2018 Delaware Trust Conference

Creative Solutions to Complex Situations

 **Situation 1**.

Mrs. Spooky created a pot trust for the benefit of all of her descendants. The trust is a dynasty trust and all of the Spooky descendants of the oldest generation and Mrs. Spooky have passed away. There are 13 grandchildren who do not agree on how the trust should be invested, and their needs for distributions vary greatly. What can be done?

Possible Solution(s): Decant the trust under Section 3528 of Title 12 of the Delaware Code to create sub-trusts for each family branch. Alternatively, there may be a power to divide the trust in this manner under the terms of the governing instrument.

 **Situation 2**.

A trust beneficiary wants a significant distribution from a trust to buy a haunted mansion as a vacation property. The Trustee has the ability to make distributions to the beneficiary under the terms of the trust instrument. The Trustee also has full investment authority. Are there other options to consider besides an outright distribution to make the purchase of the mansion?

Possible Solutions(s):

The Trustee might also consider a purchase of the mansion by the trust. If a purchase is considered, a purchase by an underlying entity of the home is generally preferred to a direct purchase by the trust. Alternatively, the Trustee may consider a loan to the beneficiary to enable the beneficiary to purchase the home. Each of these options will depend upon the Trustee’s powers as set forth in the trust’s governing instrument, and the Trustee will have to consider and satisfy its fiduciary duties in connection with the exercise of any of those powers.

An alternative option is to modify the trust under Delaware law to add a direction adviser who can direct the Trustee with respect to the distribution or purchase of the mansion (preferably through a limited liability company). Investment powers and distribution powers could be implicated and therefore the addition of both an Investment Adviser and a Distribution Adviser should be considered and/or an adviser that has the power to direct all relevant Trustee powers that are applicable in the purchase of the mansion. Decanting back to the same trust and merger are two possible options available to modify the trust, depending upon the terms of the trust’s governing instrument, place of administration and governing law. If the settlor is living, a trust modification under 12 Del. C. 3342 and a nonjudicial settlement agreement could also be utilized to make the changes. In addition, the governing instrument might contain an administrative amendment power that would permit the desired modifications to be made by an exercise of the power.

**Situation 3**.

An old trust created by the late Herman Munster back in the sixties does not contain a Trustee removal provision. How can the beneficiaries change Trustees?

Possible Solutions(s):

Attempt a trustee removal with a petition to the Court of Chancery pursuant to Section 3327 of Title 12. Because the grounds for Trustee removal are difficult to meet, requesting the Trustee’s resignation or a nonjudicial settlement agreement pursuant to Section 3338 may be the best alternative.

**Situation 4**.

Mr. Frightful is requesting the Trustee engage in a non-judicial modification of the administrative provisions of a trust that he created but does not want the beneficiaries to participate or be informed about the transaction or to execute release agreements in favor of the Trustee. Mr. Frightful is concerned that the beneficiaries will want to spend their days trick or treating and lose their incentive to pursue education and productive careers if they are aware of the trust’s existence.

Possible Solutions(s):

The Trustee could exercise its powers to decant the trust without the participation of any beneficiary if there is a discretionary principal distribution power.

If the Trustee is not able to decant or is not willing to without a release agreement from the beneficiaries, there may be other alternatives. If the beneficiaries of the trust are minors, the custodial parents may be able to bind the beneficiaries to a release or consent by virtual representation under Section 3547(d) of Title 12 of the Delaware Code, provided that the parents do not have a material conflict of interest. A conflict could exist depending on the administrative changes desired.

Alternatively, there may be provisions in the trust’s governing instrument that restrict or eliminate the beneficiary’s rights to be informed about the trust as contemplated by Section 3303(d) of Title 12. If so, there may be a designated representative appointed in the governing instrument to act on behalf of the beneficiaries in nonjudicial matters. Even absent such a provision, as the living settlor, Mr. Frightful could appoint a designated representative pursuant to Section 3339(5) of Title 12 to act as a fiduciary on behalf of the beneficiaries for purposes of executing a release agreement and participating in a modification.

**Situation 5**.

Demon Trust Company has finally agreed to resign as Trustee of a Delaware trust and is refusing to transfer the assets to Angel Bank & Trust, Inc. until their accounts are settled. What can be done?

Possible Solutions(s):

The Trustee could account judicially, but the process is expensive and time consuming, and absent a provision in the trust instrument allowing the trustee to charge the cost of such an accounting against the trust, some portion or all of the cost of the accounting might be assessed by the court against the Trustee personally. Furthermore, the Court of Chancery Rules provide that such accountings are not *res judicata* unless contested by actual exceptions.

The Trustee could attempt to account informally by a mechanism in the Trust and/or by obtaining general releases from the trust beneficiaries exonerating the Trustee from liability for conduct disclosed in the accounting. Such a release is binding under Delaware law unless (i) the release was induced by improper conduct of the trustee; or (ii) at the time the release was executed, the beneficiary did not know of his or her rights or material facts the Trustee knew or should have known with the exercise of reasonable inquiry.

If the Trustee is not able to or does not desire to obtain release agreements from trust beneficiaries, the Trustee could simply provide an informal accounting to the Trust beneficiaries without court involvement and wait out the applicable limitations period. Under Delaware law, beneficiaries have one year to object to an informal accounting, unless the governing instrument provides that claims shall survive for a longer period. If a beneficiary failed to object within the one-year period, the beneficiary is barred from bringing a surcharge action against the trustee based upon facts adequately disclosed in the accounting. Alternatively, the resigning Trustee can trigger the 120 day notice period set forth in Section 3583(a)(2). It should be 3585(a)(2). The resigning Trustee may consider holding back a reasonable amount of trust assets for indemnification purposes until the 120 day notices period concludes.

**Situation 6**.

A large trust is set to pay out to Frank N. Stein at the age of 25, in less than one (1) year from today. Can the beneficiary’s trust be extended for purposes of providing creditor protection to Frank from future creditors?

Possible Solutions(s):

If the settlor is living, the fiduciaries, settlor and beneficiaries can agree by a Section 3342 modification or a nonjudicial settlement agreement to extend the trust for Frank’s lifetime.

The Trustee can also decant the Trust into a trust lasting for the beneficiary’s lifetime (or longer).

**Situation 7**.

A large trust was created by the late Johnny Alien III, a foreign person in a foreign jurisdiction. Under the laws of the foreign jurisdiction, the trust was subject to a rule against perpetuities and its terms require the trust to terminate within a couple of years. Can anything be done to continue the trust?

Possible Solutions(s):

Move the trust to Delaware and decant to a perpetual trust. The Trust is not subject to Chapter 13 of the Internal Revenue Code having been created by a foreign person and therefore the Trust can be extended without limitation.

**Situation 8**.

A large trust moved from New York to Delaware and continues to be subject to a New York perpetuities period. Michael Myers is the sole beneficiary and has a limited power of appointment. Michael is likely to pass away without much of a taxable estate. How can Michael apply his GST tax exemption to the trust and make it perpetual?

Possible Solutions(s):

Regardless of the law governing the validity or construction of the trust, as a matter of Delaware law, the validity of an exercise of a power of appointment is governed by Delaware law if the situs of the trust is in Delaware at the time the power is exercised. *See* *Wilmington Trust v. Wilmington Trust*, 24 A.2d 309 (Del. 1942). Michael Myers could exercise his power in a way that triggers the Delaware tax trap.

Under Delaware law, a person can exercise a limited power of appointment in favor of a further trust which contains another limited power of appointment that can be exercised so as to postpone the vesting of the trust property for a period determined without regard to the date of the creation of the original power. However, under Section 2041(a)(3) of the Internal Revenue Code, if someone exercises a power of appointment in this fashion, the exercise will cause all of the assets subject to the exercised power of appointment to be included in the estate of the power-holder for federal estate tax purposes (this is colloquially known as the “Delaware tax trap”).

Michael can exercise his limited power of appointment in favor of a perpetual trust in a manner that triggers the Delaware tax trap and causes inclusion in his estate. He can use a formula in his exercise of the power to insure that just enough of the trust is included in his estate to insure that his GST tax exemption is fully utilized. His executors can apply Michael’s GST exemption to the perpetual trust and Michael’s estate will also get a step up in basis for those assets.

**Situation 9**.

Mr. Jack O. Lantern created an irrevocable Trust for his children. His relationship with one of his children sours after the child dropped out of school to attend a school for witchcraft and wizardry. He is worried that the child will contest his estate plan, including the trust. What can be done?

Possible Solutions(s):

Depending on the terms of the terms of the trust, the Trustee may be able to decant to a new trust that includes a no contest provision.

The Trustee could also merge the trust with a new trust that includes a no contest provision.

**Situation 10**.

The Howl at the Moon Trust Company is trustee of a trust that has a complicated investment portfolio, including closely held assets. Howl at the Moon Trust Company is directed by an investment adviser with respect to all investments held in the trust, and the family office is closely involved with all aspects of the trust’s management. As Trustee, Howl at the Moon Trust Company is responsible for the preparation and filing of all fiduciary tax returns for the trust, and its practice is to use Werewolf & Warlock, CPAs as its third party provider for fiduciary tax return preparation. However, the family office insists on using its own CPA to prepare the trust’s returns. What can be done to address the issue?

Possible Solutions(s):

Modify the trust by a merger, decanting or nonjudicial settlement agreement to add a “Tax Matters Trustee”. If the settlor is living, the trust could also be modified under Section 3342 of Title 12. The Tax Matter Trustee can be given powers for all tax matters, including the preparation, filing and execution of fiduciary tax returns, to the exclusion of the Trustee. As an excluded Trustee under Section 3313A of Title 12, Howl at the Moon Trust Company would not have any liability for any loss resulting from the actions taken by the Tax Matters Trustee, and would not be required to execute the fiduciary tax returns for the trust and attest to the correctness of the return.

**Situation 11**.

A trust has a dead silent period until the current beneficiary reaches the age of twenty-five years. The grantor of the trust is living. The beneficiary is twenty-four years old. The Grantor is concerned about the beneficiary and wants to extend the trust’s period of dead silence. Can it be done?

Possible Solutions(s):

The Trustee could decant the trust in order to extend the period of dead silence. The Trustee could also merge the trust with a new trust that has a longer period of dead silence.

The grantor also has the power to appoint a designated representative to represent the beneficiary in any judicial or nonjudicial matter under Section 3339 of Title 12, even if there is no designated representative provision in the trust instrument. The designated representative could represent and bind the beneficiary in any release that a trustee may request in connection with a trust decanting or merger, or may represent the beneficiary in a nonjudicial settlement agreement or Section 3342 trust modification if the period of dead silence is extended by one of those methods.

**Situation 12**.

A silent trust created by Dan Deadhand, who is now deceased, has boiler plate language that requires statements to be delivered to current beneficiaries which conflicts with the silent trust provisions in the trust’s governing instrument.

Possible Solutions(s):

Modify the trust by a merger or decanting to correct the conflict.

**Situation 13**.

The Boogeyman is concerned that a GST tax exempt dynasty trust that he created accidentally excluded the poltergeist that he adopted based on a perceived drafting error in the definition of “descendants”. The grantor wants to fix the problem so that the poltergeist shares in the trust along with all of the other descendants born to the Boogeyman.

Possible Solutions(s):

Petition the Delaware Chancery Court to reform the Trust in order to correct the mistake as of the trust’s creation. Treasury Regulation § 26.2601-1(b)(4)(i)(C) provides a safe harbor to protect the GST Tax exempt status of a trust that is reformed by judicial action if the judicial action (i) involves a bona fide issue; and (ii) is consistent with applicable state law that would be applied by the highest court of the state. This safe harbor is not available to protect the GST Tax exempt status of the trusts if the trust were modified using nonjudicial remedies.

**Situation 14**.

Mrs. Morbid exercised a limited power of appointment over a trust in further trust in favor of her daughter only. The original trust contained a broad limited power of appointment. Mrs. Morbid’s relationship with her daughter’s husband, Grim W. Reaper, was strained at the time of the exercise. At the time of Mrs. Morbid’s death, the relations between Mrs. Morbid and her son-in-law, Grim, had improved significantly. Mrs. Morbid’s daughter wants the trust to benefit her spouse after her death. How can this be done?

Possible Solutions(s):

The Trustee could decant the trust to add a testamentary limited power of appointment for Mrs. Morbid’s daughter.

**Situation 15**.

R.I.P., now deceased, created two marital trusts for his surviving spouse, Mummy. Dr. Strange is serving as an investment adviser for both trusts and the Trustee, a corporation, can only exercise its investment powers upon the written direction of the investment adviser. The investment adviser directed the Trustee to invest both marital trusts solely in fixed income holdings to maximize the required income distributions to Mummy. Dr. Strange passes away suddenly. The language in the trust’s governing instrument permits the appointment of a successor investment adviser, but only by the current investment adviser, and Dr. Strange died without appointing his successor. Investment responsibility and discretion now defaults back to the corporate Trustee, who is required to invest at least 50% of the trust in equities, which will likely impact the level of income to which Mummy has become accustomed.

Possible Solutions(s):

Trustee converts both marital trusts to 4% total return unitrusts utilizing Section 61-106 of Title 12. This will enable the trustee to invest the trusts with an acceptable equity allocation and will produce and adequate payout to Mummy to maintain her lifestyle.

**Situation 16**.

Matt Demon created a dynasty trust that is taxed as a grantor trust for income tax purposes. Matt Demon is a famous actor, but with movie roles drying up for him lately, he is experiencing what he hopes to be a temporary cash flow problem. There is an ability to terminate grantor trust status by the release of certain powers pursuant to the terms of the governing instrument, but Mr. Demon recognizes the possible future benefits to maintaining grantor trust status. He may get a leading role in a blockbuster at some point in the future.

Possible Solutions(s):

Modify the trust by a nonjudicial settlement agreement or a 3342 trust modification to add a tax reimbursement provision.

 **Situation 17**.

The Headless Horsemen Trust Company of Another Jurisdiction, Inc. serves as Trustee of a large family trust that holds a liquid portfolio and membership interests in the Legend of Sleepy Hollow, LLC, a closely held company. All parties want the Trustee to manage the liquid assets but the Trustee does not want to hold the LLC interests, and if it does manage the LLC interests the Trustee fees are very expensive.

Possible Solutions(s):

Change the Trustee to a Delaware Trustee, move the situs of the trust to Delaware and modify the trust under Delaware law to add an investment direction adviser to direct the Trustee as to all investment powers exercised with respect to the LLC interests and other special holdings held by the Trustee.