funded with 5,000 shares of Woolworth stock and 5,200 shares of Marine Midland (now HSBC) stock. At the time Mr. Knox created the trust, he was on the board of directors of both Woolworth and Marine Midland and owned 13% of all Woolworth stock.

3. The trustee repeatedly followed the expressed preferences of Mr. Knox and Seymour regarding the retention and purchase of stock. Within a year following the creation of the trust, the trustee sold 2,100 shares of Woolworth stock and purchased other equities. However, the trustee retained the balance of the stock at Mr. Knox's request. In 1985 the Woolworth stock made up 38.1% of the trust portfolio, and the concentration increased to 40.2% by 1996. The retention of the stock was approved by the trustee's regional manager due to the low cost basis of the stock and "the sensitive nature of these issues on this account." In 1991, the trustee wrote to Seymour and recommended the sale of the stock, but said they would continue to hold the stock because "co-trustee" Seymour did not want the stock sold.

4. By 1995, Woolworth was showing signs of trouble and stopped paying dividends. That year, at Seymour's request, the trust invaded principal to make up for the income lost when Woolworth stopped paying dividends, but continued holding a 33.6% concentration of the stock. There was no documentation in the file as to why the stock was retained. Seymour died in 1996.

5. In 1997, Northrup wrote to the trustee and warned against holding Woolworth stock, and informed the trustee that all Woolworth stock in the Knox Foundation had been sold. That year, the trustee sold 5,000 shares of Woolworth stock, leaving 23,000 shares in the trust, making up a 21.1% concentration. That same year, Woolworth was removed from the trustee's "hold list." In 1998, the trustee sold another 3,000 shares. Later that year, the trustee received 20,000 shares of Venator (the successor to Woolworth) stock in an exchange. The trustee did not fully divest the trust of Woolworth stock until 1999, four years after it stopped paying dividends.

6. The trust agreement expressly authorized the retention of the Marine Midland stock, even if the asset was not otherwise authorized by law as a suitable trust investment and even if the bank was acting as trustee. Internal bank documents stated that Mr. Knox understood that the trustee had complete authority to sell the bank stock for purposes of

diversification, and that Mr. Knox was not adverse to the sale but hoped other assets would be acquired rather than the bank stock sold. In 1981, Seymour informed the trustee of his preference to retain the bank stock, and the trustee retained the stock. The only documentation of the annual decision to retain the stock was a literal rubber-stamped entry in the investment diary, with no analysis in the trust files. The bank stock was finally sold in 1987.

7. In 1969, Mr. Knox and Seymour requested that the trustee purchase stock in Dome Petroleum and Leesona Corporation for the trust. The trustee determined these stocks were not good trust investments, but purchased them anyway on the approval of Mr. Knox and Seymour. Despite the trustee's negative conclusions about the Dome stock, it was held in an overweight position (well above 10% of the trust portfolio, and by 1981 as high as 43.4%) at Seymour's direction, whom the bank internally referred to as a "co-trustee" even though he was not actually a co-trustee. Even though Leesona was an off-list security not proper for the trust, the trustee held a concentration in Leesona as high as 30.4% of the trust portfolio on Seymour's authorization. There was no documentation in the file explaining the retention of the overweight position.

8. In September of 2006, the trustee brought an action in the Surrogate's Court to settle its accounting from 1957 to 2005 and to resign and be discharged as trustee. Seymour's children objected to the accounting and alleged that the trustee negligently retained the Venator Group (the predecessor to Woolworth) stock. The guardian *ad litem* appointed for Seymour's minor descendants also filed objections alleging that the trustee breached its duty by failing to diversify investments, violating its own internal procedures in making investments, improperly abdicating its fiduciary role to Mr. Knox and Seymour, and being engaged in an overall pattern of imprudence and negligence.

9. The court held that the trustee breached its fiduciary duty and was negligent in purchasing the Dome and Leesona stock at the direction of a non-trustee (at different times Mr. Knox and Seymour) when the trustee's own analysis concluded those stocks were not proper trust investments. On critical management issues, the court concluded that the trustee simply deferred to Mr. Knox and Seymour, even to the extent of allowing one or both of them to effectively override the best consideration of the sole trustee.

10. With respect to the Woolworth stock, the court held that the trustee should have sold the stock when it became an off-list holding in 1997 at the latest, and that the trustee offered no plausible explanation for its gross dereliction of its fiduciary duty.

11. With respect to the bank's stock, the court held that: (1) the trust instrument exonerated the trustee for holding its own stock, but only where it exercised its discretion with respect to the stock; and (2) since there was no proof that the trustee performed any actual analysis about the prudence of holding the stock and ignored its fiduciary duties, the trustee could not be absolved of it negligence by the trust terms.

12. The court held that the trustee negligently managed the trust by: (1) failing to maintain documentation; (2) failing to develop an investment plan; (3) being indifferent to bank policies; (4) acquiescing to directions by a non-trustee and treating Seymour as a co-trustee; (5) failing to sell the bank stock at the inception of the trust; and (6) failing to sell 90% of the Woolworth stock at the inception of the trust and the balance of the shares by 1991.

13. In a supplemental decision concerning damages against the trustee, the court: (1) used a straightforward application of the *Matter of Janes* method of calculating damages; (2) awarded 9% interest compounded annually, finding that a 9% return would have been earned by the trust assets if invested properly; (3) awarded actual damages in the amount of $21,437,084; (4) declined to order the trustee to return commissions due to a lack of evidence of malevolence or dishonesty; and (5) reserved decision about the trustee's attorneys' fees.

F. Gallagher v. Keybank, N.A.[8]. Trustee unable to shift potential liability for failure to diversify because of defects in charitable remainder trust.

1. Patricia Gallagher was the settlor and a beneficiary of a charitable remainder trust created in 2001 with Keybank as trustee. The trust was intended to qualify as a charitable remainder annuity trust (CRAT). It was funded with 4,500 shares of Wyeth stock with a value of $300,000 at $65 per share. Keybank later determined that the trust did not qualify as a CRAT as originally drafted, and notified the drafting attorneys in May or June of 2002. The drafting attorneys then prepared an amendment to the trust that was signed by both Patricia and Keybank by July of 2002.

2. By the time the trust was amended, the Wyeth stock had dropped to $49 per share, and thereafter dropped further. The stock represented 85% of the trust assets until July of 2003. By October of 2008, the value of the trust had fallen to only $66,000.

3. Patricia sued in state court to surcharge Keybank for the investment losses, alleging breach of contract, breach of fiduciary duty, negligence and breach of trust, and seeking $216,000 in damages. Keybank removed the suit to the federal court for the Northern District of New York and brought

[8] 2011 U.S. Dist. LEXIS 107361 (N.D. New York, 2011).

a third-party complaint for negligence and indemnification against the lawyers who drafted the trust. Keybank claimed that the drafting attorneys' failure to properly draft the trust as a qualifying CRAT prevented Keybank from selling the Wyeth stock in a timely manner (presumably because of the taxable gain from the sale where the trust did not qualify as tax-exempt).

4. The court dismissed all of the claims against the drafting attorneys and refused to allow Keybank to amend its third-party complaint, on the grounds that: (1) Keybank failed to allege privity with the attorneys to support the negligence claim; (2) Keybank failed to allege any facts to support a finding of express or implied indemnification owed by the drafting attorneys; and (3) under New York law, contribution is only available where the claim sounds in tort unless there is some independent legal duty, and here the claim was purely economic and based on a contract with no independent legal duty owed by the attorneys to Keybank.

G. In the Matter of Trust of Burford.[9] Trustee liable for breach of fiduciary duties in dealing with large holding of oil stock.

1. This case concerned a trust created by William and Gertrude Skelly in 1955, for the benefit of their daughter, Carolyn Skelly Burford, and granddaughter, Ann Burford Fletcher. The trust was originally funded with shares of Skelly Oil Company and shares of Socony Mobil Oil Company. William Skelly was a founder of Skelly Oil and Gertrude's family had ties to Socony Mobil Oil. The trust included the following retention provision:

   "Because of the high regard which the Grantors hold for the common stocks placed in this trust as an investment, they specifically recommend that, except for unusual circumstances, the Trustee retain all such stocks throughout the term of the trust and regardless of whether or not such retention may appear to offend against what might ordinarily be considered a sound trust investment practice and the usual principles of investment diversification."

2. The trust provided for one corporate trustee and one individual trustee. J.P. Morgan Chase Bank became corporate co-trustee through a series of bank mergers and acquisitions. J.P. Morgan served until March 3, 2006. For most of the period in question, Ann Fletcher acted as individual co-trustee.

3. Carolyn died in 1996. Ann Fletcher became the sole income beneficiary after her death. The trust represented Ann's primary source of income

[9] PT-2006-013 (Ok. Dist. Ct. 2012).

since 1998. The court stated in its findings that Ann had some cognitive impairment and limited comprehension. She had live-in help to assist with paying bills and other household matters.

4. Skelly Oil Company merged into Getty Oil Company in 1977. The Getty stock eventually was sold to Texaco in 1984. Socony Mobil eventually became ExxonMobil in 1998. The bank repeatedly recommended diversification out of the ExxonMobil position but Ann Fletcher and Rufus Griscom (an attorney who briefly acted as individual co-trustee during the time period) resisted.

5. When Fletcher requested that the trust increase income distributions in 1999, the bank sold 20,000 shares of ExxonMobil and invested in higher yielding bonds. Thereafter, the bank proposed the use of variable prepaid forward contacts (VPFs), ostensibly to increase the amount of trust income in response to requests from Fletcher. The VFPs also were recommended to provide downside price protection for the stock, and eventual diversification. The bank sent materials on the proposed use of VFPs to Ann Fletcher and to Rufus Griscom, but apparently never met to discuss them in detail. Fletcher approved the use of VFPs based on the recommendations of the trust officers. Over a period of years the trust engaged in a series of contracts. In all but one of the contracts, an affiliate of the bank was counterparty, and the bank and its affiliate received significant fees from the transactions.

6. The bank also made additional distributions to Ann Fletcher, in response to her requests. These resulted in income overdrafts. The court noted that the trust had a value of $14,392,000 in May of 2000, before the first VPF contract. The value of the trust when the bank resigned in 2006 was $12,515,086.

7. The court treated the retention clause as a justification for not diversifying: "The intent of the grantors and express desire for retention of the original holdings was clear and unequivocal and excused the default rule to diversify."

8. The court concluded that the bank breached its duties by not adequately advising the interested parties that it would be selling ExxonMobil in connection with the VPFs, contrary to the retention clause, and not properly explaining the extent to which it profited from the contracts. The court also found that the bank breached its duty of impartiality by entering into the contracts, because they favored the income beneficiary at the expense of principal. The compensatory portion of the judgment was over $18 million.

H. Carter v. Fifth Third Bank.[10] Corporate trustee not surcharged for failure to diversify Steelcase stock, but removed as trustee due to physical distance from beneficiary and potential conflicts of interest.

1. Peter Wege, one of the founders of Metal Office Furniture Company (which later became Steelcase) established a trust under his will with Fifth Third Bank as trustee. At his death in 1947, the majority of the trust assets consisted of company stock. In his will, Wege provided his trustee with discretion to retain the stock notwithstanding trust law concerning investments, and also provided that sale of any company stock by the trustee required the consent of his son and the original individual co-trustee, or the survivor of them.

2. Steelcase went public in 1998, and the trust was the largest participant in the initial public offering, selling 10 percent of its holdings in the company for $52 million. In each of 2000 and 2001 the trustee sold an additional 200,000 Steelcase shares. In April 2002, the trust was divided into seven separate trusts for Wege's grandchildren, including his granddaughter Susan Carter. Thereafter, Carter and her financial advisor agreed to an investment strategy proposed by the trustee which resulted in a reduction in her separate trust's Steelcase holdings to approximately 40 percent of the trust assets by February 2006.

3. In May 2006, Carter sued to remove the trustee and for surcharge. The probate court, on summary judgment, granted Carter's request for removal and appointed SunTrust Bank as successor, but denied Carter's request for surcharge.

4. On appeal, the Michigan Court of Appeals affirmed the denial of the surcharge request. The court found that the claim was barred by res judicata because of prior accounts approved by the probate court. In addition, it noted that the probate court correctly determined that the provision of the will granting the trustee the discretion to retain the stock notwithstanding trust law concerning investments created a "safe harbor" protecting the trustee from the ordinary diversification requirement. Carter presented no evidence that the trustee acted other than as it deemed prudent and in the best interests of the beneficiaries. Carter had made allegations of conflict of interest based on bank's business relationships with Steelcase and the fact that it had substantial Steelcase holdings in other trusts. But the mere allegation that the trustee had a conflict of interest - without evidence indicating the impact of the alleged conflict on the trustee's decisions regarding diversification - was insufficient to preclude summary judgment for the trustee.

[10] 2008 WL 2439904 (Mich. App. June 17, 2008).

5. The appellate court also found that the probate court's decision to remove and replace the trustee was not an abuse of discretion where there was evidence of the adverse impact of the distance between the trustee and the beneficiary, the beneficiary's lack of confidence in the trustee due to perceived conflicts, and other reasons including the trustee's proximity to Steelcase and the importance of Steelcase to the community.

I. Holder v. First Tennessee Bank, NA Memphis,[11] Court of Appeals of Tennessee reverses probate court's refusal to issue a declaratory judgment allowing a trustee to sell Coca Cola stock to diversify.

1. In January of 1977, Richard Holder executed a revocable trust, naming his wife as the income beneficiary of the trust. The grantor's children were named as remainder beneficiaries. The trust's assets consisted primarily of Coca Cola common stock. The terms of the trust included a clause specifying that "[t]he Grantor intends for the Trustee to act primarily in a custodial capacity with regard to the stocks in this trust, and he expressly relieves the Trustee of responsibility for any unfavorable results that may arise from lack of diversification. . . " However, the trust also specifically allowed the trustee to sell the stock for a "compelling reason," in the best interests of the beneficiaries.

2. Wary of the trust's concentration in Coca Cola stock and mindful of the requirements of the Prudent Investor Rule, the trustee sold 5,200 shares of the stock on December 2, 1997 in order to diversify. The trustee was concerned that the sale could be construed to violate the "compelling reason" provision. Consequently, he convinced the beneficiary to file a complaint for a declaratory judgment seeking construction of the trust provisions.

3. The trustee was the sole witness before the probate court. The trustee testified that retaining the concentrated position posed an "undue risk" to the entire trust and to the beneficiaries. The probate court ruled that the risk did not constitute a compelling reason for selling the stock. Absent a clear showing of detrimental change, the probate court held, the stock in the trust should be retained.

4. On appeal, the court reversed the probate court. Though the court stated that the trust had to be interpreted so as not to frustrate the intent of the grantor, and conceded that the grantor intended to limit the trustee's affirmative duty to diversify the investments, casting the trustee in primarily a "custodial capacity," the court ultimately agreed with the trustee. Because the trust authorized the trustee to do "everything it deems advisable with respect to the administration" of the trust, the document

[11] 2000 WL 349727 (Tenn. Ct. App. 2000).

permitted the trustee to sell the stock in order to diversify if the trustee demonstrated that such a sale was a "compelling reason" and in the best interests of the beneficiaries. The court noted that no evidence was offered to counter the trustee's opinion that diversification was a "compelling reason". Moreover, the sale of the stock for the purposes of diversification was consistent with the trustee's statutory duty under Tennessee law. The court thus found that the sale of the stock by the trustee was permitted under the trust.

J. In re Scheidmantel.[12] Trustee found liable for diversifying holding of its own stock in a trust.

1. In 1998, grantor executed a revocable trust agreement naming Trust Company as trustee. Trust Company is a wholly owned subsidiary of Sky Financial Group, Inc., a publicly traded company. The trust was initially funded with CDs and bank stock. Sky Financial thereafter acquired the bank and the bank stock was exchanged for Sky Financial stock. The Sky Financial stock consistently paid cash and stock dividends.

2. The grantor died in 1999. The first portfolio review occurred one month after the grantor's death (this was a departure from the Trust Company's policy of conducting the first review within 60 days of funding). At that review, the trust officer identified the investment objective of the trust as "safety and income". After grantor's death, the surviving husband's heath rapidly declined and he was moved into a nursing home. The trustee did not consult with the family about the husband's health.

3. In June 2000, a new (and presumably inexperienced) trust officer was assigned to the trust. Four days after starting employment with the Trust Company, and without consulting the husband or the family about the husband's health or income needs, the new trust officer performed an investment review for the trust and changed the investment objective of the trust to "balanced", and expanded the investment horizon to 7 to 10 years. At the same time, the trust officer, again without consulting the husband or his family, began diversifying the Sky Financial stock held in the trust (none of the Sky Financial stock had been sold since funding). In depositions, the trust officer could not explain why any of these changes were made to the trust (although at the hearing the trust officer testified about the need to diversify the large concentration of Sky Financial stock). The trust officer conceded that there was no reason to believe the Sky Financial stock was unsound, and that he had personally invested in the stock.

[12] 868 A.2d 464 (Pa. Super. 2004).

4. In the course of diversifying the Sky Financial stock, the sales were timed in a way that deprived the trust (and the husband) of over $45,000 in dividends. Thereafter, the trust officer sold assets yielding over $8,000 in annual income and purchased assets yielding only $3,000 in annual income. In September and December of 2000 (immediately before the husband's death), the trust officer invested the trust assets in several mutual funds designed for long term growth of the trust (despite the fact that the trust was to distribute outright at the husband's death).

5. Two of the remaindermen filed objections to the trustees' accounts after the husband's death. The trial court determined that the Trust Company committed gross negligence by diversifying the Sky Financial stock, breached its duty by its delay in making final distribution of the trust assets.

6. On appeal, the Court concluded that the diversification requirement of the UPIA did not apply to the trust, because the trust became irrevocable prior to enactment of the UPIA in Pennsylvania. The Court noted that the trustee was given broad discretionary investment powers under the trust agreement, but that even with broad discretion the Court could intervene if the trustee acts "beyond the bounds of reasonable judgment" under the particular facts and law of the case. The Court applied the higher standard of skill required of corporate trustees. Because the Court agreed concluded that the trustee's actions constituted gross negligence, the Court did not resolve the issue of whether a trust agreement provisions limiting liability of the trustee to acts of gross negligence was binding on the court.

7. The Court evaluated the trustee's conduct under the following standard of gross negligence: Conduct more egregious than ordinary negligence but does not rise to the level of intentional indifference to the consequences of one's acts. Gross negligence may be deemed to be a lack of slight diligence or care comprising a conscious, voluntary act or omission in "reckless disregard" of a legal duty and the consequences to another party.

8. In support of its finding that the trustee committed gross negligence in diversifying the Sky Financial stock, the Court pointed to:

    a. The trustee's failure to consult with the income beneficiary or the remaindermen, or to make periodic inquiry, about the needs of the income beneficiary, and the failure to ascertain the factual circumstances surrounding the trust;

    b. The inability to explain how the investment strategy was developed, and the inability to show that the decision was not made in reckless disregard of the consequences of the trust.

c. The altering of the investment goals of the trust without learning the circumstances of the income beneficiary.

d. The lack of any reason to sell the Sky Financial stock.

e. Diversification of the stock without regard to (a) loss of income payable to the income beneficiary, (b) diminution in value of trust through purchase of assets with high costs, (c) purchase of institutional mutual funds after the death of the income beneficiary, (d) mutual fund fees, and (e) the timing of sales to maximize the benefit to the trust.

9. The Court stated that the trustee "applied a hypothetically good strategy under specific circumstances and in a manner that made the particular diversification program selected a grossly negligent course of conduct." The Court agreed with the trial court that the loss of income could be a basis for damages, but remanded the issue of damages back to the trial court to determine the extent to which damages should be offset by the increase in the value of the other trust investments (or decreased because of mutual fund costs).

K. Other cases addressing large stock concentration emphasize the importance of the particular language of the governing instrument.

1. In National City Bank v. Noble,[13] the beneficiaries of a trust holding large concentrations of Smucker common stock sued the trustee for failure to adequately diversify. In 1980, Smucker stock constituted 87% of the trust assets. The trustees finally did begin to diversify 1983 and had reduced the Smucker stock holding to 25% of the trust by 2001.

a. In pertinent part, the trust provided:

"2. The Trustees are empowered to retain as an investment, without liability for depreciation in value, any part or all of the securities from time to time hereafter acquired by the Trustees as a gift, devise or bequest from the Grantor or any other person, even though such property be of a kind not ordinarily deemed suitable for trust investment and even though its retention may result in a large part or all of the trust's property being invested in assets of the same character or securities of a single corporation. Without limitation upon the generality of the foregoing, the Trustees are expressly empowered to retain as an investment, without liability for depreciation in value, any and all securities issued by the J.M. Smucker Company, however and whenever acquired, irrespective of the proportion of the trust properly invested therein.

[13] 2005 WL 3315034 (Ohio App. 8 Dist. 2005).

The Trustees are empowered to invest and reinvest any part or all of the trust property in such securities as they may select, irrespective of any limitation prescribed by law or custom upon the investments of trustees and even though the trust property may be entirely invested in common stocks or equities."

b. The trial court granted the trustee's motion for summary judgment and the appellate court affirmed, citing the specific terms of the retention clause of the governing instrument.

2. In McGinley v. Bank of America,[14] grantor of a revocable trust, who was age 79 when she created the trust, brought a claim against the bank for failure to diversify out of Enron stock with which the grantor had funded the trust.

a. The terms of the trust agreement granted the Bank broad fiduciary powers, subject to a restriction regarding trust investments:

[P]rovided, however, that during the lifetime of the grantor, she shall be consulted by the Trustee as to any purchase or sale, and the Trustee shall abide by the grantor's decision unless, in the sole opinion of the Trustee, the Grantor is incapable of managing her affairs, in which event the decision of the Trustee as to all investment matters shall be final and conclusive."

b. Around 7 months after the trust instrument was signed, the grantor signed a form letter, delivered to the bank by her husband, directing the trustee to "continue to retain" the Enron stock In pertinent part, the directive read:

"I hereby direct you to continue to retain the following securities as assets of the above referenced account: 1,541 shares of Enron Corp. I understand that you do not monitor these securities, and I hereby agree to exonerate, indemnify and hold the Bank harmless from any and all loss, damage and expense sustained or incurred by the Bank for continuing to retain these securities as assets of this account. I also relieve the Bank from any responsibility for analyzing or monitoring these securities in any way...This release and indemnification will remain in force and effect until my death, my disability (as determined in accordance with the trust agreement) or my written revocation of this letter."

c. The grantor never revoked the letter. Indeed, for a time there seemed no reason to: from 1991 through 2000, Enron stock's value

[14] 279 Kan. 426, 109 P. 3d 1146 (2005).

increased substantially. At the peak of its value, the trust contained 9,500 shares worth $789,687.50, representing approximately 77% of the total market value of the trust's assets. By December 31, 2001, it was 2%, at which time the trust contained 8,000 shares valued at only $4,800.

d. The court held that the bank took no action specifically because the grantor had instructed it not to. Consequently, it was relieved of liability for failing to diversify trust's concentration in Enron stock, and moreover for not monitoring the stocks negative performance. While the court noted that it would have been "the better practice" for the Bank to have communicated with grantor regarding the stock's performance, it noted that the plaintiff had produced no authority showing that the Bank had a legal obligation to do so given the directive. The Kansas Supreme Court affirmed the trial court's granting of the bank's motion for summary judgment.

3. In Fifth Third Bank v. Firstar Bank, N.A.,[15] the trustee was held liable for failing to diversify a concentrated stock position in Proctor & Gamble transferred to a CRUT. The CRUT was created and funded with the stock as a way for the grantor to increase her income by selling the stock without incurring immediate capital gains.

a. The initial trustee started to sell shares monthly, but postponed further sales when the stock price dropped. The trustee later started the sales again, but by then the value of the stock was cut in half. The trustee was dismissed and the new trustee brought suit.

b. In defending itself, the bank invoking a provision of the CRUT which stipulated:

"[t]he trustee shall have expressly the following powers: to retain, without liability for loss or depreciation resulting from such retention, original property, real or personal, received from Grantor or from any other source, although it may represent a disproportionate part of the trust."

c. The court relied upon Wood v. U.S. Bank in its analysis of the trust provision. The court held that the cited language "did not clearly indicate the intention to abrogate the duty to diversify" – a standard set out in Wood. The court moreover noted that even if the provision relieved the trustee of liability, it had failed to consider other factors in retaining the stock, notably "the economic conditions, the tax consequences, the need for liquidity when [the

[15] 2006 WL 2520329 (Oh. Ct. App. 2006).

trustee] chose to sell the P & G stock gradually over the course of a year." Given such lapses, the court held that there was sufficient evidence to create questions of fact properly resolved by the jury. The $1,040,222 jury award was thus upheld.

d. Contrast this case with Americans for the Arts v. National City Bank,[16] which illustrates how full disclosure can protect a trustee in a later dispute, in this case involving the same situation of failure to diversify quickly enough in a CRT. The trust instruments in this case authorized National City to retain assets received in trust indefinitely and provided that "any investment made or retained by the trustee in good faith shall be proper despite any resulting risk or lack of diversification or marketability and although not of a kind considered by law suitable for trust investments." All the parties had been involved in the review of drafts of the trust agreements, and none of the parties or their counsel objected to these provisions.

L. The cases involving closely held assets tend to come out more consistently in favor of the trustees, but note that the trustees still are involved in litigation and it often takes an appeal to receive vindication.

1. In In Matter of Jervis C. Webb Trust,[17] the Court of Appeals of Michigan affirmed that the trustees had not breached their fiduciary duties by retaining family stock and failing to diversify the trusts assets.

a. The two trusts in this case were funded with stock in the family's business, the Jervis C. Webb Corporation, a closely owned corporation. The claim was brought by some of the children of Jervis C. Webb.

b. Examining the trust provisions, the court noted that both trusts "relieved the trustees of any duties to diversify assets and follow the prudent man investor rule with respect to the Company's stock." The court noted a provision of the 1946 trust, stating in relevant part:

"6. The Trustees shall invest and reinvest the trust estate in such investments as they deem proper. They shall not be required to dispose of stock in the Jervis B. Webb Company, or any company succeeding to part or all of the business of Jervis B. Webb Company, and they may retain the same or may make loans to or additional investments in any such company regardless of whether

[16] 855 N.E.2d 592 (2006).

[17] 2006 WL 173172 (Mi. Ct. App. 2006).

they consider it a prudent investment for trustees. Stock dividends and stock rights are to be treated as corpus. Any action of the trustees, including voting stock for deciding on investments or sales, shall be valid if taken by a majority..."

c. Noting that the 1989 trust contained identical language to the 1946 trust, the court furthermore pointed to additional provisions in the 1989 trust that expressed the settlor's intent to retain the stock so that his children, employees of the company, would thereby benefit:

"Five of Settlor's seven children and the spouse of a sixth are employed by the Jervis B. Webb Company. Settlor believes it would enhance the interest of these six children and their spouses in the Webb Companies as that term is defined below and would strengthen the companies if the six children were to acquire a beneficial interest in them on the terms set forth below. Settlor owns stock in the companies and wants to sue it to set up such a beneficial interest. Accordingly, Settlor by these presents assigns, transfers, conveys, and delivers to the Trustees the property described in the schedule attached hereto and made a part hereof. The Trustees agree to hold the same on the following terms and conditions...The Trustees specifically are authorized to retain all shares of stock in any Webb companies without regard to any rule or requirement of diversification of investments, and even if such stock does not pay dividends or pays only a small dividend...the Trustees shall have the power to invest and reinvest the trust assets in such stocks, bonds, and other securities as they may deem advisable, including unsecured obligations, undivided interests, interests in investment funds, mutual funds, leases, properties which are outside of the State of Michigan and partnerships, all without diversification as to kind or amount and without being restricted in any way by any statute or court decision (now or hereafter existing) regulating or limiting investments by fiduciaries..."

2. Matter of Hyde.[18] Corporate trustee exonerated for failure to diversify stock concentrations on technical grounds and due to reasonable process of trustees and consideration of multiple factors in deciding to retain the stock.

a. This case involved objections to accountings for a twenty-year time period with respect to several trusts created by the daughters of Samuel Pruyn, who founded Finch Pruyn, a large manufacturer

[18] 44 A.D.3d 1195, 845 N.Y.S.2d 833 (October 25, 2007).

in Glenn Falls, New York. The trusts (referred to as the two Hyde trusts and the Cunningham trust) each was funded with large concentrations of Finch Pruyn stock. Each trust granted the trustee "absolute discretion" but contained no directions concerning the Finch Pruyn stock. The trustees moved for summary judgment to dismiss the objections, which was denied by the Surrogate's Court. At the conclusion of a lengthy trial, the Surrogate's Court dismissed all of the objections. The beneficiaries appealed.

b. On appeal, the Appellate Division affirmed the dismissal of the claims against the trustees, in part on technical grounds with respect to one of the trusts, but mainly because of the procedures followed by the trustees in deciding to retain the stock.

c. With respect to the one Hyde trust, the Appellate division found that the bank made a reasonable determination that it was in the interests of the beneficiaries not to diversify the Finch Pruyn stock, after considering (1) the liquidity of the stock, (2) the fact that the corporation was closely held and with an unusual corporate structure which discouraged liquidation, (3) the lack of marketability, (4) the disinterest of the company in buying the stock, (5) the comments made in meetings with financial advisors, investment bankers, and brokerage houses that a fair price for the stock could only be obtained through sale of the entire company, (6) the general economic condition of the trust, (7) the tax consequences of the sale, (8) the needs of the beneficiaries, (9) tax costs of a sale, (10) the significant dividends paid out with respect to the stock, and (11) the indications of the settlor's desire that the stock remain in the family.

d. Similarly, with the respect to the Cunningham trust, the Appellate Division found that the bank reasonably determined it was not in the best interests of the beneficiaries to sell the stock at a discounted price merely for the sake of diversification, upon considering the lack of liquidity, the lack of marketability of the stock, and the unusual corporate structure, and because the bank regularly explored the market for the stock, kept well informed of the company's financial condition, and regularly reviewed corporate report.

3. SunTrust Bank v. Farrar.[19] The Virginia Supreme Court reversed a surcharge award against SunTrust Bank for $2.5 million for failure to sell a coal mine held in a trust on the grounds that the beneficiaries failed to produce evidence of a willing buyer for the property.

[19] 277 Va. 546 (April 17, 2009).

a. Charles Wilson died in 1921, and was survived by his wife and two sons. Under his will, he established a trust to hold a coal mine in Harlan County, Ky. He named a corporate predecessor to SunTrust Bank as co-trustee. His wife served as co-trustee until her death in 1976. The trust provided for distributions among his wife and descendants, and upon termination (20 years after the death of his wife and children), for outright distributions to his heirs at law. Under his will, he directed that the trustees hold the coal mine "unless conditions undergo a very radical change from what they are at present."

b. Upon the death of Mr. Wilson's last surviving child in 1984, SunTrust petitioned the circuit court for authority to sell the coal mine, due to a rapid decline in the income produced by the coal mine. In 1987, the circuit court granted SunTrust the authority to sell the property. In connection with the possible sale, SunTrust hired an appraiser who valued the property at $1.1 million.

c. By the end of the 80s, the bottom fell out of the coal market. None of the offers the bank received came close the appraisal it had obtained. SunTrust eventually sold the coal mine in 1997 for $350,000.

d. The remainder beneficiaries of the trust sued SunTrust alleging breach of fiduciary duty for failure to sell the coal mine for the appraised value of $1.1 million, and seeking compensatory and punitive damages. In support of their claim, the beneficiaries only offered the testimony of an expert in economics who determined, based on a series of assumptions, that if the property had been sold for $1.1 million on Sept. 1, 1987, and invested in a mix of 65% stocks and 35% bonds, the trust distributions would have been $1,761,000 and the remaining trust assets would contain $3,709,000 in assets. The expert acknowledged he could not testify that there was a buyer on the date willing to pay $1.1 million for the coal mine. The appraiser also testified that the property did not sell in 1987 because no one was interested in it.

e. The circuit court found that SunTrust failed to properly market the property and allowed the coal mine to become unproductive and a wasting asset. It awarded the beneficiaries judgment in the amount of $2.4 million. In a separate action on SunTrust's accountings, the circuit court also ordered SunTrust to reimburse the beneficiaries for $89,000 paid out of the trust, plus interest, for costs of maintaining the property.

f. On appeal, the Virginia Supreme Court reversed the trial court and dismissed the beneficiaries' claims. because: (1) they failed to

meet their burden of proving damages; with reasonable certainty; and (3) the circuit court could not rely on speculation and conjecture. The court noted that the beneficiaries' claims were premised on the assumption that the property could have been sold for $1.1 million in 1987, and the beneficiaries presented no evidence of a willing buyer at any time whatsoever, while SunTrust presented evidence that no one was interested in the property at that time.

g. The court noted that "a trustee who retains a trust asset during a precipitous decline in the market, when there was no market for the asset, cannot be held to account so long as the trustee acted as a reasonable and prudent person would act in light of then existing conditions." The court also noted problems with the appraised value of the coal mine.

IV. Relevance of Delegation or Direction Authority

A. Shifting the Investment Duties.

1. A trust that holds a concentrated stock position may also contain provisions that allow delegation of investment authority or directed trustee provisions.

2. A corporate trustee may wish to shift the responsibility over a concentrated stock position away from itself, such as by designating a family member as investment advisor with respect to the position. This is particularly common if the holding is a position in a family business. As discussed in these materials, this does not completely shift the trustee's obligations to another.

3. Far preferable is a directed trustee arrangement, where the instrument designates a different fiduciary with authority over a particular asset.

   a. Many states now have adopted statutes that permit the creation of a directed trustee arrangement, and that provide substantial exoneration for the trustee from any liability with respect to the asset or assets over which the directing party has authority.

   b. These statutes, and specific trust provisions, should be effective in insulating the trustee from liability, but often they just shift the potential liability for failure to diversify to the directing party.

B. Trust Language on Retention

1. The law on delegation and directed trusts also is relevant because trust language on retention of an asset often must be construed to determine its scope.

2. A primary question often is whether the language constitutes a direction or whether it is more precatory in nature. If the former, the law on directed trustees is relevant; if the latter, a delegation analysis is more meaningful.

V. Delegation of Investment Authority

A. Duty to Delegate.

1. The Third Restatement's position on the ability of trustees to delegate their functions represents a dramatic departure from prior restatements which grudgingly accepted delegation only to the extent the trustee had no reasonable alternative. Under the Third Restatement, the trustee is directed to "act with prudence in deciding whether and how to delegate authority to others." (§ 227(c)(2)).

   a. With professional advice as needed, the trustee *personally* must define the trust's investment objectives. (§ 227, Comment *j*).

   b. The trustee must also make the decisions that establish the trust's investment strategies and programs, at least to the extent of approving plans developed by agents or advisors.

2. The trustee may delegate non-ministerial functions, including, with proper monitoring, the selection of specific investments, as well as ministerial functions.

3. In some instances, a trustee may have an affirmative duty to delegate.

   EXAMPLE: Trustee of a large trust determines that a portion of trust property should be invested directly (rather than through a pooled fund) in a venture capital program. If the trustee does not have the time and expertise to manage the program with the required degree of prudence, he or she has a duty to delegate management activities. (§ 227, Illustration 23).

4. The Third Restatement's position on delegation eliminates any lingering questions that may have existed concerning a trustee's authority to delegate by investing in mutual funds (either public or private). In fact, the Restatement's bias in favor of passive investing encourages this type of investment.

B. Evolution from Prohibition to Acceptance to (Sometimes) Requirement.

1. As discussed previously, the Prudent Investor Rule includes a duty to delegate in certain circumstances, and, today, it is almost universally expected that a trust agreement will authorize delegation of investment authority. The power to delegate has become a standard fiduciary power. An example of a standard trustee power to delegate is below:

> "11. To delegate to one or more investment counsel and money managers a portion or all of the trustee's powers related to the acquisition, disposition, retention and management of all or specific trust assets, and, in such event, the trustee shall not be accountable for any loss or depreciation in value sustained by reason of any action taken by such investment counsel or money manager, notwithstanding the provisions of any statute or law to the contrary;"

2. This type of provision was not always common or even permitted. At common law, a trustee was charged with the personal duty to perform all aspects of handling a trust and the trustee was forbidden from delegating the trustee's duties and responsibilities.[20] Over time, it came to be recognized that there should be an exception to the general rule that the trustee personally perform the trustee function, where a prudent person would delegate those responsibilities to others.[21]

3. According to Scott on Trusts, a trustee should consider the following factors in determining whether and under what circumstances and conditions the trustee should delegate the trustee's authority:

    a. The terms of the governing instrument of the trust,

    b. The matter being delegated,

    c. The size of the trust,

    d. The nature of the trust assets,

    e. The amount of discretion granted the trustee,

    f. The skill and expertise of the trustee regarding the activity being delegated, and

    g. The economics of the delegation.[22]

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[20] Uniform Prudent Investor Act, Section 9, comment, page 16.

[21] Scott, IIA Scott on Trusts, Section 171, page 140.

[22] Id.

4. The common law does not have clear rules on when and how a trustee can safely delegate trustee duties and responsibility. Because of the lack of clear rules in delegating investment responsibility, the National Conference of Commissioners of Uniform State Laws prepared the Uniform Prudent Investor Act which, in part, addresses the issue of trustee delegation. Those trustees serving under instruments governed by jurisdictions that have adopted the Uniform Prudent Investor Act benefit from clearer rules governing the delegation of investment responsibility.

C. Uniform Prudent Investor Act.

1. Section 9 of the Uniform Prudent Investor Act allows a trustee to delegate investment and management functions subject to certain safeguards. The Act's allowance of trustee delegation was a continuation of the trend in trust law and followed the Prudent Investor Rule in the Third Restatement of Trusts[23] and the delegation rule under Employee Retirement Income Security Act of 1974 (referred to as "ERISA").[24]

2. Section 9 of the Uniform Prudent Investor Act reads in its entirety as follows.

"(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent,

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust, and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

[23] Restatement Third of Trusts, Prudent Investor Rule, Section 171 (1992).

[24] ERISA Section 403(a)(2), 29 U.S.C. Section 1103(a)(2).

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this state, an agent submits to the jurisdiction of the courts of this State."

3. The Comments to the Uniform Prudent Investor Act state that the trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against the trustee making an overbroad delegation.

4. The Uniform Prudent Investor Act has been adopted in 43 states and an additional state has adopted a substantially similar version. Most states that have not adopted the Act have statutory provisions addressing trustee delegation.

5. Section 807 of The Uniform Trust Code, titled Delegation by Trustee,[25] follows section 9 of the Uniform Prudent Investor Act.

D. Trustee's Duties When Delegating Investment Responsibility.

1. In contemplating delegation of investment management, the trustee's first duty is to review the governing instrument and state law to verify that delegation is permitted.

   a. Very old trust agreements may not contain delegation authority. State law usually will provide adequate authority if the agreement is silent.

   b. In some cases, however, the older agreement may actually contain prohibition language. In such a situation, court reformation or a nonjudicial settlement agreement may be necessary to provide authorization.

   c. In addition, some agreements may impose requirements for a valid delegation that are more restrictive than state law.

2. Assuming delegation is authorized by the governing instrument and applicable law, a trustee has these duties in delegating investment responsibility:

   a. Determining whether the trustee should delegate all or a portion of the investment responsibility,

   b. Exercising reasonable care in the selection of the investment manager,

[25] The Uniform Trust Code has been adopted in 19 states.

c. Determining the scope and terms of the delegation, and

d. Reviewing and monitoring the delegation.

3. Although a trustee should not be a guarantor of success, a trustee must be process oriented and follow that process in carrying out the trustee's duties. The trustee should document the process followed in each of the steps.

4. After determining that investment delegation is authorized, the trustee must determine whether the trustee should delegate all or a portion of the investment responsibility. In making this decision, a trustee should consider the following factors:

   a. The skill and capabilities of the trustee (the greater the skill and capabilities, the less reason for delegation),

   b. The size of the trust (the larger the trust, the more reason a trustee should delegate all or a portion of the investment responsibility),

   c. The costs of the delegation (discussed below), and

   d. The skill and expertise of the individual or entity to which the trustee is delegating the investment responsibility.

5. A delegating trustee must exercise reasonable care in the selection of the investment manager.

   a. The first step should be the development of a written investment policy. This will involve determining the investment horizon (how long is the trust expected to last), the projected distributions to be made on an annual basis, the allocation of the trust assets, and the number of managers to be used to accomplish the objectives.

   b. After developing the investment policy, the trustee should conduct and document a search process to select the appropriate investment manager or managers. If the trustee is not a professional, the trustee may want to use a consultant to assist in this process. The Madoff scandal has illustrated in stark terms the consequences of a failure to conduct thorough due diligence on investment managers.

6. It is important that a delegating trustee determine the scope and terms of the delegation. The trustee should have a written agreement with the party to whom the delegation is made. If possible, the beneficiaries also should acknowledge the delegation. Among the matters to be covered in the written instrument of delegation are the following.

a. The investment manager should acknowledge receiving a copy of the governing instrument and the applicable statutory law.

b. The investment manager should agree to accept the delegation of the investment function of the trust pursuant to applicable law, the governing instrument, and the trustee's investment policy.

c. The investment manager should agree to invest the trust assets in accordance with the terms of the governing instrument and applicable law.

d. The trustee and the investment manager should agree on the investment objectives, the asset allocation, the appropriate measuring benchmarks, and the reporting requirements (including format and the recipients of the reports).

e. The investment manager should agree to meet periodically (in person or by teleconference) with the trustee and possibly also the beneficiaries to review the investment objectives, asset allocation, and investment performance.

f. The trustee should have the right to remove the investment manager for any reason after appropriate notice to the manager.

g. If there is a question concerning the propriety of the delegation, and it is the beneficiaries who are advocating it, the beneficiaries should formally request the trustee to enter into the delegation and agree to indemnify the trustee for any losses incurred by reason of the delegation.

7. Under the Uniform Prudent Investor Act, a delegating trustee has the duty to monitor the delegation. Thus, the trustee's duties have not ended after the trustee has delegated the investment function to one or more investment managers.

a. A delegating trustee should review the manager's actions in order to monitor the agent's performance and compliance with the terms of the delegation. The trustee's review should evaluate the performance of the manager compared to the benchmarks mutually agreed upon at the commencement of the delegation.

b. The review should also evaluate consistency of investment style and any turnover in personnel. The review should be periodic and no less frequently than annually (and quarterly is better).

8. The trustee's duty to furnish information to the beneficiaries should include a duty to inform beneficiaries of the trustee's decision to delegate and the identity of the manager or managers hired.

a. There is nothing in the general body of law on a trustee's duty to inform that specifies informing beneficiaries about delegation decisions. However, it is intertwined with the trustee's investment policy, which typically is provided to beneficiaries.

b. In addition, most jurisdictions require trustees to disclose any changes in the method or rate of the trustee's compensation, and this duty reasonably should be interpreted to include information on compensation to investment managers.[26]

E. Protection for Trustee Who Delegates Investment Authority.

1. Section 9(c) of the Uniform Prudent Investor Act provides that a trustee who complies with the delegation procedure described in Section 9(a) is not "liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated." Thus, the trustee should not have any liability <u>if the trustee has properly carried out the trustee's duties in exercising "reasonable care, skill, and caution" in selecting the manager, establishing the scope of the delegation, and monitoring the manager's actions</u>.

2. Many state statutes contain similar relief of liability provisions. For example the Illinois Trusts and Trustees Act states that, if the trustee satisfies all the requirements of the delegation statute, "the trustee shall not otherwise be responsible for the investment decisions or actions of the investment agent to which the investment functions are delegated." 760 ILCS 5/5.1(c).

3. Attempts to provide further protection for the trustee may not be effective, depending on the nature of the provision and state law. A trustee cannot prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. According to the Comments in the Uniform Prudent Investor Act, leaving the beneficiaries without a remedy against willful wrongdoing is inconsistent with the trustee's duty to use care and caution in formulating the terms of the delegation.

4. In the Restatement (Second) of Trusts, the following is provided regarding exculpation clauses.

"a. Except as stated in subsections [below], the trustee, by provisions in the terms of the trust, can be relieved of liability for breach of trust.

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[26] See Uniform Trust Code, Section 813(b)(4) (trustee "shall notify the qualified beneficiaries in advance of any change in the method or rate of the trustee's compensation").

b. A provision in the trust is not effective to relieve the trustee of liability for breach of trust committed in bad faith or intentionally or with reckless indifference to the interests of the beneficiary, or of liability for any profit the trustee has derived from a breach of trust.

c. To the extent to which a provision relieving the trustee of liability for breaches of trust is inserted in the trust instrument as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor, such provision is ineffective."[27]

5. Section 1008 of the Uniform Trust Code, titled "Exculpation of Trustee," provides:

"(a) A term of a trust relieving a trustee of liability for breach of trust is unenforceable to the extent that it:

(1) relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or

(2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.

(b) An exculpatory term drafted or caused to be drafted by the trustee is invalid as an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor."

6. Courts will closely scrutinize exculpatory clauses. The point of view of many courts is captured in the following quote from the court in <u>In re Estate of Stralem</u>:[28]

"The increasing practice of testamentary draftsmen and corporate fiduciaries in vesting in testamentary fiduciaries almost unlimited powers with a minimum of obligations, is a serious potential menace not only to the rights of a surviving spouse but of the children and other dependents of the testator and of all persons interested in estates. This tendency must be curbed. The primary duties of ordinary care, diligence and prudence...and of absolute impartiality among the several beneficiaries...are of the very essence of a trust, and any impairment of these or similar obligations of a fiduciary are contrary to public policy."

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[27] <u>Restatement (Second) of Trusts</u>, Section 222 (1959).

[28] 695 N.Y.S. 2d 274, 278 (Sur. Ct. 1999).

7. Although exculpatory clauses are closely scrutinized by the courts, these clauses may be appropriate in certain circumstances. For example, the drafter should consider an exculpation clause where the trustee is inexperienced in investment matters. This may be helpful in encouraging the trustee to delegate investment responsibility.

F. Liability of the Investment Advisor.

1. A financial institution may prefer the role of investment advisor to that of the trustee because it relieves the institution of the very high standards and fiduciary duties to which trustees are held.

2. Of course, the advisor is not relieved of all liability. Investment advisors regularly face claim of liability, in both the trust and non-trust contexts, for negligence, bad decision-making and failure to exercise proper oversight or due diligence.

3. Investment advisors may have increased responsibilities and exposure in the trust context. State statutes may impose this increased responsibility. For example, the Illinois delegation statute has three requirements applicable to the investment advisor:

"(b) For the trustee to properly delegate investment function under subsection (a), all of the following requirements apply:

....

(3) The investment agent shall be subject to the jurisdiction of the courts of the State of Illinois.

(4) The investment agent shall be subject to the same standards that are applicable to the trustee.

(5) The investment agent shall be liable to the beneficiaries of the trust and to the designated trustee to the same extent as if the investment agent were a designated trustee in relation to the exercise or non-exercise of the investment function."

760 ILCS 5/5.1(b)

G. Summary.

1. A trustee is not a guarantor of performance of an investment manager to whom the trustee has delegated the investment responsibility. But, a trustee must follow the proper process in delegating investment performance as well as reviewing and monitoring the performance of the manager.

2. The key duties of a trustee that are most relevant when delegating investment authority are:

   a. The duty to exercise reasonable care and skill; and

   b. The duty to make trust property productive.

3. Effective delegation requires a carefully thought out and effectively implemented process that must include:

   a. Setting an investment policy;

   b. Determining the extent to which delegation is appropriate in light of the investment policy;

   c. A process for selecting investment managers; and

   d. A process for regular monitoring and review of the investment managers.

VI. Directed Trustees

A. Background and History.

1. In a trust in which investment or other decision-making functions are specifically assigned to a non-trustee, or to one specific trustee, the directed trustee is in a very different role than a trustee exercising a delegation power. "Unlike the delegated trustee, the directed trustee does not have any selection or monitoring functions...." The trustee's main duty is to "follow directions of the empowered person."[29]

2. As case law has established, however, it is an over-simplification to conclude that the trustee has no other duties within the scope of the direction.

3. Although directed trustees have become more popular recently, the grantor's ability to direct a trustee is not new. In a Note in the 1965 Harvard Law Review, a commentator stated: "A trust advisor is a person who has power to control a trustee in some or all of his powers. Trust advisors are most frequently used to control investments, either in private testamentary trusts or corporate employee-benefit plans."[30] Almost 100 years ago, a widow filed a lawsuit against a trustee for investing in

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[29] Al W. King, III and Pierce H. McDowell, III, "Delegated Vs. Directed Trusts" Trusts and Estates, July 2006.

[30] Note Trust Advisers, 78 Harvard Law Review 1230 (1965).

speculative investments pursuant to the directions of the grantor.[31] Under the terms of the trust agreement, the trustee was directed to follow the grantor's directions. In holding in favor of the trustee, the court stated: "Whatever [the grantor] directed, [the trustee] had to do."[32]

4. Directed trustees are regularly used in the ERISA area. Congress enacted ERISA in 1974 to encourage and provide for the stability of employee benefit plans. ERISA seeks to accomplish this goal by requiring plans to name fiduciaries and by giving them strict and detailed duties and obligations. Specifically, ERISA requires benefit plans to "provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan."[33] For many reasons, many plans subject to ERISA provide that the plan investments will be controlled by a third party. Because a directed trustee under an ERISA plan has similar responsibilities, the case law that has arisen under ERISA is instructive to trust advisors in the personal trust setting and is reviewed later in this paper.

5. The Restatement (Third) of Trusts (Tentative Draft) recognizes the ability of a grantor to give a third party the power to direct the actions of a trustee. Section 75 of the Restatement provides:

   "Except in cases covered by section 74 (involving powers of revocation and other ownership-equivalent powers), if the terms of a trust reserve to the settlor or confer upon another a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power and comply with any exercise of that power, unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries."

B. Duty of Directed Trustee to Supervise Actions of Trust Advisor.

1. The key issue for directed trustees is the extent of the trustee's obligation, if any, to supervise or monitor the actions of the trust advisor. In determining a directed trustee's duties, the trustee must review the trust instrument and applicable state law.

2. In reviewing the trust instrument, the trustee should pay particular attention to:

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[31] Rice v. Halsey, 156 App. Div. 802, 142 N.Y. Supp. 58 (1913).

[32] Id. at 805-806, 142 N.Y.S. at 61.

[33] 29 U.S.C. § 1102(a) (10; Moench v. Robertson, 553 F. 3rd 1995 (3rd Cir. 1995).

a. The characterization of the role of the trust advisor (whether the power is held in a fiduciary capacity or personally),

b. The terms of the grant of authority to the trust advisor,

c. The duty of the trustee to supervise and monitor the directions given the trustee by the trust advisor,

d. The procedure, if any, for the directed trustee to question the directions given the trustee by the trust advisor, and

e. Whether there is any limitation on the liability of the directed trustee for following the trust advisor's directions.

3. The second source of guidance for the trustee will be state law. Although case law has allowed a grantor to provide that a third party may direct the fiduciary actions of a trustee for some time, until recently statutory authority has been slow to be enacted in the United States. The pace has now accelerated, with thirty-one states now have statutes regarding directed trustees.

4. According to one knowledgeable commentator,[34] state statutes addressing directed trustees fall into one of three categories, those states which follow the approach of section 185 of the Second Restatement of Trusts, those states which follow the approach of section 808 of the Uniform Trust Code, and those states which have enacted more protective statutory protection for directed trustees.[35]

C. The Restatement (Second) of Trusts Approach.

1. Section 185 of the Restatement (Second) of Trusts provides:

> If under the terms of the trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of the power, unless the attempted exercise of the power violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power.

2. The Restatement distinguishes between powers held personally and powers held in a fiduciary capacity. If the power is held personally, the directed trustee must follow the directions and the trustee's only duty is to verify that the exercise does not violate the terms of the trust.[36] On the

[34] Richard Nenno, Directed Trusts: Can Directed Trustees Limit Their Liability? Chapter RWN – 18, 2006 Notre Dame Tax and Estate Planning Institute.

[35] Nenno, page RWN – 18-5.

[36] Nenno, at page RWN – 18-2.

other hand, if the power is held in a fiduciary capacity, the directed trustee has a duty under the Restatement approach to verify that the exercise of the power does not violate a fiduciary duty that the power holder has to the beneficiaries of the trust. The Restatement treats a power holder who holds a power in a fiduciary capacity as a cofiduciary.

3. The Restatement should not give much comfort to a directed trustee since the trustee will have to treat the power holder as a cofiduciary. According to one commentator, two states, Indiana[37] and Iowa,[38] have statutes based on the Restatement approach. The Indiana statute provides, in part: "If the person holds the power as a fiduciary, the trustee has a duty to refuse to comply with any direction which he knows or should know would constitute a breach of a duty owed by that person as a fiduciary."[39] Although the Iowa statute puts a duty on the directed trustee to determine the capacity of the power holder, the directed trustee does not appear to have a duty to determine whether the exercise of the power violates a fiduciary duty owed by the power holder to the beneficiaries.

D. The Uniform Trust Code Approach.

1. Recognizing the growing instances of a grantor giving a third party the power to direct a trustee, the Uniform Trust Code addresses directed trustees. Section 808 of the Uniform Trust Code provides:

"(a) While a trust is revocable, the trustee may follow a direction of the settlor that is contrary to the terms of the trust.

(b) If the terms of a trust confer upon a person other than the settlor of a revocable trust the power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise 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 that the person holding the power owes to the beneficiaries of the trust.

(c) The terms of a trust may confer upon a trustee or other person a power to direct the modification or termination of the trust.

(d) A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the

[37] Indiana Code 30-4-3-9.

[38] Iowa Code 633A.4207(2).

[39] Indiana Code 30-4-3-9 (b)(1).

beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty."

2. Those states that have adopted the Uniform Trust Code approach[40] include Alabama, Arizona, Arkansas, the District of Columbia, Florida, Kansas, Maine, Massachusetts, Missouri, Nebraska, New Mexico, Oregon, Pennsylvania, South Carolina, and Texas.

3. Under the Uniform Trust Code, a directed trustee has the duty to monitor the actions of the trust advisor to make sure that the trust advisor's exercise of the advisor's power is not "manifestly contrary to the terms of the trust" or "the attempted exercise would constitute a serious breach of a fiduciary duty."[41] The key issues under the Uniform Trust Code are: What is manifestly contrary to the terms of the trust? and When is an attempted exercise a serious breach of a fiduciary duty?

4. The trustee will only know for sure when the exercise of a power is not manifestly contrary to the terms of the trust when the jury or judge finds the directed trustee liable for the following the directions of the trust advisor. Until there is case law on these subjects, a directed trustee will not know for certain when the trustee is protected in relying on the directions of a trust advisor.

E. More Protective States.

1. Some states have not followed either the approach of the Restatement or the Uniform Trust Code, but have adopted their own statutes, many of which are more protective of directed trustees. The number of states in this category is increasing regularly, and currently includes Alaska, Colorado, Delaware, Georgia, Idaho, Illinois, Indiana, Missouri, New Hampshire, Ohio, Oklahoma, South Dakota, Tennessee, Virginia and Wyoming.[42]

2. State statutes generally authorize a grantor to give a third party the power to direct the actions of a trustee and give a trustee protection from liability for following the directions of a third party authorized to give directions by the grantor. State statutes vary in the duties and types of protection given a trustee for relying on the direction of a trust advisor.

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[40] Nenno, RWN-18-5.

[41] Uniform Trust Code section 808(b).

[42] Nenno, RWN-18-5.

3. Some statutes now authorize the addition of directed trustee provisions to an existing trust, by court order or by use of a nonjudicial settlement agreement. See 760 ILCA 15/16.3 (effective January 1, 2013).

F. Liability of Directed Trustee under Delaware Law.

1. Delaware provides better protection for a directed trustee than the Uniform Trust Code. Delaware classifies a trust advisor as a fiduciary.

2. Section 3313 of Chapter 12 of the Delaware Code provides:

> "(a) Where one or more persons are given authority by the terms of a governing instrument to direct, consent to, or disapprove a fiduciary's actual or proposed investment decisions, distribution decisions, or other decision of the fiduciary, such persons shall be considered to be advisors and fiduciaries when exercising such authority unless the governing instrument otherwise provides.
>
> (b) If a governing instrument provides that a fiduciary is to follow the direction of an advisor, and the fiduciary acts in accordance with such a direction, then except in cases of wilful 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.
>
> (c) If a governing instrument provides that a fiduciary is to make decisions with the consent of an advisor, then except in cases of wilful misconduct or gross negligence on the part of the fiduciary, the fiduciary shall not be liable for any loss resulting directly or indirectly from any act taken or omitted as a result of such advisor's failure to provide such consent after having been requested to do so by the fiduciary.
>
> (d) For purposes of this section, 'investment decision' means with respect to any investment, the retention, purchase, sale, exchange, tender or other transaction affecting the ownership thereof or rights therein, and an advisor with authority with respect to such decisions is an investment advisor."

(emphasis added)

G. Duemler v Wilmington Trust Company.[43]

1. Mr. Duemler, a sophisticated investment advisor who was a securities lawyer, was named as the sole investment direction advisor and given the express power under the trust instrument to direct Wilmington Trust Company as trustee with respect to all trust investments. While Mr.

[43] C.A. No. 20033, V.C. Strine (Del. Ch. October 24, 2004)

Duemler was on vacation, Wilmington Trust Company forwarded a prospectus to Mr. Duemler with respect to which he should have taken action. Mr. Duemler did not provide Wilmington Trust Company with any directions concerning the prospectus and the investment declined in value significantly. Mr. Duemler sued Wilmington Trust Company alleging that Wilmington breached its fiduciary duty to the trust for failure to provide him with appropriate financial information to allow him to make an informed decision.

2. In an unreported and unwritten decision, Vice Chancellor Leo E. Strine, Jr. ruled in favor of Wilmington Trust Company holding that there was no evidence of "wilful misconduct" under Delaware's directed trust statute (12 Del. C. section 3313(b)).[44] The Vice Chancellor stated that the Delaware statute requires the investment advisor to make investment decisions in isolation, without oversight from the trustee and to hold otherwise would undermine the role of investment trust advisor. The Vice Chancellor did find that Mr. Duemler breached his fiduciary duty as investment advisor to the trust.

H. Rollins v Branch Banking and Trust Company of Virginia.[45]

1. In 1977, husband and wife each created separate trusts for the benefit of each other. The trusts were to terminate upon the death of the grantor's spouse and the trust assets were to be distributed to the grantor's then living children and the grandchildren of any deceased child. Each grantor named a financial institution to be the trustee. The trusts were funded primarily with shares of publicly traded stock in textile companies located in the community where the grantors lived. Under the terms of the trust agreement, the grantor directed that "Investment decisions as to the retention, sale, or purchase of any asset of the Trust Fund shall likewise be decided by such living children." The trustee obtained the written authority of the beneficiaries to over concentrate the trust investments with the textile stocks.

2. Twenty years after the trust was funded, the trustee sold the textile stocks at the direction of the children. The proceeds of sale from the stock were one-twentieth of the value of the stock at its highest value. The beneficiaries sued the trustee for $25,000,000 alleging breach of fiduciary duty. The trustee defended based on the Virginia directed trust statute.

[44] Peter S. Gordon, "Directed Trusts: The Use of Trust Advisers and Protectors: Can Fiduciaries Limit Liability Through Directed Trusts? Empowering Trust Protectors While Minimizing Their Liability. Or Can a House Divided Stand Long?" 2006 Notre Dame Tax and Estate Planning Institute, page 18-8 and 9.

[45] 56 Va. Cir. 147, 2001 WL 34037931 (Va. Cir. Ct. 2002)

3. Paragraph C of the Virginia directed trust statute, Virginia Code section 26-5.2, Liability of Fiduciary for Actions of Co-Fiduciary, provides as follows:

   "Whenever the instrument under which a fiduciary or fiduciaries are acting reserves unto the trustor, testator, or creator or vests in an advisory or investment committee or any other person or persons, including a cofiduciary, to the exclusion of the fiduciary or one or more of several fiduciaries, authority to direct the making or retention of investments, or any investment, the excluded fiduciary or cofiduciary shall be liable, if at all, only as a ministerial agent and shall not be liable as fiduciary or cofiduciary for any loss resulting from the making or retention of any investment pursuant to such authorized direction."

4. The children argued that the corporate trustee breached its fiduciary duty in failing to diversify, failing to actively secure approval for the sale of the declining stock, and failing to undertake the duties required to preserve and protect the trust assets. In response, the Court stated:

   "The plain language of the instrument, however, clearly contradicts the beneficiaries' argument. The beneficiaries, alone, had the power to make investment decisions. The statute enacted by the General Assembly recognizes the basic principal that the court cannot hold a trustee, or anyone else, liable for decisions that it did not and could not have made. The statute clearly applies in this instance and the beneficiaries have not stated a cause of action against the trustee for failing to diversify the trust assets. The demurrer is granted [no claim is stated against the directed trustee] as it relates to all claims for failure to diversify."

5. The court did not grant the trustee's demurrer (failure to assert a valid claim), on all aspects of the count for breach of fiduciary duty, however. The court concluded that the beneficiaries did raise valid claims as to the trustee's duty to inform beneficiaries and the "duty to warn." The court said this was not inconsistent with dismissal of the claims for failure to diversify.

6. Rollins was settled after the court's ruling without a final determination on the merits. Rollins can be read that a directed trustee can be protected by statute from liability for breach of fiduciary duties relating to investment performance but not for breach of other fiduciary duties that the trustee owes the beneficiaries, such as the duty to keep the beneficiaries informed. A directed trustee is still a trustee.

I. See also McGinley v Bank of America, N.A.,[46] discussed in Section III of the outline, which involved a grantor's direction to retain Enron stock during her life.

[46] 279 Kan. 426, 109 P.3d 1146 (2005).

J. ERISA and Directed Trustees.

1. The body of law on directed trustees is more developed in the ERISA area than in the personal trust area. The two areas are distinct, but the common element of fiduciary obligations imposed on those overseeing an investment fund makes the case law instructive.

2. Congress enacted ERISA in 1974 to encourage and provide for the stability employee benefit plans. ERISA seeks to accomplish this goal by requiring plans to name fiduciaries and by giving them strict and detailed duties and obligations. Specifically, ERISA requires benefit plans to "provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan." 29 U.S.C. § 1102(a) (1).[47] An ERISA fiduciary "shall discharge his duties . . . solely in the interest of the participants and beneficiaries" and must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)(B). These requirements generally are referred to as the duties of loyalty and care, or as the "solely in the interest" and "prudence" requirements.

3. Field Assistance Bulletin No. 2004-03 - Fiduciary Responsibilities of Directed Trustees.

   a. In 2004, the Department of Labor issued Field Assistance Bulletin No. 2004-03 to provide guidance to plan trustees regarding the fiduciary responsibilities of directed trustees. The Field Assistance stated that many employee pension plans are using directed trustees to carry out transactions according to instructions from a named trust advisor. Under ERISA section 403(a), which specifically recognizes that a trustee will have limited authority or discretion when the trustee is directed by a third party, a direction is proper only if the direction is "made in accordance with the terms of the plan" and "not contrary to the Act (ERISA)." Accordingly, when a directed trustee knows or should know that a direction from a named fiduciary is not made in accordance with the terms of the plan or is contrary to ERISA, the directed trustee may not, consistent with its fiduciary responsibilities, follow the direction. Because a directed trustee may not follow a direction that the trustee knows or should know is inconsistent with the terms of the plan, a directed trustee has a duty to request and

[47] Moench v. Robertson, 553 F. 3rd 1995 (3rd Cir. 1995).

review all the documents and instruments governing the plan that are relevant to its duties as directed trustee.

b. The named fiduciary has primary responsibility for determining the prudence of a particular transaction, whether the transaction involves buying, selling or holding particular assets. The directed trustee does not have an independent obligation to determine the prudence of every transaction, or duplicate or second-guess the work of the trust advisor and does not have a direct obligation to determine the prudence of a transaction. A directed trustee does not have a direct obligation of prudence, simply "to make sure" the "directions were proper, in accordance with the terms of the plan, and not contrary to ERISA."

c. If a directed trustee has material non-public information regarding a security that is necessary for a prudent decision, the directed trustee, before following a direction that would be affected by such information, has a duty to inquire about the trust advisor's knowledge and consideration of the information with respect to the direction. For example, if a directed trustee has non-public information indicating that a company's public financial statements contain material misrepresentations that significantly inflate the company's earnings, the trustee could not simply follow a direction to purchase that company's stock at an artificially inflated price.

d. Generally, the possession of non-public information by one part of an organization will not be imputed to the organization as a whole (including personnel providing directed trustee services) where the organization maintains procedures designed to prevent the illegal disclosure of such information under securities, banking or other laws. If the individuals responsible for the directed trustee's services have actual knowledge of material non-public information or performs an internal analysis in which it concludes that the company's current financial statements are materially inaccurate, the directed trustee would have an obligation to disclose to the named fiduciary before making a determination whether to follow a direction to purchase the company's security. A directed trustee does not have the obligation to disclose reports and analyses that are available to the public.

K. The Nature of a Trust Advisor's Powers – Personal or Fiduciary.

1. The duties that a directed trustee has with respect to a trust advisor may depend on the characterization of the trust advisor's power. If the trust advisor's power is a personal power, the directed trustee generally has no responsibility for the exercise of the power and consequently no duty to

review the exercise of the power. On the other hand, if the trust advisor's power is a fiduciary power, the directed trustee may have responsibility and a duty with respect to the exercise of the power by the trust advisor.

2. In determining whether the trust advisor's power is personal power or a fiduciary power, the following factors are important:

   a. The type of power granted under the trust instrument (the more personal the power, the more likely the power is a personal power);

   b. The relationship of the power holder to the grantor (if the power holder has a familial relationship to the grantor, the more likely the power is a personal power while if the power holder is independent, the more likely the power is a fiduciary power); and

   c. Whether the power holder is a trustee (if the power holder is a trustee, the more likely the power is a fiduciary power).[48]

L. Drafting to Protect a Directed Trustee.

1. Notwithstanding that a trustee is relieved statutorily of investment responsibility, a directed trustee should not feel bullet proof. A directed trustee is still a trustee and not an agent. A trustee has duties other than the duty to invest prudently. A statute similar to the Uniform Trust Code statute may protect a directed trustee from a claim of improper investments, but can the trustee be held liable for breaching the trustee's other fiduciary duties?[49]

2. A drafter who wants to protect a directed trustee should consider whether it is appropriate to include the following provisions in the trust instrument:

   a. Define whether the power is a personal power (for the benefit of the power holder) or a fiduciary power (where the power holder may be treated as a cofiduciary);

   b. Define the scope and terms of the power (what power does the trust advisor have);

   c. Determine whether the directed trustee has any duty to monitor or review the actions of the trust advisor;

   d. Provide a procedure for covering the situation if the directed trustee questions the trusted advisor's directions; and

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[48] Scott, IIA Scott on Trusts, Section 185, page 562-568.

[49] See Rollins v. Branch Banking and Trust Company of Virginia, 56 Va. Cir. 147, 2001 WL 34037931 (Va. Cir. Ct. 2002) discussed earlier in this outline.

e. Determine whether it is appropriate to have an exculpation clause protecting the directed trustee from liability.

VII. Administering Concentrated Stock Positions

A. In the majority of trusts, an authorization to retain a concentrated stock position will not be stated as a requirement. It will be precatory or permissive. The mistake many trustees make is treating the authorization as an absolute right not to diversify.

B. The permissive nature of the settlor's or decedent's direction suggests that the trustee should have a process for a concentrated stock position similar to the process for delegation of investment authority. In effect the settlor or decedent has authorized the trustee to delegate investment authority to the management of the company in which the trust holds a large position.

C. Reference to the principles of delegation in fact does provide a very useful guide for the trustee holding a concentrated stock position.

1. Authorization. Does the trust instrument authorize retention of the stock? What restrictions or guidelines did the settlor/decedent provide for retention?

2. Decision to Delegate and Select Investment Manager. The decision in effect already has been made by the settlor/decedent by leaving the stock in the trust coupled with permissive retention language.

3. Review and Monitoring. Just because the settlor has delegated, the trustee is not automatically relieved of its obligation to exercise reasonable care and skill in monitoring the investment manager, in this case the stock and the company management.

a. A first step would be to create some benchmarks for monitoring the performance of the stock. Taking into account the settlor's desire to retain it, what are the standards by which the trustee will judge the stock's performance – industry specific, general market index, or simply the standard of not losing value (or not losing value at too great a rate) over a designated period?

b. In addition to monitoring stock performance, the trustee should monitor management, just like a trustee monitors an investment manager – are there turnovers in company leadership that have resulted in a management approach inconsistent with what the settlor would have wanted? Has the company changed its product focus? Has it stopped innovating?

c. It is equally critical that the trustee maintain thorough records that document the trustee's process and periodic review. The process does not help the trustee in litigation unless the trustee has a contemporaneous written record of it.

4. Cost of Delegation. With a concentrated stock position, the primary cost question is not the cost of retaining the stock but the cost of disposing of it. There may be significant capital gains if the stock is sold because of its low basis. It may be necessary to register the stock or go through a private placement in order to sell it.

a. Another possible cost consideration enters into play if the trustee determines it is appropriate to retain the stock position but decides to use hedging transactions to reduce risk.

b. Cost considerations of a different type also are relevant. Unless it is a directed, mandatory retention, or decision-making for the concentrated stock position is assigned to a different trustee or advisor, the trustee cannot treat the concentrated stock position as an unmanaged position when pricing its services. As suggested above, some monitoring will be necessary.

5. Informing Beneficiaries. The trustee's general duty to keep beneficiaries informed properly should be interpreted as requiring the trustee to advise relevant beneficiaries of its decision to continue to retain a concentrated position, and of any major changes in the stock that occur.

D. The case law discussed previously supports the conclusion that it is appropriate, and good policy, for a trustee to treat a concentrated stock position as a form of delegation. Trustee liability most often results from situations in which the trustee has not put in place a policy for monitoring the concentrated position, because they treated the retention language as a direction not a delegation.

E. Likewise, the Restatement Third of Trusts provides support in its guidance on dealing with mandatory and permissive investment provisions (and distinguishing between the two).

1. The Restatement Third of Trusts describes through a series of examples the challenge the trustee has in properly interpreting the trust document and properly categorizing provisions as grants of authority, permissive directions, or mandatory directions. (§ 228). Drafters need to be aware of the impact that mandatory and permissive investment provisions will have on the duties of a trustee.

EXAMPLE: T is trustee of a trust silent as to the trustee's investment authority. The applicable statute is a legal list. T invests 40% of the trust assets in the stock of two corporations. The stock is appropriate under the legal list statute. Nevertheless, T may have failed adequately to diversify

and could be liable if losses result and if, under the circumstances, reasonable diversification could have been achieved. (§ 228, Illustration 2).

2. Ordinarily, a trustee is bound by a mandatory investment provision in the trust instrument. The trustee need not comply with a mandatory provision, however, if there are changed circumstances such that compliance would be illegal or would defeat or impair the trust purposes. In some circumstances, the trustee has a duty to seek court authority to deviate from trust provision.

   EXAMPLE: T is trustee of trust to pay income to surviving spouse for life, remainder to children per stirpes. T may invade principal for spouse and children (relaxing T's duty to produce reasonable amount of trust accounting income.) The trust directs T to retain a family farm. Over the next 15 years, the trust operates the farm profitably for 10 years, but there are losses in 2 of the last 5 years. T had no discretion to dispose of the farm, is not liable for the losses, and is not obligated to seek authority to vary from the terms of that trust. (§ 228, Illustration 5).

   EXAMPLE: Same facts as above, except that the farm continues to lose money and it can be shown that the trust's purpose is threatened by this pattern of losses. T has a duty to petition the court to allow deviation from the terms of the trust. (§ 228, Illustration 6).

3. Permissive trust provisions may lessen otherwise applicable standards of conservatism or productivity in general terms, or may specifically authorize the retention or acquisition of types of property impermissible under a restrictive statute.

   EXAMPLE: T, a bank, is trustee under a Trust instrument specifically authorizing T to undertake a venture capital investment program. This provision permits a lesser degree of conservatism, which is ordinarily implicit in the duty of caution. The provision does *not* relax the applicable standards or care, skill, or prudence. (§ 228, Illustration 8).

4. Although general grants of discretion to a trustee are common in most trust forms, such a grant does *not* enlarge a trustee's investment authority in a jurisdiction governed by the already flexible Prudent Investor Rule. (§ 228, Comment *g*). Even under the more restrictive Prudent Man Rule, this type of general grant is seen as a confirmation of normal investment authority.[50]

[50] Halbach, "Trust Investment Law in the Third Restatement," Real Property Probate and Trust Journal, vol. 27, no. 3, 1992.

5. In all types of jurisdictions, a grant of "absolute" or "sole and uncontrolled" investment authority in a trust will ordinarily be interpreted as lessening the degree of caution or conservatism ordinarily required of the trustee, and as permitting in general a greater than normal latitude in the development of an investment strategy. For instance, the trustee might select a more active investment strategy, or a portfolio with a higher or lower lever of risk and expected return than might otherwise be thought suitable. The duties of loyalty, care, and reasonable risk management ordinarily will *not* be affected despite extended discretion language. (§ 228, Comment *g*).

6. It is clear that if a trust provision authorizes retention or acquisition of an otherwise impermissible asset, the provision is simply given effect. However, the Third Restatement provides less guidance when a trust provision authorizes retention of an asset which is permissible in any event. The Prudent Investor Rule will seek middle ground between the two extremes of treating such a provision as redundant, and allowing the trustee to rely on the provision without regard to productivity, prudence, or management of risk.

   EXAMPLE: Trust gives T "discretion and authority to invest in all types of properties, including properties not normally permissible as trust investments." In a legal list state, this provision converts the trustee's authority to that described in the Prudent Investor Rule. In a Prudent Investor Rule state, the provision has no apparent purpose and does *not* broaden T's normal authority. (§ 228, Illustration 12).

   EXAMPLE: Same facts as above, except that the investment provision continues "and without regard to the normal duty of diversification." T's duty of to act with prudence still applies, including reasonable consideration of the role diversification plays in risk management. The language of the provision is too general to reveal a definite purpose, yet too clear not to be respected. The effect of the provision will be a matter of interpretation, justifying a court in looking more freely than it otherwise might to the circumstances, background, and settlor's objectives. (§ 228, Illustration 13 and Comment *g*).

7. As the above example illustrates, trust provisions are strictly construed against dispensing with the requirement of diversification because it is fundamental to risk management. (§ 228, Comment *f*).

8. The lesson to be taken is that where trust provisions specifically authorizes an otherwise permissible investment, the trust instrument should explain the redundancy. The settlor could intend to authorize, for example, (i) a large purchase of the particular asset; (ii) retention or expansion of an asset otherwise inconsistent with duty of diversification; or (iii) retention or expansion of an asset which would otherwise be inconsistent with the

appropriate degree of income productivity. The additional guidance from the settlor does not necessarily relieve the trust of the duties to monitor and inform, but it will provide the trustee with more guidance on the factors to consider as part of its monitoring.

EXAMPLE: T is trustee of trust to pay income to surviving spouse for life, remainder to children per stirpes. T may invade principal for spouse and children (relaxing T's duty to produce reasonable amount of trust accounting income.) The trust directs T to retain a family farm and authorizes T to liquidate other investments in order to acquire additional land to expand the farming operation. This provision would permit T to acquire suitable additional land, even though doing so would necessarily aggravate the trust's diversification situation. (§ 228, Illustration 7).

EXAMPLE: The grantor is a principal in a family business that will constitute a substantial portion or all of the trust. The grantor strongly believes that the trust should retain the business. The draftsperson might consider using the following clause in the trust: "I consider shares of stock or other evidences of interest in or indebtedness of FAMILY FORTUNE, INC., or any other entity or entities succeeding to the business of said corporation, by consolidation, merger, purchase of assets, or otherwise, which may constitute a part of trust principal as proper investments of trust principal, and the trustee is authorized to invest or retain indefinitely any part or all of the trust principal in those investments. Those investments are referred to in this instrument as "special securities." It is my belief that the interests of all beneficiaries of this trust, including all life beneficiaries and remaindermen, will be best served by the retention of the special securities, even though such securities may lack liquidity, may be considered, and in fact be, more volatile or risky than alternate investments, may never yield a dividend or other income, and constitute a very large percentage or all of the corpus of the trust. I realize that retention of the special securities may not be considered wise from a narrow financial or investment perspective. My evaluation of the best interests of the beneficiaries is based on broader considerations, including the emotional, social, and other intangible benefits of being associated with the company founded by their ancestor. No trustee shall be accountable for any loss or depreciation in value sustained by reason of the trustee's compliance with my wishes as expressed in this paragraph."

F. Drafting for Concentrated Stock Positions

1. Commentators have suggested that the cause of the litigation in many concentrated stock cases is the failure of the draftsperson to adequately

express the testator's or settlor's intent.[51] Courts have made similar comments. In Wood v. U.S. Bank. N.A., supra the court noted that "fuzzy drafting can create problems."[52]

2. The simple response is to say that the testator or settlor should have mandated the retention of the stock rather than made it permissive, or to say that the drafting attorney failed to carry out the settlor's intent by not mandating retention.

3. Such statements are a gross oversimplification. They suggest that settlors and testators actually intend that the stock never be sold, no matter what; that the settlor or testator never would have sold the stock under any circumstances.

   a. This is rarely the case. If adequately questioned on the subject, most individuals would acknowledge a variety of circumstances which would lead them to consider selling their large stock positions: sale of the company to a large conglomerate or out-of-town owners; significant negative performance over a long period of time; or a change in management and management style, just to name a few.

   b. The valuable point raised by the suggestion is that the draftspersons should spend more time exploring with the testator or settlor why he or she wants the stock position retained, and what circumstances would justify consideration of selling it. The draftsperson needs to play devil's advocate.

   c. The draftsperson then needs to build those reasons into the document, either as illustrations to further explain the person's intent, or as objective exceptions that allow the trustee to consider sale. This is the point of the Restatement commentary, discussed above, regarding the importance of explaining why certain duties of the trustee are being waived.

4. There is no one correct approach from a drafting standpoint, but the case law and commentary suggest several things for draftspersons to consider if drafting for someone who wants to encourage or require retention of a concentrated stock position.

   a. Do not rely on boilerplate clauses to do the job.

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[51] Jeffrey A. Cooper, "Speak Clearly and Listen Well: Negating the Duty to Diversify Trust Investments," 13th Annual Law Review Symposium (Ohio Northern Univ. Law Review, 2007) (Cooper, "Negating the Duty").

[52] 828 N.E. 2d at 1075.

b. If the testator or settlor wants a particular stock retained, identify that stock by name in the instrument.

c. Specify the duties that the settlor is waiving or modifying. Many draftspersons stop after saying "without regard to the duty to diversify." The case law shows that courts will strictly construe waivers of duties. A waiver of the duty to diversify is unlikely to be treated as modifying the duty to preserve trust property, the duty of reasonable care, or the duty to inform beneficiaries.

d. If the settlor wants to allow sale only "for a compelling reason", provide examples of what would constitute a compelling reason in the settlor's view.

e. Explain the settlor's reasons for wanting the stock to be retained. "It's a great company that our family built its wealth on." "I worked for the company for 40 years and have great faith in its management." "It is an important part of our local economy." All these statements provide indicators of circumstances when sale of the stock might become appropriate.

f. For a closely held family business, the reasons for retention are different, more obvious, and more compelling. Nevertheless, spell them out.

g. Jeffrey Cooper correctly suggested in his article on diversification that the draftsperson is best served by precise, specific and clear language. "While many lawyers might assume that the broadest language will have the broadest legal effect, the case law reveals the fallacy of this assumption."[53]

G. Communication and Disclosure

1. Several references have been made to the importance of communicating with beneficiaries, in the context of concentrated stock positions and elsewhere.

2. The importance of communication cannot be overemphasized. As noted by one commentator,

"Communication is an integral part of the relationship between trustee and beneficiary; in fact, often times trustees have been criticized not for taking

[53] Cooper, "Negating the Duty", at 928.

or failing to take an action, but for the failure to communicate with the beneficiary."[54]

3. If the trustee regularly communicates its decision to retain a concentrated stock position to the beneficiaries, they may be legally foreclosed from later challenging the decision, either by accounting statutes or by equitable principles such as laches.

4. In addition, thorough communication may lead a beneficiary who objects to go into court currently to advocate sale of the stock position. A trustee may think this is a negative, but judicial resolution, and hopefully approval of the trustee's decision-making process, early on is much better than a suit after the stock value has deteriorated significantly and the possible damages are much greater.

H. Strategies to Manage Risk

1. If the trustee is retaining the concentrated position, the trustee should consider strategies to hedge against the risk of significant loss of value. See Raymond Radrigan, "What It Takes To Be a Prudent Fiduciary – Especially In A Volatile Economy." Practicing Law Institute, 39th Annual Estate Planning Institute (September 8-9, 2008)

2. Purchase a Put Option. The put option allows the stock owner to sell the security at a pre-determined price, thereby setting a minimum value for the stock interest during the term of the option. The owner retains all the upside potential. The cost is the premium paid to purchase the option.

3. Equity Collar. The combination of the purchase of a put option with the sale of a call option. These are often designed to be costless – the premium paid for the put equals the amount received for the call. However, the owner has now limited the upside potential for the stock as well as protecting itself on the downside.

4. Prepaid Variable Forward Contract. An agreement to sell a variable number of shares at a future date for a specified price, in exchange for an upfront cash payment equal to a discounted percentage of the current value of the stock. It can provide downward price protection and significant upfront liquidity that can be invested in a diversified portfolio.

VIII. Conclusion

A. The common thread of advice in dealing with concentrated stock positions is that the trustee needs to have a policy for addressing the situation, must effectively

[54] Sharon L. Klein, "A Matter of Trust," – New York Law Journal (September 21, 2009)

implement and administer that policy, and should communicate the policy and its implications to the beneficiaries on a regular basis.

B. A final word on the policy – it should not be a singular noun. One policy will not fit every situation. The trustee must be prepared to alter its policy, and in some cases create a uniquely designed one, for the particular situation.

THE USES AND MISUSES OF DECANTING

I. Introduction

A. Decanting

1. Decanting is a term used to describe the trustee's exercise of a power to distribute trust property into a new trust. Like the decanting of wine into a new container, the trust assets are poured into the new trust. Decanting is used to change trust terms or to move the trust assets to a more favorable jurisdiction. Thus, it is a possible solution for an age-old problem: How to modify an irrevocable trust? This is a question beneficiaries, trustees and sometimes even trust settlors have asked for decades. ("I know the trust is irrevocable, counsel, but why can't I change it?")

2. The decanting concept is derived from the common law theory that a trustee who has the unfettered discretion to make a distribution to a beneficiary may elect to make that distribution to a trust for the beneficiary rather than outright. The authority for using this alternative admittedly is somewhat thin.

B. States have built on this common law foundation by enacting statutes that specifically authorize decanting. Seventeen states now have enacted decanting legislation. Sections III to V discuss the current state law regarding decanting and the issues that arise with the use of a decanting power.

C. Change of Situs

1. The "situs" of a trust refers to the place of its administration. The place of administration of a trust can change if an individual trustee moves to another state and administers the trust there, if a corporate trustee transfers administration of the trust to its offices in another state (for example, because the primary beneficiary has moved to that state), or if a trustee resigns and the successor trustee (individual or corporate) is located in a different state. However, a change in the trust's place of administration does not automatically change its governing law. The governing law will be determined by what the trust instrument provides, or, in the absence of a specific direction, by conflict-of-laws principles

2. As noted, a trustee may want to use decanting in order to move a trust to a new jurisdiction, to take advantage of that jurisdiction's laws. More often than not, however, a trust written in the last 25 years will contain a specific clause allowing a trustee to change the situs and governing law of a trust. A typical trust provision might read:

> "This instrument and all dispositions hereunder shall be governed by and interpreted in accordance with the

laws of the State of ____________; provided, however, that the trustee may, by written instrument filed with the trust records, change the situs and governing law of any trust to that of another state, except that any such change in governing law shall only take effect to the extent that it does not result in any significant change in the interests of beneficiaries."

3. A trustee who is contemplating a change of situs and governing law, whether pursuant to a decanting statute or a change of situs provision in the trust, must consider the implications of conflict-of-laws rules. These rules are discussed in section VI of these materials.

D. Changing an Irrevocable Trust

1. Before considering the use of decanting or a change of situs provision, it is important to review the options for changing a trust that might already be contained in the trust instrument or offered under state law.

2. More modern trusts typically build in a variety of powers that facilitate changes in the trust terms. Even older trusts may have useful provisions, especially powers of appointment.

II. Traditional Methods for Changing a Trust

A. Powers of Appointment

1. Testamentary Powers of Appointment. Testamentary powers of appointment can be used in a variety of ways to permit prospective changes to a trust. The power can give the holder broad discretion to appoint the trust property, or be limited, such as a power permitting appointment of property only among descendants. Some common powers of appointment that can be given to a beneficiary without adverse estate or gift tax consequences include:

   a. the power to appoint to descendants only;

   b. the power to appoint to descendants and spouses of descendants only; and

   c. the power to appoint to anyone other than the holder, the holder's estate, or the creditors of either.

2. This last power is the broadest type of special or limited power that can be given to the holder without causing the power to be a taxable general power of appointment.

3. The parameters for exercise of a power of appointment can be very specifically defined. For example, a power of appointment granted to a child sometimes will permit the child to appoint trust property to his or her spouse, but only in trust. This permits the child to provide for his or her spouse, but also ensures that the property in the trust will pass eventually to the settlor's descendants.

   SAMPLE TRUST PROVISION: If the child for whom the trust is named is living on the division date, then upon the death of the child, the trustee shall distribute the remaining principal of the trust to such one or more of the child's descendants or the spouse of the child as the child may appoint by will; provided, however, that any property appointed to the spouse of the child shall be held in trust and that trust must provide that (i) only income, but not principal, may be distributed to the spouse, (ii) the spouse shall not be trustee, (iii) the trust will terminate no later than the spouse's death (and the trust may terminate earlier on events such as the spouse's remarriage or cohabitation with an unrelated person), and (iv) upon termination, the trust property shall be allocated or distributed (in a manner designated by the child) among the descendants of the child.

4. A power of appointment can be limited so that it allows only certain specifically described modifications to a trust instrument. This may be attractive to a client who does not want a spouse or descendant to have the ability to alter the fundamental dispositive terms of the trust (i.e., the identity of the future beneficiaries or the amount of their beneficial interests) but wants the flexibility to address certain currently unpredictable events. For example, a client's trust may provide for separate trusts created for the children after the surviving spouse's death, with each child having a right of withdrawal over the trust at specified ages. To address the possibility that a child may later encounter creditor problems, may develop drug or alcohol problems, or may just be unreliable and financially irresponsible, the client could give his or her spouse the following testamentary power:

   SAMPLE TRUST PROVISION: Upon the death of my spouse, my spouse shall have the power, exercisable by will, to modify the provisions of [the paragraph in the trust agreement that describes a child's withdrawal rights] by changing the ages at which a child of mine may withdraw property from the trust named for the child or the amount that may be withdrawn at any given age, or by eliminating the withdrawal right entirely.

5. <u>Lifetime Powers of Appointment</u>. A lifetime power of appointment is traditionally used to permit the primary beneficiary of a trust to transfer trust property to family members. It often was used in a general power of appointment marital trust so children or others could benefit from the trust in the spouse's discretion.

EXAMPLE: Spouse is the beneficiary of a $3,000,000 general power of appointment marital trust, under which she also has a lifetime power to appoint property among her children. Spouse's separate estate is small. In order to reduce future estate taxes, spouse exercises the lifetime power each year to give $10,000 from the marital trust to each of her four children.

6. A spouse's exercise of the lifetime power is treated as a taxable release of her general power of appointment with respect to the amount distributed, and hence a gift.[1] However, the transfers will qualify for the annual exclusion from gift tax. A lifetime power cannot be given to the spouse in a QTIP trust.

7. The exercise of a lifetime power over a trust that is not includable in powerholder's estate also can have transfer tax consequences. The person who exercises the power is treated as making a gift equal to the value of the interests in the trust that he or she has given up as a result of the exercise.[2]

EXAMPLE: Child is the beneficiary of a trust which provides that child will receive all the trust income, at least annually. Child also has a limited lifetime power of appointment over the trust, which Child exercises to distribute $100,000 to his three children. Child has made a gift of his income interest in $100,000. Assume the Child is age 75 and the income interest has a value of about $48,000 under the IRS valuation tables. Child has made a gift, which qualifies for the annual exclusion, of $16,000 to each of his children.

8. A lifetime power of appointment can structured to work very much like a decanting power, except that it is the trust beneficiary that is pouring the trust assets into a new trust, rather than the trustee.

SAMPLE TRUST PROVISION: If the named beneficiary is living on the creation of a trust, then at such time at or after the date of the creation of the trust as the named beneficiary has reached the age of thirty-five years, the trustee shall also distribute to such one or more of my descendants as much or all of the principal of the trust as the named beneficiary from time to time may appoint by signed instruments delivered to the trustee during the life of the named beneficiary, which instruments shall be irrevocable unless made revocable by their terms. The named beneficiary shall not have the power to appoint any principal under this paragraph to the named beneficiary, the named beneficiary's estate, or the creditors of either, or to satisfy any legal obligation of the named

[1] Treas. Reg. § 25.2514-3(c) (as amended in 1997).

[2] *See* Estate of Regester v. Comm'r, 83 T.C. 1 (1984).

beneficiary, including any obligation to support or educate any person; *provided, however, that the named beneficiary may exercise this power to create a successor trust of which the named beneficiary is a beneficiary as long as the named beneficiary's beneficial interests in, and fiduciary and non-fiduciary powers over, that successor trust are no broader than the interests and powers of the named beneficiary in the trust named for him or her under this Article.*

B. Third Party Amendment Powers

1. An irrevocable trust may allow someone other than the settlor to amend the trust. The amendment provision often is quite limited, for example allowing amendment for the sole purposes of complying with tax laws that apply to the trust. These powers are common in trusts such as charitable remainder trusts, charitable lead trusts, qualified personal residence trusts, and grantor retained annuity trusts.

2. Increasingly, practitioners are using the concept of a "trust protector", a specially appointed fiduciary or quasi-fiduciary with amendment powers, to provide added flexibility to an irrevocable trust. A trust protector's power of amendment usually applies to one or more of three categories of circumstances:

   a. Power to amend to address changes in tax laws or other legal or factual changes that impact the trust;

   b. Power to amend administrative provisions such as trustee removal or appointment powers or trustee investment powers; and

   c. Power to amend to alter beneficiaries' interests in the trust.

3. For example, a trust protector provision could permit the protector to amend a trust so that an outright distribution need not be made to a beneficiary.

4. The use of trust protectors is also increasingly being recognized by states. Several states have enacted legislation in which trust protectors are specifically recognized. Statutes exist in Alaska, Arizona, Idaho, Illinois, South Dakota, and Wyoming.[3] For example, the Alaska statute provides that "[a] trust instrument may provide for the appointment of a disinterested third party to act as a trust protector."

5. In addition, the use of a trust protector has been recognized in Section 808 of the Uniform Trust Code, which has been adopted in some form in

[3] *See* ALASKA STAT. § 13.36.370(a); ARIZ REV. STAT. § 14-10818; IDAHO CODE ANN. § 15-7-501; 760 ILL. COMP. STAT. 5/16.3; S.D. CODIFIED LAWS § 55-1B-6; *and* WYO. STAT. ANN. § 4-10-710.

twenty-four states and the District of Columbia[4]. Section 808 of the Uniform Trust Code reads:

SECTION 808. POWERS TO DIRECT.

(a) While a trust is revocable, the trustee may follow a direction of the settlor that is contrary to the terms of the trust.

(b) If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise 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 that the person holding the power owes to the beneficiaries of the trust.

(c) The terms of a trust may confer upon a trustee or other person a power to direct the modification or termination of the trust.

(d) A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty.

C. Trust Merger Provisions

1. Another provision frequently found in trusts is a power in the trustee to merge the trust into a trust with "substantially the same" or "similar" provisions:

SAMPLE TRUST PROVISION: To merge at any time all the trust property with the property of any other trust held by the same trustee for the benefit of the same beneficiaries and upon similar terms and conditions as those set forth herein, and, at the trustee's discretion, either administer the merged assets as a single trust hereunder or transfer the trust property to that other trust, to be administered under the instrument governing that other trust, and thereafter terminate the trust hereunder as a separate entity; and in order to facilitate the merger of trusts, the trustee may shorten the perpetuities period.

[4] These jurisdictions 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 and Wyoming.

2. This provision usually is not intended to be used to alter beneficial interests, and a trustee should be reluctant to use it in that way. It might be appropriately used to change a trust's governing law, or to transfer a trust to an instrument that provides greater creditor protection, or more robust delegation provisions.

3. With irrevocable trusts, a relatively common use is to correct an inadequate Crummey power provision. Many older trusts limited Crummey withdrawal rights to the greater of $5,000 or 5% of the trust principal, thereby following the no-taxable lapse limitations in Sections 2041(b)(2) and 2514(e). If the client has an insurance trust with this limitation, and now wishes to increase annual exclusion gifts to the trust (for example because the trust wants to acquire a bigger policy), one option is to create a new trust with identical provisions except for a more liberal Crummey power.

D. Facility of Payment Clauses

1. Many trust instruments include a facility of payment clause, which permits the trustee to carry out the purposes of the trust even though a beneficiary is considered by the trustee to be incompetent or disabled. These clauses often permit the trustee to make distributions:

- directly to the beneficiary;
- for the benefit of a beneficiary;
- to a lawful guardian of the beneficiary; and
- to a custodian under the Uniform Transfers to Minors Act.

2. Some trustees feel comfortable using the authority to distribute "for the benefit of a beneficiary" to direct a distribution to a separate, vested trust for the beneficiary.

E. Reformation

1. A reformation is the modification or alteration of an instrument for the purposes of giving effect to the settlor's intent. A reformation action differs from an action to revoke a trust. It also differs from a construction action, which is a judicial interpretation of an ambiguous trust provision. In a reformation, the trust terms are not ambiguous, but they are modified to better serve the settlor's intent.

2. Any interested party may bring a judicial action to reform the terms of a trust. An interested party is a beneficiary, a trustee, or the trust settlor. A person claiming to be a beneficiary, whose rights do not appear in the instrument and are not recognized by the fiduciary, may also have

standing to bring a reformation action. All interested persons must be identified and made parties to the action.

3. In most states, reformation is only allowed in limited circumstances. It is not allowed simply because the trustee or the beneficiaries are no longer satisfied with the terms of the trust. Reformation is allowed where (i) circumstances have changed such that the settlor's intent may be defeated by the current terms of the trust, (ii) clear and convincing evidence demonstrates that a trust term was based on a mistake of law or fact by the trust settlor, or (iii) there has been a scrivener's error.

4. Some states have adopted more relaxed standards for trust reformation. The Delaware Court of Chancery will allow "Consent Petitions" for purposes of reforming irrevocable trusts. If all parties interested in the trust agree (or for tax reasons state their non-objection or take no position), the trust maybe reformed for a proper purpose, which includes changes that are in the best interests of the beneficiaries and the trust.[5]

    a. Using this procedure in combination with the Delaware virtual representation statute[6] can enable the trustee and beneficiaries to implement broader changes to a trust.

    b. On April 12, 2012, Chancellor Strine signed Amendments to Court of Chancery Rules, Section XII, Rule 100, Rule 101, Rule 102, and Rule 103. The new Rules, which took effect on May 1, 2012, impose additional requirements on consent petitions for trusts.

F. Nonjudicial Settlement Agreements

1. Many states now allow the trustee and beneficiaries to enter into a binding agreement regarding the trust. Combined with principles of virtual representation, which provide that the joinder of representative beneficiaries to an agreement will bind all current and future beneficiaries, nonjudicial settlement agreements can sometimes be an efficient way to alter unfavorable trust terms.

2. The Uniform Trust Code has codified the use of nonjudicial settlement agreements in many states. Under UTC § 411, interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust. The UTC provides that such an agreement is valid only to the extent:

    a. It does not violate a material purpose of the trust; and

[5] *See* Court of Chancery Rules, Section XII, Rule 100, Rule 101, Rule 102, and Rule 103.

[6] 12 Del. C. § 3547

b. Includes terms that could be properly approved by the court.

3. Proper subjects of nonjudicial settlements include, without limitation:

   a. The construction of the trust document;

   b. Approval of a trustee's report or accountings;

   c. Directions to trustees to refrain from any particular act;

   d. Granting trustees necessary or desirable powers;

   e. Resignation and appointment of trustees;

   f. Transfer of place of administration; and

   g. Liability of trustee for an action relating to the trust.

4. Interested persons are persons whose consent would be required in order to achieve a binding settlement were the settlement to be approved by the court. As noted, the virtual representation provisions apply, thereby making it possible to bind minor and unborn beneficiaries to a settlement agreement without a court proceeding.

5. Several non-UTC states also have enacted statutes allowing nonjudicial settlement agreements. For example, Illinois amended its virtual representation statute under its Trusts and Trustees Act, effective January 1, 2010, to allow for such agreements. The statute provides:

   "(d) Nonjudicial settlement agreements.

   (1) For purposes of this Section, "interested persons" means the trustee and all other persons and parties in interest whose consent or joinder would be required in order to achieve a binding settlement were the settlement to be approved by the court.

   (2) Except as otherwise provided in subsection (d)(3), interested persons, or their respective representatives determined after giving effect to the preceding provisions of this Section, may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust.

   (3) A nonjudicial settlement agreement is valid only to the extent its terms and conditions could be properly approved under applicable law by a court of competent jurisdiction."[7]

[7] 760 ILCS 5/16.1

G. <u>Specific Decanting Powers in the Trust Instrument</u>. There are firms and practitioners who were decanting pioneers. Many years ago, long before anyone started using the word "decanting", they created trust clauses that specifically authorized the trustee to transfer assets to another trust. These provisions may have been designed for a specific client or special situations, or the practitioner may have created what in effect is a very broad facility of payment clause is to permit distributions to be made to another trust for the beneficiary. This could be an existing trust or a new one established by the trustee or a third party for the beneficiary.

EXAMPLE: A trust directs the trustee to distribute the net income annually, in equal shares to the grantor's children or any qualified trust for their benefit. One of the children develops substance abuse problems. During that period, pursuant to a provision in the trust, the trustee distributes that child's share of the net income to a separate irrevocable trust for the child that permits accumulation of income.

SAMPLE TRUST PROVISION: Commencing as of the date of this instrument and until the basic distribution date (defined later in this Article), the trustee shall distribute to any one or more of the child and his or her descendants living at the time of distribution or to any "qualified trust" (as defined in this paragraph) as much of the net income and principal of the trust, even to the extent of exhausting principal, as the independent trustee, in that trustee's sole discretion, from time to time believes desirable. A "qualified trust" is any trust, whenever created, for the primary benefit of the child or the child and one or more of the child's descendants (whether then living or thereafter born), other than a trust with respect to which a distribution would violate any rule of law relating to perpetuities applicable to this trust.

EXAMPLE: Child is the sole current beneficiary of a GST exempt gift trust created by her parents. Child does not need distributions from the trust and would like to be able to use some of the trust property for her children. The trustee exercises its power under the instrument to transfer the entire trust principal to a new trust for child and her children.

SAMPLE TRUST PROVISION: The trustee may, in the trustee's sole discretion, distribute any part or all of the principal of the trust named for a child of mine to any other trust, whether now existing or hereafter created, for the primary benefit of the child (the "recipient trust"), even if the child is not the sole beneficiary of the recipient trust and the terms of the recipient trust are not identical to those of the trust held under this instrument; provided, however, that the trustee shall not exercise its discretion under this paragraph in a manner which violates any applicable rule of law relating to perpetuities.

III. Current Law on Decanting

A. Common Law Authority for Trustee Decanting. The discussion of the common law authority for decanting begins with a 1940 Florida Supreme Court case.

1. In Phipps v. Palm Beach Trust Co.,[8] the Florida Supreme Court held that a trust authorizing the trustee to pay all or any part of the principal or income of the trust in such proportions as the trustee determined gave the trustee a "special power of appointment" under which the trustee could create a new trust for any one or more of the beneficiaries of the current trust.

a. The Phipps court concluded that the power vested in a trustee to create a fee interest through an outright distribution included the power to create or appoint an estate less than a fee, unless the donor indicated a contrary intent. Under the Phipps holding, if a trustee has the discretionary authority to distribute property to a beneficiary, the trustee could create a trust for the beneficiary and distribute property to that new trust rather than distributing the property outright to the beneficiary.

b. Of course a case such as this, interpreting the extent of a trustee's distribution power, is state law specific. The holding is not necessarily indicative of how other states would interpret their common law.

2. In Wiedenmayer v. Johnson,[9] a New Jersey court approved the trustees' exercise of their distribution power to distribute property to another trust for the benefit of the current beneficiary of the original trust.

a. The trust in question allowed the trustees to distribute trust property to the primary beneficiary "from time to time and whenever in their absolute and controlled discretion they deem it to be for his best interests." The remainder of the trust would pass to the beneficiary's children at his death.

b. The trustees apparently wanted to distribute property to a new trust for the beneficiary because of the beneficiary's matrimonial problems. However, the new trust did not give remainder interests to the beneficiary's children. A guardian ad litem for the children objected to the distribution. The court rejected the objection, on the grounds that the trustees could have distributed the property outright to the beneficiary, which also would have eliminated the

[8] Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940).

[9] 254 A.2d 534 (N.J. Super. Ct. App. Div. (1969).

remainder interests of the children. The court concluded that the trustees appropriately exercised their authority, and that it was consistent with the settlor's intent to act in the best interests of the primary beneficiary.

3. In re Estate of Spencer[10] is a third case referred to in discussions of the common law support for decanting. In this case, however, the trustee was also the trust beneficiary and it is less clear whether the court viewed his exercise of a power to appoint to a new trust as a trustee power or a beneficiary's exercise of a power of appointment.

B. Decanting Statutes.

1. Seventeen states now have statutes under which a trustee, pursuant to a power to distribute trust assets outright, may appoint trust assets in favor of another trust. These states are:

a. Alaska[11]

b. Arizona[12]

c. Delaware[13]

d. Florida[14]

e. Indiana[15]

f. Illinois[16]

g. Kentucky[17]

h. Missouri[18]

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[10] 232 N.W.2d 491 (Iowa 1975).

[11] Alaska Stat. § 13.36.157

[12] Ariz. Rev. Stat. §14-10819

[13] Del. Code tit 12 § 3528

[14] Fla. Stat. § 736.04117

[15] Ind. Code § 30-4-3-6

[16] 760 ILCS 5/16.4, effective January 1, 2013

[17] Kent. Rev. Stat. 386.175

[18] Mo. Rev. Stat. § 456.4-419

i. Nevada[19]

j. New Hampshire[20]

k. New York[21]

l. North Carolina[22]

m. Ohio[23]

n. Rhode Island[24]

o. South Dakota[25]

p. Tennessee[26]

q. Virginia[27]

2. New York was the first state to enact a decanting stature when it did so in 1992. (It amended its law effective August 17, 2011 and expanded the scope of the statute).

   a. The original New York decanting statute required the trustee to have unfettered discretion to invade trust principal. There could be no limitations on the trustee's ability to invade principal (such as an ascertainable standard). It also precluded the reduction or elimination of a fixed income right, allowed exercise of the power only in favor the "proper objects "of the trust (not defined), and limited the recipient trust to the perpetuities period as measured by reference to the original trust. The trustee had to serve written notice of the exercise on all persons with an interest in the trust.

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[19] Nev. Stat. § 136.037

[20] N.H. Rev. Stat. § 564-B:4-418

[21] N.Y. EPTL § 10-6.6(b).

[22] N.C. Gen. Stat. § 36C-8-816.1

[23] Ohio Rev. Code § 5808.18 (effective March 22, 2012)

[24] R.I. Gen. Laws § 18-4-31

[25] S.D. Codified Laws § 55-2-15

[26] Tenn. Code § 35-15-816(b)(27)

[27] Va. Code § 55-548.16:1

b. The New York statute thus framed the primary issues that most state statutes address:

(1) Scope of trustee authority to make distributions;

(2) Protection of income (or unitrust) interests, and trustee ability to change the discretionary distribution standard of the first trust;

(3) Ability to change beneficiaries or add powers of appointment;

(4) Ability to change the trust term or perpetuities period; and

(5) Notice requirements, and right to court review.

c. Several state statutes also specifically address whether a trust from another state may elect to use its decanting law, or choose to do so after moving administration to that state.

C. Distribution Authority in Original Trust

1. The key initial inquiry under most state decanting statutes is whether the trustee's distribution power is sufficiently broad to allow the trustee to decant.

2. Florida and Indiana require that the trustee have absolute discretion to make distributions. The decanting statute is not available if the trustee's distribution power is limited by a standard.

3. By contrast, the statutes in Delaware, Nevada, New Hampshire and Tennessee are silent as to the minimum required distribution standard. It appears that any power of distribution is sufficient.

4. Several states allow the use of decanting when distributions are subject to an ascertainable standard, but limit the terms of the recipient trust in such situations. The new trust must use the same standard as the first (Alaska, Illinois, New York, North Carolina, Ohio and Virginia).

5. Several states permit decanting of trust income, or are silent on the question (e.g. South Dakota, Nevada and North Carolina). Most states limit the exercise of the decanting power to distributions of trust principal.

D. Ability to Change Distribution Rights and Discretion

1. As noted above, several states require the distribution standard in the recipient trust to be the same as in the original trust if the original trust's

distribution standard was subject to a standard. Alaska requires all trusts receiving a decanted distribution to use an ascertainable standard.

2. Many state statutes are silent on the question of changing the distribution standard, thereby implying that the standard can be changed in the recipient trust (Arizona, Florida, Indiana, Missouri, Nevada, New Hampshire, South Dakota and Tennessee).

3. The majority of decanting statutes prohibit the reduction of a mandatory or other fixed income interest in the recipient trust, and some extend this treatment to annuity and unitrust interests.[28] A number of the statutes also explicitly prohibit changes that would impact a trust's qualification for the marital or charitable deduction (e.g. Illinois, Nevada, North Carolina and Virginia).

4. The marital and charitable provisions in decanting statutes are designed as savings clauses, to preserve favorable tax treatment. In a similar vein, many of the statutes prohibit a trustee who also is a beneficiary from exercising the decanting power, thereby possibly triggering Section 2036 or 2041 issues. The IRS also could treat a beneficiary's involvement in the decanting as a gift, if the beneficiary's interest in the recipient trust is reduced and other beneficiaries benefit from that. This is discussed in section V.

E. Ability to Change Beneficiaries and Power of Appointment

1. The decanting statutes generally allow for the removal of beneficiaries but do not expressly permit the addition of new beneficiaries in the recipient trust.

2. South Dakota and Missouri are the two states with the most flexible provisions, explicitly permitting trustees to decant to trusts in favor of one or more of the current beneficiaries, and to accelerate the interests of one or more remainder or contingent beneficiaries. Most states do not expressly address the issue of accelerating interests.

3. The ability to add beneficiaries is indirectly available in those states where the statutes allow the trustee to create powers of appointment in the recipient trust. If the trustee can grant a power of appointment to beneficiaries in the recipient trust, especially a lifetime power, those beneficiaries could add new beneficiaries.

4. The statutes in Delaware, Nevada, New Hampshire, North Carolina, Ohio and Virginia state that the permissible appointees of a power of appointment are not limited to the beneficiaries of the decanted trust.

[28] *See*, *e.g.*, Va. Code § 55-548.16:1.C.4.

5. New York allows the trustee to grant a power of appointment to a beneficiary who could have received an outright distribution under the terms of the original trust.

6. In Illinois, the scope of the power of appointment that can be granted depends on whether the original trust gave the trustee absolute discretion to make distributions. If it did, the trustee may exercise the decanting power to accelerate interests and grant different powers of appointment. If not, the recipient trust must have the same class of beneficiaries and same permissible appointees under a power of appointment as the original trust.

F. Ability to Change the Trust Term or Perpetuities Period

1. Except for Delaware, decanting statutes do not preclude the trustee from extending the trust term in the recipient trust. Some statutes are explicit on the point, and others are silent. Delaware appears to prohibit extending the term in most cases, by providing that if the recipient trust has an open class of beneficiaries, then its terms must allow distributions only "when and to the extent permitted" by the original trust.

2. Most state statutes treat the decanting power like the exercise of a power of appointment, and prohibit the exercise of a power in a manner that extends the perpetuities period applicable to the original trust. Several statutes specifically state that the perpetuities rule applicable to the first trust shall apply.[29]

3. In states where the trust created by the exercise of a power of appointment may have a new perpetuities period (Arizona, Nevada, New Hampshire, Delaware), decanting theoretically could be used to achieve that. However, the trustee must consider the impact for federal generation-skipping tax purposes if the trust is grandfathered or GST exempt. Delaware law prohibits the extending the perpetuities period for any trust that is GST exempt.[30]

G. Notice Requirements and Court Review

1. No state requires beneficiary consent or court approval for decanting (except for an Ohio testamentary trust, where the court with jurisdiction over the trust must approve).

2. Alaska, Arizona, Delaware, New Hampshire and Tennessee do not require notice to beneficiaries of a decanting.

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[29] *See*, *e.g.*, 760 ILCS 5/16.4(g).

[30] *See* 25 Del. C. § 504.

3. Other states have notice requirements, varying from 20 to 60 days. Even if notice is not required, a trustee should consider giving notice, and possibly a release from the relevant beneficiaries, in order to protect itself from possible liability for exercise of the power. (However, the trustee should consider the possible argument by the IRS that a release could be treated as a gift by a beneficiary whose interest is reduced in the decanting; see section V.) Several states expressly provide that the trustee may seek court approval.

4. Any trustee exercising a decanting power should consider the fiduciary risks of doing so. A few states offer specific guidance on the standard that applies in determining the appropriateness of the trustee's exercise of discretion (e.g., Delaware, South Dakota, Illinois), or provide guidelines for the trustee to consider in exercising the power (e.g., Missouri and New York).

H. Choice-of-Law

1. The states with decanting statutes still are in the minority. Therefore, a trustee seeking to change a trust may first move the trust to a state with a decanting statute, using a change of situs provision, and then decant the trust under the new state's law. Similarly, the trustee may move the trust situs if the state of the original trust has a decanting statute but it lacks certain provisions or protections that the parties wish to use.

2. Many commentators note that the new state normally would apply its decanting law on the grounds that it is a power of administration (see the discussion below in section VI). However, an explicit provision in the state's decanting statute will provide additional comfort. Several states, including Alaska, Arizona, Delaware, Missouri, New York, Ohio and South Dakota, have helpful provisions.

IV. Reasons for Decanting or Changing Trust Situs and Governing Law

A. Modernize or Enhance Trust Terms

1. A trust may lack adequate financial powers or contain other limitations that prevent the trustee from effectively administering the trust.

   a. Inadequate or no powers regarding alternative investments, business interests, or S corporations.

   b. No provisions regarding use of affiliated entities or delegation of investments.

   c. Narrow spendthrift provisions.

d. Inadequate provisions about treatment of adopted individuals.

e. Lack of successor trustee provisions or uncertainty about succession.

f. Lack of provisions allowing the division of fiduciary powers among different individuals or entities, such as by creating a distribution trustee, or a trustee or committee for special investments.

2. The trustee may want to change trust terms to protect a beneficiary.

a. Delay a distribution or restrict a withdrawal right of a beneficiary.

b. Add supplemental needs provisions.

c. Divide a trust to separate beneficiaries and allow each trust to be better managed for that beneficiary.

3. Traditionally a trustee could try to address a trust's shortcoming with a court proceeding, and attempt to frame the proposed change as a reformation or as an issue of construction. Often, the change did not rise to the level of a reformation or construction issue, and the parties ran the risk of the court so ruling. Even if the court accepted the case, this could an expensive remedy to shortcomings in the trust.

4. More recently, with the adoption of the UTC and free-standing nonjudicial settlement statutes, it often is possible to address the problems through such an agreement

5. An alternative in states with decanting statutes is to use decanting to modernize the trust.

B. Take Advantage of Another State's Law

1. Asset protection statutes

2. Uniform Trust Code

3. Broad statutes for delegation or directed trusts

4. Trust merger or severance statutes

5. Unitrust or power to adjust statutes

6. More liberal reformation procedures

7. State income tax laws (where change of situs will change the taxation of the trust)

C. Settlor Intent

1. Dissatisfaction with the settlor's expressed intent is not a reason to decant or otherwise seek to change the trust terms. Sometimes, the phrase "unanticipated circumstances" is used as a cover for what is actually the unhappiness of a beneficiary or trustee with the terms written by the trust settlor.

2. It is the trustee's fundamental duty to carry out the settlor's intent, and not to give in to beneficiary dissatisfaction with the trust as written. As noted in one institution's newsletter:

> "There is, of course, a difference between a trust that is not fulfilling its purpose and one that is doing exactly what it was intended to do but displeases a client. It is particularly important, when advising the client or approaching the trustee to remember that any decanting must be consistent with the grantor's intent and the trustee's fiduciary duties…what is couched as a concern may merely be dissatisfaction with the actual intended purpose of the trust. Decanting is not a 'fix' for such problems, since nothing is truly broken."[31]

V. Transfer Tax Considerations

A. IRS Scrutiny of Decanting

1. There are currently no provisions in the regulations that directly address decanting as the statutory concept has developed at the state level. However, several general tax concepts can be applied to decanting, as discussed below.

2. In addition, the regulations on changes to grandfathered generation-skipping trusts contain provisions on the impact of the exercise of a power of appointment, the impact of the exercise of a discretionary power to distribute property to a new trust, and impact of any other type of modification to a trust.[32]

3. In Notice 2011-101,[33] the IRS let the tax community know that it was studying the tax consequences of decanting. The initial sentence of the Notice indicates the natural bias of the IRS on the subject:

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[31] Northern Trust, "Wealth Advisor Insights" (Third Quarter 2012).

[32] Treas. Reg. § 26.2601-1(b)(1), (4)

[33] 2011-52 I.R.B. 932

"This notice requests comments regarding when (and under what circumstances) transfers by a trustee of all or a portion of the principal of an irrevocable trust (Distributing Trust) to another irrevocable trust (Receiving Trust), sometimes called "decanting," that result in a change in the beneficial interests in the trust are not subject to income, gift, estate or generation-skipping transfer (GST) taxes".

4. Note the IRS frames the question as if the exception will be the decanting that does not have tax consequences.

B. Notice 2011-101

1. In the Notice, the IRS invited comments from the public regarding the income, gift, estate and GST tax consequences arising from decanting distributions where there is a change in the beneficial interests.

2. Comments are were invited on the following factors identified as potentially impacting the tax consequences:

a. A beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary);

b. Trust principal and/or income may be used to benefit new (additional) beneficiaries;

c. A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;

d. The transfer takes place from a trust treated as partially or wholly owned by a person under §§ 671 through 678 of the Internal Revenue Code (a "grantor trust") to one which is not a grantor trust, or vice versa;

e. The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust;

f. A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law;

g. The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

h. The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

i. Consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required but is obtained;

j. The effect of state law or the silence of state law on any of the above scenarios;

k. A change in the identity of a donor or transferor for gift and/or GST tax purposes;

l. The Distributing Trust is exempt from GST tax under § 26.2601-1, has an inclusion ratio of zero under § 2632, or is exempt from GST under § 2663; and

m. None of the changes described above are made, but a future power to make any such changes is created.

3. The Services has collected comments submitted on the Notice. It is anticipated that they will explicitly regulate the tax consequences of decanting in at least a couple of areas, two of which are discussed below.

C. Gifts from a Shift in Beneficial Interests

1. There is ample support in the tax law for a gift resulting from a shift of a beneficial interest in a trust.

a. When a beneficiary exercises a lifetime power of appointment, he or she is treated as making a gift equal to the value of the interests given up as a result of the exercise.[34]

b. Likewise a trustee who also is a beneficiary and who distributes trust property to others pursuant to a distribution power that is not limited by a reasonably fixed or ascertainable standard can be treated as making a gift.[35]

2. The same principles could apply to a shift in a beneficial interest as a result of a decanting. This is why a beneficiary should not be the trustee who exercises a power to decant, and it is why several state statutes preclude a beneficiary/trustee from exercising the power.

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[34] Estate of Regester v. Comm'r, 83 T.C. 1 (1983)

[35] *See* Treas. Reg. §25.2511-1(g)(2).

3. The concern of practitioners is that the IRS would extend this rule to apply to a beneficiary who cooperates in a decanting, or fails to oppose it, and whose beneficial interest is reduced as a result.[36]

4. The decanting statutes help address this concern by making decanting a trustee power, and not requiring beneficiary consent.

5. Ideally a trustee should not seek a beneficiary's consent to a decanting, or go to court and ask the beneficiary to support the decision, in a situation in which the beneficiary's interests were reduced as a result of the decanting.

D. Impact on GST Status of Trust

1. If the proposed decanting is from a grandfathered GST trust, the regulations regarding changes to a grandfathered trust must be considered. Under the effective date rules applicable to Chapter 13 of the Code, a modification to a trust will not be considered a constructive addition to the trust and ungrandfather it, as long as the modification does not change the "quality, value or timing of the beneficial interests originally provided for under the terms of the trust."

2. Regulations found in §26.2601-1(b)(4) provide details on applying this rule and create safe harbors for several categories of changes.

3. State law may treat a decanting power as a type of power of appointment, exercisable by a trustee.

   a. At first blush, this would appear to require looking to the separate grandfather rules applicable to powers of appointment in §26.2601-1(b)(1)(v).

   b. Under that regulation, the exercise of a power of appointment will not ungrandfather the trust if it does not postpone or suspend vesting beyond the traditional perpetuities periods incorporated into federal law (21 years after lives in being at creation of the trust or 90 years from creation).

   c. However, the regulations contain more specific modification provisions that probably apply to a decanting power.

4. Section 26.2601-(b)(4)(i)(A) addresses the "distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a

[36] *See* Rev. Rul. 84-105, 1984-2 C.B. 197 (trustee's failure to fully fund marital trust, acquiesced to by spouse, treated as gift by spouse); Snyder v. Comm'r, 93 T.C. 529 (1989) (taxpayer made gifts because of failure to exercise right to convert noncumulative preferred stock to cumulative preferred stock); Letter Ruling 200917004 (court reformation of trust to include adopteds, supported by existing beneficiaries, resulted in gifts by those beneficiaries whose interests were reduced).

continuing trust…". The exercise of such a distribution power will not ungrandfather the trust if

a. Either the terms of the trust or state law authorized distribution to a new trust at the time the trust became irrevocable;

b. The trustee can exercise the power without the consent of the beneficiary or court approval; and

c. The new trust does not postpone vesting, absolute ownership or the power of alienation beyond the traditional perpetuities periods.

5. By definition, a grandfathered trust became irrevocable before the enactment of any state decanting statutes, making this safe harbor unavailable for decantings pursuant to state statute. In Florida and New Jersey, a trustee might be able to take the position that state case law provides the necessary authority, but the support is more tenuous.

6. Section 26.2601-1(b)(4)(i)(D) of the Regulations provides an alternative safe harbor, a catch-all for modifications to a trust that do not fall under any other exception. Under this provision, the exercise of a decanting power will not ungrandfather a trust if

a. The modification "does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification…"; and

b. The modification does not extend the time for vesting of any beneficial interest beyond the period provided for in the original trust.

7. These grandfather rules limit the ability to extend a trust term or take advantage of a more favorable perpetuities period.

a. The extension of the term of the trust under the first safe harbor is possible as long as it still falls within a traditional perpetuities period. However, as noted, the first safe harbor is not likely to be available in many decanting distributions.

b. If the trustee is relying on the second safe harbor, a decanting also will not be able to shift beneficial interests to lower generations. However, it is possible to move future beneficiaries of a lower generation up, that is accelerate their interests.

8. Post-1986 GST Exempt Trusts

a. The Section 2601 regulations do not apply to post-1986 trusts that are exempt because of an allocation of GST exemption. However, the IRS has analyzed situations involving GST exempt trusts using the grandfather regulations.

b. In Letter Ruling 200743028, the trustee changed the trust's situs and then used that state's decanting statute to move assets to a new trust. The IRS acknowledged that there was no regulatory guidance on changes to GST exempt trusts but stated "[a]t a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status" of a post-1986 exempt trust.

c. In this particular ruling, the state decanting statute was enacted before the original trust was created, which would allow the trustee to rely on either one of the two safe harbors under the grandfather rules.

VI. Possible Issues in Changing Governing Law of the Trust

A. The Motivation to Change Applicable Law

1. Experience suggests that the desire to operate under another state's law is a main, if not the primary, motivation for trust decantings.

2. States increasingly are competing for trust business by adopting favorable trust laws and attempting to create a friendlier, more flexible environment for trust administration.

3. Major corporate fiduciaries have established operations in the most favorable jurisdictions, so that they can move the situs of trust administration to that jurisdiction.

4. For example, a common fact scenario is that trustees and/or the beneficiaries are interested in changes to the trust to enhance its administration. If the changes involve authority to own less common investments, or the proposed delegation of investment authority for particular investments, then the trustee probably is interested in enhanced protection for its consent to the particular investment or delegation of authority. The trustee may propose changing the situs of administration of the trust to Delaware, and then using Delaware law to effect the changes to the trust (using the Delaware decanting statute or Delaware's consent court reformation process). The changes may include making the trust a directed trust as to certain investments for which delegation of investment authority otherwise would be used.

5. In a situation such as this, the interest in using decanting originates with the trustee as much as it does with the beneficiaries.

B. Freedom to Select Applicable State Law

1. Trustees and current beneficiaries may have become too comfortable with fact situations like that described above, as states and many commentators continue to advocate the benefits of decanting and the law of particular states.

2. In most situations, changes as described above are not controversial and are made without concern. But the ability to change state law is not automatic in all situations.

3. If the trust contains a change of situs and governing law clause, then the trustee should be able to change the law of the trust for all relevant purposes, subject only to public policy concerns discussed below. However, older trusts may not contain a specific change of situs clause. In that case, the trustee relies on the general principle that a change in the place of administration allows the trust to administer the trust under the laws of that new state.

4. The determination of applicable law for a trust is a bit more complicated, and requires application of conflict-of-laws principles. These principles also are relevant when a trust settlor chooses to create a trust in another state. There are numerous excellent papers and articles on the subject.[37]

C. Determination of Applicable Law

1. Under conflict-of-laws principles, if the trust instrument is silent, the determination of applicable law depends on a number of factors.[38]

a. Whether the question at issue involves trust validity, construction or administration.

b. Whether it is an inter vivos or testamentary trust.

c. Whether the issue involves real property or personal property.

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[37] *See*, *e.g.*, Richard W. Nenno, "Relieving Your Situs Headache: Choosing and Rechoosing the Jurisdiction For A Trust," 40th Annual Heckerling Institute on Estate Planning (2006); Richard W. Nenno, Carol A. Johnston, Joshua S. Rubenstein, and W. Donald Sparks II, "The Nuts and Bolts of Changing the Situs of a Trust," 40th Annual Heckerling Institute on Estate Planning (2006).

[38] *See generally* Restatement (Second) of Conflicts of Laws §§ 267-282 (1971); Bogert, Bogert and Hess, The Law of Trusts and Trustees §§ 294-301 (2010).

2. Examples of validity issues are questions of fraud, competency, undue influences, execution formalities, and compliance with the rule against perpetuities or rule against accumulations.

3. Construction issues relate to matters such as the identity of beneficiaries, the nature of their interests, and principal and income rules.

4. Administration pertains to the trustee's duties, powers and liabilities, rights to compensation and indemnification, and trustee appointment and removal.

5. If the governing instrument is silent and the question does not involve real estate:

    a. Issues of validity generally are determined by the law of the testator's domicile in the case of testamentary trusts and by the law of the state that has the most substantial relation to the trust in the case of an inter vivos trust.

    b. Construction issues typically are determined in the same manner, taking into account the law that the settlor most likely would have wanted to apply.

    c. Administration matters are determined by the law of the state to which administration of the trust is most substantially related (i.e., the law of the trust situs). Thus, if the trustee moves administration of the trust to a different state, that state's law can be applied to issues of administration.

6. These rules are subject to state public policy exceptions. For a testamentary trust, the continuing jurisdiction of a state's court over the trust may require that its law continue to apply for all purposes. Other public policy concerns that may defeat the application of another state's law include a spouse's right of election or the rights of charitable beneficiaries.

7. The Uniform Trust Code follows the basic legal principles on public policy found at common law. Section 107 of the UTC provides:

    "The meaning and effect of the terms of a trust are determined by:

    > (1) The law of the jurisdiction designated in the items unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue…"

8. The matter that is most likely to raise public policy concerns in decanting situations is a change that results in greater exoneration of the trustee. Returning to the fact scenario at the beginning of this section, if change of situs and decanting significantly lowers the trustee's potential liability regarding investments, it is conceivable that the home state of the trust might view it as a public policy matter.

   a. In appropriate circumstances, the trustee who is moving trust situs or decanting to take advantage of stronger exoneration provisions or to create a directed trust may want court approval in the original state of the trust before moving.

   b. The risk in failing to get such approval is that a future beneficiary could bring a claim against the trustee in the original state for exercising its authority to change the trust situs, on the grounds that the act adversely impacted the beneficiary's ability to enforce claims against the trustee.

VII. Conclusion

Trust planning continues to evolve in favor of creating irrevocable trusts that will last for longer periods of time, and potentially benefit multiple generations. While practitioners endeavor to draft flexible trusts, it is likely that future developments or changes in the law will make it desirable to change the trust in ways not anticipated in the governing instrument. Decanting and change of situs provisions are two more ways to address the need to make changes. The powers must be exercised carefully, to avoid possible adverse tax consequences and cautiously, to avoid defeating the settlor's original intent and purposes.

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