

Directed Trusts and the Tools for Trust Decanting (and Other Modification Methods)

Trust Advisors Forum

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Fundamental Principles

- Freedom of disposition

- The lynchpin of Delaware trust law is 12 Del. C. § 3303(a) - “It is the policy of this section to give maximum effect to the principle of freedom of disposition and to the enforceability of governing instruments”

“Notwithstanding any other provision of this Code or other law, the terms of a governing instrument may expand, restrict, eliminate, or otherwise vary any laws of general application to fiduciaries, trusts and trust administration, including, but not limited to, any such laws pertaining to:

- (1) The rights and interests of beneficiaries, including, but not limited to, the right to be informed of the beneficiary's interest for a period of time, as set forth in subsection (c) of this section;
- (2) The grounds for removal of a fiduciary;
- (3) The circumstances, if any, in which the fiduciary must diversify investments;
- (4) The manner in which a fiduciary should invest assets, including whether to engage in 1 or more sustainable or socially responsible investment strategies, in addition to, or in place of, other investment strategies, with or without regard to investment performance; and
- (5) A fiduciary's powers, duties, standard of care, rights of indemnification and liability to persons whose interests arise from that instrument;

Protection of Trustees and Fiduciaries

- Standard of liability
 - Fiduciaries can be exculpated for any liability except for wilful misconduct - § 3303(a) “nothing contained in this section shall be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary's own wilful misconduct or preclude a court of competent jurisdiction from removing a fiduciary on account of the fiduciary's wilful misconduct”
 - “Wilful misconduct” is defined as “**intentional wrongdoing**, not mere negligence, gross negligence or recklessness and ‘**wrongdoing**’ means **malicious conduct or conduct designed to defraud or seek an unconscionable advantage.**” – 12 Del. C. § 3301(h)(4)

Flexible and Favorable Trust Laws

- Small but active Estates and Trusts Section of the DSBA
- Annual housekeeping bill
- Recent updates:
 - Section 3343 of Title 12 provides a new mechanism to restructure a trust without the need to modify a trust agreement
 - Section 3344 allows grantors of grantor trusts to be reimbursed from income tax liability without the need to modify a trust agreement
 - Revised 3322 allows the beneficiaries and trustor (if living) to consent to the selection of an agent to carry out delegated Trustee powers, and to exonerate the Trustee for failing to monitor the agent on an ongoing basis

Dynasty Trusts

- Like many states, Delaware law allows for perpetual trusts
 - Revocation of the Rule Against Perpetuities
 - 25 Del. C. § 503
 - Exception – Real estate
 - 110 year perpetuity period
 - Use of LLCs, partnership, etc.
 - 25 Del. C. § 503(e)
 - Leveraging estate tax and GST tax exemption

Directed Trusts

- Delaware law allows for the bifurcation (or more) of trustee duties (12 Del. C. § 3313)
- An “adviser” may direct, consent or disapprove any trustee decision.
- 3313(b) applies to direction advisers
- 3313(c) applies to consent advisers
- When directed the trustee has no duty to (1) monitor an adviser’s conduct; (2) provide advice to or consult with an adviser; or (3) warn any beneficiary or third party regarding instances in which the trustee would or might have exercised the trustee’s own discretion in a manner different from the manner directed (12 Del. C. § 3313(e))
- 3313 is an enabling statute. The trust agreement must set forth the desired structure.

Directed Trusts

- Liability Standards
 - When directed and acting in accordance with such direction, then except in cases of wilful misconduct, the trustee “shall not be liable for any loss resulting directly or indirectly from any such act” (12 Del. C. § 3313(b))
 - Willful misconduct is intentional wrongdoing, not mere negligence, gross negligence or recklessness (12 Del. C. § 3301(g))
 - Wrongdoing is “malicious conduct or conduct designed to defraud or seek an unconscionable advantage” (12 Del. C. § 3301(g))

Directed Trusts

- Common positions
 - Investment Direction Adviser
 - Used frequently when the trust has a concentrated portfolio, the grantor has a longstanding investment adviser or the grantor wants to continue making the investment decisions
 - Special Holdings Direction Adviser
 - Used frequently with closely-held business interests or other non-marketable trust assets
 - Waiver of Prudent Investor Rule
 - Distribution Adviser
 - Typically someone familiar with beneficiaries and their needs
 - Unusual distribution requests
 - Trust Protector
 - Trust Protector is what you make it. Could direct the trustee to (i) merge trusts, (ii) divide trusts, (iii) change situs or governing law
 - Often an attorney or accountant well versed in trust and tax law
- The direction adviser can be used to completely “bifurcate” trustee duties or to direct transactions on an “as needed” basis
- Reduced fee structure

Excluded Co-Trustees

- In 2017, Delaware adopted 3313A of Title 12
- Similar to directed trust statute (3313) but allows for an allocation of Trustee powers between co-Trustees. In a traditional directed trust, the Trustee still holds all of the Trustee powers but is directed by an adviser to carry them out.
- 3313(A) addresses several aspects of an excluded co-Trustee trust structure:
 - Statute allows a co-Trustee to direct another co-Trustee to exercise Trustee powers.
 - Standard of liability for excluded co-Trustee: Willful misconduct
 - Statute allows a trust agreement to grant Trustee powers exclusively to one co-Trustee, to the exclusion of the others.
 - Standard of liability for excluded co-Trustee: Complete exoneration. Excluded Trustee is not a fiduciary with respect to the Trustee power it does not hold.
 - Excluded Trustees have no duty to monitor the conduct of the co-Trustee, to provide advice to the co-Trustee or consult with or request directions from the co-Trustee, or to notify a beneficiary of an action taken by the co-Trustee.

Excluded Co-Trustees

- Common Positions:
 - Investment Trustee
 - Distribution Trustee
 - Administrative Trustee
- Best Uses Versus a Direction Adviser:
 - Tax Matters: A “Tax Trustee” could serve to be solely responsible for all tax-related matters when the trust is taking an aggressive or controversial tax filing position
 - Investment transactions involving representations and warranties

Appointment of Multiple Trustees

- **12 Del. C. § 3343**

- Enacted in 2019
- Allows for the appointment of multiple Trustees with different powers as long as there is the ability to appoint additional or successor trustees
- Allows for directed trusts or excluded co-trustees without the need for modification
- “The power to appoint a successor trustee under a governing instrument shall be deemed to include the power to appoint multiple successor trustees. A presently exercisable power to remove and replace a trustee under a governing instrument shall be deemed to include the power to appoint additional trustees to serve with the current trustee. The power to appoint multiple successor trustees and the power to appoint additional trustees shall be deemed to include the power to allocate various trustee powers (which trustee powers may include the power to direct or prevent certain actions of the trustees) exclusively to 1 or some of the trustees serving from time to time”
- Effectively acts as a way to modify the trust and convert a trust to a directed trust or a trust with an excluded trustee without engaging in one of the typical nonjudicial processes under Delaware law to modify trusts.

Trust Modification

- Generally speaking there are 5 ways to modify trusts under Delaware law
 - Consent Petitions
 - Decanting
 - Merger
 - Non-Judicial Settlement Agreements
 - Modification by Consent Agreements

Trust Modification - Decanting

- Decanting by power granted in the trust agreement
- Decanting by statutory authority (12 Del. C. § 3528)
 - Requirements
 - The first trust cannot expressly prohibit the trustee from distributing assets in further trust for a beneficiary
 - The trustee must have the ability to invade principal and/or income for the benefit of one or more of the beneficiaries of the first trust
 - The decanting may not add new beneficiaries. 12 Del. C. § 3528(a)(1).
 - Generally, the interests of remainder beneficiaries cannot be changed.
 - The second trust must comply with any standard that limits the trustee's authority to make distributions from the first trust. 12 Del. C. § 3528(a).
 - Trust must be administered in the State of Delaware

Trust Modification - Decanting

- Potential Liability of the Trustee
 - Viewed as the exercise of a limited power of appointment (12 Del. C. § 3528(c))
 - An exercise of a discretionary distribution decision, and is difficult to overturn unless the Trustee “abused” its discretion
- No notice or consent requirements
- Releases for Trustee from all interested beneficiaries

Trust Modification - Decanting

- **Common Modifications Achieved**
 - Bifurcation of trustee responsibilities, e.g., creation of directed trust
 - Addition of quiet trust language
 - Conversion to grantor trust or vice versa
 - Possible recognition of gain with negative basis assets
 - Division of a trust
 - Creation of a general power for basis step-up
 - Expressly allowed under Delaware law (12 Del. C. § 3528(a))
- **Circumstances that make decanting more attractive than other modification alternatives:**
 - The ability to change beneficial interests of (living and unborn) beneficiaries who are part of the current class of distributees without the participation of a beneficiary
 - The ability to decant back to the same trust
 - Extending a trust for a beneficiary's lifetime without the participation of the beneficiary
 - The availability of the Discretionary Distribution GST Tax safeharbor (Treas. Reg. § 26.2601-1(b)(4)(i)(A))

Trust Modification - Decanting

- Tax Considerations
 - Income Tax
 - Identity of the grantor
 - Continuation of tax attributes
 - Recognition of Gain
 - Estate and Gift Tax
 - Beneficiary consent
 - Taxable transfer or taxable gift
 - GST Tax
 - Be aware of “safe harbors”

Trust Modification - Decanting

- A recent change made it clear that a decanting, which traditionally had been viewed and processed as a distribution of trust assets to a “new” trust, could instead be treated as a decanting of the trust to the same trust, and effectively act as simply a modification of the existing trust.
- This eliminates the need to change the name of the trust, open a new trust account, obtain a new EIN for the trust, or file a final tax return for the existing trust.
- Under the updated language of Delaware’s decanting statute, the decanting can occur by the trustee “appointing all or part of [the trust’s] principal or income or both as is subject to the power in favor of a trustee of a second trust, which may be a separate trust or the first trust as modified after appointment under this section (the “second trust”) under an instrument other than that under which the power to invade is created or under the same instrument”

Trust Modification - Merger

- Merger by power granted in the trust agreement
- Merger by statutory authority (12 Del. C. § 3325(29))
 - A trustee is authorized to “merge all or a portion of the trust with or into any other trust or trusts . . . whether or not created by the same trustor and whether or not funded prior to the merger, to be held and administered as a single trust if such a merger *would not result in a material change* in the dispositive terms of the trust defining the nature and extent of any trust beneficiary’s interest in the principal or income of the trust.” (emphasis added)
 - Merger can be with a newly created empty trust (Delaware may be the only state to allow this)
 - Available if Delaware law governs administration
 - No notice or consent requirements
- Releases for Trustee from all interested beneficiaries
- Exercise of Trustee discretion

Trust Modification - Merger

- Common Modifications Achieved
 - Bifurcation of trustee responsibilities, e.g., creation of directed trust
 - Addition of quiet trust language
- Circumstances that make merger more attractive than other modification alternatives:
 - Only administrative changes are desired, settlor is deceased and Trustee has no discretionary distribution power

Trust Modification

- Non-Judicial Settlement Agreement (“NJSA”) (12 Del. C. § 3338)
 - Requires the agreement of all “interested persons” whose consent would be needed to achieve a binding settlement in the Delaware Court of Chancery (12 Del. C. § 3338(a))
 - Interested parties are the trustor (if living), the trustee and other fiduciaries, current and presumptive remainder beneficiaries, and all other having a beneficial interest, e.g., holder of a power of appointment
 - The interested persons may enter into a binding agreement “with respect to *any matter involving a trust...*” (except with respect to charitable trusts and purpose trusts described (12 Del. C. § 3338(b)) (emphasis added))
 - Examples provided by statute: interpretation of a trust instrument, liability of a trustee, granting powers to a trustee, etc. (12 Del. C. § 3338(d))

Trust Modification

- NJSA

- Limitation

- A nonjudicial settlement agreement is valid “only to the extent it does not violate a material purpose of the trust, and if applicable, does not change the trust's purpose in a manner that would violate subsection (b) of § 3303 of this chapter if the change was effected by court order; provided, however, that this subsection shall not apply in cases where the trustor is a party to the nonjudicial settlement agreement” (12 Del. C. § 3338(c))

Trust Modification

- Modification by Consent Agreement (12 Del. C. § 3342)
 - Enacted July of 2016
 - Allows a trust to be “modified to include any provision that could have been included in the governing instrument” regardless of “any provision of law or the trust’s governing instrument limiting or prohibiting amendment of the trust” (12 Del. C. § 3342(a))
 - **No material purpose requirement**
 - Requires the “**written consent or written nonobjection** of all of the trust's trustors, all then serving fiduciaries and all beneficiaries regardless of whether the modification may violate a material purpose of the trust.
 - A trustor's power to provide a written consent or written nonobjection to a trust's modification may be exercised: (i) by an agent under a power of attorney only to the extent expressly authorized by the power of attorney or the terms of the trust's governing instrument; or (ii) if an agent under a power of attorney is not so authorized, by the guardian of the trustor's property (or similar court-appointed representative) with the approval of the court supervising the guardian (or similar representative).
 - Section applies to any trust administered under the laws of this State.