Trusts Utilizing Entity Structures: Challenges and Solutions

2016 Delaware Trust Conference

October 26, 2016

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1. **Loss of Direct Control over Underlying Assets**
    a. *Situs issues*
        i. Where is trust being "administered" if all activity occurs at the entity level outside the control of the trustee?
        ii. This issue is exacerbated when the managers of the entity are not respecting the ownership structure. For example:
            1. Paying trust expenses from the entity
            2. Making distributions directly from the entity to trust beneficiaries
            3. Accepting contributions directly to the entity from the grantor
        iii. In extreme cases, in addition to loss of situs, the trust may be treated as an "alter ego" or "sham trust" and disregarded completely for creditor protection or tax purposes.
        iv. Best Practices
            1. All payments to and from the entity must pass through the trust account.
            2. Any transaction that creates a deemed transfer to or from the trust must be (i) properly documented and (ii) include the trust as a party on all such documentation.
            3. If possible, the entity's governing documents should highlight and require the observance of formalities and include trust and trustee protections and rights.
    b. *Liquidity issues*
        i. If all investment activity occurs at the entity level, then the investment advisor or other powerholder may not see a need to hold any liquid assets at the trust level.
        ii. This may create issues if, for example, the trust is subject to a lawsuit and the trustee needs immediate access to funds.
        iii. The trustee may also need funds to cover pre-existing obligations, such as life insurance premiums, capital calls, and taxes.
        iv. Best Practices
            1. Ideally, sufficient liquid assets would be maintained at the trust level to cover reasonably foreseen expenses, including a reserve for possible litigation based upon the trustee's determination of such risk.
            2. The trust instrument should include language negating any trustee duty to defend the trust assets from suit if the trust has insufficient liquid assets or if the trustee is not sufficiently indemnified.
            3. If the trust is directed as to investments, consider including language enabling the trustee to compel the investment advisor to create a reserve of liquid funds at the trust level.

4. Consider whether trust and trustee protections and rights can be added to the entity's governing documents to address these concerns – e.g., mandatory distributions upon the satisfaction of specified conditions.

v. What if the manager of the entity refuses to distribute funds?
   1. If the trust is a minority owner, then the trustee may not be able to compel a distribution.
   2. The trust may also be prohibited from liquidating its interest without the consent of the manager or other owners.
   3. Consider whether trust and trustee protections and rights can be added to the entity's governing documents to address these concerns – e.g., mandatory distributions upon the satisfaction of specified conditions, "put" rights exercisable in specified circumstances, or rights to cause a dissolution.

2. **Loss of Direct Access to Information Regarding Underlying Assets**
   a. The trustee may have tax and regulatory filing requirements that depend upon accurate information regarding the holdings of the entity and any subsidiaries thereunder. For example:
      i. Federal and state income tax returns
      ii. FATCA/FBAR filings
      iii. FinCEN reporting requirements
   b. The trustee also has a fiduciary duty to maintain accurate trust records.
      i. A trustee has this duty, even if serving solely in a directed or administrative capacity.
      ii. This duty includes valuing trust assets and making accurate account statements available to trust beneficiaries.
      iii. An institutional trustee's records are also subject to review by its regulators.
   c. Accurate asset values may also be necessary to carry out the trustee's other duties, including:
      i. Calculating unitrust payments
      ii. Determining appropriateness of distribution requests
      iii. Small trust terminations (including terminations due to lack of corpus)
      iv. Representations and warranties that depend upon value of trust property (e.g., the trust's status as an accredited investor or qualified purchaser)
   d. Best Practices
      i. For investment-directed trusts:
         1) Under 12 Del. C. 3317, each co-fiduciary has a duty to "keep all of the other fiduciaries for the trust reasonably informed about the administration of the trust with respect to any specific duty or function being performed by such fiduciary to the extent that providing such information to the other fiduciaries is reasonably necessary for the other fiduciaries to perform their duties."

2) In addition, under 12 Del. C. 3313(d), the term "investment decision," as such term applies to the authority of the investment advisor, includes "with respect to nonpublicly traded investments, the valuation thereof."
3) However, trustees should not rely solely upon the Delaware Code for protection.
    a) The trust instrument should specifically define the investment advisor's or co-trustee's responsibility to provide information regarding trust-owned entities, provide that the trustee may rely without liability upon such information, and release the trustee from liability for any failure to fulfill its duties if the investment advisor fails to provide it with any necessary information.
    b) The trust instrument should also state explicitly that the trustee may rely without liability upon valuation information provided by the investment advisor and that the trustee shall have no obligation to independently value any non-marketable assets held by the trust.
    c) To avoid any implied duty of investment oversight by the trustee, whenever the trustee enquires into the entities' underlying holdings or the value of trust assets, the trustee should make it clear that its actions are "administrative actions taken by the fiduciary solely to allow the fiduciary to perform those duties assigned to the fiduciary under the governing instrument" and do not "constitute an undertaking by the fiduciary to monitor the adviser or otherwise participate in actions within the scope of the adviser's authority" as set forth in 12 Del. C. 3313(e)

ii. If the entity is wholly owned by the trust, then the trust should be added as a recipient for all statements issued to the entity pertaining to its underlying investments. Consider whether this should also apply to any majority-owned entity.

iii. Consider including language in the trust instrument explicitly negating any trustee duty to account for activity not occurring at the trust level.

iv. Consider whether trust and trustee protections and rights can be added to the entity's governing documents to address these concerns – e.g., rights to inspect entity books and records, and limits on entity manager's power to maintain confidentiality and withhold information.

e. What if the manager of the entity refuses to provide information?
    i. If the trust is a minority owner:
        1) What rights does the trust have to information regarding the entity's holdings? What rights, if any, does the trust have to information regarding subsidiary entities?

2) What rights does the trust have to (1) demand that the company provide a value for its interest or (2) demand that the company cooperate in any efforts by the trustee to obtain an independent appraisal?

ii. Ideally, the entity governing documents would (1) explicitly provide that, notwithstanding any information rights available by statute and notwithstanding and power of managers to limit access to information, the owners of the entity have a right to obtain necessary information to fulfill their fiduciary responsibilities and (2) expressly provide further and particular information rights of such owners.

3. **<u>Specific AML/BSA Concerns</u>**
   a. An institutional trustee must comply with its internal AML/BSA policies as well as external reporting requirements.
   b. Beneficial ownership of entities is a current hot-button issue, which raises both regulatory/compliance issues and reputational risks. See e.g. the "Panama Papers" and new FinCEN regulations.
   c. As the trustee may have no control over the entity or its subsidiaries after it becomes an asset of the trust, the trustee may be unable to prevent the trust from subsequently becoming connected to or associated with unlawful persons or activities.
   d. <u>Best Practices</u>
      i. Due diligence on trust-owned entities should include:
         a) Copies of all governing documents
         b) Names and contact information for all managers/directors
         c) A list of assets and liabilities of the entity
         d) A description of the business of the entity and its activities
         e) A description of the tax status of the entity and, if applicable, contact information for the paid preparer/CPA who will be preparing the entity's returns
         f) If possible, the identity of all other beneficial owners
         g) If there are multiple entity layers, an organizational chart,
            1) Ideally, the items listed above would be obtained for each subsidiary entity, down to the identity of all hard assets. However, this may not always be possible.
            2) At the very least, if the trust will hold a majority interest in the entity and the entity will in turn hold an interest in another entity (other than a publically traded entity) such that the trust will be deemed to hold an indirect majority interest in that entity, then the items listed above should be obtained for each such entity held.
      ii. Due diligence should be performed, not only upon the formation or intake of the entity, but periodically so long as the entity is owned by the trust.

iii. A direction to hold an entity as an asset of the trust should include an agreement by the investment advisor to provide all necessary due diligence information and to notify the trustee of any changes.

iv. What if the manager refuses to provide information? Does the trustee have the authority to refuse to accept an entity as an asset of the trust if its BSA/AML requirements are not met?

a) The trust instrument should provide explicitly that any additions of property are subject to the trustee's consent or veto.

b) It may also be advisable to include language stating that a trustee is not required to comply with an investment direction that could increase the personal risk of the trustee.

v. What should a trustee do if it discovers information regarding an entity currently owned by the trust that would have violated its BSA/AML policies if discovered prior to accepting the entity?

a) For example, the entity is now involved in a marijuana business that is legal at the state level.

b) This raises a possible conflict between the trustee's BSA/AML responsibilities and its authority over trust investments.

c) Consider whether trust and trustee protections and rights can be added to the entity's governing documents to address these concerns – e.g., right to convert to a new class or series of investment interest that has no rights/liabilities in relation to problematic underlying assets/activities.

4. **<u>Addressing Inconsistencies between Trust and Entity Documents and Other Concerns</u>**

a. Transfer of ownership

i. What happens if the dispositive provisions under the trust conflict with a preexisting buy-sell or shareholders' agreement?

a) The outcome may depend on whether the trust fits within an exception in the agreement (generally for transfers to or for the benefit of the grantor's family).

b) See e.g., <u>Jimenez v. Corr</u>, 2014 Va. LEXIS 153 (2014) (holding that a corporation's shareholder agreement controls the disposition of the decedent's stock rather than the decedent's will/revocable trust) and <u>Blechman v. Blechman</u>, 2015 Fla. App. LEXIS 193 (2015) (holding that an LLC operating agreement controls the disposition of the decedent's interest rather than the decedent's will/revocable trust)

ii. What are the consequences of a purported transfer of an entity to the trust that did not meet the transfer requirements under the governing documents?

a) Was the transfer void *ab initio*?

b) If the entity is a Delaware limited liability company, will the trust (1) be admitted to the LLC as a member, (2) have rights with respect to the

dissolution of the LLC, or (3) have voting or other management rights or responsibilities?

iii. Best Practices

a) Prior to accepting an entity interest as an asset of the trust:

1) The entity's governing documents and any other relevant documents must be reviewed to ensure that there are no conflicts with the terms of the trust – e.g., no discretion/exercise of voting rights.

2) The transfer documents must be reviewed to ensure that all necessary steps are being taken to transfer the interest and admit the trust as a substitute owner.

3) The trust instrument and the entity's governing documents must be reviewed to ensure that the trust is an eligible owner.

- This is particularly important where there are tax considerations, e.g., for "S" corporations.

4) Consider whether trust and trustee protections and rights can be added to the entity's governing documents to address concerns – e.g., management and voting rights and exercise thereof, capital contribution obligations.

b) If an entity is already owned by the trust, the trustee should confirm whether transfers to beneficiaries or successor trusts are subject to any restrictions under the governing documents of the entity.

1) If restrictions apply, issues could arise if the trustee wishes to distribute the interest in kind (including upon termination) or is required to transfer or split the interest to fund successor trusts.

2) If the trust provides for an impermissible transfer, then attempts should be made to have the governing documents amended.

b. Incapacity

i. Both the trust instrument and the governing documents for the entity may provide that an individual is no longer eligible to serve in a particular role upon incapacity.

ii. Issues may arise if each set of documents creates a different standard for incapacity.

a) If the investment advisor is serving as manager of the entity and meets the definition of incapacity for the trust but not for the entity, then he or she can most likely be removed and replaced as manager by the successor investment advisor.

b) However, if the investment advisor is serving as manager of the entity and meets the definition of incapacity for the entity but not for the

trust, then the trustee has limited options because it is relying upon the investment advisor to direct the appointment a successor manager.

a. The situation may be further complicated if the investment advisor directs the trustee to amend the definition of incapacity under the entity's governing documents.

iii. Best Practices

a) Both the trust instrument and the governing documents for the entity should create an *objective* test for determining incapacity and provide for a clear mechanism for the appointment of a successor in that event - a determination of incapacity should not be left to the trustee's (or any party's) discretion.

b) If it is anticipated that the investment advisor would also serve as a manager, then the definition of incapacity under both sets of documents should be identical. Alternatively, the governing documents for the entity could provide that if an investment advisor is deemed incapacitated under the trust instrument, then he or she shall also be deemed incapacitated for purposes of serving as manager.