NORTHERN TRUST PROFESSIONAL ADVISOR SERIES

Long-Term Trust Design: Drafting for the Long Haul

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Section One:

Financial Sustainability

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I. Introduction:

A. 2011 – 2012 Wealth Transfer Window

1. Under current law, 2012 represents a closing window of opportunity\(^1\) to transfer substantial wealth by gift to family members, particularly through long term trusts designed to be exempt from the Rule Against Perpetuities.

2. The Tax Reform Act of 2010 unified both exemptions and rates under the Federal Estate Gift, and Generation Skipping Transfer Taxes\(^2\)

\[
\begin{array}{c|c|c}
\text{2011} & \text{2012} \\
\hline
\text{Exemptions} & $5,000,000 & $5,120,000 \\
\text{Rate on Excess} & 35\% & 35\% \\
\end{array}
\]

B. Rule Against Perpetuities

1. Approximately 29 states have either repealed, optioned or extended the permissible period under the common law Rule Against Perpetuities (see Table A) making these states a logical choice for the situs of a long-term family (or “dynasty”) trust.

2. President Obama has proposed, in the General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals (commonly referred to as the “Green Book”) that the Federal GST exemption be limited in duration to a period of ninety years.


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\(^1\) On January 1, 2013, Federal transfer taxes will revert to the following levels:

\[
\begin{array}{c|c|c}
\text{Exemption} & \text{Rate} \\
\hline
\text{Gift} & $1,000,000 & 41-55\% \\
\text{Estate} & $1,000,000 & 41-55\% \\
\text{GST} & $1,390,000 (estimated) & 55\% \\
\end{array}
\]

\(^2\) Chapters 11, 12 and 13 of the Internal Revenue Code of 1986
C. Tax – advantaged techniques for both transferring assets to and managing wealth in long-term trusts include:

1. Leveraged wealth transfer strategies such as the use of valuation discounts for unmarketable and minority interests, short-term grantor retained annuity trusts, defined value clauses, installment sales, and self-cancelling installment notes, among others.

2. The ability to obtain grantor trust treatment for fiduciary income tax purposes. See Revenue Ruling 85-13, 1985-1 Cum. Bul 184. See also Sections 671 et seq. of the Internal Revenue Code.

II. Financial Sustainability of Long-Term Trusts:

A. Financial Modeling:

Tax Planning, Reproductive Reality, and the Financial Sustainability of Long-Term Trusts.

1. Many financial models used to illustrate the asset accumulation in long-term trusts inadequately assess the impact of the two critical phenomena in trust management:

   a. The expansion of beneficial interests through generations.

   b. The timing and extent of trust distributions tied to beneficiaries’ life stages.

B. Reproductive Data:

1. The mean age of a mother at first birth is 25.2 years in the United States.3

   a. Significant differences in age at first birth exist among U.S. States and among racial and ethnic groups:

      (1) Massachusetts has the highest average maternal age at first birth – 27.7 years.
      (2) Mississippi has the lowest average maternal age at first birth – 22.6 years.
      (3) Asian or Pacific Islander women had the oldest maternal age at first birth – 28.5 years.
      (4) Alaskan native women had the youngest maternal age at first birth - 21.9.

2. Fertility rates in the United States have declined over the last three generations, from a high of 3.0 births per women, for women born in 1935, to 2.0 births per woman, for women born in 1960.

   a) The total fertility rate (TFR) for the United States in 2009 was 2007.0 births per 1,000 women.

3. Statistical data on the average age difference between siblings are difficult to interpolate from census data. I have assumed a three year gap between first and second children for modeling purposes.

C. Modeling Assumptions:

1. Family Size – See Table B

2. Distribution Rates (Annual)

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3. Special Principal Distributions

   $100,000 in each of years 15, 18, 20, 23 (inflation adjusted)


5. Tax Assumptions

   a. Taxable Trust
      Ordinary Income
      2012 - 35%
      2013 to end - 43.4%

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5 Service Center for Disease Control/National Center for Health Statistics.

Capital Gains
2012 - 15%
2013 - 23.8%

b) Defective Grantor Trust

No tax for years 1 – 13
2013 rates thereafter
Section Two:

Trust Design

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Northern Trust
I. Trust Design

A. Setting aside the tax issues, determining how a trust should be structured is a significant issue in its own right. Many practitioners utilize a standard approach that may or may not address the issues raised in a particular circumstance. However, from both a beneficiary and trustee perspective, these design issues have critical implications—they directly affect the ability of the trust to satisfy the grantor’s intentions and handle the beneficiary’s desires in the intended manner.

B. Single Fund v. Separate Pots

1. In most trusts, after the death of the grantor and his spouse, the balance of the trust assets is held for the benefit of the grantor’s descendants. For example, the Northern Trust Form Book provides:

   Upon the death of my wife any part of the Bypass Trust not effectively appointed, including any amounts added thereto from the Marital Trust, (or upon my death if my wife does not survive me, the Bypass Trust) shall be divided into equal shares to create one share for each then living child of mine and one share for the then living descendants, collectively, of each deceased child of mine. Each share created for the descendants of a deceased child shall be distributed per stirpes to those descendants, subject to postponement of possession as provided below. Each share created for a living child shall be held as a separate trust and disposed of as hereinafter provided.

2. The default language provides for separate trusts for each child (or the descendants of a deceased child), beginning immediately upon the death of the surviving spouse. Alternative language in the Northern Trust Form Book provides an alternative approach:

   SECTION 3: After the death of my wife any part of the Bypass Trust not effectively appointed, including any amounts added thereto from the Marital Trust, (or after my death if my wife does not survive me, the Bypass Trust) shall be held and disposed of as hereinafter provided.

   SECTION 4: Until the time hereinafter fixed for distribution, the trustee may pay so much or all of the income and principal of the Bypass Trust to any one or more of my children and the descendants of a deceased child of mine from time to time living, in equal or unequal proportions and at such times as the trustee deems best, considering the needs, other income and means of support, and best interests of my children and those descendants, individually and as a group, and any other
circumstances and factors which the trustee deems pertinent, adding to principal any income not so paid. No payment of income or principal to a child or other descendant of mine shall be charged against the share hereinafter provided for the child or descendant or his or her ancestor or descendants.

SECTION 5: If upon or whenever after the death of the survivor of my wife and me there is no living child of mine under the age of 25 years, the trustee shall distribute the Bypass Trust in equal shares to such of my children as shall then be living, except that the then living descendants of a deceased child of mine shall take per stirpes the share which the child would have received if living, subject to postponement of possession as provided below.

3. And a third alternative, which is seen most often in dynasty trusts intended to last for multiple generations, is to leave the funds in a single pot for the duration of the trust.

4. While all of these alternatives are effective in achieving a tax result, the implications in terms of the day to day administration of the trust for the trustee and the beneficiaries are significant. For example:

   a) What if one child has not yet attended college, while the others have completed college?

   b) What if one child chooses an inexpensive college while another elects to attend an Ivy League school?

   c) What if one child has significant medical bills, while another child has no demonstrated need for funds for any reason?

   d) What if one child has medical needs that exceed the value of her separate share/pot?

   e) What if one child requests funds to start a business, which is permitted under the document, but with no provision regarding treating such funds as an advancement?

   f) What if one child becomes disabled and so does not receive any funds for much of his or her lifetime—does this affect what is available for that child’s descendants, either currently or in the future?
g) If a beneficiary makes a request that is clearly within the terms of the
trust and its discretionary language, but the request will significantly
deplete the total funds available, can/should the trustee approve the
request?

h) If a beneficiary has a continued need for trust assets, in excess of
either his “share” or the amount which can be withdrawn without
impacting the long term viability of the trust, should the distribution be
made?

Of course, there are many other such scenarios where the design choice
has a significant impact.

5. Over time, the potential financial impact of the approaches can be
significant.

a) If a single pot is created, there is a potentially greater opportunity for
diversification, as well as greater flexibility in investing, due to the
larger size of the asset pool.

b) By contrast, separate trusts are likely to continue to be reduced in size,
even where distributions of principal are minimized because of the
need to divide them among beneficiaries after a death. This results in
smaller trusts at each generation because of the division requirement.

6. As a general rule, there are pros and cons of each of the two broad
approaches:

a) Single Pot
   (1) Pros

   (a) Better investment opportunities.

   (i) An increasing number of investments require
   investors to meet Accredited (also known as
   Qualified) Investor standards. These generally
   require a net worth of at least $1 million or annual
   income of at least $200,000. Small trusts may be
   unable to meet these requirements.
(ii) It may be easier to truly diversify if sufficient assets are available to allow such diversification. As the size of the trust gets smaller, the use of mutual funds may be the only option available for diversification.

(b) Lower administrative costs

(i) Because most fees are charged on a sliding scale, having a single larger pot of assets will likely result in lower fees on a host of fronts—investment advice, trustee fees, and other similar expenses.

(ii) Additionally, the need to rely on mutual funds, with their administrative costs and likely generation of capital gains at year end, will be reduced in larger accounts, where there are sufficient assets to allow for diversification through the purchase of individual securities and bonds.

(c) Reduced administrative burden

(i) If statements, tax reporting and other administrative burdens are required from only one place, the relative administrative burden is reduced.

(d) More flexibility to address significant needs of a single beneficiary

(i) In some circumstances, an individual beneficiary may require very large distributions to respond to extraordinary needs, such as major medical problems or disability. If assets remain in a single pot, it may be possible to distribute an amount in excess of that beneficiary’s proportionate share (assuming the trust terms and the grantor’s intent make such disproportionate distribution appropriate) to address the extraordinary need.
(ii) The trustee has more ability to consider and weigh the needs of the beneficiaries, and determine what is appropriate without concern about the proportionality, if the document permits such consideration.

(iii) If the split is done after a designated event, may allow for more fairness in addressing age differences and achievement gaps.

(iv) If the funds remain in a single pot for some part of the trust’s life span and then divide into separate trusts upon the occurrence of a stated event, the burden of expenses prior to the division date are shared.

(v) This approach can address significant differences in beneficiaries’ ages, where some may have incurred expenses, such as education costs, prior to the creation of the trust, while other beneficiaries will look to the trust for payment of such expenses. Utilizing a single pot until such event occurs (such as the youngest beneficiary completing her college or post graduate education) may be more fair to younger beneficiaries, who would otherwise be penalized for their age or for selecting more expensive institutions or pursuing more years of education.

(2) Cons

(a) All beneficiaries see other beneficiary’s distributions.

(i) There will be no privacy regarding distributions made to one beneficiary. Even if descriptions are very general, a beneficiary may not want others to see what or to whom payment has been made.

(ii) There is no ability to prevent all current beneficiaries from seeing how much others received.
(b) May result in unfair distribution allocation if needs vary significantly

(i) The ability to distribute disproportionate amounts to a needy beneficiary means there is also an ability to unfairly benefit a beneficiary who has more immediate needs, to the detriment of beneficiaries whose needs are not current or immediate, but instead intend to look to the trust in retirement or at some other future time.

(ii) Disproportionate distributions may be inevitable in single pot trusts under some distribution standards, particular more narrow standards that require proof of need.

(c) May increase the risk of family disharmony

(i) The possibility of disproportionate distributions and the ability of all beneficiaries to see what others have received increases the likelihood of conflict among beneficiaries. Even where beneficiaries agree that a need is legitimate, they may dislike seeing disproportionate amounts being distributed as a result.

(ii) Litigation against the trustee may also be more likely. Beneficiaries who have received less are more likely to question the distributions made to others.

(d) More challenging for trustee to handle impartially
(i) The duty of impartiality is particularly difficult to implement in single pot trusts. The likelihood of disparate needs among current beneficiaries, combined with the larger pool of remainder beneficiaries, makes distribution decisions far more challenging.

(ii) The ability to weigh these interests and ensure impartiality and fairness will challenge even the most experienced trustees.

b) Separate Trusts

(1) Pros

(a) Allows beneficiary to make choices with a clear understanding regarding financial impact

(i) Because the trust assets are held only for the benefit of one beneficiary (and his descendants, if applicable), the beneficiary has a clearer understanding of the impact that distributions will have on the financial status of the trust. This can be challenging where assets that benefit multiple beneficiaries are held in a single pot.

(ii) Even with this information, some spendthrift beneficiaries will be unable to control their spending.

(b) More confidentiality among beneficiaries of the same generation

(i) Holding trusts as separate funds allows distributions to be made and disclosed without fear that the information will be conveyed to others.

(ii) This can be especially important in families that are prone to conflict or have strained relations, where the disclosure of potentially private information may be especially upsetting to some beneficiaries.

(c) More fair at the start—each beneficiary receives the same amount
(i) Holding assets separately gives each beneficiary of the same generation within a given family line the same start—the assets are divided equally.

(ii) Any disparity at the end will therefore be a consequence of the decisions made by that beneficiary, and the beneficiary will be unable to blame others for the status.

(2) Cons

(a) Investment options may be more limited

(i) Because of the smaller size, it will be more difficult for the trust to make some investments.

(ii) It may not be economically feasible to hold individual issues, resulting in more mutual funds and their resulting gains and fees.

(iii) The trusts are less likely to qualify as an Accredited Investor, if that is desired.

(b) Trusts may become unreasonably small after first or second generation

(i) As the number of beneficiaries increases with each subsequent generation, the number of pots into which the assets must be divided will increase, resulting in smaller pots.

(ii) These smaller pots may be infeasible to manage over time, as the size decreases and the impact of fees becomes proportionately larger.

(iii) This may lead to a decision to terminate the trust, which may be contrary to the grantor’s intention to create a pot that will last for many generations, or perhaps forever.

(c) Less flexibility to address significantly disproportionate needs of a single beneficiary
(i) Because a separate pot is created for each beneficiary, there is no way to deal with disproportionate needs.

(ii) It is an open question whether such an inability fits within the grantor’s goals for the trust or not.

(3) Ultimately, the choice between the two trust designs is a question of grantor intent—what does the grantor want to accomplish? What are the grantor’s priorities and goals? The type of trust chosen needs to further those goals and intentions; if it does not, it has failed.

C. Beneficial Interests

In the same way that the choice of the type of trust has a significant impact on how the trust is administered by the trustee and for the beneficiaries, so too the creation and design of the beneficial interests under the trust significantly impacts what is available to the beneficiaries and when. Considering the impact of these choices is equally as important and impactful.

1. Discretionary Powers and Standards

a) The choice of discretionary standards is often driven by the tax consequences of the various standards. If the intention is to ensure that the trust qualifies for the IRC §2056(b)(7) qualified terminable interest property (QTIP) election (or the reverse QTIP election under IRC §2652(a)(3)), an ascertainable standard under IRC §2041 is required; this is usually accomplished by using the HEMS (health, education, maintenance and support) standard provided for in the Code. The same HEMS standard is also used if a beneficiary is acting as trustee of a trust for his own benefit that is not intended to be includible in the beneficiary’s taxable estate.

b) The more challenging issue arises when there is not a tax reason for selecting a particular standard, or where various standards will lead to the same tax result.
(1) For example, the IRS and case law have allowed for a distribution for (i) maintenance in health and reasonable comfort, (ii) support in reasonable comfort considering the beneficiary’s standard of living as of the date of the grantor’s death and considering the beneficiary’s other income and property known to the trustees, and (iii) maintenance and support, with all three standards deemed to be ascertainable under IRC §2041. However, a Trustee will look at each of the three proposed standards differently, and may determine that a distribution permissible under one of the standards is not authorized under another.

(2) The impact is even more stark when there is no need for an ascertainable standard. In those circumstances, the difference between welfare, best interests, and the trustee’s sole discretion without a defined standard will not impact the tax consequences, but will impact what the beneficiary is able to receive.

(3) The grantor’s intention under each of these standards is presumably different as well, and will be interpreted as such by a court, in the event one ever needs to become involved. If the drafter chooses the standard without understanding what the grantor wants to accomplish, the end result for the grantor may not be satisfying.

(4) Grantors don’t necessarily understand what these terms mean or how they have been interpreted by the courts, so the drafter needs to explain the nuances and differences.

c) The other issue raised by the discretionary standard is the extent to which the trustee takes a strict constructionist view (to borrow a term generally used in the constitutional realm) or a more liberal, activist approach.

(1) Trustees will carefully consider the exact language used in an attempt to discern the grantor’s intentions.

(2) Different trustees will adopt different approaches, with potentially different responses to identical requests.

(3) Use of a statement of intent can be especially useful in these circumstances, where the means of interpretation is a potentially open issue.
D. Five and five powers

1. Five and five powers are authorized and created by Section 2041(b)(2)

   a) Under Section 2041(b)(2),
   
   The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

   (A) $5,000, or

   (B) 5 percent of the aggregate value,
   at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

   This language allows a beneficiary to be granted a 5 & 5 power without adversely impacting the tax treatment of the trust. The result is potentially large payments to the beneficiary on an annual basis without Trustee approval and not subject to any standard.

   b) The choice whether to include a 5 & 5 power, particularly in a long term trust, can have major implications.

   (1) As an initial matter, granting such a power, particularly if the value of the trust is large or anticipated to increase over time beyond the normal rate of appreciation, may provide for significant funds to pass to the grantee.

   (2) If the trust is not growing significantly and the power is being exercised annually concurrent with other discretionary distributions from the trust, the value of the trust may decrease significantly, calling into question the long term economic viability of the trust. While 5% is generally considered to be an economically sustainable rate of withdrawal, it will not qualify as sustainable if the 5 & 5 power is coupled with significant discretionary principal distributions.
c) The advantage to the inclusion of the power is that the beneficiary has a source of funds from which to draw without any requirement that need or compliance with stated standards be shown. In addition, the withdrawal amount is readily available as a source of annual exclusion or taxable gifts, which may be beneficial from a planning or beneficiary flexibility perspective.

(1) The beneficiary can use the funds to make gifts to individuals who are not beneficiaries of the subject trust.

(2) The question is whether such flexibility actually reflects the intention of the grantor.

d) There is the ability for the beneficiary to chose not to exercise the power; however, in most situations, the drafter should assume that the power will be exercised annually, and discuss with the grantor the consequences of such a withdrawal on the long term viability of the trust.

E. Testamentary Powers of Appointment

1. A power of appointment is a power given to an individual to direct the disposition of property.

2. The taxable character of the power is determined under Section 2041 of the Internal Revenue Code. Under Section 2041, a power to appoint to any of the following appointees renders the power general, and requires that the assets subject to the power be included in the power holder’s gross estate for estate tax purposes:

   i. The power holder
   ii. The power holder’s estate
   iii. Creditors of the power holder
   iv. Creditors of the power holder’s estate

3. If none of these appointees is a permissible appointee, the power is a limited one, and the assets are not included in the power holder’s estate (assuming there are no other characteristics that would otherwise require their inclusion).

4. How the power should be exercised may be defined in the document which grants the power. For example:
If a child dies before receiving his or her share in full, then upon the death of the child his or her share shall be held in trust hereunder or distributed to or in trust for such appointee or appointees, with such powers and in such manner and proportions as the child may appoint by his or her Will making specific reference to this power of appointment, except that any part of the child’s share not subject to withdrawal prior to the death of the child may be appointed only to or for the benefit of any one or more of the child’s surviving spouse, the child’s descendants and their respective spouses and my descendants (other than the child) and their respective spouses. For purposes of this agreement, the term “spouse” shall include a widow or widower, whether or not remarried.

5. The document may also indicate what needs to be done in order for the Trustee to rely on the exercise. For example:

In disposing of any trust property subject to a power to appoint by Will, the Trustee may rely upon an instrument admitted to probate in any jurisdiction as the Will of the donee or may assume that the power was not exercised if, within 3 months after the death of the donee, the Trustee has no actual notice of a Will which exercises the power. The Trustee may rely on any document or other evidence in making payment under this agreement and shall not be liable for any payment made in good faith before it receives actual notice of a changed situation. The Trustee may consult with legal counsel and other agents at Trust expense and shall not be liable for any action taken or omitted in good faith reliance upon the advice or recommendation of the legal counsel or other agent. The Trustee shall not be personally liable for acts or omissions done in good faith.

6. If the instrument is silent, state law provides guidance. For example, under Illinois law (755 ILCS 5/4-2(b)):

Manner of exercise of power. Unless the contrary intent is evidenced by the terms of the instrument creating or limiting a power of appointment, a donee of a power of appointment may (1) make appointments of present or future interests or both; (2) make appointments with conditions and limitations; (3) make appointments with restraints on alienation upon the appointed interests; (4) make appointments of interests to a Trustee for the benefit of one or more of the objects of the power; (5) make appointments that create in the object of the power additional powers of appointment to permissible objects of the power of appointment pursuant to which such powers are created; and (6) if the donee could appoint outright to the object of a power, make appointments that create in the object of the power additional powers of appointment and such powers of appointment
may be exercisable in favor of such persons or entities as the person creating such power may direct, even though the objects of such powers of appointment may not have been permissible objects of the power of appointment pursuant to which such powers are created.

7. Powers of appointment make long term trusts significantly more flexible, as they allow a beneficiary to take a second look at the terms of the trust and adjust them based on circumstances in existence at the time.

   a) Powers of appointment can be used to address changes in the family structure or dynamic. For example, if a descendant of a beneficiary plans to marry a same sex partner or be a party to a civil union, a power of appointment can be used to allow the same sex partner or spouse to be a beneficiary.

   b) Powers of appointment can also address challenges due to assisted reproduction, such as surrogacy or egg donation.

   c) Powers of appointment can also be used to change, in essence, definitions in the trust, such as the definition of descendants or family, the scope of educational expenses that are included and similar challenges that reflect changes in circumstances.

8. The inclusion of powers of appointment within the trust may also affect who is entitled to notice as a qualified beneficiary in some states that have adopted the Uniform Trust Code (UTC); at present the UTC has been adopted in some form in at least 23 states.

   a) Under Section 103(13) of the UTC, a qualified beneficiary is “a beneficiary who, on the date the beneficiary’s qualification is determined:

   (A) is a distributee or permissible distributee of trust income or principal;
   (B) would be a distributee or permissible distributee of trust income or principal if the interests of the distributee described in subparagraph (A) terminated on that date without causing the trust to terminate; or
   (C) would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date.
b) Under Section 302 of the UTC, “To the extent there is no conflict of interest between the holder of a general testamentary power of appointment and the persons represented with respect to the particular question or dispute, the holder may represent and bind persons whose interests, as permissible appointees, takers in default, or otherwise, are subject to the power.”

(1) It is not clear why this provision is restricted to general testamentary powers of appointments. If the logic is that the contingent remainder beneficiaries do not have a current interest, but instead will receive assets only through the exercise or nonexercise of the power, the same would seem to be true of a limited power.

(2) If the holder of a power of appointment can represent the permissible appointees, there is an argument that no statements need be provided to the permissible appointees.

c) Under Section 813(a) of the UTC, a trustee is required to “keep the qualified beneficiaries reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests.”

d) The definition of a qualified beneficiary, coupled with the other cited provisions, leaves open the issue of whether the permissible appointees under a limited power of appointment are qualified beneficiaries. In most states, this remains an open issue; in Nebraska (Nebraska LB 189--Trustee can conclusively presume powers have not been exercised unless notified) and Tennessee (Tennessee HB 1622-Trustee can presume non-exercise of power and also non-occurrence of events not reasonable expected to occur), the law has been drafted to directly respond to this issue.

e) The uncertainty regarding who is a qualified beneficiary leaves open the possibility that the granting of a limited power of appointment may allow a grantor in a UTC state to avoid providing statements to contingent remaindermen. However, there is risk in agreeing to this approach; if the courts do not agree, the statute of limitations will not run as to those beneficiaries’ rights under the trust.
f) Florida (Fla. Stat. §736.0306) offers an alternative, as does Maine (18-B Me. Rev. Stat. §105(3)), Missouri (Mo. Stat. §456.1-105(3)), Ohio (Ohio Rev. Code §5801.04(C)), Oregon (Or. Rev. Stat. §130.020(3)) and the District of Columbia (D.C. Stat. §19-1301.05(c))—the grantor may appoint a designated representative under the document who is entitled to receive notices and statements.

(1) This avoids providing the information to beneficiaries whom the grantor does not want to inform.

(2) It does not necessarily prevent a trustee from nonetheless providing the notice, not does it prevent a court from ordering such notice or statements be provided.

g) These same issue impact who is entitled to be a party to a virtual representation agreement. It remains an open issue whether the use of virtual representation provides adequate due process to a beneficiary, particularly one is alive and an adult at the time of the agreement, but is virtually represented by another party.
Section Three:

Trust Modification

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Creating Flexibility Without Going to Court

The disappearance of the traditional rule against perpetuities, combined with the rise in popularity of dynasty trusts intended to maximize generation-skipping tax exemptions, has likely contributed to the explosion of trusts designed to last multiple generations. The need for flexibility in the administration of a trust is particularly acute with these long-term trusts, as it is unlikely the settlor (or the drafting attorney) owns a crystal ball. There are many drafting options available to create flexibility, and in the absence of trust provisions there are numerous statutes that have codified trust modification. We will examine a number of the alternatives.

I. Trust Protectors

The trust protector concept is not a new one. English common law has recognized the efficacy of a non-trustee having power over trust assets for centuries. The use of trust protectors has been most prevalent within the offshore trust world, but it is making more frequent appearances in domestic trusts. It started gaining popularity with the adoption of self-settled asset protection trusts in a number of jurisdictions such as South Dakota, Idaho and Alaska, and quickly migrated to general domestic trusts as drafting attorneys recognized the potential utility. One should not be surprised that clients readily adopted the concept of a trust protector as a means of avoiding sometimes lengthy and expensive court proceedings to modify or terminate trusts.

a. What is a Trust Protector?

While some attorneys use the terms “trust protector” and “trust adviser” interchangeably, and to a certain extent their functions align, it is important to distinguish their roles. For purposes of this paper, we define “trust protector” as someone who has limited authority to engage in specified actions, separate and apart from the overall management of the trust by the trustee. The trust protector must take some action to exercise his or her authority, such as remove a trustee, consent to the trustee’s recommendation, or amend the trust. The term “trust advisor,” on the other hand, will be used to indicate someone who has authority to direct the trustee to act in a certain way. While some trust instruments include a trust advisor whose authority is limited to non-binding advice, that role is of little benefit since the trustee cannot rely on the advice as a protection against a breach of duty claim and the advisor has no authority to enforce the advice. While a trustee may find comfort in precatory language or advice, it is of little consequence when the litigation begins. For our purposes below, we will focus on the role of the trust protector as a mechanism to create flexibility in long-term trust administration.

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7 Compare these designations to a “special trustee” who is given a specific function or special responsibility. See, e.g., Bogert, Trusts and Trustees § 122 (2d rev. ed. 1984).
The Uniform Trust Code (“UTC”), and those states that have adopted it, recognized the developing trend of naming an individual or committee to serve as a trust protector, or to give direction to the trustee. The comments to Section 808 of the UTC state:

“Subsections (b)-(d) ratify the use of trust protectors and advisers. Subsections (b) and (d) are based in part on Restatement (Second) of Trusts § 185 (1959). Subsection (c) is similar to Restatement (Third) of Trusts § 64(2) (Tentative Draft No. 3, approved 2001). “Advisers” have long been used for certain trustee functions, such as the power to direct investments or manage a closely-held business. “Trust protector,” a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. Subsection (c) ratifies the recent trend to grant third persons such broader powers.”

A number of states that have not adopted the UTC have their own statutory provisions for either a trust protector or directed trustees.8

b. What do they do?

The primary job of a trust protector is to oversee the trustee, watching to be sure that the administration proceeds in accordance with the trust instrument and standing ready to exercise his or her authority to alter the course of administration when necessary, or simply desirable. To a great extent, the trust protector can be said to be the eyes and ears of the settlor. The trust protector can also serve as a liaison between the trustee and the beneficiaries. The trust protector plays a particularly important role in long-term trusts as the beneficiary generations become more remote from the settlor and the settlor's original intentions. The settlor defines the scope of the trust protector’s authority, be it narrow or broad, and by doing so also defines the trustee’s field of operation. But here the drafter must tread cautiously, for while the authority that can be granted to a trust protector is arguably limitless, there is a strong argument to be made that the broader the authority the more like a trustee the trust protector becomes, and with it all of the fiduciary responsibilities and liabilities.

A trust protector is frequently named for the specific purpose of removing and replacing an acting trustee, or appointing additional trustees. While most trust instruments confer that authority on one or more of the beneficiaries, the potential abuse of the removal power by the beneficiaries should be considered. Furthermore, trust law traditionally relies on the beneficiaries to monitor the actions of a trustee via the accounting and initiate the removal of a trustee through a claim for breach of fiduciary duty. But if a disgruntled beneficiary has an unlimited right to remove and replace a trustee, you can be sure that the power will be exercised, and perhaps

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8 See, e.g., Alaska, Delaware, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Utah and Wyoming, that acknowledge a trust protector within their asset protection trust statutes. Arizona, Idaho, and Michigan have separate provisions recognizing trust protectors in private trusts, unrelated to asset protection trust statutes. Currently 24 states have adopted the Uniform Trust Code in some version.
It is not uncommon to encounter a trust beneficiary “shopping” for a successor trustee that promises to be more accommodating with discretionary distribution requests. Some drafting attorneys address this issue by limiting removal to actions defined as “cause” for removal by the instrument, or limiting the frequency of trustee changes. A trust protector could provide the objectivity that a beneficiary lacks in making these important decisions.

The trust protector’s authority may extend beyond simply supervising the trustees with an eye toward removal. Some trust protectors are expected to take a participatory role in administrative decisions. For example, the trust protector may act as a tie-breaker when multiple trustees are serving and have reached an impasse, or may hold final authority for approval of discretionary distributions or the sale or management of specific assets. Whenever multiple trustees are acting there is always potential for disagreement. This may be inherent in the selection of co-trustees, where each is selected for individual skills or experience, but each also brings to the table their own personal values and biases. Enabling a trust protector to “mediate” these potential disputes as a tie-breaker for evenly divided trustees, or as a veto holder, can ensure the continued functioning of the trust without the necessity of visiting the courthouse.

The trust protector’s role may extend even to altering the beneficial interests in the trust. This may include an authorization to modify the trust terms, including dispositive provisions, approve how the beneficiaries exercise powers of appointment, and even approve termination of the trust. In this role, the trust protector’s knowledge of the settlor’s wishes and family history may become crucial. It is also in this role that the trust protector can provide the best benefit to a long-term trust.

It is unlikely that a trust drafted today will remain functional 100 years from now. Circumstances, laws and family relationships change too often to not require some adjustments. While many state statutes and the UTC now contain provisions that allow nonjudicial modification of trusts for a wide variety of reasons, including a change in circumstances not foreseen by the settlor, it can still be a cumbersome process to engage all of the interested beneficiaries and obtain consents. In some instances it may be necessary to have a guardian ad litem appointed for minors or unascertained beneficiaries, or a guardian of the property for a disabled adult beneficiary. There is also uncertainty raised by whether the proposed action meets the statutory requirements, or whether the virtual representation statutes do, in fact, afford the equivalent of actual representation. The trustee may still require a court order approving the modification to address these concerns. Yet a trust protector with broad authority to modify the trust terms could be an efficient and effective way to achieve the modification with any of the attendant issues.

The trust protector should also be aware of potential generation-skipping tax issues when dealing with a trust that is exempt from GST. The safe harbor inRegs. §26.2601-1 provides for continuation of the exemption of a grandfathered trust with a trust modification if there is no shift in beneficial interests to a younger generation and the interests vest within the original perpetuities period. It is less clear whether this safe
harbor also applies to exempt trusts that are not grandfathered. A modification that causes the trust property to be subject to a new gift or estate tax will create a new transferor for GST purposes, and thus a loss of any GST exemption previously allocated.

As a more practical matter, trust protectors are often imbued with the authority to modify the trust terms to accommodate changes in tax law, change the principal place of administration, or even change applicable state law. This may be particularly helpful in a mobile society where beneficiaries may be spread across the globe. While a trustee is frequently granted the option to change the principal place of administration (and in some circumstances has a duty to do so), a trust protector may not be bound by the same duties as a trustee in effecting the change. The trust protector may better able to make an informed decision about what is best for a particular beneficiary or set of beneficiaries without being hampered by the duty of impartiality.

c. Who should serve as Trust Protector?

When considering the individual (or individuals) to select as trust protector it is important to do so in the framework of the trust protector’s scope of responsibilities. As with a trustee, the specific responsibilities may imply certain attributes or skills that would be beneficial in a trust protector. For example, if the trust protector is to exercise authority to modify the trust to accommodate changes in applicable tax law, one would look for a trust protector with both an understanding of tax law and an appreciation for how it impacts the provisions of the particular trust instrument. If the trust protector’s authority is to oversee and provide final approval on a beneficiary’s exercise of a power of appointment, one would select a trust protector with an understanding of the family history and dynamics and the settlor’s concerns that prompted the appointment of a trust protector. Different powers may call for different trust protectors, or even a committee of trust protectors. Selections can be made from within the family, business partners, close friends, attorneys, accountants or other professional advisors.

While the trust protector may serve as the figurative eyes and ears of the settlor, it is important with an inter vivos trust to be sure that the appointment of a trust protector does not cause adverse estate tax consequences for the settlor or the trust protector. The trust protector should not be the settlor or any other donor to the trust. If the trust protector is the settlor’s spouse or a beneficiary of the trust, and the trust protector has an unrestricted power to remove and replace the trustee, consideration should be given to whether the attribution of the trustee’s powers to trust protector may cause estate or gift tax consequences.

A committee of trust protectors presents its own challenges. A committee of trust protectors may be desirable to provide the perspective of multiple disciplines (legal, tax, family governance) and allow for continuity and historical knowledge. However, the key to any successful committee is structure. If the settlor appoints an even number of trust protectors, the drafter must provide a way to break an impasse. The settlor should also be sensitive to the interaction of the various personalities and anticipate possible
conflicts as well as providing methods for resolution. An obvious solution may be to mandate an odd number of trust protectors, which addresses the impasse issue, but may not address the personality conflicts. If the same group of trust protectors always find themselves in the minority position, their likely reaction is to resign. Who then appoints their replacements can cause a further shift in the power balance.

i. Succession Issues.

As with the appointment of a trustee, it is important to provide for succession of the trust protector. A well drafted trust protector provision will include a section that addresses the death, incapacity or resignation of the trust protector as well as the appointment of a replacement trust protector. There should be a mechanism for notice to the trustee and possibly beneficiaries that a trust protector can no longer serve and must be replaced. It is probably wise to use the same criteria for determining the incapacity of a trust protector as the trust instrument provides for an individual trustee. This would also suggest that an individual appointed as trust protector be required to sign a HIPAA waiver so that interested persons can make appropriate inquiry with the trust protector’s physicians should that become necessary, and if the determination of incapacity requires a physician’s assessment.

d. Is a Trust Protector a fiduciary?

The answer to this question depends on whom you ask and in what jurisdiction you ask the question. The legal status of a trust protector is still a matter of developing law in the United States. Whether a trust protector is held to the same fiduciary standards as a trustee is one of the most ardently debated issues surrounding the use of a trust protector. A close second is whether the settlor can waive any fiduciary obligations of the trust protector.

The word “protector” conjures images of a knight on horseback, lance poised, ready to defend king and kingdom. But is a trust protector really defending the settlor and cestui que trust, or is he a mercenary, left to his own devices with little, if any, accountability? This is really a question with two facets – what liability does the trust protector have for affirmative actions taken by her, and what liability does she have for a failure to act? The resolution of this question may depend on both statutory and case law.

The UTC creates a presumption that a person holding a power to direct the trustee’s actions is a fiduciary who is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries, and is liable for any loss that results from a breach of a fiduciary duty. That standard is barely (if at all) distinguishable from the standard applied to trustees. The comment also indicates that the settlor may modify the presumption that the trust protector is a fiduciary by overriding the default rule in the trust instrument. The UTC prohibits a trust instrument

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9 See, Section 808, Uniform Trust Code.
from reducing a trustee’s duty below this minimum standard.10 To the opposite extreme are states like Alaska and Arizona, whose statutes specify that a trust protector is not a fiduciary unless the trust instrument specifically provides that they are to be held to a fiduciary standard. Illinois law does not specifically recognize a “trust protector” but does provide that the settlor may specify in the trust instrument the rights, powers, duties, limitations and immunities applicable to the trustee, beneficiary and others and the trust provisions take priority over other general provisions of the Trusts and Trustees Act.11 This would imply that the settlor can appoint a trust protector and describe his or her duties, authority and liability limitations. But what happens when there is no specific statutory framework?

In one of the first reported U.S. decision on trust protectors, the Missouri appellate court interpreted the terms of the trust to impose a fiduciary duty on the trust protector. In *Robert T. McLean Irrevocable Trust v. Davis*, 283 S.W.3d 786 (Mo. Ct. App. 2009) the court held that the trust protector’s authority to remove the trustee placed the primary responsibility for monitoring the trustee on the trust protector, rather than the beneficiaries. Missouri did not have a statutory provision for trust protectors. The trust instrument itself specified that the trust protector’s authority was conferred in a fiduciary capacity and was to be exercised in that capacity, but that the trust protector would not be held liable for any action taken in good faith. The lower court found that the trust protector had no legal duty to supervise the trustees. The appellate court disagreed, finding that the exoneration of the trust protector for any action taken in good faith implied a general fiduciary duty to act to protect the trust (and possibly the trust beneficiary). The case was remanded for further proceedings on the scope of the trust protector’s duties and liability for potential breach. Of particular note is a comment in the concurring opinion by Judge Rahmeyer, that “[t]rusts are, in my opinion, dangerous devices when they undertake to break new ground insofar as designating obligations or rights of a nature not theretofore established by statute or prior judicial determination.” *Caveat emptor.*

If the trust protector is a fiduciary, the minimum standard by which his conduct is judged is whether or not he has acted in good faith, and in the best interest of the beneficiary and the purposes of the trust. The second facet of the liability issue is whether the settlor can modify this standard of conduct, perhaps by limiting the trust protector’s liability to only include a breach arising from her actions taken in bad faith or due to willful misconduct or even gross negligence. The UTC identifies Section 808 as one of the modifiable default provisions, meaning the drafter can create a completely different set of standards. It is essential that the trust instrument indicate whether and under what circumstances the trust protector will be acting in a fiduciary capacity. If the trust protector is not to be held to a fiduciary standard, that should also be stated explicitly. The trust instrument should also specify whether the required standard of conduct is good faith, reasonableness or some other standard. Special situations that

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10 See, Section 105, Uniform Trust Code.
11 See, 760 ILCS 5/3.
involve the exercise of professional judgment or expertise may require a higher standard.

**e. Trustee liability issues**

Closely related to the question of whether the trust protector’s actions may cause liability for the trust protector is whether the trustee has potential liability. Section 808 of the Uniform Trust Code and Section 185 of the *Restatement (Second) of Trusts* express the requirement that a trustee has a duty to act in accordance with the instructions of a person who has power to control the trustee’s action unless the action being directed is contrary to the terms of the trust or is a violation of a fiduciary duty. The extent of the trustee’s duty and liability may also depend on whether the trustee need only seek the consent of the trust protector (thus preserving the trustee’s affirmative duty to act) or is truly a directed trustee that needs take no action until directed to do so. For example, a trust provision that empowers the trust protector with the sole authority to approve recommended sales of a stock concentration does not relieve the trustee of its responsibility to monitor the performance of the company and make recommendations for retention or sale, since the trust protector is simply the final arbiter of the decision. To the contrary, a directed trustee would arguably have no duty to monitor the stock or make any recommendations, but would simply execute on any instructions to buy or sell provided by the trust advisor.

But even a directed trustee may not turn a blind eye to the efficacy of the direction in most states. Section 808 of the Uniform Trust Code provides that even a directed trustee may not act when the direction 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.”12 The natural follow up question is whether the trustee has a duty to investigate to attain the requisite “knowledge”. The trustee has a responsibility to fully inform the beneficiaries regarding facts that are material to the beneficiary’s interest in the trust. So while a trustee may be directed as to when and how to sell a concentrated stock holding, the trustee is not relieved of the general responsibilities of administration and may have an obligation to notify the beneficiaries of the concentration and its attendant risks if retained.13

A provision that exonerates the trustee from any liability for actions taken by a trust protector, or for acting at the direction of a trust advisor, will significantly increase the trustee’s comfort level. Whether it provides absolute protection to the trustee, particularly where a trustee recognizes that the action would be a breach of trust if undertaken by the trustee, is yet to be finally determined. But one could argue that there is little incentive to use a trust protector if the trust protector is held to the same standards as the trustee. The flexibility of having a trust protector is enhanced by the trust protector’s ability to function outside of the typical trustee limitations, and for this

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12 See, F.S. 736.0808.
arrangement to function effectively the trustee must not be held accountable for those actions. This is not an argument for zero accountability; rather, full accountability with limited liability. If the trust protector has acted in a manner envisioned by the settlor using powers specifically granted by the settlor, the trust protector should be protected, as should the trustee.

While naming a trust protector can offer very broad, or very narrow, flexibility in the administration of a trust, the current uncertainty in the legal status of a trust protector and the legal effects of the trust protector’s actions should give pause to those who think a trust protector is a magic bullet. This lack of certainty places additional responsibility on the drafting attorney to be thoughtful in drafting the necessary trust provisions, considering the scope of authority, the status as a fiduciary, any applicable duties, and defining the liability of the trust protector as well as the trustee. Ancillary yet important considerations include succession of the trust protector, administrative issues with multiple trust protectors, and compensation of the trust protector.

II. Decanting

“Decanting” has quickly become another tool in the challenge to keep trusts relevant and reactive in a rapidly changing environment.

a. What is decanting?

A trustee is said to have the authority to “decant” a trust when the trustee may transfer the trust assets to a new or existing trust. As with the analogy to decanting wine, the intention is to move trust assets from one container to another in an effort to improve the result.

b. Power of Appointment or Power of Distribution?

There has been significant commentary on whether the trustee’s power to decant assets is a power of appointment. The general consensus appears to favor decanting powers as a fiduciary power, similar to a power to distribute trust assets, rather than a power of appointment. This distinction determines whether the exercise of the decanting power by the trustee is subject to general fiduciary duties. If the power were a true power of appointment, the holder of the power likely has no duty to act in good faith or in the interests of the beneficiaries or the purposes of the trust. The Restatement (Third) of Trusts §50 (2003), comment a, provides that a trustee’s “discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power.” Clearly an action taken by the trustee, even within very broad distributive discretion, must be exercised in a way that reflects the terms of the trusts and the interests of the beneficiaries. This premise has found its way into most of the state statutes specifically authorizing trustee decanting (discussed below). In addition to the state statutes, decanting powers may be specifically granted in a trust instrument or may rest in common law concepts.
i. Case law

The authority to decant trust assets to another trust has been the subject of relatively few cases. The most frequently cited case in the U.S. recognizing the authority of a trustee to move assets from one trust to another is a Florida case, *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782 (1940). Here the trustees were vested with absolute authority, on the written direction of the individual trustee, to "pay over and transfer all or any part of the rest, residue and remainder of the trust estate, both principal and income, which may at any time remain and be in the hands of the Trustees to the said John H. Phipps, Hubert B. Phipps, Margaret Douglas and Michael G. Phipps and to the descendants of any of them, in such shares and proportions as the said Individual Trustee, in his or her sole and absolute discretion, shall determine and fix even to the extent of directing the payment of the entire trust estate to one of said parties." The Florida Supreme Court ruled that the settlor granted the individual trustee absolute power to dispose of the trust estate to any one of the named beneficiaries to the exclusion of the others, with unlimited discretion as to time, amount, manner, and conditions. This unlimited discretion included the ability to direct the funds into further trust with different beneficiaries and with a further power of appointment in the recipient trustee. Note that the court characterized the trustee’s power as a "power of appointment".

ii. States with statutory authority

A number of states have enacted statutes that expressly authorize a trustee to move assets between trusts. The first of these was New York in 1992 (amended in 2011), followed shortly by Florida, Alaska, Arizona, Delaware, Indiana, Missouri, Nevada, New Hampshire, North Carolina, South Dakota and Tennessee. Most of the state statutes refer to the decanting power as a limited power of appointment, and some even go so far as to specifically state that the power may not be exercised in favor of the trustee, the trustee’s creditors, the trustee’s estate, or the creditors of the trustee’s estate, to avoid the implication of a general power of appointment and the resulting tax consequences under Internal Revenue Code §2041. All of the state statutes require that the decanting must be consistent with the trustee’s

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15 Florida Statutes §736.04117.
17 Arizona Revised Statutes §14-10819.
18 Delaware Code Ann. title 12 §3528.
19 Indiana Code §30-4-4-36.
20 Mo. Revised Statutes §456.4-419.
21 13 Nevada Revised Statutes §163.556.
22 New Hampshire Revised Statutes §564-B:4-418.
23 North Carolina General Statutes §36C-8-816.1.
fiduciary duties, despite being termed a “power of appointment”. Despite these similarities, there are many differences in the state statutes, including restrictions on eliminating a fixed right to income and restricting permissible appointees to the same beneficiaries under the existing trust.

c. When to use decanting

There are a number of opportunities where the trustee’s power to decant presents an efficient methodology to address changes in applicable law or circumstances of the beneficiaries. In short, decanting can be used for most of the same purposes where a trust protector could be authorized to act.

i. Adjustments for changes in tax law

As decanting gained popularity its application was primarily limited to converting a generation skipping trust by granting a general power of appointment to the current class of beneficiaries, thereby causing inclusion in their taxable estates at death and application of the federal estate tax (and its exemptions) instead of a generation skipping tax on future distributions and terminations.\(^\text{26}\) Decanting remains a viable method to accomplish this objective, as well as address other changes in state or federal tax law. Decanting can also be helpful to correct drafting errors, such as omission of a Crummey withdrawal power of a general power of appointment in the original trust. Decanting may also be used to convert a grantor trust to a non-grantor trust, and vice versa.

ii. Changes in circumstances

The trustee can decant the trust assets to a new trust that alters administrative provisions, such as appointing an investment director or modifying the trustee’s investment powers; alters trustee succession and requirements for appointment, such as limiting the class of persons who may serve as co-trustee or their age attainment before they can be appointed; changing dispositive provisions, such as extending a trust for the lifetime of a particular beneficiary before he reaches a required age for distribution, granting powers of appointment, converting an income interest to a unitrust interest; consolidation or division of trusts; changing the governing law of a trust to confirm to its principal place of administration; and even correcting drafting errors.

d. Tax issues

Practitioners should be careful as decanting may trigger a gift or estate tax. While this trigger may be intentional, one should be careful to avoid an inadvertent taxable event caused by a shifting or elimination of beneficial interests. The gift and estate tax issues occur primarily where the trustee is also a beneficiary, or where beneficiary consent to the decanting is required. A beneficiary’s consent to the

decanting may arguably result in an indirect transfer by the beneficiary if a vested interest of the beneficiary is lessened or eliminated. The settlor should also refrain from any participation in the decanting process.

There are also potential income tax consequences which, if not intentional, should be carefully considered. The decanting of a grantor trust to a non-grantor trust (or vice versa) is an example of an intentional income tax triggering event. A partial decanting could trigger inadvertent income tax consequences if the distribution is treated as a discretionary distribution, carrying out DNI. One should also be alert to potential income tax consequences when assets transferred have debt in excess of basis, LLC or limited partnership interests with a negative capital account, or previously undistributed taxable income that may trigger state or local income tax consequences.

As mentioned previously, decanting was often used as a GST “fix” to avoid future taxable distributions and terminations. However, the broader application of decanting that results in postponing or altering beneficial interests may have adverse GST tax consequences that should be carefully considered. Under existing law, the safe harbor for trusts that are grandfathered for GST purposes is contained in IRC Regs. §26.2601-1. If decanting was authorized by state law or the governing instrument when the trust became irrevocable, and the distribution may be made without the consent or approval of any beneficiary or court, then the grandfathered status will remain as long as the interests in the receiving trust vest within the original perpetuities period. There is no specific prohibition on a shift in beneficial interests to a younger generation. This same safe harbor is available to a GST trust that is exempt due to allocation of exemption when there is no shift in beneficial interest. However, the IRS has indicated that it is studying and, thus, will not rule on whether a trustee’s distribution of property from an irrevocable GST tax-exempt trust to another irrevocable trust that results in a change in beneficial interests will cause a loss of exempt status or cause a taxable termination or taxable distribution for GST tax purposes. Rev. Proc. 2011-3, 2011-1 I.R.B. 111, §5.17. The same limitation applies to ruling requests on whether the trustee’s decanting to another irrevocable trust is: (1) a distribution for which IRC §661 deduction is allowable or IRC §662 gross income inclusion is required; and (2) a gift under IRC §2501. Id. at §§5.09, 5.16.

III. Nonjudicial Settlement Agreements

Whether called a “nonjudicial settlement agreement” or a “family settlement agreement”, the objective is to effect a change in the trust by consent of all affected parties rather than pursue a court order. The concept of a nonjudicial settlement agreement differs from other statutory provisions that authorize nonjudicial modification in that the scope of appropriate matters for resolution is much broader than simply modification and limited only by what a court could otherwise approve.

a. Origin in the Uniform Trust Code
There are numerous provisions in the UTC that allow, and some might say encourage, modification of trusts without judicial intervention or oversight. These provisions include administrative matters such as combinations or divisions of trusts (Section 417) and changing the principal place of administration (Section 108). Sometimes it is necessary to obtain consent of the beneficiaries to accomplish a modification, such as nonjudicial modification or termination (Section 411), unanticipated circumstances or situations that impair the trustee’s ability to effectively administer the trust (Section 412), cy pres (Section 413), or termination of small trusts (Section 414). Many of these UTC provisions were already incorporated into state laws in one form or another. But a provision unique to the UTC is a recognition and validation of the nonjudicial settlement agreement under Section 111.

Section 111 allows interested persons (a defined term meant to encompass the persons who would be necessary parties to a court proceeding) to enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust that could otherwise be properly approved by a court or the beneficiaries under the UTC. Examples provided in the section include:

1. the interpretation or construction of the terms of the trust;
2. the approval of a trustee’s report or accounting;
3. direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power;
4. the resignation or appointment of a trustee and the determination of a trustee’s compensation;
5. transfer of a trust’s principal place of administration; and
6. liability of a trustee for an action relating to the trust.

The drafters of the UTC contemplated that nonjudicial settlement agreements would be a useful means to resolve issues among the trustee and beneficiaries, but not that it would be necessary in every instance that beneficiary approval is required. As an example, the comment to Section 111 cites to a trustee’s right to resign pursuant to Section 705 solely by giving notice to the qualified beneficiaries and any co-trustees, and then notes that a nonjudicial settlement between the trustee and beneficiaries will frequently prove helpful in working out the terms of the resignation.

In addition to the states that have adopted the UTC, provisions for settlement agreements may be found in other states’ laws, such as Illinois and Minnesota.

b. Scope of authority

Statutes authorizing nonjudicial settlements facilitate the making of such agreements by giving them the same effect as a court order so long as the nonjudicial settlement contains terms and conditions that a court could properly approve. In sum, under the UTC provision you cannot accomplish by nonjudicial settlement what is not
authorized by law, such as to terminate a trust in an impermissible manner, but you can do anything else provided it does not violate a material purpose of the trust.

Some state statutes have limited the breadth of issues that can be properly addressed by a nonjudicial settlement. Minnesota, for example, limits the scope to approving a trustee’s accounting, resignation or compensation, transferring the trust situs, or terminating a small noncharitable trust. Oregon specifically requires a modification or termination of an irrevocable trust by nonjudicial settlement to comply with the provisions of ORS 130.200 (their equivalent of UTC Section 411). Although not stated specifically in UTC Section 111, this is a gentle reminder that the terms of a nonjudicial settlement must still satisfy the requirement of other provisions governing modification or termination of irrevocable trusts.

c. Interested parties

To be effective and truly binding, a nonjudicial settlement agreement must include all necessary parties. The UTC uses the phrase “interested parties” and loosely defines them as persons whose consent would be required in order to achieve a binding settlement were the settlement to be approved by a court. As such, this definition may turn on interpretations of applicable state law and its requirements for necessary parties to a judicial proceeding. Minnesota’s statute defines the required parties as the trustee and all beneficiaries of a trust not under court supervision. The statute does not address how to bind persons under court supervision, but typically that can be accomplished by the court appointed guardian acting on their behalf (with court approval to do so). Oregon has adopted the UTC, but refined its definition of “interested person” to include any settlor of a trust who is living, all beneficiaries of the trust who have an interest in the subject of the agreement, any acting trustee of the trust, and the Attorney General if the trust is a charitable trust subject to the enforcement or supervisory powers of the state or the Attorney General under the provisions of applicable Oregon law.

Since most irrevocable trusts will have beneficiaries who are minors or as yet unborn, and possibly beneficiaries who are disabled adults, or even yet unascertained, the identification of those persons and obtaining their joinder in the nonjudicial settlement can be problematic. Their interests must either be represented by a guardian ad litem appointed by a court, or where available, the doctrine of virtual

28 Minnesota Statutes §501B.154.
29 Oregon Revised Statutes §130.045.
representation. While the UTC and many state laws have adopted the concept of virtual representation in a nonjudicial settlement or action, the doctrine has been previously limited to judicial actions where a court has determined that the interests of those being represented are not in conflict with the interests of those purporting to represent them. The adequacy of the representation may become a critical issue in a future challenge to the settlement agreement or other action, and as of yet there has not been a reported decision of any significance on this particular issue. Section 111 (e) hints at this issue by stating that any interested person may seek court approval of the nonjudicial settlement for the specific purpose of determining whether the representation was adequate to bind those represented.

The representation provisions in Article 3 of the UTC attempt to address the issue by allowing the person being represented to object to the representation before the consent given on their behalf would otherwise become effective. While in theory this seems to address the issue for competent adults being represented, in practicality it raises concerns about adequacy of notice to the beneficiary that their interest is being represented and the ability of the beneficiary to raise an objection, particularly if the beneficiary is a minor, under some form of disability, or even unascertained. Caution would suggest that matters involving changes to the substantive vested rights of a beneficiary (as opposed to purely administrative matters such as trustee succession) should rely on virtual representation only where there is court approval of the representation as being adequate. This is probably less of an issue if the beneficiary is being represented by the holder of a true general power of appointment as that beneficiary’s interest is subject to divestment by the holder of the power.

d. Tax issues

The same tax considerations that one must address in the context of a decanting are equally applicable to nonjudicial settlements, but even more attention must be paid to the effect of a beneficiary’s participation in the agreement as a consent that could result in an indirect gift.
Section Four:

Statements of Intent

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I. Introduction

A. Repeal of the Rule Against Perpetuities and the Proliferation of Dynasty Trusts

1. The Rule Against Perpetuities has been repealed, extended or optioned in roughly twenty-nine states and the District of Columbia. (See Table A).

2. The increase in and unification of the Gift and Generation Skipping Tax (GST) exemptions under the Tax Reform Act of 2010 allow donors to transfer significant wealth to long-term trusts, without imposition of transfer taxes upon funding and without further imposition of transfer taxes during their administration.
   a. In 2012 a husband and wife may transfer as much as $10.24 million of assets without tax.
   b. Leveraged transfer techniques, such as short-term grantor retained annuity trusts, installment sales, discounts for lack of marketability and minority interests, among others, frequently allow for significantly higher non-taxable wealth transfers.
   c. Several threats to long-term, GST-exempt trusts exist, including the Green Book’s proposal that the Federal GST exemption be limited in duration to a period of ninety years, and the American Law Institute’s position, in retaining the Rule Against Perpetuities, “that the recent statutory movement allowing the creation of perpetual or non-perpetual trusts is ill advised.” Restatement (Third) of Property, Wills and Other Donative Transfers §27.1 (2011).

B. Dead Hand Control v. Beneficiary Rights

1. The proliferation of dynasty trusts has accentuated a longstanding tension between the ability of donors to control property interests in the future (even perpetually, in states which have repealed the Rule Against Perpetuities) and a preference (reflected in the Rule) that the power of alienation not be suspended indefinitely.

2. In deference to donor control, the common law has generally permitted early termination of trusts only with either:
   a. Settlor consent; or
b. A determination that early termination would not frustrate a material purpose of the settlor (the Claflin doctrine, Claflin v. Claflin, 20 N. E. 454 (Mass. 1889)).


Material purposes are not readily to be inferred. A finding of such a purpose generally requires some showing of a particular concern or objective on the part of the settlor, such as concern with regard to a beneficiary’s management skills, judgment, or level of maturity. Thus a court may look for some circumstantial or other evidence indicating that the trust arrangement represented to the settlor more than a method of allocating the benefits of property among multiple intended beneficiaries, or a means of offering to the beneficiaries (but not imposing on them) a particular advantage. Sometimes, of course, the very nature or design of a trust suggests its protective nature or some other material purpose.

4. Spendthrift clauses may or may not be deemed to constitute a material purpose of the trust.

a. The Uniform Trust Code (§411 (c)) provides that a spendthrift clause “is not presumed to constitute a material purpose of the trust.”

b. Several states have enacted the UTC without §411 (c) or have explicitly provided that spendthrift clauses constitute a material purpose.

C. “Perpetual” is a Long Time: Preserving Settlor Intent and Navigating the Vagaries of the Future.

a. Restatement (Third) of Trusts, Foreword 2003

The Restatement’s principles “have two main themes. One is to make it easier to accomplish the settlor’s intentions, so long as those intentions can be reliably established [emphasis added] and do not offend public policy. The second is to recognize appropriate authority, through doctrines that include cy pres, to enable the living – especially judges – to adapt the settlor’s expressed purposes to contemporary circumstances.”

b. Perpetual, private trusts will need to navigate myriad unforeseen circumstances, including:

a. Economic cycles

b. Changes in capital markets and investment practices
c. Modification of federal and state tax law

d. Changes in state trust law

e. Demographic changes affecting beneficiaries, such as
   1) Reproductive technology
   2) Blended families and generational overlap
   3) Expansion of the marriage relationship and the definition of spouse
   4) Increased life expectancies

c. The Equitable Deviation doctrine has traditionally allowed court modification of a trust’s administrative terms when unanticipated circumstances would defeat or substantially impair a trust’s purpose. Restatement (Second) of Trusts §167 (1) (1959).

   a. The Uniform Trust Code, Section 412 (a) has expanded the doctrine of Equitable Deviation to court modification of both administrative and dispositive terms and termination so long as it will “further the purposes of the trust.”

D. Instructions to the Trustee (and Other Fiduciaries)

1. Letters of Wishes – are frequently used in common law jurisdictions (outside the United States) to provide guidance to executors and trustees on a wide range of issues, including management or distribution of particular assets, treatment of family members, funeral arrangements, exercise of discretionary powers, and tax planning.

   a. Letters of Wishes are legally non-binding, but accorded deference in English jurisdictions. American jurisdictions typically accord no weight to extraneous documents executed without required formalities pertaining to the will or trust.

   b. For a useful discussion of Letters of Wishes, see The Trustee, The Beneficiary, and The Letter Wishes – Be Careful What You Wish For, Alexander A. Bove, Jr., Trust & Estates (Primedia, January, 2006)

2. Precatory Language – trust documents often include non-binding instructions relating to the exercise of a discretionary or administrative power.
Example: In exercising its authority to distribute principal to any beneficiary hereunder, the trustee may, but is not required, to consider the beneficiary’s resources from sources other than this trust.

While such precatory language may expand (or in some cases, limit) the scope of the trustee’s authority, precatory language is neither enforceable nor useful as an indication of a settlor’s motives.

3. Statements of Intent – an effective Statement of Intent should reflect a grantor’s unique, personal values and goals with respect to the particular trust, its beneficiaries, and potentially, any unique asset held in the trust.

A Statement of Intent should satisfy four requirements:

a. It should demonstrate a unique intention of the grantor that is tied to personal history, personal values, or personal history.

b. It should clearly articulate a direct connection between the grantor’s unique personal intentions and the creation of the specific trust; i.e. it should define the trust’s material purpose or purposes.

c. It should express the grantor’s views on modification or termination of the trust by the beneficiaries, a trustee (or other fiduciary, such as a trust protector), or a court.

d. It must not violate public policy.

1) The Uniform Trust Code (§404) provides that “a trust may be created only to the extent that its purposes are…not contrary to public policy…”

2) “Purposes violatire of public policy include those that tend to encourage criminal or tortuous conduct, that interfere with freedom to marry or encourage divorce, that limit religious freedom, or which are frivolous or capricious.” Uniform Trust Code §404 Comment (2004).

3) In non-UTC states, or in circumstances not addressed by the UTC’s provision, state common law controls. Uniform Trust Code §106 (2004).

4) For an interesting contemporary case on estate planning and public policy limitations, see In re Estate of Max Feinberg, 2009 Ill. 106982 (S. Ct. Ill.), in which the Illinois Supreme Court validated the exercise of a power of appointment with a “beneficiary restriction clause” which eliminated distributions to
those descendants of the settlor who married outside the settlor’s religious tradition.

e. Communications to Beneficiaries

1. Wills and Trusts and Personal Communication. While will and trust documents’ primary purposes comprise the transfer and management of property, the appointment of fiduciaries, payment of debts, expenses, and taxes, etc., they should also be considered as a means of communicating to family members. Indeed, personal communications in a will or trust may be the “last word” to family members who knew the testator/settlor, and will likely be the “only word” to members of more remote generations who are beneficiaries of perpetual trusts.

2. Ethical Wills. Ethical Wills have been written for centuries, typically by older generation members to younger family members, as a means of communicating deeply-held beliefs and values.

   a. Ethical Wills are not wills as we understand from an estate planning perspective. Rather they are separate documents, often written in the form of a letter to family members or other relatives and close friends.

   b. In his excellent article, Statements of Wealth Transfer Intent (Trusts & Estates, May 2012) Raymond C. Odom writes that “Ethical Wills are about transcendent goals and spiritual values; wealth transfer is about practical goals and material values.”

   c. Eric L. Weiner, MSW, PhD, recommends, in his book (available at familylegacyadvisor.com) “Words from the Heart: A Practical Guide to Writing an Ethical Will” that Ethical Wills express one or more of the following themes:

   1) Hopes for the Future

   2) Experiences in Life

   3) Appreciation

   4) Religion, Spirituality, Core Beliefs

   5) Treasures
3. Family Mission Statements

a. The impetus for organizations (including for-profit, non-for-profit, and governmental) to develop organizational mission statements, began to captivate individuals and families, in part, due to the publication of Stephen R. Covey’s widely read book, The 7 Habits of Highly Effective People, in 1989.

1) Habit 2: Begin With the End in Mind, advocated that “one of the best ways to incorporate Habit 2 into your life is to develop a Personal Mission Statement.”

b. Mission statements and private wealth. For those families who have undertaken the development of a mission statement (in our experience, few families have successfully completed this endeavor) they have been effective in several areas:

1) Family governance (in large, complex families, typically with family enterprises)

2) Family businesses

3) Family foundations

4) Management of shared assets

4. Statements of Intent

a. See Outline Section D.3. for requirements

b. Formulating Statements of Intent

1) Inductive Method. Each client’s personal values shape the decisions they make in the estate planning process with issues such as the balance between philanthropy and private wealth, the ages at which children should receive inheritances, etc. For many clients these values are foundational but largely unarticulated.

a) Helping clients to inventory and express these values can lay a foundation from which a statement of intent may be formulated. Indeed each family’s values will have influenced the perspectives which children and grandchildren hold about inheritance and wealth transfer.

c) Charles W. Collier, author of the highly respected book, Wealth in Families (Harvard University, 2001) proposes that families should ask and answer five questions before estate planning is undertaken:

- What is really important to your family?
- What are the true assets of your family?
- What should you do to guide and support the life journey of each family member over time?
- How wealthy do you want your children to be?
- Do you feel you have a responsibility to society?

d) Collier also recommends that families inventory all their wealth, (or “capital”), including:

- Human capital (who individual family members are, and what they are called to do)
- Intellectual capital (how family members learn, communicate and make joint decisions)
- Social capital (how family members engage with society at large)
- Financial capital (the property of the family)

2) Deductive Method. Some clients may be reluctant to examine and articulate their values, and for these individuals, advisors may be able to deduce the values (which would help shape a Statement of Intent) by leading the client through a series of questions, such as:
• What is the meaning and purpose of your family’s financial wealth?

• Is the highest and best use of wealth
  o to spend it
  o to provide a higher standard of living for family members
  o to enable family members to choose careers not based on economics
  o to fund new family businesses, to provide a comfortable retirement
  o to provide for family emergencies
  o to provide resources for philanthropy, or a combination of all these? (Source: Charles W. Collier, Wealth in Families).

c. Examples of Statements of Intent

1) Intent Regarding Discretionary Distributions. In determining whether to distribute or accumulate such income and principal, the Trustee shall take into consideration (a) the income and principal (known to the Trustee) which such child may then have available from all other sources, (b) the tax laws then in effect or about to become in effect, (c) the economics of maintaining the trust created for such child and (d) what in the opinion of the Trustee will make such a child a useful and productive member of society, will encourage such child to realize such child’s full potential and will not be detrimental to such child’s own sense of self-reliance.

2) Broad Statement. To my descendants and their Trustees, both living and those to be conceived and born in the future: On the most basic level, the purpose of this trust is to further the pursuit of happiness by my descendants. I use the phrase the pursuit of happiness in the same way as our Founding Fathers used it in the Declaration of Independence. Neither they nor I were or
are talking about acquiring more material goods or taking longer vacations but rather the sense of self-sufficiency that is derived from becoming self-reliant and financially sound, having a sense of emotional, social, and mental competence and giving back to the community. The money in this trust will help make things more convenient for my descendants but it cannot make them happy. I believe that the family’s money, including the money in this trust should be viewed as a tool to support the growth of the family’s real capital, which consists of the family members and their knowledge achieved through life experience and education. This is why I believe that travel, involvement in philanthropy and education to one’s maximum potential are so important.

Section Five:

Trustee Selection & Succession

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Trustee and Succession Issues

The selection of a trustee is probably the most important, and most difficult, decision a settlor will make in the drafting process. The decisions on how to distribute assets and minimize taxes, while cumbersome, do not usually cause much distress. Clients have a general idea of who they want to benefit from their estate and how. But the decision-making process around a trustee often includes very tangible issues such as compensation and location, as well as intangible issues such as experience and beneficiary perceptions. The right choices can make a trust administration proceed smoothly. And the wrong choices can result in much angst, attorney’s fees and anger.

I. Multiple Co-Trustees

When a trust has more than one trustee, each trustee is subject to the same duties and responsibilities, and has equal rights to participate in the administration of the trust, unless the trust instrument provides otherwise. The general comment to the Restatement (Third) of Trusts §81 states that each co-trustee is expected to participate and cooperate with the others in the prudent administration of the trust, and in so doing to conform to the duties of loyalty and impartiality.

Clients typically appoint co-trustees because they feel that each trustee brings different history, skills and expertise to the position. A corporate trustee is frequently selected for its permanence and professional skills, while being paired with a family member or other close personal friend or advisor with knowledge of the family history and dynamics. Some clients feel strongly that the family members actively participate in the management of the trust and decisions regarding distributions as well as investments.

But the advantages to be gained by having co-trustees can often be offset by the potential difficulties. The comment to UTC Section 703 calls specific attention to the difficulties with appointing co-trustees. It states:

“Cotrusteeship should not be called for without careful reflection. Division of responsibility among cotrustees is often confused, the accountability of any individual trustee is uncertain, obtaining consent of all trustees can be burdensome, and unless an odd number of trustees is named deadlocks requiring court resolution can occur. Potential problems can be reduced by addressing division of responsibilities in the terms of the trust.”
Fortunately, many of these difficulties can be managed effectively with good drafting and forethought. The duties of multiple trustees can be reduced, modified, or specially allocated by the terms of the trust. Some of the relevant considerations include:

- Division of responsibilities among co-trustees;
- Whether to hold an individual trustee to a different level of accountability than a corporate trustee;
- Potential deadlocks and mechanisms for resolving them;
- Practical inefficiencies of requiring multiple trustees to consent to particular actions

A. **Minimum Trustee Approval.**

Under the Uniform Trust Code ("UTC") and most other state laws, two trustees must act unanimously. If there are three or more trustees, a majority vote of the trustees is sufficient. A dissenting co-trustee who joins in an action at the direction of the majority of the co-trustees and who notifies any co-trustee of the dissent at or before the time of the action is not liable for the action. The statutory default can be overridden in the trust instrument.

B. **Deadlock.**

The UTC does not say how issues are to be resolved if the trustees are evenly divided on an issue. In some cases, the instrument will state that in the event of a disagreement either the decision of the individual or corporate trustee will control. Other alternatives include naming a trust protector or committee with tie-breaker authority, or requiring the co-trustees to participate in alternative dispute resolution.

But note that a provision of this type simply provides a mechanism for the dispute to be resolved so that an action may be taken (or not taken). The co-trustee on the “losing” end of the decision-making should be clear in their opposition to the proposed action, but may be required to join in the action to avoid a charge of obstruction.

C. **Delegation Between Co-Trustees.**

Uniform Trust Code Section 807 provides that a trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. But when it is a question of one co-trustee delegating to another co-trustee rather than a non-trustee agent, the controlling provision is found in Section 703(5). This provision specifically states that a co-trustee may not delegate to another co-trustee the performance of a function the settlor reasonably expected the co-trustees
to perform jointly. The only clear statutory exception to this general prohibition is the clarification recognizing that a co-trustee may delegate investment authority under applicable prudent investor laws.

The traditional standard is that a trustee has a duty not to delegate. The Uniform Trust Code adopted the modern theory of fiduciary responsibility as reflected in the Restatement (Third) of Trusts §80, which rejects the common law rule, followed in earlier Restatements, requiring unanimity among the trustees of a private trust. See, Restatement (Second) of Trusts § 194 (1959).

The trustee’s duty to participate in the administration of the trust does not require that each trustee participate to an equal degree. It may be very appropriate for the co-trustees to decide that one trustee may bear more responsibility for particular actions (such as investment research) to more fully inform the other co-trustees. It does prevent the co-trustees from dividing responsibilities, unless the trust instrument specifically authorizes such a division. See comment c to the Restatement (Third) of Trusts §81.

Delegation of responsibility among multiple trustees may be very prudent, particularly as to ministerial or routine administrative actions that implement decisions made by the co-trustees collectively. The efficiency and cost savings to be gained should be considered.

Ordinarily, the settlor's intentions with respect to delegation between co-trustees should be addressed specifically in the trust instrument. It is interesting to note, however, the statement in the comment c(1) to §81 of the Restatement that "delegation of investment authority is generally authorized by implication when a settlor designates his or her surviving spouse to serve as co-trustee with a skilled professional trustee (or provides that the co-trustee position should always be filled by one of the settlor's children, to serve with a professional trustee) when the settlor was aware that the spouse (or children) had neither skill nor interest in investment or relevant financial matters.

D. Responsibilities and Liability for Breach by Co-Trustee

Under general principles of trust law, where there are two or more trustees, a trustee is not liable for a breach of trust committed by his co-trustee unless he is himself guilty of a violation of a duty to the beneficiaries. Such a violation occurs if the co-trustee: (a) participated in the breach of trust; (b) improperly delegated the administration of the trust to his co-fiduciaries; (c) failed to exercise reasonable care, thereby enabling the co-trustee to commit the breach of trust; (d) approved or acquiesced in or concealed the breach of trust; or (e) neglected to take the proper steps to redress the breach of trust. Scott & Fratcher, The Law of Trusts § 224 (4th ed. 1987); Restatement (Second) Trusts § 224 (1959). The provisions of UTC Section 703 codify the substance of the Restatement.
Notwithstanding the allocation of responsibilities, and language in the instrument that relieves of a trustee of liability for the actions of a co-trustee, if the trustee knows that a co-trustee is committing or attempting to commit a breach of trust, the trustee must take steps to prevent the breach, or obtain redress on behalf of the trust. See UTC Section 703(g). The only exceptions are when the trustee is a dissenting trustee as provided in subsection (h) of Section 703 and the breach is not a “serious” breach, or where the trust instrument specifically waives a trustee’s duty to monitor the actions of a co-trustee and take appropriate action if a breach is discovered.

II. Directed Trustee Considerations

The settlor may want to name a person (or a committee) to serve as co-trustee or trust advisor in a role that allows that person (or committee) to control specific decisions in the trust administration process. For example, the settlor may appoint a corporate trustee and an individual trustee and assign to the individual trustee the sole responsibility for making decisions on the retention or sale of a closely-held family business owned by the trust. Another common example is the designation of an investment advisor with authority to make all decisions regarding the investment of the trust assets.

While it is clear that a co-trustee with specific responsibilities is still a co-trustee, and thus subject to all of the fiduciary duties of a trustee, what liability does the other co-trustee have to monitor the performance of those specific responsibilities and intervene to prevent a breach? Or can the trustee who is “passive” as to those responsibilities be relieved of the obligation to monitor and protect against a breach by the other co-trustee? As discussed previously, the UTC and basic trust law create an obligation for one co-trustee to exercise reasonable care in preventing a co-trustee from committing a serious breach of trust and, if one occurs, to compel the co-trustee to redress the breach.

The same obligations arise with a third person holding a power to direct the trustee’s actions. Section 808 of the UTC creates a presumption that a person holding a power to direct the trustee’s actions is a fiduciary who is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries, and is liable for any loss that results from a breach of a fiduciary duty. Section 185 of the Restatement (Second) of Trusts expresses the requirement that a trustee has a duty to act in accordance with the instructions of a person who has power to control the trustee’s action unless the action being directed is contrary to the terms of the trust or is a violation of a fiduciary duty. Section 808 of the Uniform Trust Code provides that even a directed trustee may not act when the direction 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.”
Under the Restatement and the UTC, a directed trustee must follow the direction of a person holding a power to direct and may be held liable if the directed trustee does not follow such direction. But before acting, the directed trustee has an obligation to ensure that the direction is within the terms of the trust and may also need to ensure that the director/co-trustee is not violating a duty owed to the trust and beneficiaries. Unless these responsibilities are altered in the trust instrument, the directed trustee still has significant responsibilities to monitor the actions of the director/co-trustee and step in to prevent a breach. It may even become necessary to seek a court instruction on the proposed action. The comment to Section 808 of the UTC highlights this issue:

“Powers to direct are most effective when the trustee is not deterred from exercising the power by fear of possible liability. On the other hand, the trustee does have overall responsibility for seeing that the terms of the trust are honored. For this reason, subsection (b) imposes only minimal oversight responsibility on the trustee. A trustee must generally act in accordance with the direction. A trustee may refuse the direction only if the attempted exercise would be manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty owed by the holder of the power to the beneficiaries of the trust.”

The settlor can alter these requirements to provide the directed trustee with less responsibility, and ideally less liability, for acting in accordance with the director/co-trustee’s directions. The trust instrument can provide that the directed trustee must follow the direction of the director/co-trustee without question and waive the directed trustee’s responsibility to monitor or investigate whether the direction constitutes a breach of fiduciary duty. An exoneration provision for following the direction will also add a certain measure of comfort. However, the waiver and exoneration is most effective when the direction is coming from a director, as the responsibilities for preventing a breach by a co-trustee may not be modified under certain enactments of the UTC. An interesting alternative is included in the Florida UTC provision on co-trustees, section 736.0703(9), which provides a helpful clarification of the responsibilities of the directed trustee (referred to in the statute as the “excluded” trustee:

If the terms of a trust instrument provide for the appointment of more than one trustee but confer upon one or more of the trustees, to the exclusion of the others, the power to direct or prevent specified actions of the trustees, the excluded trustees shall act in accordance with the exercise of the power. Except in cases of willful misconduct on the part of the trustee with the authority to direct or prevent actions of the trustees of which the excluded trustee has actual knowledge, an excluded trustee is not liable, individually or as a fiduciary, for any consequence that results from compliance with the exercise of the power, regardless of the information available to the excluded trustees. The excluded trustees are relieved of any obligation to review, inquire, investigate, or make recommendations or
evaluations with respect to the exercise of the power. The trustee or trustees having the power to direct or prevent actions of the trustees shall be liable to the beneficiaries with respect to the exercise of the power as if the excluded trustees were not in office and shall have the exclusive obligation to account to and to defend any action brought by the beneficiaries with respect to the exercise of the power.

In states without a comparable statutory provision, this may provide a good framework for a trust provision to exonerate a directed trustee.

A number of states provide more protection to a directed trustee than the UTC. Delaware is an excellent example of a broadly protective statute (See, Delaware Code Annotated, title 12, §3313(b)). Delaware has long recognized the settlor’s ability to appoint someone other than the trustee to make distribution decisions and investment decisions. The ability to direct investments may be limited to a specific stock holding or asset, or it may be broad enough to cover all trust investments. The statute is clear that a trustee may follow the direction of a trust advisor authorized by the trust instrument to give such direction without breaching the trustee’s fiduciary duties. In Delaware, the trustee has no obligation to determine if the direction comports with the purposes of the trust or otherwise constitutes a breach by the advisor. As the Delaware protection of directed trustees is particularly strong, more trusts are being moved to Delaware to be administered under these protective laws. This may be a simple process if the trust instrument does not mandate that the trust be administered under the laws of another state. Even if the trust does have a contrary governing law provision, it may be possible to pursue a modification of that provision, or decant into a trust without the offending provision.

III. Trustee Removal

Prior to adoption of the UTC, very few state laws contained specific provisions on removing a trustee, other than as a general remedy for breach of trust. As a result, most trust instruments contain some mechanism to allow one or more of the beneficiaries, a co-trustee, or a trust protector to remove an acting trustee, with or without cause. These provisions typically work well, although they can become cumbersome if it requires the removal by “a majority of the beneficiaries” without further clarification. The unanswered question of what constitutes a “majority” can be answered in multiple ways, based on either a head count of living beneficiaries or a measure of their respective interests in the trust. What may be most problematic is identifying the beneficiaries, particularly in a multi-generation “spray” trust, and where many of the beneficiaries may be minors. The best course of action is to keep it simple, and be specific identifying the persons with authority to remove and replace trustees.
The other significant consideration is whether the right to remove and replace a trustee should be granted to a beneficiary, and if so, whether limitations should be placed on the frequency with which the right may be exercised, or whether the trust instrument should limit the removal to situations defined as “for cause”. The risk of an unfettered right of removal is that the beneficiary will be tempted to seek out a replacement trustee whenever the trustee and the beneficiary have a disagreement about any matter of administration, most commonly discretionary distribution requests.

The UTC Section 706 provides a number of grounds that justify a trustee’s removal by a court, including:

1. a serious breach of trust by the trustee,
2. lack of cooperation among multiple trustees that substantially impairs the administration of the trust,
3. unfitness, unwillingness, or persistent failure of the trustee to administer the trust effectively that indicates removal is in the best interest of the beneficiaries, or
4. there has been a substantial change of circumstances or removal is requested by all of the qualified beneficiaries, the court finds that removal of the trustee best serves the interests of all of the beneficiaries and is not inconsistent with a material purpose of the trust, and a suitable cotrustee or successor trustee is available.

Subsection (b)(4) also contains a specific but more limited application of Section 411. Section 411 allows the beneficiaries by unanimous agreement to compel modification of a trust if the court concludes that the particular modification is not inconsistent with a material purpose of the trust. Subsection (b)(4) of Section 706 similarly allows the qualified beneficiaries to request removal of the trustee if the designation of the trustee was not a material purpose of the trust. Before removing the trustee the court must also find that removal will best serve the interests of the beneficiaries and that a suitable co-trustee or successor trustee is available. While Section 706 of the UTC refers specifically to removal by court order, the same can be accomplished by nonjudicial settlement agreement pursuant to Section 111 of the UTC.

While there is no right or wrong decision as to the most appropriate person or entity to serve as the trustee, it is important to be sure that the correct decision is being made. Careful consideration of the who, what, when, where and how will ensure the proper administration of the trust.
Section Six:

Unique Assets

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Long Term Planning for Unique Trust Assets

A. Recurring Challenges with Unique Trust Assets

1. Fiduciary Responsibility

2. Liquidity Issues

3. Retention versus Diversification

B. Fiduciary Responsibility

1. Directed or Administrative Trusts

a. The laws of several states including Delaware, allow for the “bifurcation” of fiduciary responsibility by permitting settlors to grant to investment advisors full and exclusive responsibility and authority for the investment of trust assets. 12 Del. C.§3313 (b).

b. The administrative or directed trustee under a Delaware directed trust is authorized to take direction from the names investment advisor, without any liability for the results of those directions. Under the Delaware statute, the administrative trustee has no responsibility to:

   1) Monitor the advisor’s conduct;

   2) Provide advice to or consult with the advisor;

   3) Warn or apprise beneficiaries about the advisor’s directions. 12 Del. C. §3313 (e)

   c. Directed trustees, acting under the Delaware statute, who follow an advisor’s direction are liable for losses only in the event of their own “willful misconduct.” 12 Del. C. §3313 (b).

2. Uniform Trust Code

a. Section 808 of the Uniform Trust Code (Powers to Direct) permit “The terms of a trust to confer upon a person…power to direct certain actions of the trustee.”
b. The primary trustee “shall act in accordance with an exercise of the power unless the attempted exercise is:

1) “Manifestly contrary to the terms of the trust”

Or

2) “The trustee knows the attempted exercise would constitute a serious breach of fiduciary duty that the person holding the power owes to the beneficiaries of the trust.” Uniform Trust Code §808(b).

c. “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.” Uniform Trust Code §808(d).

d. Pursuant to Section 105 of the UTC, the advisor provisions of Section 808 may be altered by a trust settlor. “A settlor can provide that the trustee must accept the decision of the power holder without question.” Uniform Trust Code §808 Comment.

3. **Common Law States**

   a. The laws of most states permit a settlor to allocate responsibility for trust functions among the primary trustee and trust advisors as they provide in the trust document. See Northern Trust Form 201-30 (attached).

   b. Drafting to allocate trust responsibility to an advisor must address:

   1) The scope and terms of the advisor’s responsibility;

   2) The standard of review, if any, or none, which the primary trustee should exercise in fulfilling the advisor’s directions. If the primary trustee has no responsibility to assess the advisor’s directions, the trust should indicate that beneficiaries shall have no recourse against the trustee for following those directions;

   3) Whether the power conferred upon the advisor is fiduciary or personal in nature.
C. Liquidity Issues

A. Liquidity issues (i.e., sufficient cash flow to cover operating expenses) can arise with a wide range of trust assets, including:

a. Real Estate
   1) Non-income producing
   2) Long-income producing (e.g., timber)
   3) Recreational
   4) Legacy

b. Non-marketable Entities
   1) Family limited partnerships
   2) Limited liability corporations

c. Tangible Personalty and Collections
   1) Artwork
   2) Antiques
   3) Musical instruments
   4) Valuable documents
   5) Valuable memorabilia (particularly that of public or sports figures)

d. Intellectual Property

B. In planning for these assets, assessing trustee’s holding and management costs is critical to their effective administration and management. Examples of these costs include:

a. Real Estate
   1) Property taxes
   2) Special assessments
3) Insurance
4) Utilities
5) Consulting or management fees
6) Appraisal fees

b. Limited Market Entities
   1) Advisor fees
   2) Appraisal fees
   3) Taxes on phantom income

c. Tangible Personality
   1) Insurance
   2) Appraisal fees
   3) Storage fees

d. Intellectual Property
   1) Advisor fees
   2) Appraisal fees
   3) Registration fees

C. Consider “endowing” unique, non-income producing assets with a portfolio of marketable assets, sufficient in size to produce cash flows which will provide the trustee with adequate resources to properly administer and manage the assets.

D. Diversification

1. Statutory and Judicial Pronouncements on Diversification
   a. Uniform Prudent Investor Act, Section 3. Diversification
A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

b. **Restatement Third, Trusts §91F**

Whether and to what extent a specific investment authorization may affect the normal duty to diversify the trust portfolio (see §90, Comment g) can be a difficult question of interpretation. **Because permissive provisions do not abrogate the trustee's duty to act prudently and because diversification is fundamental to prudent risk management, trust provisions are strictly construed against dispensing with that requirement altogether.** Nevertheless, a relaxation in the degree of diversification may be justified under such an authorization by special opportunities for the trust or by special objectives of the settlor.


A trustee’s duty to diversify may be expanded, restricted, eliminated, or otherwise altered by the terms of the trust. But this statement is true only if the instrument creating the trust clearly indicates an intention to abrogate the common law, now statutory, duty to diversify.

2. **Client Concerns About Diversification**

a. Adverse Income Tax Consequences

b. Unfamiliarity with Other Asset Classes

c. Loss of Control

d. Performance Expectations

e. Impact on Portfolio Yield

f. Legacy Holdings

g. Fees

3. **Reasons for Non-Diversification**

a. Purpose of Trust

b. Legacy Holdings
c. Termination Date of Trust

   (1) Interest of Beneficiaries
   (2) Step-Up in Basis

d. Illiquidity

e. Loss of Controlling Interest

f. Related Trusts’ Holdings

g. Beneficiaries’ Assets

h. Adverse Income Tax Consequences

d. Grantor Intent Regarding Retention…and Common Trust Terms

   a. Document is silent
   b. Retention of assets acquired from the grantor is permissible
   c. Retention of a particular asset or assets is permissible
   d. Retention of a particular asset is preferred
   e. Retention of a particular asset is mandatory

e. Retention Language

   a. Identify the Asset
   b. Explicitly Waive the Duty to Diversify
   c. Articulate the Reasons for Retention
   d. Address Asset “Conversion” Issues

      (1) Equities: Mergers, Acquisitions, Spin-offs
      (2) Real Estate: Sale, Reinvestment

   e. Identify the Circumstances Under Which, and by Whom, Sale Should be Considered

   f. Consider Modifying the Fiduciary’s Standard of Care
g. If the Asset has Unfunded Operating or Holding Cost, Endow Them

h. If the Asset’s Retention May Cause Contention Among Beneficiaries:
   (1) Provide a Mechanism for Dispute Resolution
   (2) Protect the Fiduciary

6. Concentration Management Process
   a. The trustee’s asset management policy should address concentrations consistent with the Prudent Investor Rule and trust terms.
   b. The investment management process must identify and periodically evaluate concentrated holdings.
   c. Trust documents must be reviewed to determine grantor intent and fiduciary responsibility, consulting with counsel or advisors as needed.
   d. The trustee must evaluate appropriate retention or diversification strategies, discuss these with beneficiaries, their advisors, and implement appropriate strategies.
   e. The trustee’s actions must be documented.
D. Trust Assets…Really!

- Bolivian tin mine
- Bombay cement factory
- Sewage plant
- Railroad
- Las Vegas Casino
- Hemp factory
- Methadone clinic
- Las Vegas Wedding Chapel
- Nudist colony
- Motel with hourly rates
- Pet hotel
- Emu farm
- Llama farm
- Race horse
- ½ of a race horse
- Animal reproductive material
- Ammunition
- $2 million ’cello
- Wig collection
- Collection of shrunken heads
- Parrot who could sing the Star Spangled Banner
If non-marketable assets (e.g., partnership interests, closely held stock, real estate, loans) or investment concentrations of marketable securities may be included in a trust, this should be discussed in advance with the corporate trustee. If these assets are to be retained, clients usually want to relieve the corporate trustee of investment responsibility for them. If this is desired, add to the end of SEVENTH:

SECTION 20: A Trust under this agreement may hold some or all of the following assets, which shall be known as “special assets.”

Notwithstanding the general investment powers of the trustee, the following provisions shall apply to the special assets in the trust:

a) I appoint the following individuals who are willing and able to act (singly, and in the order listed) to act as manager for the special assets in the trust:

i. Myself
ii. The remaining individual cotrustees or cotrustee of the trust (if any)
iii. ______________________________
iv. ______________________________

b) While a manager is acting, the manager shall have sole investment, voting and management responsibility (and the trustee shall have no such responsibility) for the special assets in the trust. The trustee shall sell the special assets, and deal with them, only upon the written direction of the manager. The trustee shall be under no obligation to review the special assets, make any investment recommendation with respect to them, solicit any direction from the manager, or value special assets which are non-marketable. The trustee need not review whether the manager is satisfying his or her responsibilities hereunder, and the trustee shall not be liable for any action or inaction of the manager.

c) The powers of the manager (other than myself) shall be deemed to be and exercised as fiduciary powers. Special assets may include stock or other interests in a corporation, partnership, limited liability company or other entity (herein called a “company”). The manager’s fiduciary powers shall not preclude the manager from holding office in a company, accepting remuneration from it, voting any interest in favor of himself or herself as director, manager or officer,
or purchasing or selling interests in the company. The trustee shall make tax elections with respect to a company only as the manager directs. If a firm succeeds to part or all of the business or assets of a company by merger, consolidation, reorganization or otherwise, the trust’s interest in that firm (whether or not publicly traded) shall continue to be a special asset of the trust.

d) Special assets may include interests in real estate. The trustee shall have no responsibility, other than title-holding, for those interests and the tangible personal property associated with them. The manager shall have sole responsibility for managing, insuring, leasing and repairing the properties, collecting rents, and paying all taxes and expenses on the properties. The trustee shall deal with the properties only as and when directed to do so by the manager. If the manager asks the trustee to provide additional money for the expenses or improvement of a special asset, however, the trustee shall have responsibility for determining whether or not to provide funds. The manager may employ property managers at the expense of the trust or may manage the properties personally. The trustee need not review or inspect the properties, except that the trustee shall have the right (but not the duty) to exercise the trustee’s environmental powers under this agreement.

e) A manager shall be entitled to reasonable compensation, unless waived, and to reimbursement for reasonable expenses, include travel costs.

f) The statement of the trustee that it is acting according to this section shall fully protect all persons dealing with the trustee. The trustee shall have no responsibility for any loss that may result from acting in accordance with this section.