2016 Delaware Trust Conference

This v. That: What can be done in other Jurisdictions

Ohio Materials

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1. Directed Trusts.

Ohio's directed trust statute protects a directed fiduciary from all liability for following the instructions of the directing party or for not acting on its own proposed action where the consent of the other party is required and not forthcoming. Ohio Rev. Code § 5815.25. Ohio's "no liability" standard for the directed fiduciary puts it in the same field as Alaska, New Hampshire, Nevada and South Dakota. A recently-formed committee is following the proposed Uniform Directed Trust Act, which adopts Delaware's standard of willful misconduct, but it is not anticipated that Ohio will change its law in this respect.

Further to the liability of the directed fiduciary, Ohio has a special carve-out for a purely administrative trustee. The powers of this "administrative fiduciary" must be limited to "only the administrative duties and responsibilities" of the trust. The statute provides a non-inclusive list of such powers including, for example, custody of trust property, record-keeping and reporting, and preparation of tax returns.

The liability of the directing or consenting party is not specifically addressed, except that Ohio retained the provision of the Uniform Trust Code providing for the "presumptive" fiduciary status of the directing party. Ohio Rev. Code § 5808.08 (D). The trust instrument can provide otherwise. Ohio statutory and case law do not explicitly address the issue of a disappearing fiduciary duty, where an otherwise fiduciary act (involving the investment, management or distribution of the trust estate) is granted to a directing or consenting party who is facially relieved from liability under the terms of the trust. In this regard, it is noteworthy that the proposed Uniform Directed Trust Act provides that the trust instrument cannot exonerate the directing or consenting party for bad faith or reckless indifference to the purposes of the trust and the interests of the beneficiaries. Such is the minimum standard for fiduciaries under the Uniform Trust Code. The Ohio committee will be considering whether to clarify the liability of the directing or consenting party.

Ohio law permits the directing or consenting party to hold "any power". It does not forbid any powers or limit permissible powers to an enumerated list. While permitting the party to hold any power, the law does provide for broad categories of specifically permissible powers, namely, investment management powers and powers to modify or terminate a trust. Ohio Rev. Code §§ 5815.25(C) & 5808.08(C). The Ohio committee following the proposed Uniform Directed Trust Act is unlikely to recommend limiting the directing or consenting party to an exclusive list of powers, as this proposed Act does.

2. Silent Trusts and Designated Representatives.

Ohio has a designated representative statute that permits the settlor to create a trust that is entirely silent by appointing a "beneficiary surrogate" to receive the notices, information and reports that would otherwise be owing to a beneficiary. The surrogate must act "in good faith to protect the interests" of the represented beneficiaries. Ohio Rev. Code § 5801.04(C). Thus, the statute imposes a fiduciary duty on the surrogate.

Ohio's statute could be improved in several ways. First, it could be changed to clarify that the settlor can designate a surrogate for an entire class of beneficiaries, such as current beneficiaries in being from time to time. Second, the statute could provide that a trustee or other person acting in a fiduciary capacity has the power to designate a surrogate for a beneficiary or class, at least if the terms of the trust so allow. Third, the statute could provide that the surrogate is not only a person who receives reports but is one who can act in the beneficiary's behalf, *e.g.* to vote on the removal of a trustee or advisor, to consent to an action, to bring an action to enforce the trust, or to represent the beneficiary in any other action.

3. Nonjudicial Methods of Modification.

Ohio has statutes governing decanting and non-judicial settlement agreements.

A. Decanting.

The decanting statute is very liberal in its provisions. It applies to purely discretionary trusts and to trusts where the discretion is limited by reasonably definite or ascertainable standards. If the trust is purely discretionary, the decanting can generally eliminate a beneficiary and otherwise change dispositive terms. In the case of discretion limited by an ascertainable standard, the decanting cannot result in a material change of beneficial interests. Ohio Rev. Code § 5808.18 (A) & (B).

A decanting cannot interfere with a mandatory distribution or withdrawal power once the right or power has come into effect. A distribution right is not mandatory if current distributions of principal may be made to another beneficiary. There are a number of tax-saving clauses that are presumed to be further limitations on the decanting power, but the trust instrument may provide otherwise. Ohio Rev. Code § 5808.18 (C).The settlor may also waive the statutory provision that notice be provided to beneficiaries. Ohio Rev. Code § 5808.18 (N). The trustee may be directed to decant by an advisor acting in a fiduciary capacity. Ohio Rev. Code § 5808.18 (G). A fiduciary who acts "reasonably and in good faith" in decanting the trust is presumed to have acted according to the terms and purposes of the trust and the interests of the beneficiaries. Ohio Rev. Code § 5808.18 (I).

B. NJSAs.

Ohio adopted a statute governing non-judicial settlement agreements that differed significantly from the Uniform Trust Code. Under Ohio law, a NJSA may involve "any matter concerning the construction of, administration of, or distributions under the terms of the trust, the investment of income or principal held by the trustee, or other matters."

The limitations on this broad mandate are threefold. First, the agreement may not cause a premature termination of the trust. Second, it may not change the interests of beneficiaries except to save the qualification of the trust for tax purposes. Third, it may not include terms and conditions that could not properly be approved by a court. Ohio Rev. Code § 5801.10.

The statute was changed in 2012 to clarify that common law methods of trust modification remain unaffected.

4. Pre-Mortem Trust Validation.

Ohio law does not currently permit a pre-mortem trust validation process, but a proposed statute is being written. *See* Lehman, "Wills and Trusts: Updating Ohio's Pre-Mortem Validation Law," Probate L.J. of Ohio, Vol. 26, Is. 5 (May/June 2016). Ohio does provide for the pre-mortem validation of wills. Ohio Rev. Code § 2107.081 *et seq*.

5. Domestic Asset Protection Trusts.

Ohio's DAPT statute has been in effect since March 27, 2013. It passed both houses of the Ohio legislature by unanimous vote and was signed by Governor Kasich in December 2012. It is officially titled as the Ohio Legacy Trust Act. Ohio Rev. Code § 5816.01 *et seq*.

The Ohio Legacy Trust and related law have several salient features that, taken together, make it one of the strongest and most flexible of all the state statutes. Among these are:

1) There are a limited number of exception creditors, all of which are family-type claims. These include only child support, spousal support and spousal division of property. There are no exceptions for governmental claims or tort claims.

   With respect to spouses, the exception creditor is limited to person to whom the transferor had been previously married or to whom the transferor was married at the time of the transfer. Any subsequent spouse is excluded. Furthermore, with respect to a subsequent spouse, the Act specifically provides that the property in a Legacy Trust shall not be subject to an equitable award of separate property in a divorce action.

2) A creditor who brings an action to avoid a transfer to a Legacy Trust must be able to prove that the transferor had the specific intent to defraud that specific creditor. Unlike claims under the Uniform Fraudulent Transfers Act, it is not enough to establish intent to defraud creditors generally or intent to hinder or delay a creditor. And in contrast to claims of pre-transfer creditors under the UFTA, a showing of constructive fraud is insufficient. The evidentiary standard in an avoidance action is clear and convincing.

3) There are no limitations on the amount or type of property that can be transferred to a Legacy Trust. An affidavit of solvency must be provided to the trustee with each disposition, but the failure to do so is not fatal to the validity of the trust or the transfer. The failure can be used as evidence of intent.

4) The Act contains the shortest statute of limitations on avoidance claims. A creditor whose claim arose before the transfer to the Legacy Trust (the "qualified disposition") must bring a claim within eighteen months after the transfer or six months after the creditor discovered or reasonably could have discovered the qualified disposition, whichever is later. Regarding claims that arise after a qualified disposition, the statute of limitations is a strict eighteen months.

   A further qualification on the six-months-after-discovery period for pre-transfer claims is that the creditor must have made a written demand for payment or filed a suit on the claim within three years after the qualified disposition.

5) A notice recording statute for personal property was instituted in the same Ohio legislation (2011-2 HB 479). It provides that upon recording of a notice of personal property transfer with the proper Ohio county recorder, the transfer is notice to the world. Ohio Rev. Code § 317.08(E).

6) As a beneficiary of the trust, the transferor may enjoy a broad range of interests. These include: the right to receive trust income, including a unitrust interest; an interest in receiving trust income or principal pursuant to the discretion of the trustee or a distribution advisor; the right to occupy real estate and use tangible personal property held as part of the trust assets, including use of real estate under the terms of a qualified personal residence trust; the right to trust income or principal pursuant to the terms of a charitable remainder annuity trust or a charitable remainder unitrust; an annuity or unitrust interest under GRATs and GRUTs and a remainder interest in a charitable lead trusts; and the right to distributions to pay taxes on income generated by the trust, or an interest in receiving such tax distributions in the discretion of the trustee.

7) The transferor may retain a broad range of powers, short of a power to revoke. These include: the power to veto a proposed distribution to any beneficiary; a limited power to appoint trust assets during life or at death; the power to invade trust principal once per calendar year up to an amount equaling five percent of the value of the principal as of the time of exercise; the right to remove and replace a trustee or advisor; and the right to serve as investment advisor to the trustee.

8) A beneficiary of a Legacy Trust does not enjoy a property interest in any trust property whenever the distribution of that property is discretionary.

6. <u>Miscellaneous Statutes of Interest</u>.

   A. *Private Trust Companies.*[1]

   On June 14, 2016, Ohio Governor Kasich signed into law the Ohio Family Trust Company Act. In bill form, the Act passed the Ohio House with an 84-8 vote and the Ohio Senate with a 30-2 vote. The Ohio Family Trust Company Act allows an Ohio family to establish its own private trust company to serve as its long-term,

[1] Many thanks to my associate, Alethea Teh Busken, for this piece on family trust companies.

multigenerational trustee, eliminating the need for a bank or trust company to administer its family trusts. Ohio joins the other 15 or so states to have enacted such legislation.

An Ohio Family Trust Company ("FTC") is either a limited liability company or a corporation organized and qualified to do business in Ohio. However, unlike normal trust companies, a FTC is wholly-owned by family members, allowing for greater privacy and control for the family. The definition of "family member" is broad and is intended to track the SEC's definition of a "family office". FTCs may not advertise and may not perform general banking activities. Families may elect for their FTC to be licensed or unlicensed.

A licensed FTC is subject to more regulation, but allows for the broadest definition of "family member" and "family clients" served, including some individuals who are not family members. In contrast, an unlicensed FTC may provide services to a limited (but still fairly broad) class of "family members" and "family clients," but is not audited by the Ohio Division of Financial Institutions (DFI). An unlicensed FTC must submit an annual affidavit confirming compliance with statutory limitations, and is subject to certain restrictive SEC rules to be able to provide investment advice without registering with the SEC as a registered investment advisor (RIA). An unlicensed FTC is not subject to state banking regulations.

A licensed FTC is subject to the following requirements: (1) it must have a minimum capital balance of at least $200,000 and up to $500,000; (2) it must have at least three directors or managers, one of whom must be an Ohio resident; (3) it must hold at least two governing board meetings per year in Ohio with a quorum physically present; (4) it must hold quarterly board meetings to review the books, or have an auditor do so; (5) it must have an office in Ohio with at least one part-time employee; (6) it must perform a certain number of administrative activities in Ohio including having an account with a bank that has an office in Ohio; and (7) it must maintain a fidelity bond and directors/officers liability insurance in the amount of $1M each. A licensed FTC is also subject to supervision by the DFI and will be audited within 18 months of licensing and once every 3 years thereafter, with all costs for the examination borne by the FTC.

An Ohio FTC, licensed or unlicensed, is not subject to state financial institution taxation. Further, IRS Notice 2008-63 clarifies the federal government's intention toward family private trust companies. It says, in essence, that families may have the desired control of an FTC, as long as its governing documents contain mechanisms or firewalls to separate family members from decisions that affect gift and estate taxes. For example, any person may serve on a discretionary distribution committee, but no such committee members may participate in making decisions about distributions from trusts of which they themselves are settlors or beneficiaries. Further, governing documents may only be amended by independent persons.

Because of the significant cost of maintaining a premises and staff, developing policies and procedures, performing accounting and auditing, etc., it is recommended that families should have greater than $50 million to $100 million in assets to set up a FTC. A family

for whom an Ohio FTC would be a good fit might have family business assets that are closely held or difficult to value that they want the family to be able to control with flexibility. The family might desire to involve future generations and train them in the family business and in family philanthropy while maintaining as much privacy as possible. Previously, such Ohio families have had to set up FTCs out of state, but as of now, they may do all their business in Ohio.

B. *Limited Liability Companies*.[2]

Ohio Senate Bill 181 (SB 181) made substantial modifications to the Ohio Limited Liability Company Act.

1) Non-Competition Default Duty

In 2012, the default duties of members of Ohio LLCs were amended to include a restriction against the member competing with the LLC. This provision was a concern to many passive investors for Ohio LLCs and was strongly advocated against since 2012. As a result, SB 181 removes this default member non-competition duty (previously Ohio Rev. Code § 1705.281(B)(3)). Of note, the Ohio Limited Partnership Act still has this default non-competition duty.

2) Elimination of Fiduciary Duties

In following other jurisdictions (including Delaware), SB 181 applies strong freedom of contract principles for the fiduciary duties of members, managers and officers. Previously, the Ohio LLC Act allowed for LLCs to lower the standards of a member or manager's fiduciary duties, however, these fiduciary duties were not allowed to be eliminated entirely.

Now, ORC § 1705.081(C) provides that, "[a] written agreement, including a written operating agreement, that modifies, waives, or eliminates the duty of loyalty, the duty of care, or both for one or more members, managers, or officers shall be given effect." Therefore, the members of an LLC can now completely eliminate these fiduciary duties towards each other. Of note, SB 181 did not eliminate the ability for an LLC to eliminate the duty of good faith through a written agreement.

3) Clarification regarding Single-Member LLCs

SB181 clarified that a creditor's only remedy against a member of a single-member LLC is a charging order.

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[2] The author acknowledges and thanks his associate, Aaron Monk, for his preparation of this piece.