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## CHRISTIAN PURPOSE TRUSTS

THOMAS E. SIMMONS<sup>†</sup>

Noncharitable purpose trusts are recognized under the Uniform Trust Code and the non-uniform laws of many jurisdictions. In 2019, Oregon enacted a stewardship trust statutory scheme. A stewardship trust is a purpose trust which is designed to hold and preserve corporate stock. Properly drafted, a stewardship trust can soften the indefatigable pursuit of profits that drive corporate entities. A stewardship trust can substitute ethical ideals – at least in part – for shareholder return. The purpose trust statutes of other jurisdictions could also partially permit ambitions similar to those which motivated the Oregon legislation to be realized. The concept of a stewardship trust might be pursued even in jurisdictions which do not specifically contemplate purpose trusts being utilized for the prudent but compassionate stewardship of a closely-held business enterprise.

### I. INTRODUCTION

This Article contextualizes noncharitable purpose trusts, outlines and critiques the Uniform Trust Code provisions governing purpose trusts, and proposes a corporate purpose trust format which preserves a business founder's core Christian values modeled on a recent statutory enactment in Oregon. With careful drafting, a corporate purpose trust could ensure a form of dead hand control with particularly inspirational outcomes. A corporate purpose trust embedded with Christian precepts could preserve those precepts by stitching them into the fabric of a trust as the primary, or even the sole, shareholder of company stock.

A purpose trust, for example, might insist that a closely-held business close on Sundays, distribute excess profits to local churches, and prohibit the company from marketing or producing pornography, alcohol, contraception, caffeinated drinks, cannabis/tobacco products, or weapons.<sup>1</sup> It might prohibit investing in abortions, contraception, human cloning, embryonic stem-cell research, or for-profit health care industries that provide or pay for any of the same. It might pursue

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<sup>†</sup> Professor, University of South Dakota School of Law.

1. See Kim Bhasin & Melanie Hicken, *17 Big Companies that are Intensely Religious*, BUSINESS INSIDER (Jan. 19, 2012, 10:29 AM), <https://www.businessinsider.com/17-big-companies-that-are-intensely-religious-2012-1> (describing “faith-friendly” companies which insist, *inter alia*, upon provision of pastoral care to employees, citation to Bible passages on its products or packaging, or insist on high levels of corporate responsibility regarding their workers and vendors).

board diversity, fair wages, and generous family leave time policies for company employees. It might require a retail store's background music to include songs from a hymnal.<sup>2</sup> It might ban investments in fossil fuels. It might even seek, as Pope Francis does, to overturn an "idolatrous economic model that feels the need to sacrifice human lives on the altar of speculation and profit alone, considering only immediate advantage to the detriment of protecting the poor, the environment and its resources."<sup>3</sup> It might seek to topple the single-minded pursuit of profits with which corporations are otherwise traditionally endowed.<sup>4</sup> Or – if not topple – perhaps tweak.

## II. ANALYSIS

In the sections which follow, I will first introduce the concept of "res purpose trusts" – purpose trusts which are oriented towards a particular purpose or property, while owning that property as a component of the trust estate. For a purpose trust to best achieve its objectives in preserving the mission of its original founder, it will be advisable for the trust to maintain status as a shareholder of the company. A res purpose trust would permit this sort of structure. Second, I will explore "hybrid purpose trusts" which permit distributions of any dividends issued by the company to beneficiaries (e.g., to the business founder's descendants). A successful "Christian Purpose Trust" will combine the concepts of res purpose trusts and hybrid purpose trusts. Third, I will consider the recent legislative innovation in Oregon authorizing stewardship trusts. Finally, I will discuss how this new model of corporate ownership could reorient the profits-only path of closely held corporations.

### A. RES PURPOSE TRUSTS

I begin with the concept of res purpose trusts and how they benefit from structural efficiencies by virtue of owning the property toward

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2. Hobby Lobby stores, for example, pipe in gospel music: "There's an awful lot of gospel. It's not all gospel music but an awful lot of gospel. We put together our own song (lists) and our own music in our own stores. People ask for the CDs and so we sell the CDs of music that we are playing in our stores." *David Green: Chapter 2, Picking Cotton*, VOICES OF OKLAHOMA (May 14, 2011), <http://www.voicesofoklahoma.com/interview/green-david/>.

3. *Pope Francis in Mauritius: Do Not Pit Economy Against Environment, Poor*, CATHOLIC WORLD REPORT (Sept. 9, 2019), <https://www.catholicworldreport.com/2019/09/09/pope-francis-in-mauritius-do-not-pit-economy-against-environment-poor/>.

4. The idea of curbing the less charitable effects of undiluted capitalism is currently being expressed in many contexts. See, e.g., Ellie Anzilotti, *The End of Capitalism Is Already Starting–If You Know Where to Look*, POCKET (Oct. 10, 2019), [https://getpocket.com/explore/item/the-end-of-capitalism-is-already-starting-if-you-know-where-to-look?utm\\_source=pocket-newtab](https://getpocket.com/explore/item/the-end-of-capitalism-is-already-starting-if-you-know-where-to-look?utm_source=pocket-newtab).

which their noncharitable purpose is oriented. Because “pet trusts” are the most familiar and easy to conceptualize variety of noncharitable purpose trusts, they can be readily utilized to illustrate these concepts.

Pet trusts are the most common type of noncharitable purpose trusts.<sup>5</sup> While many pet owners consider their pets to be quasi-members of their families, pets are merely chattels (tellingly, from the French/Latin word for cattle)<sup>6</sup> under the law. Legally speaking, pets are not much different from toasters, melons, or shares of stock.<sup>7</sup> Pets are merely a form of personalty. Ordinarily, trusts are constructed for the benefit of either individual human beings or charitable enterprises. It would be unusual for a trust to be designed for the benefit of a chattel, but this is precisely what purpose trusts are often designed to do. A pet purpose trust is oriented toward the preservation and care of a particular animal; a particular family pet or pets.

Pets are alienable. Therefore, a pet could form a part of the *res* or corpus of a trust. A pet might be conveyed to the trustee of a pet trust by inter vivos or testamentary transfer. There may be advantages for a purpose trust to hold, as part of the trust estate, the very chattel which the trust is designed to supervise and protect. Consider, for example, a testamentary trust designed to care for a tabby cat named “Fluffy,” with the remainder of the trust corpus to be distributed at Fluffy’s death to the settlor’s children. The trust might be funded with a reasonable amount of cash or other property which the trustee can invest and distribute in order to ensure that Fluffy’s welfare is maintained. Fluffy might be placed with a caregiver and the trustee will likely develop a punch list for monitoring Fluffy’s well-being from time to time. The trustee might check on the health of Fluffy, for example. Typically, a purpose trust will also name an enforcer to monitor the trustee with standing to object, or even correct, a wayward or lax trustee.<sup>8</sup> The enforcer is a sort of guardian ad litem for the pet in connection with the administration of a pet trust. The enforcer can oversee distributions to benefit a pet much like a minor’s conservator can monitor a trustee’s distributions to benefit a child. In our hypo-

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5. See Breahn Vokolek, Comment, *America Gets What It Wants: Pet Trusts and a Future for Its Companion Animals*, 76 UMKC L. REV. 1109, 1128 (2008) (estimating that a quarter or more “of pet owners include their pets in their estate planning”).

6. *Chattel*, THE AMERICAN HERITAGE COLLEGE DICTIONARY 222, 238 (1993).

7. There are, however, laws which prohibit cruelty to animals. *E.g.*, NEB. REV. STAT. § 28-1009. But there are no prohibitions on cruelty to toasters. Thus, pets-as-chattels and other chattels do have this important difference.

8. See, *e.g.*, *id.* § 30-3834(b) (providing that a pet trust “may be enforced by a person appointed in the terms of the trust or, if no person is so appointed, by a person appointed by the court”); see also *id.* § 30-3835(2) (authorizing enforcers for other varieties of non-charitable purpose trusts).

thetical, the enforcer might be a friend of the settlor or a fellow pet lover.

Perhaps, after some period of time, the enforcer alerts the trustee to some concerns. After investigating, the trustee becomes concerned as well. Fluffy appears to be malnourished. The trustee might demand an independent veterinarian examination of Fluffy and might even conclude that Fluffy's caregivers need to be replaced. If the caregivers resist the idea of an examination, the trustee announces that it will suspend distributions. The enforcer intervenes, noting – correctly – that suspending distributions for Fluffy's grooming, care, and food could harm Fluffy. So, the trustee decides to simply place Fluffy with more suitable caregivers. The current caregivers dig in their heels and refuse to relinquish Fluffy. The trustee suspects their resistance is motivated by a desire to maintain trust distributions, but the trustee lacks any readily available legal mechanism to force the caregivers to release the cat. What's a trustee to do?

No easy solution for the trustee readily presents itself. With any pet trust, periodic assessments of the pet are required, and the ability to remove and replace a caregiver is critical – but these responsibilities prove difficult, especially if the caregiver of the pet has an ownership interest in the animal. Contractual rights could have been negotiated with the caregiver ahead of time, but if they were not, the trustee's options are few.<sup>9</sup> The trustees of pet trusts occasionally even become suspicious that the pet in question seems to be enjoying a remarkable life span. Could the pet have died and been replaced by a similar-looking animal to trick the trustee into continuing distributions to the caregiver?<sup>10</sup> The trustee's duties to the remainder beneficiaries are clearly implicated. Woe to the trustee who is determined to have continued trust distributions for the pet long after the natural end of the pet's life.<sup>11</sup>

One straightforward way for the trustee to minimize some of the potential risks with administering a pet trust is to maintain title to the pet itself; to include the pet-as-chattel as part of the trust

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9. The trustee may have negotiated a contract with the caregivers whereby the caregivers covenant to relinquish possession of Fluffy periodically for independent examinations. The contract could also articulate events of default under which the caregivers must transfer title and/or possession of Fluffy to successor caregivers.

10. See RESTATEMENT (SECOND) OF TRUSTS § 226 cmt. b (AM. LAW INST. 1959) (imposing trustee liability for mistakenly delivering property to an ineligible person); see also NEB. REV. STAT. § 30-3896 (allowing trustees to escape liability by requiring trustees to “exercise[] reasonable care to ascertain the happening of the event”).

11. See, e.g., Nat'l Acad. of Scis. v. Cambridge Tr. Co., 346 N.E.2d 879, 885 (Mass. 1976) (trustee liable to remainderman for continuing trust distributions to the settlor's widow long after she remarried where her trust distributions were to have terminated upon her death or remarriage).

corpus.<sup>12</sup> Elsewhere, I've termed a purpose trust which owns the property to which its purpose is oriented as a *res* purpose trust.<sup>13</sup> The Cayman Islands STAR Trust legislation specifically authorizes this concept.<sup>14</sup> It is rare that a jurisdiction's statutes specifically endorse the idea of a *res* purpose trust.<sup>15</sup> But there are generally few if any limitations on what property may form a part of the trust estate.<sup>16</sup> If the trustee holds title to Fluffy, then the trustee can more easily insist that the animal be delivered to it for periodic examinations and arrange for alternative caregiving if the current caregiver is determined to be unsuitable. A *res* purpose trust better equips the trustee to accomplish the trust's aims by making the property in question more accessible to the trustee.<sup>17</sup>

## B. HYBRID PURPOSE TRUSTS

While pet trusts are commonly thought of as having a singular focus – the care and oversight of a beloved animal – there may also be advantages from combining a purpose trust with a trust for one or more ascertainable beneficiaries. Consider again the settlor who funded the trust for Fluffy's care. If the settlor had two young children, she might have created a testamentary trust for her children. She could have combined this testamentary trust for her children with

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12. If the pet in question represents a high risk of liability (e.g., a dangerous pit bull or a particularly aggressive and venomous snake), the benefits of a *res* purpose trust might be offset by personal injury liability concerns.

13. Thomas E. Simmons, *A Will for Willa Cather*, 83 Mo. L. REV. 641, 693 (2018); see also S.D. CODIFIED LAWS § 55-1-20 (2020) ("Any property may form a part or all of the trust estate, including some, all, or an interest in some or all of the property that is the subject or purpose of a purpose trust.").

14. CAYMAN I. TRUSTS LAW § 99 *et seq.* (2011). See also, e.g., *The Use of Jersey Special Purpose Vehicles in Structured Finance Transactions*, CAREY OLSEN (June 1, 2013), <https://www.careyolsen.com/briefings/the-use-of-jersey-special-purpose-vehicles-in-structured-finance-transactio> (noting that under the trust law of Jersey, "it is possible to establish a noncharitable purpose trust, i.e. where the share capital of [a special purpose vehicle] is held by the trustee on trust to carry out specified purposes which do not qualify as charitable purposes"). The Cayman Islands legislation, however, excludes the ability of a purpose trust from owning real property situated in the Cayman Islands when the purpose of the trust was to preserve, maintain, or otherwise benefit that same property.

15. *But see* S.D. CODIFIED LAWS § 55-1-20 ("Any property may form a part or all of the trust estate, including some, all, or an interest in some or all of the property that is the subject or purpose of a purpose trust.").

16. See RESTATEMENT (THIRD) OF TRUSTS § 40 (2003) (providing that "a trustee may hold in trust any interest in any type of property").

17. Even with a *res* purpose trust (wherein the trustee retains title to the property toward which the purpose of the trust is oriented), the trustee may be advised to utilize contracts to discharge the trustee's obligations. Where the *res* in question is real property, prudent lease agreements may be recommended. With a pet *res*, a comprehensive caregiver agreement would be advisable.

a purpose trust to care for Fluffy, directing the trustee to support the children as well as the cat.

The trust might read in relevant part:

The trustee shall distribute for the health, education, maintenance and support of my children. During the term of the trust, the trustee is also directed to maintain and preserve any household pets owned by me at my death which survive me including, by way of example, reasonable costs in connection with a respectful disposal of the remains of any deceased pet.

When my youngest child attains twenty-five (25) years of age, the trustee shall distribute the remaining corpus to my then-living children in equal shares. In carrying out final distributions, the trustee shall distribute any living pets held by the trust in such a manner as to maximize the likelihood that such pets will be well cared for; the trustee may, but is not required to, distribute such pets to one or more of my children. The trust shall then terminate and the trustee shall be discharged.

Presumably, the settlor would desire to preserve and care for Fluffy but would also desire that her children would find comfort and companionship from Fluffy, especially in view of the fact that the trust would only be funded in the event of their mother's premature demise. The support of Fluffy might, in other words, be ancillary to but connected with the welfare of the testator's children. The settlor might therefore stipulate that the aspect of the trust which benefits Fluffy continue only so long as Fluffy continues to provide comfort and companionship to her children. Or she might prefer to simply ensure that Fluffy's welfare is ensured independent of any benefits to her children in preserving Fluffy. She might, in that instance, insist that the trustee maintain Fluffy's proper care without regard to whether her children benefit from Fluffy's companionship.

Commonly, a purpose trust will identify remainder beneficiaries (individuals or charities) following the accomplishment of the trust's purpose (e.g., upon the death of the pet).<sup>18</sup> With holographic instruments or poorly drafted trusts, remaindermen might not be named. In that case, the settlor's estate or residuary clause will typically supply

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18. See, e.g., *In re Copland*, 988 N.Y.S.2d 458, 459 (N.Y. Sur. Ct. 2014) (describing a trust for two cats until the death of the last cat whereupon "the home and its contents were to be sold, and the remainder distributed to 33 animal oriented charities in the percentages set forth in the instrument plus a \$50,000 bonus to [the caregiver]"); *In re Renner's Estate*, 57 A.2d 836, 837 (Pa. 1948) (considering a trust "for the maintenance of my pets . . . and for their interment upon their respective deaths in the Franciscvale Cemetery" with the remainder to one Mary Faiss Riesing).

the identity of the final distributees.<sup>19</sup> Thus, prior to the enactment of validating legislation, one of the recurring complaints of those persons challenging pet trusts – that the trust lacked ascertainable beneficiaries – was not entirely accurate.<sup>20</sup> Pet trusts would always have ascertainable remaindermen, even if only by default.<sup>21</sup> But they would commonly lack concurrent ascertainable life tenants. And they would lack any mechanism by which insufficient distributions for pet care could be challenged.

In a typical pet trust, the trustee would be accountable to the post-pet remaindermen, who could complain, for example, that the trustee's distributions for Fluffy's benefit were overly generous, thus representing the duty of loyalty tension present in any trust – the tension between the trustee's duty of loyalty to the current beneficiaries of the trust versus the duty of loyalty to the remainder beneficiaries.<sup>22</sup> What a pet trust would typically lack would be ascertainable *current* beneficiaries with any motivation to complain that the trustee's distributions for Fluffy's benefit were insufficient. No one would have standing to complain on behalf of Fluffy. If the trustee owes no fiduciary duties to a distributee, it seems that the trustee is not really a trustee at all. This key omission was remedied with the office of an “enforcer” endowed with the authority to essentially speak on Fluffy's behalf and to hold the trustee accountable vis-à-vis the trustee's duty of loyalty to Fluffy's welfare.<sup>23</sup>

In the trust sketched above, Fluffy and the settlor's children will enjoy trustee support payments simultaneously. (One suspects that in the tragic circumstances of a trust supporting orphaned children that the trustee would see the wisdom in reasonable distributions relating to the expense of a pet – whether the pet was a part of the family before the parent's death or not – and whether the trust expressly insisted upon distributions for the purpose of a pet's welfare. Distribu-

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19. See NEB. REV. STAT. § 30-3834(c) (2020) (providing that excess or remaining property in a pet trust may be “distributed to the settlor, if then living, otherwise to the settlor's successors in interest” unless otherwise provided in the trust instrument).

20. See, e.g., Hahn v. Estate of Strange, No. 04-07-00253-CV, 2008 WL 372467, at \*2 (Tex. Ct. App. 2008) (appeal of a trial court's decision which had reasoned, *inter alia*, that a pet trust for cats failed for want of ascertainable beneficiaries and that the designated caregiver could not be considered a beneficiary because his health problems did not allow him to care for the cats). Texas now recognizes pet trusts by statute. See TEX. PROP. CODE ANN. § 112.037 (West 2020).

21. NEB. REV. STAT. § 30-3834(c).

22. UNIF. TRUST CODE § 803 (2000); see also *id.* § 105(b) (insisting that a trustee's duty “to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries” cannot be modified by the terms of the trust).

23. With charitable trusts lacking ascertainable beneficiaries, the standing problem is remedied by vesting the attorney general with standing to monitor and enforce the trustee's duties. See, e.g., NEB. REV. STAT. § 30-3810(d).

tions for pet-related expenses would provide welfare-enhancing benefits to the orphaned children and likely be approved as readily as babysitter costs, toys, clothing, medical expenses, tuition, and music lessons). In a purpose trust where the trustee is directed to both carry out distributions to ascertainable beneficiaries as well as support an articulated noncharitable purpose such as preserving Fluffy, those two aims might overlap and even coincide. Still, this sort of a purpose trust – a hybrid purpose trust we’ll call it – is a unique configuration: beneficial interests which are concurrent with a noncharitable purpose.<sup>24</sup>

The Uniform Trust Code (“UTC”) does validate purpose trusts, although it contains several restrictions that limit their effectiveness.<sup>25</sup> The primary stumbling block is the trust duration limitation of twenty-one years.<sup>26</sup> A secondary problem is the potential of a court to defund an over-funded trust.<sup>27</sup> A third problem with UTC section 409 is that it disallows hybrid purpose trusts.<sup>28</sup> UTC section 409 permits trusts “for a noncharitable purpose *without* a[n] . . . ascertainable beneficiary.”<sup>29</sup> Because this provision relates to the creation of a purpose

24. See, e.g., S.D. CODIFIED LAWS § 55-1-22 (2020) (defining and authorizing hybrid purpose trusts).

25. See UNIF. TRUST CODE § 409 (other noncharitable purpose trusts); *id.* § 408 (2000) (pet trusts).

26. *Id.* § 409(1) (2000). Compare NEB. REV. STAT. § 30-3835(1) (“The trust may not be enforced for more than twenty-one years.”), with OR. REV. STAT. § 130.190 (2019) (Oregon’s version of UTC 409(1) allowing purpose trusts (other than pet trusts or stewardship trusts, discussed *infra* Subsection D) to “be enforced for [not] more than 90 years”).

27. See UNIF. TRUST CODE § 409(3) (2000) (“Property of a trust authorized by this section may be applied only to its intended use, except to the extent the court determines that the value of the trust property exceeds the amount required for the intended use.”); NEB. REV. STAT. § 30-3825(3) (same).

28. Thomas E. Simmons, *Purpose Trust* Cy Pres, 45 ACTEC J. 67, 70 (2019) (hereinafter, Simmons, *Purpose Trust*). Alternatively, one could also read section 409(1) to permit trusts for a noncharitable purpose *notwithstanding* a lack of ascertainable beneficiaries. This is probably what was intended since there seems to be no policy objective in disallowing hybrid purpose trusts. Support for reading UTC section 409(1) in this way can be found in the historical evolution of noncharitable purpose trusts – absent authorizing legislation, a purpose trust would often fail for lack of any ascertainable beneficiaries; the existence of ascertainable beneficiaries was a required element of any noncharitable trust. See, e.g., *Fosdick v. Town of Hempstead*, 26 N.E. 801, 805 (N.Y. 1891) (concluding “that [a] gift to [a] town was not an absolute one, but in trust, for purposes which were not corporate or administrative, and that the town could not take it for that reason; and the trust itself is void because of a lack of any ascertained or ascertainable beneficiaries to enforce the same”). UTC section 409 cured that common law defect, one might argue, by permitting noncharitable purpose trusts even when there are no ascertainable beneficiaries to enforce the trustee’s duties. See UNIF. TRUST CODE § 409 cmt. (noting that at common law, a trust for a noncharitable purpose “was honorary only and did not create a trust [but that] under this section, however, the disposition is enforceable as a trust . . .”).

29. UNIF. TRUST CODE § 409(1) (emphasis added). Arguably, even a non-hybrid purpose trust with ascertainable remainder beneficiaries may violate section 409(1).

trust, it appears to represent a mandatory rule; a rule which the attorney cannot simply draft around.<sup>30</sup> Under this reading, only purpose trusts which lack ascertainable beneficiaries are authorized.<sup>31</sup> Strangely, purpose trusts in which the trustee herself selects the purpose of the trust do not contain this same flaw.<sup>32</sup> On the positive side, the text of the UTC suggests that *res* purpose trusts are permissible.<sup>33</sup> And any sort of noncharitable purpose is allowed, so long as the purpose is not illegal, impossible, or offensive to public policy.<sup>34</sup>

### C. OREGON'S STEWARDSHIP TRUST LEGISLATION

A statute enacted by the Oregon legislature in 2019 allows a new variety of succession planning for family-owned businesses.<sup>35</sup> Professor Susan Gary, who was instrumental in the legislative process, explains that Oregon's legislation "creates a structure for a stewardship trust that protects the mission of the company using this structure, provides adequate mechanisms for enforcement of the purposes, and creates enough flexibility so that the managers of the business can adapt to changes over time."<sup>36</sup> Because there are really no such things as irrevocable bylaws or articles of incorporation, the mission and values of a corporation are subject to the evolving whims and pref-

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For example, a trust to preserve and maintain an artist's creative works, with remainder to the settlor's children would have ascertainable beneficiaries as remaindermen. And section 409 only recognizes purpose trusts "without a[n] . . . ascertainable beneficiary." *Id.*

30. *Compare id.* § 409(1) (permitting trusts to "be created for a noncharitable purpose without a definite or definitely ascertainable beneficiary") (emphasis added), *with id.* § 105(b)(1) (providing that "the requirements for creating a trust" as set forth in the code supersede the terms of the trust itself).

31. *Id.* § 409(1) (2000); *see also id.* § 409(3) ("Property of a trust authorized by this section may be applied *only* to its intended use.") (emphasis added).

32. *See id.* § 409(1) ("A trust may be created for a noncharitable . . . but otherwise valid purpose to be selected by the trustee.").

33. *See id.* § 409. Nothing in the text of UTC section 409 suggests that a purpose trust could not own the property to which its purpose is oriented. *See also id.* § 103(12) ("Property" means anything that may be the subject of ownership, whether real or personal, legal or equitable, or any interest therein."). The UTC comments explain:

The definition of "property" (paragraph (12)) is intended to be as expansive as possible and to encompass anything that may be the subject of ownership. Included are choses in action, claims, and interests created by beneficiary designations under policies of insurance, financial instruments, and deferred compensation and other retirement arrangements, whether revocable or irrevocable. Any such property interest is sufficient to support creation of a trust.

*Id.* § 103 cmt.

34. *Id.* § 409(1) (2000) (allowing trusts for any "noncharitable . . . but otherwise valid purpose"); *see also id.* § 404 (allowing a trust "only to the extent its purposes are lawful, not contrary to public policy, and possible to achieve").

35. OR. REV. STAT. § 130.193 (2020); *see also* Susan N. Gary, *The Oregon Stewardship Trust: A New Type of Purpose Trust that Enables Steward-ownership of a Business*, U. CIN. L. REV. (forthcoming) [hereinafter Gary, *The Oregon Stewardship Trust*].

36. Gary, *The Oregon Stewardship Trust*, *supra* note 35.

erences of future stakeholders. The Oregon legislation allows for the basic ideas contained within a pet trust to be applied to a trust oriented toward the care and oversight of a corporation. For the small business owner who treats her business with as much care and concern as some pet owners treat their pets, the stewardship trust creates a mechanism by which these concerns can be expressed.<sup>37</sup>

If a sole or majority shareholder imprints her values into her corporation's bylaws (requiring, for example, the business to close on Sundays), nothing prohibits or even inhibits the next generation's shareholders from electing members of the board of directors who would repeal the requirement.<sup>38</sup> The profit-orientation of the corporation might almost guarantee the shedding of any precepts which tended to diminish returns. Indeed, when the shareholder is a fiduciary such as a trustee, there is an even greater incentive for the fiduciary to prioritize wealth preservation and growth of share value over objectives which might run counter to profit.<sup>39</sup> With a *res* purpose trust holding all of a corporation's voting shares, however, those values can be imprinted upon an irrevocable and potentially perpetual mechanism – a stewardship trust – a single shareholder endowed with the original shareholder's values, ideally, in perpetuity.<sup>40</sup>

Alongside the typical parties to a purpose trust – the trustee who administers the trust and an enforcer with beneficiary-like enforcement powers – the Oregon legislation introduces a third party: a stewardship committee vested with the powers to manage the business owned by the trust.<sup>41</sup> A stewardship committee must have at least three members.<sup>42</sup> It has the power to remove and replace a trustee.<sup>43</sup> It has the power to vote the shares held by the trust and thereby elect the corporation's board of directors.<sup>44</sup> It also has the power to determine whether dividends should be issued, but because a hybrid stew-

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37. *But see* Susan N. Gary, *The Need for a New Type of Purpose Trust, the Stewardship Trust*, 45 ACTEC J. 37, 39 (2019) (noting two special concerns unique to stewardship trusts – “that the purposes of a business and not profit should drive decision-making and that people close to the business should control its management”).

38. *See* 18 C.J.S. *Corporations* § 174 (2020) (amending bylaws is typically vested in the stockholders or board of directors).

39. *See, e.g.*, William Sanders, *Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing*, 35 PACE L. REV. 535, 567 (2014) (observing that absent “a statute specifically allowing or mandating [socially responsible investing or] SRI, legal scholars had generally been of the view that SRI violates a fiduciary's duties”).

40. *See* Gary, *The Oregon Stewardship Trust*, *supra* note 35 (noting that a stewardship trust will own all of a corporation's voting stock but that the corporation could “issue non-voting redeemable preferred stock to investors, who may include family members in a family business or stakeholders in a mission-driven business”).

41. OR. REV. STAT. § 130.193(4).

42. *Id.*

43. *Id.* § (7)(a).

44. *Id.* § 7(f).

ardship is not permitted and given the compressed income tax rates applicable to non-grantor trusts, it is contemplated that few dividends will typically be issued by a business held in an Oregon Stewardship Trust.<sup>45</sup> The composition of the stewardship committee will vary according to the needs and circumstances of the particular trust. The stewardship committee fills a role comparable to a trust director of a directed trust.<sup>46</sup>

As Professor Gary explains:

The committee will depend on the type of business and the reasons behind transferring the business into a stewardship trust. If the business is owned by a family, the committee might include family members, key employees, and non-family, non-employee members. Election to the committee could be by existing members, specified family members could elect all members, or some combination of family and employees could elect members. The specifics will depend on the business and should be drafted into the trust instrument.<sup>47</sup>

Thus, administration and decision-making involving the trust will be trifurcated into three offices: the trustee, the enforcer, and the stewardship committee. The precise interlockings and staffing of these offices – and delineating their respective duties and responsibilities – requires careful forethought and drafting.

Although Oregon is governed generally by a ninety-year Rule Against Perpetuities, stewardship trusts are exempt from the rule.<sup>48</sup> The term of a stewardship trust may be – like a typical corporation’s – indefinite.<sup>49</sup> Since the “life span” of a corporation may be indefinite it

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45. Gary, *The Oregon Stewardship Trust*, *supra* note 35. Typically, Gary explains, earnings will be retained and reinvested at the corporate level. *Id.* The accumulated earnings tax (or a state income tax law equivalent) could undermine this strategy. *See* 26 C.F.R. § 1.532-1 (2019). LLCs and S corporations – whose profits are taxable to their shareholders – might also prove poor candidates for an Oregon Stewardship Trust.

46. UNIF. DIRECTED TRUST ACT § 6 (2019). *See also* OR. REV. STAT. §§ 130.193(7)(a), (b), (e) (granting the stewardship committee the power to remove and replace trustees and direct trust distributions). A stewardship committee, however, is also granted default powers *equal* to that of the trustee. *See id.* § 130.193(7) (providing: “Unless the terms of the trust provide otherwise, the trust stewardship committee has the power . . . to . . . (f) [e]xercise *all rights belonging to the trustee*”) (emphasis supplied). Thus, although formally structured as a kind of directed trust, the trustee seems to have powers coextensive with a committee overseeing it unless the governing instrument pares down the stewardship committee’s powers. *Compare* UNIF. DIRECTED TRUST ACT Prefatory Note (“In a directed trust, the terms of the trust grant a person other than a trustee a power over *some aspect* of the trust’s administration.”) (emphasis supplied).

47. Gary, *The Oregon Stewardship Trust*, *supra* note 35.

48. OR. REV. STAT. § 130.193(14).

49. *Id.* *Cf.* 18 C.J.S. *Corporations* § 67 (noting that “if the period of [a corporation’s] existence is not limited by its charter, a corporation will exist indefinitely and until it is legally dissolved”). The potential lifetime of corporations took time to evolve. Initially, some states capped their term at even a shorter span than the Rule Against Perpetuities. *See, e.g.,* *DuVall v. Moore*, 276 F. Supp. 674, 685 (N.D. Iowa 1967) (“Iowa

is especially sensible for the life span of the trust-shareholder to also be indefinite. The particular framing of the purpose of a stewardship trust must be oriented toward “a business purpose” but that aim “may seek economic and non-economic benefits.”<sup>50</sup> A stewardship trust might, for example, be oriented toward developing products or services which improve the quality of life of its customers. Professor Gray again: “The specific purposes depend on the business, but the overall idea behind steward-ownership is that the purposes guide business decisions and profits are merely the means to attain the mission.”<sup>51</sup>

#### D. CHRISTIAN PURPOSE TRUSTS

Nebraska’s Uniform Trust Code provisions authorize noncharitable purpose trusts so long as the term of the trust does not exceed twenty-one years.<sup>52</sup> The same authorization can be found in most of the other Uniform Trust Code jurisdictions – of which there are currently thirty-five.<sup>53</sup> The Uniform Trust Code seems to suggest that hybrid purpose trusts are unauthorized.<sup>54</sup> And although *res* purpose trusts are not specifically endorsed, nothing in the text of the Uniform Trust Code implies that a purpose trust could not own the property toward which the purpose of the trust is oriented. With these limitations and possible uncertainties in mind, a Christian Purpose Trust can be sketched.

The prototypical Christian Purpose Trust would be structured as a hybrid *res* purpose trust. It would be funded with all or the majority of shares in the settlor’s closely held business enterprise and provide for discretionary distributions of income and principal to the settlor’s descendants (or other beneficiaries that the settlor wants to name). The trust might also address how the trustee and enforcer should con-

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was basically an agrarian state at the time the initial statute was enacted in 1851 and its corporate enterprises consisted primarily of small, closely-held ventures. The duration of corporate life was fixed at twenty years.”).

50. OR. REV. STAT. § 130.193(1).

51. Gary, *The Oregon Stewardship Trust*, *supra* note 35.

52. NEB. REV. STAT. § 30-3835(1) (2020).

53. UNIF. LAW COMM’N, *Enactment Map*, TR. CODE, <https://www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d> (last updated 2005).

54. *See* UNIF. TRUST CODE § 409(1) (2000); NEB. REV. STAT. § 30-3835(1) (“A trust may be created for a noncharitable purpose *without* a definite or definitely ascertainable beneficiary.”) (emphasis added); *see also* UNIF. TRUST CODE § 409(3) (“Property of a trust authorized by this section may be applied *only* to its intended use.”) (emphasis added); *accord*, NEB. REV. ST. § 30-3835(3). These concerns are unpacked in Simmons, *Purpose Trust*, *supra* note 28, at 69.

sider any future sale, distribution, or encumbrance of the shares held in trust.<sup>55</sup>

The trust would name a trustee and an enforcer. It would address whether the enforcer or trustee could elect themselves to any positions on the corporation's board of directors and whether there were any circumstances in which the trustee or enforcer could also serve as employees of or consultants to the business. To avoid conflicts of interest, the trust might ban the trustee or enforcer from serving in any role within the business enterprise.

The trustee would be directed by the terms of the trust instrument to carry out the noncharitable purposes of the trust indirectly by means of the prudent exercise of shareholder rights.<sup>56</sup> The trustee, as a shareholder, would not make day-to-day business decisions or set company policy, but would determine how to exercise the primary right of a shareholder – voting for members of the board of directors – based upon how those vote allocations could best advance the settlor's articulated objectives.<sup>57</sup> Here, it is helpful to recall once more our trust for Fluffy. The trustee of Fluffy's trust did not care for Fluffy, but the trustee did select a caregiver, instruct the caregiver, and monitor the caregiver's performance.<sup>58</sup> In much the same way, the trustee of a Christian Purpose Trust would oversee the performance of the enterprise's board of directors.

The owner of a closely-held business enterprise can exercise her will and autonomy by imprinting her own Christian values on the way her business operates. The stewardship trust concept allows the settlor to endow an irrevocable trust with those same values, and ensure that the trustee will best be able to ensure these values are recognized by the business enterprise by funding the trust with a *res* of those

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55. The settlor of any *res* purpose trust – whether a pet trust, a stewardship trust, or otherwise – may not infrequently desire to flatly prohibit any sale, encumbrance, or distribution of the purpose-*res*. Any attempted prohibitions going to the alienability of any part of the trust estate should take account of the common law's view of restraints on alienation as repugnant and unenforceable. *See generally*, JOHN CHIPMAN GRAY, RE-  
STRAINTS ON THE ALIENATION OF PROPERTY (2d ed. 1895). The repugnancy is preserved by statute in some jurisdictions. *See, e.g.*, OKLA. STAT. tit. 60 § 175.47(A) (2020) (insisting that “the absolute power of alienation of real and personal property, or either of them, shall not be suspended by any limitations or conditions whatever for a longer period than during the continuance of a life or lives of the beneficiaries in being at the creation of the estate and twenty-one (21) years thereafter”).

56. Alternatively, the trustee could be directed by a trust director with those responsibilities by means of a directed trust structure. *See* NEB. REV. STAT. § 30-4301 *et seq.* (codifying the Nebraska Uniform Directed Trust Act).

57. *Id.* § 21-270.

58. *Cf.* UNIF. TRUST CODE § 703 cmt. (noting that “trustees should be encouraged to delegate functions they are not competent to perform”); *see also id.* § 807(a)(1)-(3) (providing that when trustees delegate, they must “exercise reasonable care, skill, and caution in” selecting, monitoring, and instructing the person to whom they delegated).

shares.<sup>59</sup> As suggested above, a Christian Purpose Trust might include restrictions or requirements such as those often found in socially responsible investing mandates. For example, the trust might direct the trustee to exercise its shareholder powers to ensure that the corporation does not participate in purchase, shipment, or marketing of weapons. It might direct the trustee to campaign for Sunday business closing policies or generous family leave time. The particular objectives can in large measure mirror the same firmly-held values of the settlor herself. Those values can be endowed with momentum and preservation by the text of the purpose trust instrument.

Renowned purpose trust scholar Alexander Bove notes the following objectives that might be achieved with a purpose trust or “stewardship ownership plan” for a closely-held business:

1. Ensure retention and continuation of the business indefinitely;
2. Allow family members, descendants, and key employees to manage or participate in management of the business;
3. Provide benefits to family members in and out of the business, as well as other parties, such as employees and charities;
4. Consider and develop the favorable impact the company has on the community;
5. Protect against outside disruptions or exposure to loss of business ownership, such as divorce, lawsuits, estate disputes, and the like; and
6. Protect against sale of the business or hostile takeovers by outside investors.<sup>60</sup>

Perhaps the greatest stumbling block to a fully realized Christian Purpose Trust in Nebraska and most other jurisdictions is the Rule Against Perpetuities (“RAP”) or its Uniform Trust Code analogue of twenty-one years for purpose trusts.<sup>61</sup> While the public policy objectives and concerns which reside within RAP are legitimate, they have been largely rejected in the business context insofar as business entities with a perpetual or indefinite term of existence are commonplace. Indeed, insisting that corporate existence terminate within twenty-

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59. See Alexander A. Bove, Jr., *The Purpose Trust Has a New Purpose*, 33 PROB. & PROP. 40, 42 (2019) (asserting “that the steward ownership arrangement produces far better performance results than the typical, closely-owned, for-profit companies, possibly on account of the clear long-term view that the managers must take, as opposed to the typical near-term bottom line results to please shareholders”).

60. *Id.*

61. See UNIF. TRUST CODE § 409(1). Compare NEB. REV. STAT. § 30-3835(1) (“The trust may not be enforced for more than twenty-one years.”), with OR. REV. STAT. § 130.190 (2019) (Oregon’s version of UTC 409(1) allowing purpose trusts (other than pet trusts or stewardship trusts, discussed *infra* Subsection D) to “be enforced for [not] more than 90 years”).

one years of lives in being would be roundly rejected by most policy-makers today. Since stewardship trusts are joined to corporate shares, relaxing or rejecting RAP's application to at least one particular variety of purpose trusts ought to be relatively uncontroversial. In Oregon, at least, the legislature perceived that the benefits of eliminating RAP as applied to stewardship trusts outweighed the downsides.

### III. CONCLUSION

Unchecked corporate profit-seeking ambitions are making the rich richer and the poor poorer.<sup>62</sup> Recently, Robert Cardinal Sarah wrote:

We need a true freedom of enterprise in order to develop a just economy. But his freedom must be imbued with the virtue of justice. Our freedom has a purpose, a meaning; it must flourish in a form of friendship. It cannot give free rein to the appetites for ownership while leaving it up to hypothetical laws of the marketplace to regulate these unbridled desires.<sup>63</sup>

Stewardship ownership via a Christian Purpose Trust as outlined above could act as a powerful check on corporate greed and accelerating wealth disparities. Moreover, a Christian Purpose Trust would permit an entrepreneur to ensure that her particular values are shared by her successor shareholder, while also providing for a legacy for her family or other loved ones. Business succession planning is a challenging endeavor which must take account of the particular dynamics, circumstances, and objectives of the individual testator/settlor. Christian Purpose Trusts can provide one additional planning option by which to map and achieve those objectives.

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62. Christopher Ingraham, *Companies' Pursuit of High Profits Is Making the Rich Richer at Everyone Else's Expense, According to New Research*, WASH. POST (Dec. 31, 2018), <https://www.washingtonpost.com/business/2018/12/31/companies-pursuit-high-profits-is-making-rich-richer-everyone-elses-expense-according-new-research/>.

63. ROBERT CARDINAL SARAH, *THE DAY IS NOW FAR SPENT* 312 (2019) (Michael J. Miller trans.); see also, e.g., Pope Benedict XVI, *Message for the Celebration of the World Day of Peace*, THE HOLY SEE (Jan. 1, 2012), [https://w2.vatican.va/content/benedict-xvi/en/messages/peace/documents/hf\\_ben-xvi\\_mes\\_20111208\\_xlv-world-day-peace.html](https://w2.vatican.va/content/benedict-xvi/en/messages/peace/documents/hf_ben-xvi_mes_20111208_xlv-world-day-peace.html) (noting that those aspects of modern culture, founded on "individualistic economic principles, have cut off the concept of justice from its transcendent roots, detaching it from charity").



## COGNITIVE COMPETENCE AND DECISION-MAKING CAPACITY

JULIE BLASKEWICZ BORON<sup>†</sup>

This essay is based upon a panel discussion at the 2020 Creighton Law Review Symposium and Tepeel Lecture entitled *The 21st Century Trust: Evolution, Innovation, Adaptation*. As the population of the United States shifts, resulting in a larger proportion of individuals living to age 65 and older, ensuring that these individuals are supported in terms of maintaining their decision-making independence when appropriate, is essential. There are normative age-related changes in both cognitive and physical functioning with age, but the impact on an individual's decision-making is often nonexistent, minimal, or temporary. This essay includes information on normative age-related changes in cognition and the relation to capacity and competency. In addition, appropriate considerations for decisional capacity and evaluation of capacity are discussed, along with suggestions to support aging clients.

### I. NORMATIVE COGNITIVE CHANGES AND THE IMPACT ON CAPACITY AND COMPETENCY

As people age, there are normal changes in many different cognitive abilities<sup>1</sup>; some, such as processing speed, attention, and working memory tend to marginally decrease<sup>2</sup>, while other abilities more related to experiences, such as verbal ability, tend to slightly increase or stay the same<sup>3</sup>. These differential changes do not tend to negatively impact a person's ability to function in everyday life and/or make decisions—if the cognitive changes experienced are within the realm of what is considered “normal.” In that regard, neither decision-making capacity nor competency should be negatively impacted. However, the distinction between capacity and competence should be clarified.

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<sup>†</sup> Doctoral Program Chair and Associate Gerontology Professor at the University of Nebraska Omaha.

1. K. WARNER SCHAIE, *DEVELOPMENTAL INFLUENCES ON ADULT INTELLIGENCE: THE SEATTLE LONGITUDINAL STUDY* (2d ed. 2012).

2. Paul B. Baltes, *The Aging Mind: Potential and Limits*, 33 *GERONTOLOGIST* 580 (1993); T.A. Salthouse & E. Ferrer-Caja, *What Needs to Be Explained to Account for Age-related Effects on Multiple Cognitive Variables?*, 18 *PSYCHOL. & AGING* 91 (2003).

3. Paul B. Baltes, *Theoretical Propositions of Life-span Developmental Psychology: On the Dynamics Between Growth and Decline*, 23 *DEVELOPMENTAL PSYCHOL.* 611 (1987); John L. Horn & Scott M. Hofer, *Major Abilities and Development in the Adult Period*, in *INTELLECTUAL DEVELOPMENT* 44 (Robert J. Sternberg & Cynthia A. Berg eds., 1992).

Capacity is a term used in the psychological literature to refer to a person's capabilities to make his/her own decisions; it is more about the autonomy of the individual. A functional assessment by a clinician that has some training in psychology or neuropsychology can be conducted to ensure that the person is capable of making his/her own decisions. This can obviously vary as a function of domain, such as health or financial-related decisions. These two domains are discussed and studied most often due to the relevance for aging individuals.

Competency, on the other hand, is a global assessment; it is not focused solely on decision-making for financial matters or decision-making for health or other domains. It is a global assessment that is a legal determination made by a judge in a court about whether someone has the mental capacity to decide in accordance with his/her own personal goals, concerns, and values. People are considered legally competent unless demonstrated otherwise by the court. Thus, competency is an absolute yes or no, whereas capacity can vary. This variability can occur over time, and/or as a function of domain, thus, capacity is a more flexible construct compared to competency. However, it is important to note that a person would not be deemed incompetent if he/she had capacity.

The other issue that makes competency particularly challenging is that it can also be an ethical issue – this is a global determination about whether someone is competent to make decisions for him/herself. The decision has to be made with caution because, ultimately, it can vary depending upon the context, as is known from research on capacity. However, a competency decision cannot consider different contexts based upon domain or time. It is yes, the person has the ability, or no, the person does not. Because a person's ability may be fluid, or change over time depending upon the source of the problem, a person's inability may be temporary. This is one of the reasons why making a permanent legal determination of lack of capacity is difficult. Thus, many legal professionals are left to determine a person's ability on singular occasions because more often than not, a person will not have lost his/her legal ability to make decisions.

The capacity versus competency distinction is important whenever a person is either temporarily or possibly permanently incapacitated. It is important to keep the person's best interests in mind in terms of his/her goals, values, and what he/she is striving toward, as well as provide protection from potential abuse. Although, beyond the scope of the present consideration, abuse may occur from others that are interested in what the person may have in terms of his/her estates. From a psychological perspective, this capacity versus compe-

tency distinction is most often important when considering health and/or financial decision-making. In particular, it can be relevant in regard to estate planning, challenges to wills, trusts, donative transfers, and/or guardianships, along with other domains.

In order to determine whether a person is temporarily or permanently disabled, knowing the cause or source of the problem is important. This can relay information about the prognosis, whether the problem is temporary or permanent, if it will get better or worse, whether it could improve with treatment, etc. Answers to these types of questions can help determine whether this is an issue that might resolve over a period of time, or whether it will continue to get progressively worse. If there is a possibility for improvement, then attempting to temporarily delay decision-making for a period of time may be the best option.

Relating competency and capacity back to cognitive functioning, decision-making capacity is not synonymous with cognitive ability.<sup>4</sup> However, it is noteworthy that both working memory and verbal fluency, two abilities that experience normative age-related decline, have been implicated in ability to apply decision rules.<sup>5</sup> Regardless, when the change is normative, the impact on daily life and functioning is minimal. Of concern to most is non-normative cognitive change representative in forms of dementia. Depending on the stage of dementia, this disease can negatively impact a person's decision-making capacity. However, despite the increasing number of people with dementia, the majority of people will not experience dementia with age. Dementia is considered non-normative cognitive decline, much more extensive than what most people experience. In 2019, approximately 5.8 million Americans were living with Alzheimer's disease, representing 10% of those aged 65+; these rates increase to 17% of those aged 75-84, and up to 32% of those aged 85+ years.<sup>6</sup> These rates are similar for those experiencing mild cognitive impairment, which is also considered non-normative cognitive change; only approximately 15% of those with mild cognitive impairment will transition to dementia. If an individual has a diagnosis of dementia, it is important to consider the degree to which decision-making capacity may be impaired.

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4. Barton W. Palmer & Alexandria L. Harmell, *Assessment of Healthcare Decision-making Capacity*, 31 ARCHIVES OF CLINICAL NEUROPSYCHOLOGY 530 (2016).

5. Alessia Rosi, Wandu Bruine de Bruin, Fabio Del Missier, Elena Cavallini, & Riccardo Russo, *Decision-making Competence in Older and Younger Adults: Which Cognitive Abilities Contribute to the Application of Decision Rules?*, 26 AGING, NEUROPSYCHOLOGY AND COGNITION 174 (2017).

6. ALZHEIMER'S ASSOCIATION, 2019 ALZHEIMER'S DISEASE FACTS AND FIGURES (2019).

The normal age-related declines that we experience in different types of cognitive abilities is not sufficient to impair our ability to make decisions important to our everyday life and functioning and to live independently. Although there are changes, there are some abilities that plateau or even increase, such as crystalized abilities focused on language, comprehension, and experiences. Although decline occurs in some types of abilities, other abilities are retained or even increase, which can serve a compensatory function. There is a tendency to consider any aging person that exhibits trouble with cognitive functioning, whether it is memory, concentration, calculations, etc., must be exhibiting early signs of dementia. Maybe, but maybe not. It is very possible that even if his/her impairment is mild that there will not be a transition to full-blown dementia, and, in that regard, he/she may still be competent to make his/her own decisions.

Finally, if somebody has a very quick change—a significant change in cognitive functioning within a week or a few weeks' worth of time, it is most likely not dementia, but may be delirium. Most people recover memory challenges they experienced as a result of delirium. Another consideration is cognitive or memory impairment due to depression, or another mental health issue. In this regard, mental health is usually treatable, suggesting that the impaired cognitive functioning may be temporary.

## II. CONSIDERATION AND EVALUATION OF DECISIONAL CAPACITY

In the majority of the decision-making literature, regardless of the domain, the Four Component Model of Decisional Capacity is utilized.<sup>7</sup> This model includes four different components/areas that are assessed in studies on decision-making capacity. The first is understanding, which is comprehension of the topic that is under discussion. Appreciation, the second component, involves having full knowledge about the risks, benefits, and significance of the situation. Regardless as to whether the topic is health-related or financial, being able to thoroughly understand the risks and the benefits to each of the various alternatives is essential to demonstrate appreciation. The third component is reasoning, being able to apply the decision to the current context. From the psychological perspective, there is a focus on whether the person can make rational decisions. Finally, being able to express a choice or indicate a preference in some way is the final

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7. See THOMAS GRISSO & PAUL S. APPELBAUM, *ASSESSING COMPETENCE TO CONSENT TO TREATMENT: A GUIDE FOR PHYSICIANS AND OTHER HEALTH PROFESSIONALS* 31 (1998); see also Alan Meisel et al., *Toward a Model of the Legal Doctrine of Informed Consent*, 134 *AM. J. PSYCHIATRY* 285 (1977).

component. Even if a person lacks the ability to verbally communicate due to a temporary or permanent problem, if the person is able to somehow indicate a preference by pointing, nodding, blinking, etc., this can be helpful. When evaluating these components, it is important to consider whether someone was once able to do something that he/she is no longer capable of – the question is whether there has been a noticeable change in ability – and again, whether that change in ability is a permanent or temporary change. The fields of psychology and law may concentrate on different components due to the differential focus on what demonstrates capacity versus competency. To satisfy competency, the legal system may attend to understanding the topic and expressing a choice. Mental health professionals assessing capacity tend to concentrate on whether the person can appreciate the significance of the situation and engage in rational decision-making. This contrast is subtle but corresponds with the differences between capacity and competency.

Many practicing in law are confronted with making their own determinations about someone's decision-making abilities while in the midst of a session. Thus, what can be done to determine if somebody is indeed competent or has decision-making capacity? It is important to be able to look for, observe, and interpret signs of diminished capacity. If signs of diminished capacity are detected, this does not translate into determining that the person should not be allowed to make decisions; however, this can serve as an initial indicator to reconsider whether this is an appropriate time to make decisions. It might be possible to temporarily postpone decision-making or slow down to allow the person the opportunity to make a decision under different circumstances whereby capacity may be improved.

There are cognitive, emotional, and behavioral signs of diminished capacity. Short-term memory loss, communication difficulties, comprehension problems, lack of mental flexibility, calculation errors, and/or overall disorientation may be cognitive indicators of diminished capacity. Emotional signs include various forms of distress and/or inappropriate or quickly changing emotions. Grief, recent changes in health status or diagnoses, amongst other changes, in one's personal life can cause stress that can temporarily diminish one's capacity. Finally, behavioral signs can include poor hygiene or grooming, presence of delusions or hallucinations, and/or new needs for assistance with activities or instrumental activities of daily living. With any of these signs, the emphasis is on noticeable differences from previous encounters with the same individual. Looking for these signs in clients and being able to observe and interpret is important, particularly in regard to whether the sign(s) may be something short-term that might resolve. In addition, keeping a note of signs observed and

then looking for them the next time you interact with the person can be really helpful.

Observations of signs should also be made while considering the following: a person's abilities rather than his/her cooperation, whether there is a change from prior history, being sensitive to potential age-based stereotypes (e.g., trouble concentrating translating into an assumption about dementia), and the potential impact of other mitigating factors. Even in instances where there are some signs present, it may or may not impact the decision currently under consideration. Various mitigating factors, such as stress, temporary medical conditions, normal fluctuations, and sensory changes could impact an individual. If there has been a recent significant change in vision or hearing for an individual, he/she might still be adapting to using new device(s), such as new hearing aids, and might seem very disoriented or disagreeable. Other mitigating factors can include socioeconomic status and cultural differences, which may impact the degree to which people engage in making decisions on their own versus integrating others.

If a lawyer makes a judgment that further evaluation is needed to determine decision-making capacity, this will likely lead to a psychological/psychiatric evaluation. This evaluation will include: 1) a clinical interview, which assesses global cognitive ability and values/preferences; 2) objective tests to assess functional abilities, cognitive functioning, and psychopathologies/psychiatric illnesses; and 3) collateral interview(s) with person(s) close to the individual. In regard to functional abilities, this will assess what the individual is physically able to do on his/her own, such as take care of him/herself (ADLs<sup>8</sup> and IADLs<sup>9</sup>), in terms of his/her physical body – feeding him/herself, grooming, etc., and managing his/her independent lifestyle including finances, medications, getting to appointments, etc. Cognitive assessments examine attention, language, memory, visual perception, speed of processing, executive functioning, etc. Finally, with some aging individuals collateral interviews will be completed with people who are close to the aging individual to get their perspective on abilities, changes in ability, and whether the changes have been slow or quick. This clinical evaluation will show where a person falls on the continuum, but it will not provide a definitive judgment as to whether someone is competent or not. The placement on the continuum may vary

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8. ADLs stands for Activities of Daily Living. These include self-care activities such as bathing, contingence, grooming, dressing oneself, eating, etc.

9. IADLs stands for Instrumental Activities of Daily Living. These activities have more of a cognitive component such as medication and financial management, shopping, using transportation, making and attending appointments, housekeeping, preparing food, etc.

based upon time or domain. However, when, in terms of the legal perspective, it has to be an absolute yes or no, a clinical assessment can be used in the court to help make a competency judgment. In the court, the person is either deemed competent to make decisions for him/herself on any domain or he/she is deemed incompetent to make decisions for him/herself on any domain.

The American Bar Association and the American Psychological Association have been in collaboration with one another regarding this issue since 2001. Handbooks to support both lawyers and psychologists regarding capacity have been produced.<sup>10</sup> In the algorithm for lawyers, the flowchart guides one to first consider if there are observational signs of diminished capacity. If so, then mitigating factors should be taken into account. If mitigating factors are present, it is recommended to revisit signs of diminished capacity at a later time. If mitigating factors are not present, then the lawyer needs to consider the transaction to be completed and make a legal judgment regarding whether the person is intact, has mild problems, more than mild problems, or severe problems. If the person is intact, this means that there is no or very minimal evidence of diminished capacity. In this case, the lawyer proceeds as he/she always would. When mild problems (e.g., some evidence of diminished capacity but not enough to interfere with the proposed transaction) are detected, the lawyer may proceed or consider suggesting a medical referral, clinical consultation, or evaluation. This may depend upon the lawyer's comfort level and/or history with the client. When the legal judgment is more than mild or severe, it is unlikely that the transaction will proceed exactly as initially intended. This suggests that there is substantial evidence of diminished capacity (i.e., more than mild). In this regard, consultation with a neuropsychologist or a clinical psychologist would be recommended in most circumstances. In some instances the transaction may proceed with caution. In all cases of severe problems, the transaction will not continue, and the lawyer may decline/withdraw representation or at least request protective action for the client until a formal capacity assessment has occurred.

### III. SUPPORTING AGING CLIENTS

In cases of diminished capacity, whether temporary or progressive, lawyers can support aging clients to enhance capacity; this may be particularly relevant when mitigating factors are present or only mild problems may be evident. These techniques may also be used in

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10. See AMERICAN BAR ASSOCIATION COMMISSION ON LAW AND AGING & AMERICAN PSYCHOLOGICAL ASSOCIATION, *ASSESSMENT OF OLDER ADULTS WITH DIMINISHED CAPACITY: A HANDBOOK FOR LAWYERS* (2005).

cases of more substantial diminished capacity to simply support the client, even if the transaction does not proceed. To foster trust and confidence with clients, ensuring confidentiality is essential. Demonstrating respect and encouragement, providing additional time to make decisions, and supporting continued participation in decision-making (regardless of legal determinations of competency) can also enhance client capacity. Extending the amount of time, even over multiple sessions, can be particularly helpful, especially in cases of mild concern that might temporarily resolve themselves over time. In this case, at the beginning of the next session, decisions made in the prior session could be briefly revisited to ensure no changes are desired before continuing. Being mindful of sensory changes, particularly in regard to vision and hearing, is also important to enhance client capacity. It is essential that the client can hear and understand what is being spoken and communicated.

In regard to cognitive impairments, adaptations can be made. Again, approximately 15% of people with mild cognitive impairment progress to dementia, but the majority of them do not. Also, less than 10% of people aged 65+ have mild cognitive impairment, whereas this number increases to approximately 15% of those aged 75 to 85, and 30% of those aged 85 and older. Depending upon the individual, and possibly the day, mild cognitive impairment may place someone in the mild or more than mild designation. The cognitive impairment may be permanent or temporary. Thus, simplifying as much as possible, slowing the pace, and allowing sufficient time to make decisions (when appropriate) is necessary. Providing additional cues and rephrasing may also help. Finally, strengthening client engagement in decision-making is encouraged.<sup>11</sup> Even in instances where there is a power of attorney involved, or a guardianship, or someone has been deemed incompetent to make decisions, they can and should be included in those decision-making processes to the extent that they can.

In conclusion, there are various strategies to support aging clients. It is essential to keep in mind that some instances of diminished capacity are temporary, and mitigating factors can be influential. Further, the majority of aging clients will not have dementia, so utilizing strategies to support those experiencing normative changes and/or mitigating factors is essential to maintaining a positive relationship with clients. Looking for, observing, and interpreting potential signs of diminished capacity are important, and should be regularly attended to in all adults, but particularly in aging adults when mitigating factors may be present. These indicators might be temporary or

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11. Linda F. Smith, *Representing the Elderly Client and Addressing the Question of Competence*, 14 J. CONTEMP. L. 61, 90-92 (1988).

permanent. Additional suggestions include asking and encouraging clients to consider advanced care planning, such as living wills and advanced directives.<sup>12</sup> There are dementia-specific advanced directives available to consider care at each stage of dementia. There are many options in regard to who an individual may want to make healthcare and/or financially-related decisions in the event that he/she is temporarily or permanently unable to do so. In that regard, completing planning documents by the time a person is 50 or 60 and then revisiting it every five years to make sure that his/her wishes have not changed can be helpful. Finally, another form of planning is to offer the option for shared decision making and, when necessary, integrating powers of attorney, either globally or specifically for health or financial-related decisions.<sup>13</sup> Advanced planning can also be discussed in regard to guardianship if a person would ever need that. Regardless, all named individuals should be those that will adhere to advanced planning documents and keep the person's goals, values, etc. in mind. It is always important, regardless of a person's legal competence, to include him/her to the maximum extent possible in decision-making.

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12. Jane deLima Thomas et al., *Advance Care Planning in Cognitively Impaired Older Adults*, 66 J. AM. GERIATRICS SOC'Y 1469 (2018).

13. Andrea M. Mejia et al., *Shared Decision Making in Mild Cognitive Impairment*, 9 NEUROLOGY CLINICAL PRAC. 160 (2018).



## TEPOEL LECTURE: BOND TRUSTEES AND THE RISING CHALLENGE OF ACTIVIST INVESTORS

STEVEN L. SCHWARCZ<sup>†</sup>

### I. INTRODUCTION

A bond indenture is the contract controlling the relationship between investors in corporate bonds and the issuer of those bonds. Large financial institutions, such as U.S. Bank, Bank of NY Mellon, and Deutsche Bank, typically administer the governance of bond indentures on behalf of the investors; in that role, they are called indenture trustees or, more colloquially, bond trustees.

#### A. BONDHOLDERS AND SHAREHOLDERS

Bondholders, therefore, are the primary beneficiaries of indenture governance, just as shareholders are the primary beneficiaries of corporate governance. As beneficiaries, though, bondholders and shareholders have much different expectations. Indenture governance and corporate governance have evolved differently to meet those different expectations.

For example, because bondholders are only entitled to—and thus, only expect to receive—principal and accrued interest on their bonds, indenture governance has evolved to protect that recovery.<sup>1</sup> In contrast, because shareholders, as residual claimants of the firm, are entitled to (and thus expect to receive) the firm’s surplus value, corporate governance has evolved to increase that value.<sup>2</sup>

Most people would consider corporate governance as much more important than indenture governance. In part, that is because corporations and stock markets are highly visible to the average person. Also, a corporate manager’s job—to try to increase shareholder value—involves more judgment and discretion, and thus can be more

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<sup>†</sup> Stanley A. Star Professor of Law & Business, Duke University School of Law; Senior Fellow, Centre for International Governance Innovation (CIGI). This Lecture is adapted from *Indenture Trustee Duties: The Pre-Default Puzzle*, forthcoming in a U. CIN. L. REV. symposium issue on “The Business Uses of Trust.” Although I have been a consultant and expert witness in litigation involving some of the issues examined in this Lecture, the views expressed are entirely my own and intended to be impartial.

1. See Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. L. 559, 561 (2003).

2. See *id.*

interesting (and more desirable of scholarly study), than an indenture trustee's job of merely protecting bondholder recovery.

Still, indenture governance is critically important. Domestically and worldwide, the amounts invested in bonds dwarfs the amounts invested in stock. Recent data show, for example, that global bond issuance is almost thirty times greater than global equity issuance.<sup>3</sup>

## B. INDENTURE TRUSTEE DUTIES

Historically, an indenture trustee's governance duties turn on whether the trustee is acting pre-default or post-default.

### 1. *Post-Default Duties*

Once an indenture defaults—in the worst case, because the issuer has failed to pay its bonds—the law requires the indenture trustee to act on behalf of the bondholders as would a prudent person in similar circumstances regarding its own affairs.<sup>4</sup>

Many post-default decisions—such as whether to accelerate the maturity of the bonds or to liquidate collateral—involve difficult judgment calls.<sup>5</sup> These decisions are made more difficult by what I have called a “protection gap”: when things go wrong, investors often blame parties with deep pockets, especially indenture trustees, for failing to protect them.<sup>6</sup>

Post-default indenture governance becomes even more complicated when the bondholders themselves have conflicting interests caused, for example, by conflicting payment priorities or conflicting sources of payment.<sup>7</sup> The indenture trustee then also faces the difficult task of trying to understand and balance the respective obligations owed to conflicting classes, sometimes called “tranches,” of investors—which involves what some have called “tranche warfare.”

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3. See, e.g., SIFMA, SIFMA FACT BOOK 45-46 (2018), <https://www.sifma.org/wp-content/uploads/2017/08/US-Fact-Book-2018-SIFMA.pdf> (showing that, in 2017, global long-term bond issuance was \$21,099.7 billion versus global equity issuance of only \$720.7 billion).

4. See, e.g., Trust Indenture Act of 1939 § 315(c), 15 U.S.C. § 7700o(c) (2018) (“The indenture trustee shall exercise in case of default . . . the same degree of care and skill . . . as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.”).

5. See Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALA. L. REV. 1037, 1040 (2008) (“Indenture trustees for defaulted bonds . . . face the conundrum that they are required to act prudently but lack clear guidance on what prudence means.”).

6. Steven L. Schwarcz, *The Roberta Mitchell Lecture: Structuring Responsibility in Securitization Transactions*, 40 CAP. U. L. REV. 803, 804 (2012).

7. See generally Steven L. Schwarcz, *Fiduciaries with Conflicting Obligations*, 94 MINN. L. REV. 1867 (2010).

Notwithstanding its complexities, post-default indenture governance is informed by case law. And perhaps *because of* its complexities, post-default indenture governance is also informed by legal scholarship.

## 2. *Pre-Default Duties*

In contrast, pre-default indenture governance is not yet well-informed by either case law or legal scholarship. The paucity of guidance reflects that, absent a default, bond investors were relatively passive. The rising challenge of activist investors is now changing that. Thus, it is critical to understand what an indenture trustee's pre-default duties should be.

For example, activist investors—which include hedge funds and so-called “vulture” funds—are buying bonds of troubled companies, at deep discounts. As bondholders, they then make demands on indenture trustees. They also sue indenture trustees for losses on their bonds.

Indenture trustees must know how to respond. My goal is to try to provide a framework for guiding an indenture trustee's response.

To start, let us consider the history of an indenture trustee's pre-default duties.

## II. BACKGROUND

### A. THE TIA HISTORICAL RECORD

The history of enactment of the Trust Indenture Act of 1939 (“TIA”)<sup>8</sup> provides a valuable record of the original debate over indenture trustee's pre-default responsibilities. Congress enacted the TIA in order to restore investor confidence in the bond markets following the stock-market crash of 1929 and the Great Depression.

The TIA currently requires the appointment of an indenture trustee for bondholders in most public bond issuances over \$10 million.<sup>9</sup> The indenture trustee's basic role, according to the TIA, is to help solve the collective action problem that bondholders individually may be unable to coordinate their actions with other bondholders.<sup>10</sup>

The 1929 report of the Securities and Exchange Commission (“SEC”) that led to enactment of the TIA criticized the passive, or

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8. 15 U.S.C. §§ 77aaa–77bbb (2018).

9. Trust Indenture Act of 1939, 15 U.S.C. § 77ddd(a)(9) (2018).

10. See 15 U.S.C. § 77bbb(a)(1) (stating that the TIA was enacted because “individual action by [investors] . . . is rendered impracticable by reason of the disproportionate expense,” “concerted action by [investors] in their common interest . . . is impeded by reason of the wide dispersion of [investors] through many States,” and relevant information may not be available to all investors).

“ministerial,” pre-default role generally taken at that time by indenture trustees.<sup>11</sup> The SEC recommended that a post-default “prudent man” standard should apply to indenture trustee performance both pre- and post-default,<sup>12</sup> and that indenture trustees should be required to actively monitor actions of a bond issuer.<sup>13</sup> Almost a decade later when the TIA was enacted, however, the pre-default ministerial role had become widely accepted in market practice and was codified into the TIA.<sup>14</sup>

## B. BOND MARKET CHANGES

The indenture trustee’s pre-default duties have not been seriously re-examined since 1939, but the bond market has changed dramatically. Institutional investors now dominate, holding over 80% of corporate and foreign bonds.<sup>15</sup> There are few retail investors. Institutional investors face less of a collective action problem than retail investors.

Whether or not due to bond-market changes, there are conflicting views today of the indenture trustee’s pre-default role. The dominant view by far reflects the ministerial role that was codified in the TIA: that indenture trustees have no pre-default fiduciary duties to bondholders. Rather, their indenture-governance duties are ministerial and limited to the specific terms of the indenture.<sup>16</sup> These duties typically include administrative tasks such as mailing notices or selecting bonds for redemption or delivering certificates, preparing and transmitting reports, and forwarding notices.

Since the 2007 to 2008 financial crisis (the “financial crisis”), however, some investors argue that indenture trustees—especially indenture trustees of securitized bond issues—should have some pre-default fiduciary duties. Understanding this requires an understanding of the categories of bond issues.

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11. SEC. & EXCH. COMM’N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART VI—TRUSTEES UNDER INDENTURES 110 (1936).

12. Wilber G. Katz, *Responsibility of Trustees Under the Federal Trust Indenture Act of 1939*, 26 A.B.A. J. 290, 291 (1940).

13. Stewart M. Robertson, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 HARV. J.L. & PUB. POL’Y 461, 472-73 (1988).

14. 15 U.S.C. § 7700o(a)(1).

15. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNT OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS: SECOND QUARTER 2015 122 (2015).

16. See, e.g., Trust Indenture Act of 1939, 15 U.S.C. § 7700o(a)(1) (2018); Elliott Assocs. v. J. Henry Schroder Bank & Tr. Co., 838 F.2d 66, 68-71 (2d Cir. 1988).

## C. THE CATEGORIES OF BOND ISSUES

In unsecured bond issues, which dominate bond issuance, the indenture trustee acts for the benefit of investors whose right to payment is based on a contract claim against the issuer. This is little different from how an “agent bank” acts for a syndicate of unsecured bank lenders. In secured bond issues, the indenture trustee acts that same way and, usually, also as a collateral agent for the investors.

In securitized bond issues,<sup>17</sup> the indenture trustee acts for the benefit of investors whose right to payment is limited to collections on specified financial assets, such as mortgage loans.<sup>18</sup>

Even prior to the financial crisis, credit-rating agencies debated whether indenture trustees of securitized bond issues have greater duties than indenture trustees of other types of bond issues.<sup>19</sup> During the financial crisis, some practitioners also observed expectations that indenture trustees of securitized bond issues may have higher pre-default duties than indenture trustees of other bond issues.<sup>20</sup>

Whether or not inspired by these precedents, I have seen several complaints in recent lawsuits alleging that, pre-default, an indenture trustee of a securitized bond issue should “police the deal” for, or otherwise protect, the investors.<sup>21</sup> To date, however, courts have not

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17. The indenture in a securitized bond issue is often designated a pooling and servicing agreement, or “PSA.” In my experience, the relevant provisions concerning the trustee of a securitized bond issue are identical whether it uses an indenture or a PSA. Also, some securitized bond issues, even though involving a public offering, have been interpreted to be outside the scope of the TIA. *See* *Ret. Bd. of Police v. Bank of N.Y. Mellon*, 775 F.3d 154, 164 (2d Cir. 2014) (holding that certain pass-through mortgage-backed securities were exempt from the TIA under § 304(a)(2) because they were “certificate[s] of interest or participation in two or more securities having substantially different rights and privileges,” namely, the numerous mortgage loans held by each trust”). My normative analysis of securitized bond issues is not dependent on whether such bond issues are subject to the TIA.

18. Steven L. Schwarcz, *What is Securitization? And for What Purpose?*, 85 S. CAL. L. REV. 1283, 1295-98 (2012).

19. *Compare* MOODY’S GLOBAL CREDIT RESEARCH, MOODY RE-EXAMINES TRUSTEE’S ROLES IN ABS AND MBS 3-4 (2003) (suggesting that indenture trustees in MBS transactions have an affirmative duty to investigate likely servicer defaults and to be proactive participants) *with* *Fitch: Seller/Servicer Risk Trumps Trustee’s Role In U.S. ABS Transactions*, BUS. WIRE (Feb. 24, 2003), <https://www.businesswire.com/news/home/20030224005501/en/Fitch-SellerServicer-Risk-Trumps-Trustees-Role-U.S.> (stating that such “unrealistic reliance on [indenture] trustees” in MBS and other securitization transactions not only “misses the mark” but also “increases the risk to investors by potentially masking other more important considerations” such as the quality of servicer performance).

20. *See, e.g.*, Christopher J. Brady, Marla Chernof Cohen, & Harold L. Kaplan, *The Role of the Trustee in Securitization Transactions*, ch. 9, at 9-3, in *SECURITIZATION OF FINANCIAL ASSETS* (Jason H.P. Kravitt ed., 3d ed. Supp. 2013).

21. *See, e.g.*, Complaint at 2-3, *Commerzbank AG v. Bank of New York Mellon*, No. 1:15-cv-10029 (S.D.N.Y. Dec. 23, 2015) (contending that prior to an Event of Default, a trustee for a securitized bond issue is required to police the deal for investors).

ruled that indenture trustees have greater duties in securitized bond issues.

### III. ANALYZING PRE-DEFAULT DUTIES

To analyze what pre-default duties an indenture trustee should have, consider the possible normative frameworks for legally imposing duties in a business context. There are two potentially overlapping frameworks: to correct market failures and to maximize efficiency.

#### A. CORRECTING MARKET FAILURES

The fundamental normative justification for financial regulation is to correct market failures. The primary justification for regulating the duties of a trustee pre-default, therefore, should be to correct pre-default market failures.

When the TIA originally was enacted in 1939, many of the bondholders for whom indenture trustees acted were retail investors. Without an indenture trustee acting for them, they were unable to adequately protect themselves because of a collective action problem—which is a type of market failure. Today, institutional investors dominate the bond markets, greatly reducing that collective action problem.

But the rise of activist investors and the emergence of securitized bond issues have created other market failures. The rise of activist investors has created a possible agency failure: activist investors do not necessarily act for the benefit of the other investors. The emergence of securitized bond issues has created a possible information failure: some securitized bond issues are so complex that investors do not always fully understand them.<sup>22</sup>

I do not see why indenture trustees should, or even how they could, correct the agency failure. Activist investors are responsible for that failure. Future indentures should be drafted to try to limit the ability of those investors to cause such failure.

Nonetheless, indenture trustees should not want to exacerbate that failure. When requested to take an action, for example, an indenture trustee may wish to consider whether that action could create or worsen a conflict of interest among investors. If so, it should have the right to refuse to take that action—provided that refusal violates neither the indenture nor formal investor directions.

Nor do I see why indenture trustees should, or how they could, correct the information failure. Securitizations can be extremely com-

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22. Steven L. Schwarcz, *Securitization and Post-Crisis Financial Regulation*, 102 CORNELL L. REV. ONLINE 115, 131 (2016).

plex. It can take around forty pages to describe the underlying financial assets, and around thirty pages to describe how cash flows from those assets are allocated.<sup>23</sup> Large securitizations may be even more complex, including multiple types of underlying financial assets and multiple tranches of bonds.

There is no evidence, though, that indenture trustees could correct that information failure. Indenture trustees receive relatively tiny fees, and the trust departments of financial institutions normally engage in only relatively ministerial tasks.<sup>24</sup> Indenture trustees rarely even negotiate the terms of the indentures. Instead, they are usually presented the transaction documents at the last minute and asked to sign with little to no opportunity to make changes.<sup>25</sup>

In contrast, the institutional investors in securitized bond issues, including the activist investors, are highly sophisticated. In the Rule 144A-exempt transactions that characterize many securitized bond issues, the investors must be qualified institutional buyers (“QIBs”): the highest SEC ranking of investor sophistication and size. Indenture trustees could not understand complex securitized bond issues better than those investors.<sup>26</sup>

#### B. MAXIMIZING EFFICIENCY

Another normative justification for financial regulation is maximizing efficiency. In theory, correcting market failures should make private markets work efficiently.

In practice, though, maximizing efficiency requires avoiding any duplication of efforts. The pre-default duties of indenture trustees are usually limited to straightforward administrative tasks. Indenture trustees should not be performing additional pre-default roles that duplicate what other parties are doing.

Also, if future indentures require indenture trustees to perform additional pre-default roles, they would then want to be further compensated. Payment of that compensation would reduce the value of the trust estate for bondholders.

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23. Andra C. Ghent et. al., *Complexity in Structured Finance* 14 (Nov. 2, 2017) (unpublished draft), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2325835](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2325835).

24. AM. BANKERS ASS'N, CORPORATE TRUST COMMITTEE, *THE TRUSTEE'S ROLE IN ASSET-BACKED SECURITIES* 3 (2010).

25. *Id.* at 4.

26. *Cf.* Press Release, Dep't of the Treasury, Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman Before the Structured Finance Industry Group 1st Annual Private Label Symposium (Nov. 12, 2014), <https://www.treasury.gov/press-center/press-releases/Pages/jl2694.aspx> (concluding that the “core competency of [indenture] trustees is in carrying out administrative functions, not in forensic activities that require subjectivity and judgment, which is ultimately what a fiduciary must exercise”).

The current equilibrium of small trustee fees and (except when the trustee is formally directed by investors, as I will later discuss) ministerial pre-default duties represents the current market practice for balancing costs and benefits. Market practice provides a presumption of efficiency.

#### C. ARTICULATING A NORMATIVE RULE

This analysis suggests the following rule. Pre-default, an indenture trustee should only have the duties specified in the indenture. An indenture trustee also should have the right to refuse to take an action that could create or exacerbate a conflict of interest among investors, provided that refusal violates neither the indenture nor formal investor directions.

This rule could result in a pre-default protection gap if the indenture fails to assign any specific party to enforce pre-default remedies. For example, some securitization indentures fail to assign a party to enforce certain remedies for breaches of representations and warranties regarding purchased financial assets.

If such a protection gap arises, the bondholders typically could protect themselves, such as by marshalling the requisite voting rights (and providing adequate indemnification of costs) to contractually direct the indenture trustee or the servicer to enforce those remedies. Sometimes, bondholders might be unable to marshal the requisite voting rights to protect themselves; but courts have refused to infer implied covenants to protect sophisticated bondholders.<sup>27</sup>

#### IV. APPLYING THE PROPOSED PRE-DEFAULT NORMATIVE RULE

Next, let us apply the rule for determining an indenture trustee's pre-default duties to the types of issues that may arise in lawsuits.

##### A. TAKING ENFORCEMENT AND OTHER REMEDIAL ACTIONS

Even prior to a formal default, one or more investors may demand that the indenture trustee take some enforcement or other remedial action to try to correct a perceived problem. Compliance with that demand could be expensive; indenture trustees normally are entitled to reimbursement of their enforcement costs from the trust estate, which would reduce the value of that estate for investors generally. Taking

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27. *Cf. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504 (S.D.N.Y. 1989) (refusing to find an implied covenant protecting investors where the bond indenture lacked that protection).

remedial action could, therefore, create a conflict if it would disproportionately benefit only certain investors.

For example, activist investors may purchase “underwater” subordinated (junior) bonds at pennies on the dollar. Those investors may then demand that the indenture trustee take an expensive enforcement action, with relatively little chance of success—but a high recovery if successful.

If the issuer is solvent enough to pay the senior bonds, then taking that enforcement action would be unlikely to benefit the senior investors. It could hurt them, though, if the cost of a failed enforcement action reduces the issuer’s ability to pay the senior bonds.

The activist investors, nonetheless, would want the indenture trustee to take that enforcement action. Absent that action, their subordinated bonds are worth little—so they would lose little if the action is unsuccessful. But taking the action gives them a small chance of being paid in full.

Absent formal investor directions, an indenture trustee should have the right to refuse to take that action. In case of doubt, an indenture trustee could seek—or could request the investors demanding the action to arrange for—formal investor directions. An indenture typically allows investors with at least 25-50% of voting rights to direct the indenture trustee to act, and to indemnify the indenture trustee for the cost of taking the action.<sup>28</sup>

#### B. INVESTIGATING “RED FLAGS” AND OTHER SUSPICIOUS OCCURRENCES

Investors may become aware of so-called red flags or other suspicious occurrences in a bond issue (such as an unusual number of mortgage-loan defaults), even prior to a formal default. One or more investors may then demand that the indenture trustee investigate the event. Compliance with that demand could be costly, reducing the value of the estate for investors generally.

The indenture trustee’s engagement in such an investigation could, therefore, create a conflict if it would disproportionately benefit only certain investors. For example, an investor in subordinated bonds who might benefit from an expensive investigation would have an incentive to direct the indenture trustee to make that investigation

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28. See, e.g., Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L. J. 637, 709 (2013) (observing that a typical indenture allows holders of more than 25% principal amount of bonds to control trustee actions). The TIA requires indentures to authorize at least majority bondholders to direct the trustee’s exercise of power. Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(a)(1) (2018).

if the costs of an unsuccessful investigation are disproportionately borne by investors in more senior bonds. Absent formal investor directions, an indenture trustee should have the right to refuse to make that investigation.

Even absent an investor demand, investors sometimes use the indenture trustee's failure to investigate a red flag or other suspicious occurrence as a basis for a later claim against the indenture trustee as a deep pocket. Although indentures typically absolve trustees from liability unless they act negligently or with willful misconduct, investors sometimes argue that a trustee's failure to make the investigation constitutes negligence. Reading an indenture as a consistent whole, however, the more specific governing text would appear to be the standard provision that the trustee "undertakes to perform . . . only such duties as are specifically set forth" in the indenture and has no duty to investigate any "facts or matters" unless appropriately requested by investors to do so. An omission cannot be negligent if there is no duty to act.

### C. MONITORING AND SUPERVISING SERVICERS (AND OTHER PARTIES)

In securitized bond issues, the bondholders are dependent on collections on the purchased financial assets. Invariably, therefore, these transactions require a party, usually called a servicer (or sometimes, collection agent), to service those financial assets and collect payment thereon.<sup>29</sup> In litigation filed following the financial crisis, which caused widespread defaults on residential mortgage loans, some investors argued that indenture trustees in mortgage-backed securities transactions should have monitored or supervised the performance of the mortgage-loan servicer.<sup>30</sup>

An indenture could specifically require the indenture trustee to supervise the servicer or assure that the servicer complies with the indenture. However, more typically in my experience, indentures provide that the indenture trustee has no duty to monitor or supervise the servicer. Instead, the servicer itself typically attests periodically to its own compliance, and the indenture trustee is entitled to rely on the truth and accuracy of that attestation.<sup>31</sup>

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29. The servicer normally is required to act in the "best interests" of the investors. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 392 (2008).

30. See, e.g., *Ellington Credit Fund, Ltd. v. Select Portfolio Servicing, Inc.*, 837 F. Supp. 2d 162, 178 (S.D.N.Y. 2011) (alleging that trustee of securitization breached its duty for insufficient supervision of servicer).

31. Sometimes an experienced master servicer may be appointed to supervise the servicer's performance.

Absent clear indenture language, should the indenture trustee have a pre-default duty to monitor or supervise the servicer? I think not. Imposing a monitoring or servicing requirement would be duplicative and expensive—and thus inefficient. Furthermore, most indenture trustees are not equipped or compensated to monitor or supervise the servicer's performance, which typically involves collecting payments on the financial assets, communicating with borrowers, addressing borrower delinquencies and bankruptcies, working out loan modifications or other borrower difficulties, foreclosing on properties, maintaining foreclosed homes, and selling real-estate-owned properties after foreclosure.

#### D. MONITORING FOR FORMAL DEFAULTS

Investors sometimes claim that an indenture trustee should have a pre-default duty to monitor for the existence of a formal default, sometimes termed an “Event of Default.” Such a default could trigger the post-default heightened “prudent person” duty. Some practitioners have likewise suggested that indenture trustees for securitized bond issues might have this pre-default monitoring duty.<sup>32</sup> Indentures normally provide, however, that notwithstanding the actual existence of a formal default, the indenture trustee's post-default heightened duty is not triggered until a responsible officer of the indenture trustee has “actual knowledge” or, if the indenture provides, written notice of that formal default.

Consistent with that indenture language, I do not believe that an indenture trustee should have a pre-default monitoring duty. Requiring such a duty would require the indenture trustee to constantly investigate all events that might trigger the default. That would be expensive and time consuming—and thus, inefficient—with investors bearing the cost.

Requiring such a duty also could expose the indenture trustee to indeterminate liability if it failed, even for reasons beyond its control, to become aware of a default. Uncertainty of the standard by which their performance would be judged would discourage financial institutions from acting as indenture trustees, or at least motivate them to charge higher fees to compensate for the risk.

Investors sometimes may notify the indenture trustee that a default has occurred, without clearly showing the existence of the default. What should be the duty of an indenture trustee regarding an

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32. Brady et al., *supra* note 20, at 9-7 (discussing the additional sophistication and specialization needed for such a trustee “to achieve an appropriate awareness of possible weakening financial condition of an issuer or servicer or to determine early amortization events”).

alleged, but unproved (or possibly disputed), default—such as an allegation based solely on news media, that the servicer is acting improperly?

The answer should take into account and attempt to balance common-sense, practical considerations. That could include the indenture trustee having conversations with the servicer about its performance, communicating the results of those conversations to the investors, and seeking, or requesting the investors to obtain, formal investor directions.

## V. RESOLVING AMBIGUITIES

Any normative rules for determining an indenture trustee's pre-default duties inevitably will face ambiguities. Consider how an indenture trustee could try to resolve ambiguities.

### A. OBTAIN LEGAL OPINION

An indenture trustee could try to obtain a legal opinion to resolve ambiguities. Section 8.01 of most indentures, entitled "Duties and Responsibility of the Trustee," usually allows indenture trustees acting in good faith to "conclusively rely" on opinions that conform to the indenture's requirements.<sup>33</sup>

Furthermore, § 8.02 of most indentures, entitled "Certain Rights of the Trustee," usually allows indenture trustees to consult with counsel and to rely on "the written advice" or "an opinion" of counsel as "full and complete authorization and protection for any action taken, suffered or omitted by it in good faith and in accordance with such advice or opinion."<sup>34</sup>

### B. OBTAIN INVESTOR DIRECTIONS

An indenture trustee also could attempt to resolve ambiguities by trying to obtain formal investor directions, as mentioned.<sup>35</sup> If the indenture trustee receives those directions, it should be justified in following them.

### C. SEEK JUDICIAL GUIDANCE

In more difficult or sensitive cases, an indenture trustee could seek judicial guidance. Two basic types of judicial procedures—interpleader and declaratory judgment actions—may be appropriate.

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33. See, e.g., NAT'L ASS'N OF BOND LAWYERS, MODEL FORM OF TRUST INDENTURE § 8.01(a)(2).

34. *Id.* § 8.02(d).

35. See *supra* note 28 and accompanying text.

Interpleader is a procedure whereby a party with property subject to competing claims may compel the parties asserting those claims to litigate their dispute in a single proceeding.<sup>36</sup>

An indenture trustee also might request a declaratory judgment to have a court determine its rights prior to taking action that may expose it to liability. Unlike interpleader, however, a declaratory judgment action requires the existence of an “actual controversy.”<sup>37</sup>

#### D. EXERCISE COMMON SENSE

Lacking other guidance, an indenture trustee ultimately should rely on common sense. For example, regardless of what the indenture trustee’s duty otherwise should be, the occurrence of a suspicious event should not trigger a duty to investigate occurrences and events that are unrelated to that event. Such an extraneous investigation could significantly reduce trust assets without commensurately benefitting the investors.

Similarly, absent formal investor directions, an indenture trustee should not generally take an action that would be expensive but unlikely to lead to a net favorable outcome—such as investigating whether a bankrupt or clearly insolvent party had breached one or more of its representations and warranties. Even if the indenture trustee could prove such a breach, a damage claim against that party may be unrecoverable.

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36. CYCLOPEDIA OF FEDERAL PROCEDURE § 22:1 (3d ed. 2005).

37. Robert J. Coughlin et al., *Rule 22 to Resolve a Catch-22: Defensive Maneuvers for Corporate Trustees Faced with Conflicting Claims*, in NEW DEVELOPMENTS IN SECURITIZATION 2008 777, 783 (2008).



## TWENTY-FIRST CENTURY TRUSTS AND ETHICS: ESTATE PLANNING FOR COUPLES

CARLA SPIVACK<sup>†</sup>

### I. INTRODUCTION

Representing spouses jointly may seem natural to estate planning attorneys.<sup>1</sup> Most casebooks discuss the ethics of joint representation as if it were the default for this type of practice.<sup>2</sup> The American College of Trust and Estate Counsel (“ACTEC”) Commentaries on Rules 1.6 and 1.7 also seem to employ this presumption. This seems sensible at first glance: marriage is a partnership after all,<sup>3</sup> and, especially in cases where the couple has joint children, the assumption might be that the couple’s estate planning goals are in harmony and can be achieved more efficiently and cost-effectively this way. Both the Model Rules and the ACTEC Commentary offer a routine procedure for explaining the confidentiality rules of joint representation, and agree that a signed statement can waive a conflict.<sup>4</sup>

Some practitioners, however, flatly refuse to engage in joint representation of couples, fearing potential confidentiality and conflict of interest problems. The literature addressing this ethics problem in spousal estate planning typically refers to the problem of the “unilat-

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<sup>†</sup> Professor of Law at Oklahoma City University School of Law. My thanks to Victoria Haneman and the Creighton Law Review for inviting me to this Symposium, and to Gerry Beyer, Valerie K. Couch, and Jim Roth for their very helpful interventions.

1. See Teresa Stanton Collett, *Disclosure, Discretion, Or Deception: The Estate Planner’s Ethical Dilemma From A Unilateral Confidence*, 28 REAL PROP., PROB. & TR. J. 683, 684 (1994) (noting that “[c]ounseling husbands and wives as joint clients is a common practice among the estate planning bar”). See also Stanley A. Kaplan, *The Case of the Unwanted Will*, 65 A.B.A. J. 484, 486 (1979); Ronald C. Link et al., *Developments Regarding the Professional Responsibility of the Estate Planning Lawyer: The Effect of the Model Rules of Professional Conduct*, 22 REAL PROP., PROB. & TR. J. 1, 8 (1987); Clare H. Springs, *Advice on Representing Both Husband and Wife*, 130 TR. & EST. 21, 21 (1991).

2. See, e.g., SUSAN N. GARY ET AL., CONTEMPORARY TRUSTS AND ESTATES: AN EXPERIENTIAL APPROACH 27 (2d ed. 2014) (noting that “one of the most common situations that creates ethical concerns for an estate planning attorney” is joint representation).

3. This is generally understood to be the prevalent view of marriage today. See, e.g., Alicia Brokars Kelly, *Rehabilitating Partnership Marriage As a Theory of Wealth Distribution at Divorce: In Recognition of a Shared Life*, 19 WIS. WOMEN’S L.J. 141, 148 (2004) (noting that “the ideal [of marriage] recognizes sharing and joint contribution as core components of marriage”).

4. MODEL RULES OF PROF’L CONDUCT R. 1.7 (2019); AM. COLL. TR. & EST. COUNS., COMMENTARIES ON THE MODEL RULES OF PROFESSIONAL CONDUCT 101-02 (5th ed. 2016) [hereinafter ACTEC].

eral confidence.” This describes the situation where the couple seeks joint representation in estate planning, but at some point later in the process, one spouse tells the attorney something in confidence that is material to the representation.<sup>5</sup> This may occasionally happen, but most practitioners agree that it is rare, and this particular dilemma does not concern me here. Rather, I want to re-orient the conversation by posing this more fundamental question: given the economic inequality between men and women, and between primary caregivers and primary wage-earners in today’s American family, can a couple—same or opposite sex—ever be assumed to be non-adverse in estate planning? Or would it be wiser to reverse this presumption? I pose this question in the context of the twenty-first century trust because I think that it in all of its permutations highlights the problems I identify.

## II. BACKGROUND

The Model Rules of Professional Conduct offer the estate planning attorney little help in regard to potential conflict between spouses. Rule 1.7 provides:

- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
  - (1) the representation of one client will be directly adverse to another client; or
  - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
- (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
  - (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
  - (2) the representation is not prohibited by law;
  - ...
  - (4) each affected client gives informed consent, confirmed in writing.<sup>6</sup>

Because the Model Rules were not drafted with estate planning—or, some might argue, any transactional practice—in mind, the American College of Trusts and Estates Counsel (“ACTEC”) has prepared

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5. See, e. g., Collett, *supra* note 1, at 685 (referring to this as the “unilateral confidence”).

6. MODEL RULES OF PROF’L CONDUCT R. 1.7 (2019).

Commentaries on the Rules geared toward trusts and estates attorneys. The ACTEC Comment to Rule 1.7 reads as follows:

It is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate plan . . . . In some instances the clients may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. The fact that the estate planning goals of the clients are not entirely consistent does not necessarily preclude the lawyer from representing them. Advising related clients who have somewhat differing goals may be consistent with their interests and the lawyer's traditional role as the lawyer for the "family." Multiple representation is also generally appropriate because the interests of the clients in cooperation, including obtaining cost-effective representation and achieving common objectives, often clearly predominate over their limited inconsistent interests. Recognition should be given to the fact that estate planning is fundamentally nonadversarial in nature and estate administration is usually nonadversarial . . . . Before, or within a reasonable time after commencing the representation, a lawyer who is consulted by multiple parties with related interests should discuss with them the implications of a joint representation (or a separate representation, if the lawyer believes that mode of representation to be more appropriate and separate representation is permissible under the applicable local rules). . . . In particular, the prospective clients and the lawyer should discuss the extent to which material information imparted by either client would be shared with the other and the possibility that the lawyer would be required to withdraw if a conflict in their interests developed to the degree that the lawyer could not effectively represent each of them. The information may be best understood by the clients if it is discussed with them in person and also provided to them in written form, as in an engagement letter or brochure.<sup>7</sup>

The Comment goes on to urge attorneys to meet with each client separately in this situation to make sure they do not have adverse interests.<sup>8</sup> The Rules and Comments seem to take this "joint representation-with-safeguards" as a norm. But should they? I suggest that it has never been appropriate, and that the explosion of asset protection trusts in the twentieth and twenty-first century makes it even less so.

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7. ACTEC, *supra* note 4, at 101-02.

8. *Id.* at 102.

## III. STRUCTURAL ADVERSITY

The problem is that trust law has accelerated faster than the social, financial, and legal situation for women and for economically dependent and caregiving partners. While trust law now offers a myriad of ways for the financially independent spouse to “protect” assets from the other partner, the law offers no compensatory structures to alleviate the financial detriments that partner often suffers due to child and elder care, career sacrifice and deferral, and the resulting lost wages. This mismatch between accelerating trust law and our society’s uneven progress toward support for financially dependent caregivers creates the potential for adversity for couples in estate planning that ethics rules should not ignore.

Despite the contemporary commonly accepted view of marriage as an equal economic partnership, there are a number of social realities that undermine this vision. First, in the case of opposite sex couples, women are simply still not situated as economic equals to men.<sup>9</sup> The female member of an opposite sex couple is statistically much more likely than the man to be the one who sacrifices career and earnings for caregiving of children and parents.<sup>10</sup> This disparity results in lower savings, less retirement income, and lower social security benefits for women.<sup>11</sup> Compounding this reality is the fact that, even in community property states, women who are financially dependent on their male partners have much less control over day-to-day management of family assets (retirement plan allocations, investment decisions, etc.) than the male primary earner.<sup>12</sup> This disparity in control, followed by divorce or spousal survivorship, can lead to the former spouse’s impoverishment.

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9. See, e.g., *Fact Sheet: Women & Socioeconomic Status*, AM. PSYCHOL. ASS’N, <https://www.apa.org/pi/ses/resources/publications/women> (last visited Mar. 22, 2020) (noting the lower economic status of women in the United States due to lower income and earning ability).

10. Kim Parker, *Women More Than Men Adjust Their Careers for Family Life*, PEW RES. CENTER (Oct. 1, 2015), <https://www.pewresearch.org/fact-tank/2015/10/01/women-more-than-men-adjust-their-careers-for-family-life/>.

11. See Alicie Adamczyk, *Women Lag Behind Men in Retirement Savings—Here Are 3 Things They Can Do to Catch Up*, CNBC MAKE IT (Nov. 18, 2019, 3:14 PM), <https://www.cnbc.com/2019/11/18/women-are-still-lagging-behind-men-when-it-comes-to-saving.html> (noting that “women face many obstacles to saving and investing that their male coworkers may not: There is a persistent wage gap between men and women, and women leave the workforce more often than men to act as a caregiver. They also tend to live longer, meaning they actually need to save more than men do”).

12. See generally Elizabeth R. Carter, *The Illusion of Equality: The Failure of the Community Property Reform to Achieve Management Equality*, 48 IND. L. REV. 853, 854 (2015) (noting the “unequal participation in financial decisions by spouses in the American community property states”).

Add to this the simple actuarial fact that women tend to outlive men,<sup>13</sup> and the seeds of conflict take root and flower. But these disparities are not present just in opposite sex marriages. When same sex couples choose to have children, they often face the same dilemma of child care (even if they don't, they may face, like many same sex couples, the dilemma of elder care). Because of the lack of affordable day care and workable family leave policies in this country,<sup>14</sup> someone will probably have to take a financial hit which will make that person dependent, to one degree or another, on their partner.

Finally, studies show that there are often gender-based power differentials in heterosexual marriage – probably arising from this economic inequality.<sup>15</sup> And this is the reality in violence-free “normal” families. Domestic violence is present in about twenty percent of marriages and intimate relationships,<sup>16</sup> severely skewing power balances between the partners. Further complicating matters, the abuse in the relationship can be hard for an untrained observer to see.<sup>17</sup> Very few estate planning attorneys have such training. This is unfortunate and adds to the concerns I express here: joint representation for a couple with domestic violence issues is clearly problematic, but may well proceed if the attorney is oblivious to it.

These likely disparities will matter in two crucial instances in the course of the couple's lives: divorce, which will happen to half of them,<sup>18</sup> and death, which will happen to all of them. Estate planning, now abetted by new trust forms, offers too many ways for the partners' interests to diverge at these junctures. Indeed, one might call these life events “hinge moments” in people's lives, the pivots on which a life

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13. See, e.g., Thomas Peris & Ruth Fretts, *Why Women Live Longer than Men*, CARNEGIE MELLON U. (June 1998), [https://www.cmu.edu/CSR/case\\_studies/women\\_live\\_longer.html](https://www.cmu.edu/CSR/case_studies/women_live_longer.html).

14. See Laura T. Kessler, *The Attachment Gap: Employment Discrimination Law, Women's Cultural Caregiving, and the Limits of Economic and Liberal Legal Theory*, 34 U. MICH. J.L. REFORM 371, 375 (2001) (noting that “law [has] failed to address the conflicts between work and family that continue to disproportionately burden women”).

15. See generally Amy Wax, *Bargaining in the Shadow of the Market: Is There a Future for Egalitarian Marriage?*, 84 VA. L. REV. 509, 547 (1998) (observing that men have more bargaining power in heterosexual marriage than do women).

16. *Prevent Domestic Violence in Your Community*, CENTER FOR DISEASE CONTROL PREVENTION (Nov. 1, 2019), <https://www.cdc.gov/injury/features/intimate-partner-violence/index.html>.

17. See Jennifer Casarella, *What Are the Signs of Domestic Abuse*, WEBMD (Mar. 13, 2020), <https://www.webmd.com/mental-health/mental-domestic-abuse-signs#1> (noting that these signs are “not always as obvious as you might think . . . because domestic abuse is about controlling someone's mind and emotions as much as hurting their body”).

18. *Marriage & Divorce*, AM. PSYCHOL. ASS'N, <https://www.apa.org/topics/divorce/> (last visited March 31, 2020).

may swing in a completely new direction.<sup>19</sup> Estate planning through joint representation can negatively affect these moments by disempowering or affirmatively depriving the economically dependent spouse. I refer to this in the context of estate planning as “structural adversity,” by which I mean adversity resulting from inequality imposed by social forces external to any particular couple.<sup>20</sup>

To summarize, then, the estate planning couple does not always consist of two financially independent people coming together to dispose of their estates in complete harmony and autonomy. In fact, it frequently does not. In the course of the initial consultation, of course, it may become clear that the two are in fact each financially self-sufficient, in complete agreement about their plans, and equal in power. The current rules, however, seem to presume this scenario. This presumption should be reversed to account for the many instances where it may not be the case.

This topic is particularly suited to a conference on the twenty-first century trust. The dramatic expansion of trusts in a myriad of ways magnifies all of the concerns I have outlined above. Asset protection trusts are advertised as a way to avoid taxes and creditors, including ex-spouses and children with support orders – and even regular old everyday trusts offer a way to keep assets out of the hands of a surviving spouse. In light of these expanding possibilities, I suggest that estate planning ethics need revisiting.

You may object to everything I am saying on the grounds that the Rules and Comments both stipulate that the attorney explain to each partner separately the rules governing joint representation, specifically those governing material disclosures; the Commentary goes so far as to suggest that best practices would do this in writing. This does not address the many possibilities for adversity between the two partners in a couple, however. First, adversity may emerge down the road, and may not take the form of the much-touted “unilateral disclosure” – in fact, it may not even look like adversity. For example, in the course of the representation, one spouse may want to place assets in an asset protection or Qualified Terminable Interest Property (“QTIP”) Trust for perfectly solid estate planning reasons. Either form of trust, however, may harm the interests of the financially-de-

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19. See Joel Garreau, *Hinges of Opportunity*, WASH. POST (Oct. 14, 2001), <https://www.washingtonpost.com/archive/lifestyle/2001/10/14/hinges-of-opportunity/5b68da10-a33f-49b6-a812-5f12e6424fb5/> (describing hinge moments as “pivots on which our lives move from one world to another”).

20. In a different context, Henry M. Ordower urges estate planners not to impose “default settings” for estate planning, such as trusts, that disempower a surviving spouse. Henry M. Ordower, *Trusting Our Partners: An Essay on Resetting the Estate Planning Defaults for an Adult World*, 31 REAL PROP. PROB. & TR. J. 313, 315 (1996).

pendent spouse on divorce or death of the other spouse.<sup>21</sup> The parties' interests now seem adverse, but such a development may not have been clear at the beginning. Further, marital relationships are the site of submerged power dynamics often invisible to the casual observer – and this is not to speak of actual domestic violence.

I'll begin with that not-so-new trust: the QTIP Trust. What is the ethical duty of a lawyer tasked with preparing a QTIP Trust for a couple? As most of us know, a QTIP Trust allows the decedent spouse's estate to take advantage of the marital deduction while leaving the surviving spouse only a life interest, with distributions often subject to the discretion of a trustee.<sup>22</sup> This leaves the survivor – statistically likely to be the wife – with significantly less than a full interest in the property. As a practical matter, this limited interest may prevent her from making investments, getting loans, or simply spending what she wants. As an existential matter, it disempowers her as a person with control over her property and treats her like a child. More practically, it deprives her of the ability to use the bulk of the estate to influence the world around her through political or charitable gifts, for example – important incidents of property ownership. Not to speak of the fact that each spouse understands that the survivor's estate will not benefit from the marital deduction, since it applies only to the estate of the first to die.

At the point it becomes clear that a QTIP Trust will be part of the estate plan, have the spouses become adverse? What are the attorney's ethical duties at this point? Can she continue to represent them both? The spousal adversity of the QTIP Trust as an estate planning device is quite obvious to those who market them: One law firm suggests that the QTIP creator may want to “prepare” the spouse; one law firm suggests “[y]our spouse, for example, should know that income will flow life-long, but access to the trust principal will be limited.”<sup>23</sup> Another advises that spouses may want to pick a good moment to discuss the QTIP because “[t]he surviving spouse typically resents the restrictions against unlimited access to principal.”<sup>24</sup> The reality is that estate planners drafting QTIP – and other provisions for a surviving spouse – think about these things from a male first-to-die perspective. One (female) practitioner recommends a QTIP Trust in case the

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21. See Wendy C. Gerzog, *The Marital Deduction QTIP Provisions: Illogical and Degrading to Women*, 5 UCLA WOMEN'S L.J. 301, 308 (1995) (discussing the limitations on control of assets central to the QTIP).

22. See *id.* (noting that at the same time, Congress enacted the QTIP).

23. *QTIP Trusts Still Offer Advantages*, HOGAN TAYLOR (Dec. 16, 2015), <http://hogan-taylor.com/qtip-trusts-still-offer-advantages/>.

24. Laurie Israel and Deborah Danger, *QTIPs Made Easy*, ISRAEL VAN KOOY L., <http://ivkdlaw.com/the-firm/our-articles/divorce-and-estate-planning/qtips-made-easy/> (last visited Mar. 31, 2020).

surviving spouse “marries the pool boy[.]”<sup>25</sup> Also typical is a Florida Bar Opinion in which a husband reveals privately to the estate planning lawyer that he wants to leave assets to his extra-marital paramour.<sup>26</sup> Advice for estate planners often seems written from the perspective of a husband in a heterosexual marriage and not from that of a partner in an equal economic partnership. This point of view may operate subliminally to obscure the adverse nature of estate planning for marriages in which there is an economic imbalance.

In another not-so-new trust issue, there is the matter of the trust’s ability to siphon assets from the marital estate from which the survivor’s elective share is taken. At least sixteen states allow a spouse to remove assets from his or her estate by placing assets in a revocable trust during life.<sup>27</sup> Most of us are familiar with the case of Gilles Shoukroun,<sup>28</sup> who put about 400,000 dollars into a revocable trust for his daughter from a previous marriage, leaving a much smaller amount – plus his Toyota Highlander – to his then-wife, Kathleen Karsenty.<sup>29</sup> Kathleen elected to take against the will, and argued that the trust assets should have been part of the elective share pot because Gilles had complete access to and control over them during his life.<sup>30</sup> The Supreme Court of Rhode Island, however, ruled that if Gilles’ transfer was done in “good faith” – that is, as legitimate estate planning and not a “contrivance” to disinherit the wife – it should stand.<sup>31</sup> If Gilles and Kathleen had engaged in joint estate planning – and there is no evidence that they did – would the attorney have had to withdraw at the point Gilles decided to use the revocable trust, which, probably unbeknownst to Kathleen, could serve to disinherit her? If the attorney had withdrawn from the joint representation at this point, how could the attorney have gone on representing one of the parties, having information adverse to the other party? Is there an ethical duty to explain to the spouse of someone putting assets in a revocable trust how that trust may disinherit him or her?

In the twenty-first century, there is a new offspring in the trust family: Asset Protection Trusts (“APTs”) and their spinoff, Domestic

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25. Natalie C. Annis, *Special Ethical Considerations and Concerns in Estate Planning and Trust Administration*, in ETHICS FOR TRUSTS AND ESTATES PRACTITIONERS (2013), available at 2013 WL 4188069, at \*5.

26. Fla. Bar Ass’n Ethics Op. 95-4 (1997).

27. See generally, Angela M. Vallario, *The Elective Share Has No Friends: Creditors Trump Spouse in the Battle over The Revocable Trust*, 45 CAP. U. L. REV. 333 (2017) (noting that sixteen jurisdictions allow the use of a revocable trust to disinherit a spouse).

28. *Karsenty v. Schoukroun*, 959 A.2d 1147 (Md. 2008).

29. *Karsenty*, 959 A.2d at 1153-54, 1178.

30. *Id.* at 1151.

31. *Id.* at 1172.

Asset Protection Trusts (“DAPTs”). These trusts allow the settlor to create trusts for him-or-herself with spendthrift clauses protecting the trust assets from the settlor’s creditors.<sup>32</sup> It has been possible for over a century to equip trusts for third-party beneficiaries with the traditional spendthrift clause. There are several infamous American cases where courts have upheld these clauses to bar collection from the beneficiary’s creditors, including creditors who won jury awards against the beneficiary for child molestation,<sup>33</sup> paralyzing someone in a drunk driving accident,<sup>34</sup> and beating an elderly woman to death during a robbery.<sup>35</sup> You may think this is morally or ethically wrong, or you may be willing to accept it in the name of testamentary freedom – but the reality is, the third-party spendthrift trust is now boilerplate.<sup>36</sup> Many states do allow an exception to spendthrift restrictions for child and spousal support creditors, so-called super creditors, however.<sup>37</sup>

Not so the new crop of APTs and DAPTs. They allow a settlor to place her own assets out of reach of creditors in the same way as the traditional spendthrift trust did for third-party beneficiaries. As of this writing, sixteen states have legalized this type of trust.<sup>38</sup> There are many reasons to worry about these trusts; here I focus only on those applicable in a spousal estate planning context. Firms that market these trusts advertise their potential to “shield” assets from creditors, among them – and most frequently mentioned – are spousal

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32. For a general discussion of these trusts, see Cherish D. Van Mullem, *Shield Assets Kept Nearby with Asset Protection Trusts*, 45 EST. PLAN. 32 (2018).

33. See *Sheffel v. Krueger*, 782 A.2d 410, 412 (N.H. 2001) (refusing to create a judicial exception to spendthrift protection for tort creditors, because “[w]here the legislature has made specific exemptions, we must presume no others were intended”).

34. *Sligh v. First Nat’l Bank*, No. 96-CA-00033-SCT, 1997 WL 620799 (Miss. 1997).

35. *Duvall v. McGee*, 826 A.2d 416 (Md. 2003).

36. Thomas P. Gallanis, *The New Direction of American Trust Law*, 97 IOWA L. REV. 215, 228 (2011) (observing that “most modern trusts contain a boilerplate spendthrift clause”).

37. ALA. CODE § 19-3B-503(b)(1) (2020); ARIZ. REV. STAT. ANN. § 14-10503 (2020); CAL. PROB. CODE § 15305 (West 2020); FLA. STAT. § 736.0503(2)(a) (2020); GA. CODE ANN. § 53-12-80(d) (2020); LA. REV. STAT. ANN. § 9:2005(1) (2019); MO. REV. STAT. § 456.5-503(2) (2020); NEB. REV. STAT. § 30-3848(b) (2020); N.H. REV. STAT. ANN. § 564-B:5-502 (2020); N.M. STAT. ANN. § 46A-5-503(B) (2020); N.D. CENT. CODE § 59-13-03 (2019); OHIO REV. CODE ANN. § 5805.02(B)(1) (2020); OKLA. STAT. tit. 60, § 175.25(B)(1)(a) (2020); OR. REV. STAT. § 130.310(2) (2020); S.D. CODIFIED LAWS § 55-16-15(1) (2020).

38. The current states that allow these self-settled trusts are: Alaska, Colorado, Connecticut, Delaware, Hawaii, Indiana, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming. See generally David G. Shaftel, *Twelfth ACTEC Comparison of the Domestic Asset Protection Trust Statutes*, AM. COLL. TR. & EST. COUNS. (Aug. 2019), <http://www.actec.org/assets/1/6/Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust-Statutes.pdf>. For a discussion on the current climate of self-settled asset protection states, see Adam J. Hirsch, *Trust Law in the 21st Century: Fear Not the Asset Protection Trust*, 27 CARDOZO L. REV. 2685 (2006).

and child support creditors.<sup>39</sup> They are also advertised as a better alternative to prenups because there is no need to negotiate their terms with the other party.<sup>40</sup> In other words, firms sell these trusts as a way, among other things, to avoid asset division and support payments after divorce by shielding assets from the settlor's spouse and children.

Again, this raises the question of adversity in joint representation in spousal estate planning. For example, certain professions in particular find these trusts attractive: those in the medical profession, fearing giant malpractice awards, and physicians in high-risk sectors of medicine, such as obstetrics.<sup>41</sup> This fear might appear reasonable and even mutually advantageous to a spouse of someone in this field. That spouse might not know about the barriers to spousal recovery also embedded in the trust. If such a trust turns out to become a component of a couple's estate plan, does this create a conflict for the attorney, knowing how it can disadvantage the non-settlor spouse?<sup>42</sup> Or is it, again, safer to refuse joint representation in the first place?

What about contracts to make wills? Spouses might seek an arrangement in which the survivor of them promises to devise the remaining marital property a certain way; this could appeal to those in second or third marriages who have children from prior relationships. Or, a contract to devise might arise from one spouse's promise to care for the other at the end of life in exchange for receiving the decedent's estate after death. Contracts to make wills are enforceable in most states if they are in writing, either as part of the will in question or separately. But courts are split as to whether these contracts trump elective share laws or not.<sup>43</sup> This is legal information which may create a conflict between spouses, one of whom assumes the contract will be enforced. In a related vein, the UPC is clear that mutual or joint

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39. See, e.g., *Florida Asset Protection Trust*, L. OFF. DAVID M. GOLDMAN, <https://www.jacksonvillelawyer.pro/florida-asset-protection-trust.html> (last visited Mar. 31, 2020) (advertising that the trust "even protects assets from any elective share claims by a future spouse").

40. See, e.g., *Trust vs. Prenuptial Agreement: Which is Right for You?*, ASSET PROTECTION PLANNERS, <https://www.assetprotectionplanners.com/strategies/trust-vs-prenuptial-agreement/> (last visited Mar. 31, 2020) (explaining the advantages of asset protection trusts over prenups).

41. See *Who Needs Asset Protection?*, LODMELL & LODMELL, <https://www.lodmell.com/wealth-preservation/who-needs-asset-protection> (last visited Mar. 31, 2020) (recommending asset protection for "healthcare professionals").

42. This ignores the question of whether it is even ethical for an attorney to recommend such a trust if she does not practice in a state that allows it. In such a case, is the DAPT against the state's public policy?

43. See generally Caroline L. Dessin, *The Troubled Relationship of Will Contracts and Spousal Protection: Time for an Amicable Separation*, 45 CATH. U. L. REV. 435 (1996).

wills do not constitute contracts.<sup>44</sup> Could this give rise to conflict? Does one party benefit at the expense of the other from the lack of enforceability of provisions of the will? Given the uncertainty of these contracts in courts, and the distinct likelihood that a court will refuse to enforce such a contract,<sup>45</sup> is there a potential conflict between the two parties to the contract? Does the attorney have a duty to advise the promisee that a court may not enforce the contract if the promisor breaks his word?

#### IV. CONCLUSION

Overall, I have tried here to unseat the assumption that couples are generally not adverse in estate planning and that joint representation should be the norm. Because of the still economically unequal position of caregivers and women in our society, there is such a thing as structural adversity. Structural adversity is present in couples not because of anything specific to their relationship—such as the literature of the “unilateral confidence” assumes—rather it arises from the way men, women, and caregivers are situated in society in relation to wealth.

This insight indicates that a revision of the ACTEC instructions about joint representation might be appropriate. This revision might look like this:

It is often appropriate for a lawyer to represent one spouse separately in connection with estate planning when one of the spouses is not financially independent. “Financially independent” means that the spouse has significant assets in his/her own name, paid work with sufficient remuneration to support that person in a lifestyle similar to that existing in the marriage, or some other independent source of sufficient support. In instances where both spouses are financially independent, the clients may be better served by joint representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. In such cases, the fact that the estate planning goals of the clients are not entirely consistent does not necessarily preclude the lawyer from representing them, but the lawyer should be careful to avoid situations where one spouse might have estate planning goals that are adverse to the long term interests of the other spouse. In particular, this is a possibility when either spouse has children from prior marriages he or she might

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44. UNIF. PROB. CODE § 2-701 (amended 2010).

45. See generally, e.g., *Borelli v. Brusseau*, 16 Cal. Rptr. 2d 16 (Cal. Ct. App. 1993) (declining to enforce a contract in which a husband had promised to leave his estate to his wife if she cared for him during his final illness).

also wish to benefit, or where one spouse has significantly greater assets or earning capacity than the other spouse. Advising related clients who have somewhat differing goals may be consistent with their interests and the lawyer's traditional role as the lawyer for the "family," but this should not allow the lawyer to ignore the vulnerability of the less well-off spouse. Multiple representation is appropriate when, in the judgment of the lawyer, taking into account the financial dependence of one of the spouses, the interests of the clients in cooperation, including obtaining cost-effective representation and achieving common objectives, clearly predominate over their limited inconsistent interests.

Such guidance for attorneys takes into account – and draws the lawyer's attention to – what I have called structural adversity. In doing so, it would better serve the ethical goals of zealously representing each spouse.

## ESTATE PLANNING CHOICE OF WEALTH MANAGEMENT ENTITY: THE LIMITED PARTNERSHIP AS AN ALTERNATIVE TO THE TRUST

ELAINE HIGHTOWER GAGLIARDI<sup>†</sup>

### I. INTRODUCTION

The substantial and steady increases in the amount a taxpayer can transfer free of federal estate, gift, and generation skipping transfer taxes<sup>1</sup> makes transfer tax planning irrelevant when counselling more than 99.9% of Americans.<sup>2</sup> Traditional estate planning structures set in place at a time when the estate tax impacted many more Americans may no longer achieve a client's current estate planning goals. The seismic shift in the estate planning paradigm requires estate planners rethink use of planning structures in light of shifting client objectives. Evaluated in terms of these shifting objectives, the limited partnership may prove just as nimble as the trust in reacting to altered goals of affluent clients who desire continued management

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<sup>†</sup> Elaine Hightower Gagliardi is a Professor of Law at the University of Montana Blewett School of Law. She is an Academic Fellow of the American College of Trust and Estate Counsel and of the American College of Tax Counsel. She would like to thank Professor J. Martin Burke for his comments on an earlier draft, and Kimberly Wein for her helpful comments and editing.

1. See Rev. Rul. 93-12, 1993-1 C.B. 202. Limited partnerships grew in popularity as an estate planning tool following issuance of Revenue Ruling 93-12, which signaled the ability to take minority interest discounts for interests held in a family limited liability entity. From 1987 through 1997, the aggregate transfers, both during life and at death, that an individual could pass free of federal estate and gift tax totaled \$600,000, based on a unified credit amount of \$192,800. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 401(a)(2)(A), 95 Stat. 172 (codified as amended at I.R.C. § 2010(b) (2018)). The Taxpayer Relief Act of 1997 ushered in a gradual increase in the amount an individual taxpayer could pass free of Federal estate and gift tax from \$600,000 to \$675,000. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(a)(1)(A), 111 Stat. 788 (codified as amended at I.R.C. § 2010(a) (2018)). Congress again enacted increases in 2001 from \$1,000,000 to \$3,500,000 effective as of 2009. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 521(a), 115 Stat. 38 (codified as amended at I.R.C. § 2010(c) (2018)). In 2011, Congress retroactively increased the amount to \$5,000,000 as of 2010, with inflation adjustments beginning in 2012. Most recently, in 2017, Congress temporarily increased the amount from 2018 through 2025 to an inflation adjusted \$10,000,000. Act of Dec. 27, 2017, Pub. L. No. 115-97, § 11061(a), 131 Stat. 2054 (codified as amended at I.R.C. § 2010(c)(3) (2018)).

2. *Tax Policy Center Briefing Book: Key Elements of the U.S. Tax System*, TAX POLICY CENTER, URBAN INSTITUTE AND BROOKINGS INSTITUTION, <https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax> (last visited Feb. 15, 2020); see also INTERNAL REVENUE SERV., PUB. NO. 5332, ESTATE TAX RETURNS FILED FOR WEALTHY DECEDENTS, FILING YEARS 2008-2017 (2018).

as assets pass to the next generation. This Article explores the continued viability and new role the limited partnership can take in estate planning.

Many clients formed limited partnerships as an estate planning vehicle to minimize estate tax. Limited partnerships, if created to achieve a significant non-tax motive, have historically yielded sizeable valuation discounts, thereby minimizing estate tax.<sup>3</sup> With the goals of many affluent clients shifting from estate tax savings to income tax savings, some professionals have counselled clients to dissolve existing limited partnerships. Eventual modification of the partnership agreement, as opposed to dissolution of the limited partnership, however, may prove the better strategy.

Closer scrutiny of limited partnership characteristics important to non-tax succession goals indicates some clients may prefer the limited partnership to using the more traditional structure of a trust. Differences in investment duties, income taxation, and ease of amending terms, when compared to a trust, can make the limited partnership a favored choice for clients who wish to provide a flexible wealth management vehicle as assets transfer to the next generation. The limited partnership, with its characteristic use of an entrenched general partner, mimics the trust in ways important to the continued management of assets, and yet at the same time it provides ability to simplify and lower the costs of ongoing administration. The latest version of the Uniform Limited Partnership Act,<sup>4</sup> (“ULPA”) in fact, was crafted with estate planning uses in mind.<sup>5</sup> Not surprisingly, when tested against primary planning goals of affluent clients for whom the estate tax has become irrelevant, specifically continued management

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3. See, e.g., *Lappo v. Comm’r*, 86 T.C.M. (CCH) 333 (2003) (allowing a 15% minority interest discount, and a 24% lack of marketability discount); *Adams v. U.S.*, 218 F.3d 383, 387-88 (5th Cir. 2000) (allowing a 20% minority interest discount for assignee’s lack of control, a 10% portfolio discount for poorly diversified assets and a 35% lack of marketability discount for lack of a ready market).

4. UNIF. LTD. P’SHP ACT (amended 2013) [hereinafter ULPA].

5. UNIF. LAW. COMM’N, THE UNIFORM LIMITED PARTNERSHIP ACT: A SUMMARY (2019), <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=BA658bd6-ac05-be85-fc99-178fd09f21da&forceDialog=0> [hereinafter SUMMARY]. The Summary, provided as part of the legislative enactment kit, indicates: ULPA (2001) was drafted for a world in which limited liability partnerships (LLPs) and limited liability companies (LLCs) can meet many of the needs formerly met by limited partnerships. Therefore, ULPA (2001) targets two types of enterprises that are largely beyond the scope of LLPs and LLCs . . . . Second, ULPA (2001) addresses the modern needs of estate planning arrangements, so-called “family limited partnerships.” In addressing these concerns, this act assumes that people utilizing it will want both strong centralized, entrenched management, and passive investors or limited partners with little capacity to exit the entity. As a result, the act’s rules, and particularly its default rules, have been designed to reflect those assumptions. *Id.*; see also ULPA Prefatory Note.

oversight, creditor protection, and income tax minimization, the limited partnership reveals itself as a viable estate planning entity. After taking into account the benefits of simplified administration duties and administrative costs associated with the limited partnership, the limited partnership may evolve to find a niche as a viable wealth management strategy for those clients who have no ongoing estate tax planning concern.

This Article takes a closer look at the limited partnership as an alternative to the trust. After summarizing the shift in client perspective and objectives in part two, this Article analyzes specific characteristics of the limited partnership important to achieving those goals in comparison to the trust; in part three, it reveals the general partner, much like a trustee, can provide management of partnership assets and determine the timing and appropriateness of distributions to interest holders. The limited partnership, further, can provide some protection of assets from the immediate reach of a limited partner's creditors. It also can minimize income tax burdens when compared to a trust. The limited partnership can meet these client preferences and, at the same time, avoid certain downsides of trusts, such as more stringent investment duties and hurdles faced in trust modification. The analysis reveals that the characteristics of the limited partnership, as compared to a trust, make it a viable choice for affluent clients.

## II. OVERARCHING CLIENT GOALS IMPACTING ENTITY CHOICE

Clients often come to an estate planning conference with some generalized estate planning goals. Most have a clear idea of who they wish to inherit the use of their property but may not have a set understanding of how to address issues of children from a prior marriage or special needs a child may have. Many come to the conference with a desire to minimize the portion of their estate used to pay taxes. Some specifically want to protect assets from a beneficiary's creditors. The choice of planning strategy should strive to maximize these goals to the greatest extent possible.

### A. MEETING CLIENT OBJECTIVES

In addition to estate tax minimization for those who must pay it, the following are among the most typical planning goals voiced by clients:

- Provide for multiple beneficiaries, including spouse and children, from present and prior marriages;
- Assist beneficiaries with asset management;

- Control timing and amounts of distributions made to beneficiaries;
- Protect assets from a beneficiary's creditors; and
- Obtain an income tax basis step-up for appreciated assets on decedent's death.

Both lifetime trusts and those trusts funded on the death of the client can meet some or all of these goals. Use of limited liability entities, in particular the limited partnership, can also assist a client in meeting these goals. The appropriate choice depends on how a client weighs and balances these goals and the associated administrative costs in using the entity as a wealth management vehicle.

The planner should consider benefits and costs attendant with each choice—trust and limited partnership—given the client's circumstances and assets. In addition to the planning goals listed by the client, the following are additional factors to weigh in assessing the appropriateness of the entity used in transferring wealth:

- ability to modify or amend terms of the governing instrument;
- ability to limit fiduciary duties of care and management;
- ability to allow flexibility in investment choices; and
- ability to minimize any ongoing state income tax burden.

Some of these goals can best be addressed through the use of trusts, others may be achieved by forming a limited partnership or other limited liability entity.<sup>6</sup> Because its drafters designed the most recent version of the limited partnership specifically for use in estate planning, whereas the limited liability company was designed with general business needs in mind, this article focuses on the limited partnership as the alternate choice of entity for wealth management to the trust.

Very generally, for clients whose goals include the desire to provide multi-generational protections and tailored decision making, the trust remains the optimal entity to achieve these goals. For clients who prefer minimal administrative interventions and yet some control over timing of distributions, the limited partnership may provide an excellent cost-effective choice to achieve family succession planning. The limited partnership allows greater opportunity for streamlining income tax planning decisions, increasing investment flexibility, and easing procedures to amend the governing agreement. These last can tip the choice in favor of the limited partnership for some clients.

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6. ULPA Prefatory Note. The most recent version of the ULPA includes as part of the limited partnership default rules those anticipated preferences of clients who wish to use the entity to minimize estate tax costs. This is not the case with the Uniform Limited Liability Company Act. For this reason, the following analysis concentrates on comparing trusts and limited partnerships formed under the ULPA.

## B. KEEPING IT SIMPLE

In assessing advantages and disadvantages of estate planning strategies, most clients prefer adherence to the adage, “keep it simple.” Clients shy away from the complexity of trust administration and legal restrictions imposed on trusts. Their questions tend to proceed in a similar fashion when considering whether to put a trust in place. Commonly voiced questions of clients include:

- Can the terms of the trust be changed if our family circumstances change?
- Can I require the trustee not to sell my assets?
- How much is this trust going to cost me and my family in the future?
- If the client is a litigator by trade: Can I exculpate the trustee to avoid litigation fees for breach of fiduciary duty claims?

Even upon learning the answer to these questions, the prospect of paying 40% in estate tax often encourages clients to move forward with intricate estate tax planning. For those clients whose cost-benefit analysis no longer includes payment of estate tax, yet who still wish to provide for management and control of family assets, a limited partnership may achieve estate planning goals with more tolerable costs and fewer disadvantages than a trust.

The susceptibility of trusts to a number of increased administrative costs, in comparison to the limited partnership, makes the limited partnership an option worth considering as a primary estate planning vehicle for those clients whose estates fall within the expected inflation adjusted basic exclusion amount.<sup>7</sup> Some of the administrative costs unique to trusts include, (1) the possibility of federal income taxation at compressed rates,<sup>8</sup> (2) the possibility of exposure to multiple state taxing jurisdictions assessing income tax,<sup>9</sup> (3) the likelihood of litigation for failure to diversify the trust’s investment portfolio and

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7. I.R.C. § 2010(c) (2018). The basic exclusion amount is the aggregate amount an individual can transfer without paying estate or gift tax. *Id.* The basic exclusion amount for years 2018 through 2025 is \$10,000,000, as that amount is adjusted for inflation. The 2020 inflation adjusted basic exclusion amount equals \$11,580,000. Rev. Proc. 2019-44, 2019-47 I.R.B. 1093. Absent further action by Congress, the basic exclusion amount in 2026 reverts to an inflation adjusted \$5 million, essentially halving the basic exclusion amount as of 2026. I.R.C. § 2010(a)-(c).

8. Compare I.R.C. § 1(j)(2)(E) (addressing taxable income of a trust or estate in excess of \$12,500, as adjusted for inflation, at the highest individual rate for tax years 2018 through 2025), with *id.* § 1(j)(2)(A) (addressing taxable income of married individuals filing jointly in excess of \$600,000, as adjusted for inflation to the highest individual rate for tax years 2018 through 2025).

9. See N.C. Dep’t of Revenue v. Kimberley Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213, 2221-22 (2019) (acknowledging the possibility of trust income subject to state income taxation in multiple states).

failure to treat beneficiaries impartially,<sup>10</sup> and (4) the difficulty and delay incurred in responding to changed circumstances.<sup>11</sup> Limited partnerships, for the most part, can minimize these administrative costs. The ability to minimize administrative costs goes a long way to keeping it simple for the client.

### C. CHOOSING AN APPROPRIATE WEALTH MANAGEMENT ENTITY

Neither the Uniform Limited Partnership Act nor the Uniform Limited Liability Company Act require the carrying on of a business or a business purpose, and this opens the door for use of these entities as an estate planning vehicle.<sup>12</sup> The default rules applicable to a limited liability company can be changed to mimic the default rules of the limited partnership. In fact the flexibility in entity structure means each of the three entities—the limited partnership, the limited liability company and the trust—for the most part, can achieve most client objectives with carefully crafted drafting.<sup>13</sup> To the extent entity default rules mirror client objectives, the more likely it is the client will be able to gage the outcome of a matter in light of case law interpreting the default rule. Thus, the limited partnership may prove preferable to the limited liability company in light of its specific design to achieve estate planning goals.<sup>14</sup> One factor in “keeping it simple” is to choose the entity with default rules most closely aligned to client preferences.

## III. COMPARING ENTITIES GIVEN PRIMARY CLIENT OBJECTIVES

Control, tax savings, and creditor protection goals often drive estate planning choices for clients. The client engages in estate planning principally to control and direct transfer of assets on death. The extent of control a client wishes to exert, however, varies among clients. With regard to tax savings, few clients would make the choice to

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10. See generally UNIF. TR. CODE § 803 (amended 2010) (addressing the duty of impartiality); UNIF. PRUDENT INVESTOR ACT §§ 3, 6 (1995) (discussing the duty of impartiality and duty to diversify); ACTEC FIDUCIARY LITIGATION COMMITTEE, FIDUCIARY REMEDY AND DAMAGES SURVEY: 50 STATE DAMAGES (2018). Partners owe duties of loyalty and care to one another, but investment choices are not circumscribed by duties under the ULPA. ULPA § 409(a)-(c).

11. See generally UNIF. TR. CODE §§ 410-412 (setting forth procedures for modification of trusts); UNIF. DECANTING ACT (2015). Partners in a limited partnership agreement may amend by the requisite vote required by the partnership agreement without further procedures.

12. ULPA § 110(b); UNIF. LTD. LIAB. CO. ACT § 108(b) (amended 2013).

13. ULPA § 105 (noting that except for specified matters, default rules may be changed); UNIF. LTD. LIAB. CO. ACT § 105 (except for specified matters, default rules may be changed); UNIF. TRUST CODE § 105 (amended 2010).

14. See SUMMARY, *supra* note 6.

increase the tax burden born by beneficiaries. The tax saving focus for 99.9% of Americans since 2010 has shifted primarily to income tax savings, as opposed to estate tax savings. Creditor protection, like tax savings, proves to be an objective most clients would prefer to achieve if given the choice. Obtaining a client's objectives, however, often involves trade-offs among these three principal objectives. For example, in some cases, the greater the control granted a beneficiary, the less creditor protection that can be obtained.<sup>15</sup> Likewise, the more control exerted by the donor over the beneficiary's actions, the higher the tax burden that can result.<sup>16</sup> The following discussion evaluates the ability of the limited partnership to achieve the primary goals of control, minimization of tax burden, and creditor protection, shared by most clients, in comparison to the trust, which has served as the historic entity for achieving these three client objectives. It then compares the ability to simplify and minimize administrative costs associated with the trust and limited partnership.

#### A. MATCHING THE CLIENT'S Control Objectives

Discerning a client's objectives for controlling future use of assets by beneficiaries drives in part the decision as to choice of wealth management entity. A number of questions can help explore the client's objective to control succession of assets. Why does the client want to avoid outright gifting? Is it to provide management and investment oversight? Is it to control the timing of distributions? Is it to control the purposes to which the beneficiary will put distributions? Is the client comfortable with the beneficiary having discretion to make distribution decisions? Does the client prefer a professional manager to make key decisions? Does the client wish for distributions to be made equally among children? Does the client desire to divide the use of assets to allow a spouse to use the life interest and children the remainder interest? For how many generations does the client wish to exert control? As can be gleaned from the following comparisons, the more control a client wishes to exert in the answers to these questions, the more likely the trust is the best choice of entity. Along those same lines, the more willing the client is to place discretion in the hands of

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15. For example, a beneficiary who holds a presently exercisable general power of appointment can exert essentially owner-like control of the assets subject to the power of appointment. As a result, the Uniform Power of Appointment Act § 501 (2013), allows a creditor to reach assets subject to the general power of appointment.

16. For example, if the trustee exercises discretion over distributions, and chooses to retain income and not make a distribution to the beneficiary, the retained income likely becomes subject to a higher tax rate due to the compressed income tax rate schedule applicable to trusts. See I.R.C. § 1(j)(2)(E) (2018).

the beneficiaries to make decisions in the future, the more likely the limited partnership provides an alternative to the trust.

### 1. *Controlling Distributions*

Clients explore trusts and other wealth management vehicles for the purpose of controlling use of the assets over a period of time. The trustee of a trust and the general partner of the limited partnership serve in a fiduciary capacity with powers to determine distributions. Appropriate distribution standards depend in large part on the amount of control a client desires to assert over receipt of the assets. The ability to design and target distribution standards to achieve various objectives differs between trusts and limited partnerships.

#### a. Trusts

Trusts flexibly accommodate the grantor's preferences for timing and purpose of distributions. The grantor can provide for wholly discretionary distributions, on the one hand, and more circumscribed distributions, on the other, by specifying the date distributions are to be made and the purposes for which they are to be used (i.e., for support or education). The choices made by the client about the timing of distributions and the standard for distributions often depend on the needs of the beneficiary.

Historically, for those clients with the objective to minimize estate taxation, the estate tax code drove the choice of distribution standard in many situations. For example, if a client wishes to name a beneficiary as trustee, distributions to that beneficiary and those to whom the beneficiary owes a duty of support must be limited to an ascertainable standard relating to health, education, support, or maintenance in order to avoid an adverse estate tax result for the beneficiary.<sup>17</sup> Similarly, if a beneficiary serves as trustee, in order to provide the trustee-beneficiary creditor protection, an ascertainable standard must also be used.<sup>18</sup> Alternatively, if a client wishes to name a professional trustee, wholly discretionary distributions may provide the best protection against a beneficiary's creditors, other than exception creditors carved out by state statute, which typically include children and a former spouse.<sup>19</sup>

Trusts can also accommodate the need to provide for a surviving spouse and children of a prior marriage. One type of trust, known as the qualified terminable interest property trust ("QTIP trust") achieves both an estate tax marital deduction and division of the use

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17. See I.R.C. § 2041(b)(1)(A) (2018).

18. See UNIF. TRUST CODE § 504(e) (amended 2010).

19. See *id.* § 504(b).

of trust assets as between the surviving spouse and other trust beneficiaries. QTIP trusts require that all income passes to the surviving spouse with no distributions of principal to anyone other than the surviving spouse during his or her lifetime.<sup>20</sup> On the death of the surviving spouse, the client's children or other named beneficiaries receive what remains for distribution as remainder beneficiaries.

The estate planner can tailor the distribution standard employed in a trust to meet specific planning goals and client preferences. For clients no longer concerned about incurring federal estate tax or obtaining a marital or charitable deduction, the options for designing distribution standards become broad indeed, limited only by the planning goals undertaken and the desire to obtain creditor protection for the person serving as trustee.

#### b. Limited Partnerships

Limited partnerships cannot match the flexibility provided by trust law in the design of distribution standards. The general partner, however, can control timing of distributions and determine the amount of distributions.<sup>21</sup> The general partner, unlike a trustee, is not given discretion to make differing allocations among partners.<sup>22</sup> Variations in distributive shares must instead appear in the partnership agreement. The partnership agreement can provide for partnership interests with different economic rights, but once the general partner determines a distribution is appropriate, the general partner makes distributions according to the economic rights as specified in the agreement.<sup>23</sup>

The drafter can craft preferred interests to match a donor's preference for treating holders of certain limited partnership interests differently from holders of other interests. For example, preferences may require distributions be made first to the class of partnership interests to be transferred to and owned by the surviving spouse. Preferred interests can also be designed to ensure certain owners receive distributions before others and in differing amounts. In addition, voting preferences can allow certain owners of limited partnership interests to have more control than others should the client wish to provide vot-

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20. I.R.C. § 2056(b)(7).

21. ULPA § 503(b). The discretion of the general partner to make distributions is limited. A general partner may not make distributions without bearing personal liability for the amount distributed to the extent that partnership assets are insufficient to pay the limited partnership's creditors or to the extent that the distribution would cause partnership income to be insufficient to meet partnership debts as they come due in the ordinary course of business. See ULPA §§ 504(a), 505.

22. See generally *id.* § 503.

23. See *id.* § 503(a).

ing rights to limited partners on certain issues.<sup>24</sup> Preferences can also be scheduled to convert on the death of the original beneficiary. The ability to tailor economic benefits and management preferences in a limited partnership allows the client to designate benefits received by holders of the varying interests and to designate the amount of management control exercisable by interest holders.

If it is important to the donor's plan, the spousal preferred interests can carry preferential rights to achieve a marital deduction. For couples whose assets do not exceed the applicable exclusion amount, it is not necessary to qualify property passing in trust for the marital deduction unless the planning goal is to obtain a second step-up in basis on the survivor's death.<sup>25</sup> Clients, who no longer need to claim a marital deduction to avoid payment of estate tax until the survivor's death, can be more creative in the division of property as between spouse and children. It is possible to divide interests by carefully designing separate classes of limited partnership interests with varying economic rights. These rights can protect the spouse by providing distributions that first satisfy preferred rights held by the surviving spouse, and only if those rights have been fully satisfied do other limited partners receive any portion of the distribution.<sup>26</sup> Absent estate tax concerns, the applicable elective share statute, not the need to qualify for the marital deduction, now serves as the primary constraint in designing an estate plan for an affluent married client with assets under the basic exclusion amount.<sup>27</sup> The limited partnership offers an excellent vehicle to meet the requirements of the elective share statute as it can ensure ultimate transfer of assets through enforcement of buy-out provisions in favor of the client's children and grandchildren.<sup>28</sup>

The estate tax planning strategies, developed to freeze the value of a client's estate by having the client retain preferred interests and other preferences in relation to limited and general partnership interests, caused Congress to enact estate tax anti-abuse provisions in

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24. *Id.* § 303(a). The current ULPA allows limited partners to vote on issues without losing the benefit of the limited liability shield. *Id.* A client can also provide for differences in voting rights of the general and limited partners without triggering adverse tax consequences. *See* I.R.C. § 2701(a)(2)(B) (2018). These provisions allow the client to provide a voice in certain management issues to owners of limited partnership interests.

25. I.R.C. § 1014(b)(10).

26. Although I.R.C. § 2701 may apply to such rights, the rights can be structured as a qualified payment to alleviate estate and gift tax concerns, or if there is no concern regarding estate tax, the rights can be structured otherwise. *See id.* § 2701.

27. Elective share statutes typically require a client to transfer a certain portion of the client's assets to the surviving spouse at death. *See* UNIF. PROB. CODE §§ 2-201-2-214 (amended 2019)

28. *See infra* notes 38-42 and accompanying text.

1990.<sup>29</sup> The anti-abuse provisions directly address valuation of interests retained and transferred by a donor in the context of entities, trusts, and buy-out agreements. Careful structuring of a limited partnership can nevertheless achieve substantial estate tax planning goals despite the anti-abuse rules.<sup>30</sup> In planning for the 99.9% of clients with no estate tax worries, the planner need not necessarily adhere to the roadmap for achieving estate freezes provided by the anti-abuse rules, although given the political nature of the size of the basic exclusion amount, it is always a good idea to keep in mind and accommodate the strictures of the anti-abuse provisions to the extent feasible in light of client objectives.<sup>31</sup>

Although trusts offer flexibility in designing standards for distributions, some clients prefer the ability of a limited partnership to define distributions in terms of economic interests. The general partner, like the trustee, can control timing of distributions. Like a trustee, the general partner can also exercise discretion over the amount distributed. Once the general partner exercises discretion to make a distribution, however, each interest holder receives an amount as defined by the limited partnership agreement. The certainty of how distributions will be divided among owners of partnership interests can be attractive to clients who hesitate to place too much discretion in the hands of the fiduciary.

The limited partnership provides an alternative for more tailored standards when the client objective is to obtain creditor protection or flexibility to amend.<sup>32</sup> The use of wholly discretionary standards in trusts has increased of late to accommodate client objectives of creditor protection and flexibility for a trustee to modify trust provisions as necessary to achieve tax planning and other objectives of beneficiaries in the future. Wholly discretionary standards take control from the client and place it with a trustee. This shift in control concerns some

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29. See I.R.C. §§ 2701–2704.

30. See, e.g., N. Todd Angkatavanich & Johnathan A. Mayer, *A Tale of Three Freezes*, N.Y. ST. SOC'Y CERTIFIED PUB. ACCT. (Aug. 1 2018), <http://www.nysscpa.org/most-popular-content/a-tale-of-three-freezes#sthash.Uu4F5qpg.dpbs>; William T. Kriesel, *Accomplishing Estate Planning Goals through the Use of Partnership Income Tax Rules*, CPA J. (May 2017), <https://www.cpajournal.com/2017/05/29/accomplishing-estate-planning-goals-use-partnership-income-tax-rules/>; Christopher Pegg & Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era Of Large Gift Tax Exemptions*, 87 FLA. B.J. 34 (2013).

31. In 2019, Senator Bernie Sanders introduced a bill to reduce the basic exclusion amount to its former \$3,500,000. For the 99.8 Percent Act, S. 309, 116th Cong. (2019).

32. The need to easily amend trust provisions without providing for representation of unidentified beneficiaries led to the adoption of the Uniform Decanting Act, which allows a trustee who holds discretionary powers to “decant” assets of a trust to a new trust with different provisions under certain circumstances. UNIF. TRUST DECANTING ACT §§ 11–12 (2015).

clients.<sup>33</sup> The limited partnership provides an avenue to achieve both the objective of obtaining a modicum of creditor protection and the ability to respond to future needs to modify terms without placing discretion wholly in the fiduciary.<sup>34</sup>

## 2. *Generational Planning*

Another aspect of control important to clients is the ability to control the use and distributions of family assets over the course of multiple generations. The prospect of using a client's exemption from generation-skipping transfer tax and future estate tax ("GST exemption") to protect property from federal estate tax over the course of multiple generations has made dynasty planning attractive to affluent clients.<sup>35</sup> The rule against perpetuities, in those states where it has not been repealed, dampens the ability to maximize the tax savings effect of GST tax planning. Those states without a rule that limits the time a trust for private beneficiaries can exist encourages planning for the purpose of maximizing use of the GST exemption.<sup>36</sup>

### a. Trusts

The trust, unlike the limited partnership, can provide for control over multiple generations and for effective use of the GST exemption. The client can allocate his or her GST exemption to protect trust assets from estate taxation for multiple generations. Trust terms can ensure longevity of the trust subject to any applicable perpetuities period. GST trusts typically provide for discretionary distributions, with principal not distributed retained in the trust for use by future generations. The terms of such trusts prevent inclusion in a beneficiary's gross estate for purposes of applying the federal estate tax.

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33. The desire of clients to avoid placing complete discretion in the hands of a fiduciary proved the impetus for the Uniform Directed Trust Act. The Act generally allows a person specified in the trust instrument to direct the trustee as to certain acts and decisions to temper discretion held by the trustee. UNIF. DIRECTED TRUST ACT (2017).

34. See *infra* notes 126-31 and 143 and accompanying text.

35. The GST exemption currently equals the basic exclusion amount. I.R.C. § 2631(c) (2018). This means for transfers made in 2020, a client can allocate up to \$11,580,000 of GST exemption to protect property held in a dynasty trust from further federal estate and gift taxation. *Id.* § 2010; Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

36. A majority of states have eliminated or modified the rule against perpetuities to allow for certain private trusts to continue beyond the time limit imposed by the rule against perpetuities. AM. COLL. OF TR. & ESTATE COUNSEL, THE RULE AGAINST PERPETUITIES: A SURVEY OF STATE (AND D.C.) LAW (2012). The survey indicates that as of March 2012: "A majority of states have eliminated the rule against perpetuities, either entirely or for certain types of trusts, or have adopted a very long fixed permissible period of the rule." *Id.* at 7.

## b. Limited Partnerships

A limited partnership alone cannot ensure longevity of planning in the same way that a trust can. Although a limited partnership, under the latest version of the ULPA, has unlimited duration,<sup>37</sup> the partnership may be dissolved under certain circumstances.<sup>38</sup> The limited partnership is subject to administrative dissolution if required state filings and fees are not kept current and to court ordered dissolution under certain circumstances.<sup>39</sup> If a client desires to control use of assets over multiple generations, the client should use a trust to achieve effective use of the GST exemption. A limited partnership proves an appropriate planning vehicle if a client wishes to place some control in the hands of the ultimate beneficiaries of the partnership interests to continue the benefits of the entity long term, but not necessarily for multiple generations.

The partnership agreement can, however, provide limitations to prevent a limited partner from transferring the partner's interest except to other family members. In this way, the partnership agreement can encourage limited partners to make subsequent transfers to children, grandchildren, and other family members of the client. The default rules of the ULPA help achieve this goal by restricting a limited partner's right to dissociate. A limited partner does not have the right to dissociate under the ULPA.<sup>40</sup> There are no provisions in the ULPA that would force the partnership to buy the limited partner's interest on dissociation. On dissociation, the limited partner would have no more than a transferee interest. To become a partner, a transferee of the limited partner's interest generally would need to obtain the unanimous consent of the partners or satisfy the provisions otherwise provided in the partnership agreement.<sup>41</sup> The partnership agreement, however, can change these restrictions under the ULPA. If appropriate, the partnership agreement can allow gratuitous transfer of partnership interests during life or at death to a limited class of transferees, including for example, descendants of a particular partner or former partner. On an attempted sale or other transfer by a limited partner of a transferee interest, the limited partnership agreement can require other partners be given rights of first refusal. Limitations on the transfer of a limited partnership interest can serve to maintain continued family control over assets.

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37. See ULPA § 110(c).

38. See generally *id.* § 801.

39. *Id.* §§ 801(a)(6)–(7).

40. *Id.* § 601(a).

41. *Id.* §§ 301(b)(1)–(3).

### 3. *Choosing Fiduciaries*

Clients must necessarily appoint a fiduciary to manage assets of the trust or limited partnership. Client choices for providing management services include professional managers, trusted family members, and trusted advisors, or a combination of these persons. Some clients prefer to appoint multiple fiduciaries to jointly make decisions. Both the trust and the limited partnership allow for an array of management choices.

#### a. Trusts

In deciding responsibility for trust management, clients typically appoint either a trusted family member or friend, or a professional trustee. Because both bring different expertise and perspective, some clients appoint co-trustees, one a professional trustee and the other a family member. Some clients instead divide trustee rights and responsibilities among more than one co-trustee. It has become popular of late to use a form of directed trust where an administrative trustee is subject to directions by another as to distributions or investment.<sup>42</sup> Generally, a directed trustee and the person provided authority to direct certain aspects of the trust are each subject to fiduciary duties.<sup>43</sup> The Uniform Directed Trust Act clarifies that trusts can also be designed to grant a person a non-fiduciary power of appointment not subject to fiduciary duties, which can be exercised at the discretion of the power-holder subject to the terms of the power granted.<sup>44</sup> The client, thus, has considerable flexibility in determining a trust's management design.

#### b. Limited Partnerships

The limited partnership's general partner exclusively manages the partnership.<sup>45</sup> Typically the general partner will own an interest in the partnership; however, the most recent version of the ULPA recognizes a limited partnership need not be formed for a business purpose and permits a general partner who does not acquire a transferable interest or make a contribution in exchange for the interest.<sup>46</sup> This provision, thus, accommodates appointment of an individual, family or non-family member, or a professional manager to serve as general partner. Similar to co-trustees, multiple persons may act

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42. See UNIF. TRUST CODE § 808 (amended 2010) (superseded by UNIF. DIRECTED TRUST ACT §§ 6–7 (2017)).

43. *Id.*

44. UNIF. DIRECTED TRUST ACT § 5(b) cmt. 1.

45. ULPA § 406(a).

46. *Id.* § 401(c)(1) cmt.

as general partners with disagreements resolved by a majority vote.<sup>47</sup> In addition, the partnership agreement may designate particular duties to one or more named general partners thereby allowing for division of duties similar to that which is accomplished by use of a directed trust. By allocating duties among persons serving as general partner, general partners obtain relief from performing duties assigned to other general partners.<sup>48</sup> With careful drafting, the limited partnership can provide for client preferences as to who will manage with much the same intricacy as can be achieved in appointing a trustee to manage a trust. Under the most current version of the ULPA, clients can achieve much the same preferences when appointing general partners as is achieved when appointing trustees.

The exclusive management rights of a general partner historically caused the general partner to bear personal liability for debts of the partnership. To avoid imposition of personal liability, planners structure the general partner as a corporation. The corporate form essentially provides the limited liability for the general partner otherwise absent from limited partnership statutes. Responding to the proliferation of limited liability entities, in 2001, the ULPA added limited liability provisions in the form of a limited liability limited partnership to protect general partners without the need to form a corporation to own the general partnership interest.<sup>49</sup> The limited partnership, thus, may provide limited liability protection for the general partner either through careful planning with a corporate general partner or by electing limited liability limited partnership status. The limited liability protection for the general partner bears similarity to that afforded a trustee for contracts and those torts for which the trustee is not personally at fault.<sup>50</sup> The limited liability limited partnership essentially provides the same liability protection to the fiduciary general partner as the trust provides the trustee.

#### 4. Resignation, Removal, and Succession

Clients exercise continued control over who manages family assets by setting forth a procedure to name successor fiduciaries. The Uniform Trust Code specifically acknowledges the ability of a trustor

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47. *Id.* § 406(a).

48. *Id.* Any division of duties, however, must not be manifestly unreasonable. *Id.* § 105(d)(2)(A). An example deemed by the comments to be reasonable is allocation of the management of each of three separate businesses to each of three separate general partners. *Id.* § 105(d)(2)(A) cmt.

49. *Id.* § 404(c) cmt.

50. UNIF. TRUST CODE § 1010 (amended 2010). Anticipating that the trustee may serve as a general partner of a limited partnership, the Uniform Trust Code further specifically provides trustee limited liability for actions taken as a general partner of a limited partnership, with trust assets footing the liability. *Id.* § 1011.

to provide for succession of trustees.<sup>51</sup> The ULPA does not directly address succession of general partners, however, it acknowledges that the partnership agreement can provide for another person to become general partner on dissociation of the initial general partner.<sup>52</sup>

a. Trusts

The language of trust law speaks in terms of resignation, removal, and appointment of a successor trustee. The trust can be drafted to allow resignation by the trustee, removal of a trustee by beneficiaries, and appointment by beneficiaries of a successor trustee. Absent specific provisions, statutory default rules generally require the trustee provide at least thirty-days' notice of resignation or otherwise obtain the court's approval,<sup>53</sup> with appointment of a successor trustee by the unanimous agreement of certain beneficiaries or, absent such appointment, by the court.<sup>54</sup> Courts may also remove a trustee for specified reasons.<sup>55</sup>

b. General Partners

The ULPA defines these same events in terms of dissociation, expulsion, and becoming a general partner. A general partner may dissociate, in other words, withdraw by giving notice to the limited partnership.<sup>56</sup> The partnership agreement may not change this power of a general partner to dissociate.<sup>57</sup> As to expulsion, while the partnership agreement may provide terms for expulsion, regardless of those terms a court may expel a general partner for materially breaching the agreement or a duty owed to the partnership, if done willfully or persistently.<sup>58</sup> On dissociation of a general partner, dissolution of the partnership may occur under certain circumstances absent a specific provision in the partnership agreement. Administrative dissolution by the Secretary of State and dissolution on order of a court that it is unlawful or not reasonably practicable to continue the partnership may not be varied by the partnership agreement.<sup>59</sup> If the client desires continuation of the partnership in the event a designated general partner no longer serves, the agreement should specifically provide for continuation of the limited partnership by allowing a

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51. *Id.* §§ 704–706.

52. ULPA § 604(a); *id.* § 603(a)(1).

53. UNIF. TRUST CODE § 705(a) (amended 2010).

54. *Id.* § 704(d).

55. *Id.* § 706.

56. ULPA § 604(a); *id.* § 603(a)(1).

57. *Id.* § 105(c)(11).

58. *Id.* §603(5)(B); *id.* § 105(c)(10).

59. *Id.* § 801(a)(6)-(7); *id.* §§ 105(c)(12), 105(c)(16).

successor to become a general partner.<sup>60</sup> The current ULPA specifically allows the partnership agreement to provide for the manner in which a person becomes a general partner after formation.<sup>61</sup> In drafting provisions to determine who may become a general partner and how this transition occurs, the limited partnership agreement could provide for successor general partners in a manner similar to that provided for successor trustees in a trust agreement.

### 5. Control Over Lifetime Transfers

Clients who decide to make lifetime transfers typically inquire whether they can act as trustee or general partner. Other planning objectives often cause clients to forgo naming themselves as fiduciary. In the alternative those clients seek to retain removal and appointment powers over the person serving as fiduciary.

#### a. Trusts

Donors, who undertake lifetime transfers in trust to minimize estate tax generally must refrain from serving as a trustee. When establishing a trust, although the donor can choose to serve as trustee, if the donor has discretion, as trustee or otherwise, regarding the timing of distributions or recipients of income or principal, the transferred assets remain subject to estate taxation in the donor's estate.<sup>62</sup> For federal gift tax purposes, retention of discretion over how and to whom distributions are made, regardless of the capacity in which this discretion is exercised, results in characterization of the transfer as an incomplete gift.<sup>63</sup> Donor retained interests in transferred property, like donor retained powers over property, cause gross estate inclusion of transferred assets.<sup>64</sup> Non-donor beneficiaries, who can exercise, as trustee or otherwise, distribution powers to benefit themselves, hold a power of appointment resulting in gross estate inclusion unless the discretion is subject to an ascertainable standard.<sup>65</sup> The goal of achieving estate tax savings, thus, essentially requires donor to forgo

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60. Keep in mind that, for estate tax purposes, however, any variation of the terms regarding dissolution may be disregarded in valuing partnership interests for wealth transfer tax purposes under I.R.C. § 2703. See *Estate of Cahill v. Comm'r*, 115 T.C.M. (CCH) 1463, at \*25–26 (2018). For those taxpayers no longer concerned about the possibility of paying estate tax, I.R.C. § 2703 should not pose a concern.

61. ULPA § 401(b)(1). The ULPA, specifically § 105, does not limit the ability of the partnership agreement to address the manner in which a person becomes a general partner. As a consequence, the limited partnership agreement could use provisions similar to those employed in designating successor trustees.

62. I.R.C. §§ 2036, 2038 (2018).

63. Treas. Reg. § 25.2511-2 (1999).

64. I.R.C. §§ 2036–2037.

65. *Id.* § 2041.

acting as trustee or naming a beneficiary to serve as trustee with discretionary powers of distribution.

For affluent clients whose assets fall within the basic exclusion amount and are not anticipated to ever exceed that amount, tax planning goals no longer require a trade-off as between client control and income tax savings. A key income tax planning goal for clients, especially those with assets under the applicable exclusion amount, is to minimize gain and maximize any available depreciation deductions following death by obtaining a step-up in basis for appreciated property.<sup>66</sup> To obtain a basis step-up, the client's appreciated assets generally must either pass at death or, if assets are passed prior to death, be included in the decedent's gross estate.<sup>67</sup> Gross estate inclusion typically requires the client to retain control or rights to transferred assets.<sup>68</sup> Serving as trustee with discretion to determine when and to whom distributions will be made achieves the client's anticipated income tax planning goals.<sup>69</sup> Control of assets for 99.9% of clients now coincides with achieving income tax planning goals to obtain a basis step-up for appreciated assets. Traditional estate tax limits on clients serving as trustee no longer apply in the instance where the client has no estate tax worries.

#### b. Limited Partnerships

When initially conceived as an estate tax planning strategy, the beauty of the limited partnership was that it allowed the client to retain control over transferred assets and, at the same time, to achieve estate tax savings. The Internal Revenue Service initially acknowledged that fiduciary duties owed by the general partner to the limited partners proscribed the type of discretion that would cause gross estate inclusion.<sup>70</sup> Initial rulings cited the United States Supreme Court's decision in *United States v. Byrum*<sup>71</sup> as authority for the proposition that fiduciary duties owed by a controlling shareholder to minority shareholders in essence precluded the controlling shareholder from "promoting . . . personal interests at the expense of corporate interests."<sup>72</sup> Prior to the Tax Court's decision in *Estate of Strangi v. Commissioner*,<sup>73</sup> clients choosing to use the limited partnership to

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66. *Id.* § 1014.

67. *Id.* §§ 1014(b)(1), 1014(b)(9).

68. *Id.* §§ 2036–2038.

69. *Id.* § 1014(b)(9). Keep in mind, some items such as IRD are not eligible for a step-up despite inclusion in the gross estate. *Id.* § 1014(c).

70. See I.R.S. Priv. Ltr. Rul. 94-15-007 (Apr. 15, 1994); I.R.S. Priv. Ltr. Rul. 93-32-006 (Aug. 13, 1993); I.R.S. Priv. Ltr. Rul. 93-10-039 (Mar. 12, 1993).

71. 408 U.S. 125 (1972).

72. *United States v. Byrum*, 408 U.S. 125, 137 (1972).

73. 85 T.C.M. (CCH) 1331 (2003).

achieve estate tax savings often retained control by retaining ownership of the general partnership interest and carefully planning for succession of general partners. The Tax Court in *Estate of Strangi* distinguished the *Byrum* decision on the basis that duties in that case were owed to non-family member minority shareholders, whereas in *Estate of Strangi* the decedent and decedent's family stood on both sides of the transaction as a shareholder of the general partner and owners of limited partnership interests.<sup>74</sup> In order to avoid adverse estate tax consequences following the Tax Court's decision in *Strangi*, planners structure limited partnerships to preclude the donor from retaining direct or indirect control of the general partner. The substantial 2018 increase in the basic exclusion amount opens the possibility for the many donors who no longer face payment of estate tax to achieve tax planning goals and, at the same time, retain control of the general partner interests. For those clients who use the limited partnership as a technique to minimize estate tax, they may not serve as general partner or indirectly control the general partner, just as they are not able to serve or control who serves as trustee of a trust.

#### 6. Choice of Entity Based on Control Factors

The above discussion demonstrates that the trust and the limited partnership both achieve many of the most common client objectives for control and can be made to do so in similar ways. Critical differences lie in the inability of a limited partnership to achieve goals of generation-skipping transfer tax planning and tailoring distributional interests based on purposes such as those for support, health, and education. On the other hand, the limited partnership achieves more clearly defined economic rights based on preferred and non-preferred limited partnership interests. The ability of the limited partnership to parallel the trust in achieving many clients' control objectives opens the door for the limited partnership to find a continued niche in a world where 99.9% of clients will no longer use the limited partnership as an estate tax planning technique.

#### B. ACHIEVING THE CLIENT'S INCOME TAX PLANNING OBJECTIVES

With the wealth of more than 99.9% of Americans falling within the basic exclusion amount, income tax planning becomes the primary focus for many affluent clients. Income tax planning strategies aim to minimize tax on gains by obtaining a fair market value date of death basis, minimize ongoing federal income tax paid by the next generation on transferred assets, and reduce the incidence of state income

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74. *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331, at \*16-17 (2003).

taxation. The following evaluates the ability of the trust and the limited partnership to achieve these client objectives.

### 1. *Achieving a Fair Market Value Basis*

For certain assets, death can eliminate income tax on untaxed gain inherent in appreciated assets by providing a stepped-up basis to the date of death fair market value, sometimes referenced as “Section 1014 basis.”<sup>75</sup> The ability to pass assets with Section 1014 basis depends on the type of asset, as not all assets are eligible to receive a fair market value basis.<sup>76</sup> Assuming appreciating assets eligible for Section 1014 basis, when basis steps-up to fair market value at death, a sale at that value yields zero gain.<sup>77</sup> Optimally, assets would take a stepped-up basis not only on the client’s death, but again on the death of a beneficiary. Both trusts and limited partnerships require careful planning to achieve a basis step up in the hands of a beneficiary or donee limited partner.

#### a. Trusts

Assets owned by the client and eligible for a step-up in basis take a fair market value date of death basis on transfer by decedent at death to a trust.<sup>78</sup> In contrast, lifetime transfers of assets by a client to an irrevocable trust generally will not receive a fair market value date of death basis if trust assets are not subject to inclusion in the client’s gross estate for estate tax purposes.<sup>79</sup> The goal of planning strategies using irrevocable trusts, for the most part, has been to escape estate tax. With the shift in focus to income tax planning, it is

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75. I.R.C. § 1014 (2018).

76. I.R.C. § 1014 excludes from its purview property constituting a right to receive income in respect of a decedent. *Id.* § 1014(c). For example, a retirement plan that remains subject to income tax as withdrawals are made. In addition, property for which an alternate valuation election, special use valuation election, or conservation easement exclusion has been made take a basis prescribed by the election. *See id.* § 1014(a)(2)-(4). Certain appreciated property acquired by decedent by gift within one year of death does not receive a Section 1014 basis if the original donor is the beneficiary of the property. *Id.* § 1014(e).

77. Assets that have depreciated since purchase also take a fair market value date of death basis, resulting in a stepped-down basis. Ever the optimists, clients typically plan assuming appreciating assets.

78. I.R.C. § 1014(b)(1) (2018).

79. Assets transferred during life pass to the trust with a transferred basis under I.R.C. § 1015. *See id.* § 1015(a)-(b). Assets held in trust, however, can achieve a step-up in basis if included in the transferor’s gross estate at death, usually due to application of I.R.C. §§ 2036 through 2038. *See id.* § 1014(b)(9). In addition, certain community property can obtain a fair market value basis for both spouses’ community property interests, where decedent’s one-half interest is included in the gross estate. *Id.* § 1014(b)(6). QTIP trust property included in the survivor’s gross estate can also obtain a fair market value basis on the survivor’s death. *See id.* § 1014(b)(10).

important to consider whether powers of appointment or distribution can be used effectively to obtain a step-up in basis relative to the assets under their control or the distributed assets. New drafting techniques have developed to provide formula powers of appointment to beneficiaries for the purpose of maximizing the ability to obtain a Section 1014 step-up in basis.<sup>80</sup> Absent the beneficiary possessing a general power of appointment over property held in an irrevocable trust or an ability on the part of the trustee to distribute property to the beneficiary, it is difficult to achieve a step-up in basis for appreciated assets held in the trust on the subsequent death of the beneficiary. However, strategies like triggering the Delaware tax trap may achieve a step-up on exercise of a limited power of appointment by causing assets to be included in the gross estate, thereby triggering a fair market value basis.<sup>81</sup> Strategies also exist to achieve a step-up on the beneficiary's subsequent death.

#### b. Limited Partnerships

Limited partnership interests owned and transferred at death receive a step-up in basis.<sup>82</sup> In a limited partnership designed to obtain estate tax savings, fair market value of the limited partnership interests would likely take into account significant marketability and minority discounts.<sup>83</sup> Clients, however, prefer a basis calculated without adjusting for marketability and minority discounts. For those clients who are no longer concerned with minimizing estate tax, it should be possible to obtain an undiscounted fair market value basis for limited partnership interests. This is possible by providing decedent and decedent's personal representative the right, for a limited period of time beginning on the date of death, to put the limited partnership interests held by decedent to the limited partnership in exchange for a value based on the proportionate interest of undiscounted assets of the

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80. See *Trust and Estate Talk, Powers of Appointment: From Snoozy to Sexy*, AM. COLL. TR. & EST. COUNS. (June 2018), <https://actecfoundation.org/podcasts/powers-of-appointment/>.

81. I.R.C. § 1014(b)(9); see Richard W. Nenno, *Getting a Stepped-Up Income-Tax Basis and More by Springing — or Not Springing — The Delaware Tax Trap the Old-Fashioned Way*, 40 TAX MGMT. EST., GIFTS, & TR. J. 215 (2015); Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using the 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242 (1988).

82. See I.R.C. § 1014(b)(1) (2018).

83. It is for this reason that some attorneys counsel clients who have limited partnerships in place for the purpose of minimizing estate tax to dissolve the partnership. The goal is to avoid a discounted fair market value basis. Before dissolving the partnership, the client may wish to consider putting in place a buy-out provision that would avoid this result.

partnership.<sup>84</sup> The contemplated buy-out provision should result in gross estate inclusion of the limited partnership interests at close to the undiscounted fair market value of the underlying partnership assets. Buy-out provisions based on such a formula should yield the desired higher value for the limited partnership interests.<sup>85</sup> The partnership can then make an election to correspondingly increase the inside basis of partnership assets to reflect the increase in the outside basis of the partnership interests.<sup>86</sup> By making the partnership tax election (“Section 754 election”)<sup>87</sup>, the increased Section 1014 basis of the limited partnership interests, the outside basis, benefits the basis of the underlying partnership assets, the inside basis. In this way, the limited partnership can imitate the trust in obtaining fair market value basis on death of the client, who is the initial transferor of assets to a trust.<sup>88</sup>

Use of a limited partnership allows for management of basis generally. A brief foray into the intricacies of partnership taxation is required to explain the ability to manage basis. The Section 754 election is of particular importance in this regard. For example, a non-liquidating distribution of cash to a partner will result in gain to that partner to the extent the cash exceeds the partner’s outside basis—the partner’s basis in her partnership interest.<sup>89</sup> If the partnership has made a Section 754 election, Internal Revenue Code Section 734(b)(1)(A) will provide for an increase in the inside basis of the partnership’s capital gain property.<sup>90</sup> As a result, the partnership, upon selling capital gains property, will recognize less gain or more loss.

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84. See Prop. Treas. Reg. § 25.2704-3(b)(5)(v), 81 Fed. Reg. 51413, 51423 (Aug. 4, 2016). Put rights were recognized for purposes of according value in these now withdrawn proposed I.R.C. § 2704 regulations. *Id.* Withdrawal rights, sometimes referenced as *Crummey* powers, in reference to the Ninth Circuit case upholding their viability, operate based on a similar principal of recognizing legally enforceable rights in determining tax consequences. See generally *Crummey v. Comm’r*, 392 F.2d 82 (9th Cir. 1968).

85. Buy-out provisions included to avoid applying discounts should not fall within the reach of I.R.C. § 2703 because that section targets provisions decreasing, as opposed to increasing, value. It focuses on agreements to sell “at a price less than the fair market value” and on “restrictions” to sell. I.R.C. § 2703(a)(1)-(2). Techniques used to achieve a step-up in basis would aim to achieve a fair market value basis and would allow, as opposed to restrict, sale.

86. See *id.* § 754. This election is known as the I.R.C. § 754 election. *Id.*

87. *Id.*

88. Keep in mind that the buy-out should only be provided to the client (the original donor) to assets to attain a step-up in basis on the client’s death. Allowing other partners a limited right to sell to certain persons or allowing the partner or partner’s estate a put right following death of the partner, although arguably yielding an increase in the date of death fair market value of the limited partnership interests, might result in creditors of the limited partner being able to force a sale at a similar price.

89. *Id.* § 731(a).

90. *Id.* § 734(b)(1)(A).

Similarly, as a general rule, a partner receiving a non-liquidating distribution of property other than cash will take a basis in the distributed property equal to the adjusted basis the partnership had in that property.<sup>91</sup> However, the partner cannot take a basis in the property greater than the partner's basis in her partnership interest.<sup>92</sup> Thus, if the distributee partner's outside basis is \$10.00 and the partnership's adjusted basis in the distributed property is \$30.00, the partner will take a \$10.00 basis in the property. If a Section 754 election is in effect, however, the \$20.00 of basis that was "stripped" from the property when distributed, will result in an increase of \$20.00 to the inside basis of the partnership in its remaining assets allocated pursuant to Internal Revenue Code Section 755 and the regulations thereunder.<sup>93</sup> Again, as a result of the increase in the inside basis of assets, the partnership will recognize less gain or more loss on the taxable disposition of those assets. If a Section 754 election is in effect, on a sale or exchange of a partnership interest or on the death of a partner, Internal Revenue Code Section 743 will, as a general rule, adjust the inside basis of partnership property so as to equate the transferee's outside basis with the aggregate of the partnership's inside bases in its assets. The adjustment is with respect to the transferee partner only. Obviously, where the transferee's basis—a Section 1014 basis in the case of a devisee of a partnership interest—is greater than the aggregate of the partnership's inside bases in its assets, a Section 754 election can prove most beneficial.

Despite this ability to manage basis in a limited partnership, as with an irrevocable trust, it is difficult to achieve a second step-up in basis on a beneficiary's death for limited partnership interests held by the beneficiary. A put right, as discussed above in reference to the client, would work similarly for donee limited partnership interests, but it would do so at the expense of other important client objectives, such as ongoing control and creditor protection. It is also important to acknowledge that the Tax Court decision, *Estate of Powell v. Commissioner of Internal Revenue*<sup>94</sup> has left it difficult at best to accurately predict what basis will result in the hands of the limited partner in a traditional estate tax effective limited partnership. In a split decision, with two judges concurring in result only, no clear holding left doubt as to whether the client's gross estate will include the limited partnership interests or the underlying partnership assets.<sup>95</sup>

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91. *Id.* § 732(a)(1).

92. *Id.* § 732(a)(2).

93. *See id.* § 734.

94. 148 T.C. 392 (2017).

95. *See* Elaine Gagliardi, *On The Family Limited Partnership in 2018: Powell, Cahill, and Income Tax Basis at Death*, LEXIS FED. TAX J.Q. § 1 (2018). This article pro-

## 2. Incidence of Federal Income Taxation

Tax rate directly impacts overall income tax burdens. Taxation of income received over the term of the trust or partnership is an important consideration. Overall tax burden proves somewhat difficult to predict given that effective rates for trusts depend in part on whether trust income is taxed to the trust or to the beneficiary. Effective tax rates for limited partnerships depend on the respective partners' rates.

### a. Trust Income Taxation Generally

The tax burden on income from assets held in trust depends on what trust tax regime applies. Trusts taxed as “grantor trusts” treat the grantor as owner of the trust for income tax purposes.<sup>96</sup> All other trusts are categorized as simple or complex trusts depending on whether all income is required to be paid to the beneficiaries.<sup>97</sup> For these trusts, distributions to beneficiaries carry with them trust income and deductions taxable to the beneficiary.<sup>98</sup> Income not distributed to beneficiaries remains in the trust, and as such, is subject to tax at the trust level on a much more compressed rate schedule. For simple trusts, where the trust terms require all income be distributed, only capital gains allocable to trust principal typically remain subject to taxation inside the trust. For complex trusts, including those where the trustee has discretion to distribute income and principal, both income and gains may be subject to taxation inside the trust. For the tax year 2020, trust taxable income in excess of \$12,950.00 is taxed at the highest 37% individual tax bracket.<sup>99</sup> The differences in income tax treatment require trustees be cognizant of the impact of distributions on overall income taxes and earnings of the trust.

### b. Limited Partnership Taxation Generally

Taxation of limited partnerships is reasonably simple in comparison to taxation of trusts. Absent an election under the check-the-box

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vides a complete analysis of basis in light of the Tax Court's opinion in *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017). *See id.*

96. *See generally* I.R.C. §§ 671–679 (2018). Grantor trust status results in grantor bearing the tax burden on trust assets even though grantor has not retained any direct benefit from the trust assets. Some grantors want to preserve the option for grantor trust status to terminate. Fiduciaries, however, may be loath to take the step of turning off grantor trust status. Exercise of the power, granted in the trust instrument, to toggle grantor trust status on and off, thereby relieving the grantor of the income tax burden, may be subject to fiduciary duties owed by the person making the decision to toggle.

97. *See generally id.* §§ 651–652, 661–662.

98. *Id.*

99. *Id.* § 1(j)(2)(E); Rev. Proc. 2019-44, 2019-47 I.R.B. 1093, §§ 2-3.

regulations, the limited partnership generally is taxed as a partnership for purposes of the federal income tax.<sup>100</sup> The Internal Revenue Code taxes partnerships as complete pass-through entities. Partnership income, while determined at the partnership level, passes through to and is reported by the partner. Decisions on when, what, and how to distribute can also become complex and can impact income tax paid by a partner, but unlike trusts, partnership income is taxed solely at the partner level. The partnership avoids “trapping” income inside the entity and subjecting it to a higher rate, as can occur with trust income. Provided the partnership is substantively recognized for income tax purposes under Internal Revenue Code Section 704(e), income will be taxed at the various partners’ tax rates.<sup>101</sup>

The underlying policy of Section 704(e) prevents shifting the incidence of income tax liability to younger donee family members. Very generally, if capital is a material income-producing factor, a partner who owns a capital interest in the partnership will be recognized as a partner for income tax purposes.<sup>102</sup> The fact that a general partner controls decisions in a limited partnership is key in meeting the objective test used to evaluate the application of Section 704(e).<sup>103</sup> The donee, however, must have sufficient control over the partnership interest to be treated as the real owner.<sup>104</sup> Distributions of income to a donee partner will provide strong evidence the partner is exercising control of his or her interest.<sup>105</sup>

### 3. State Income Taxation Implications

State income tax rules often follow federal income tax rules for both trust and limited partnership tax purposes. Unlike with trusts, there is no need to determine a state’s taxing jurisdiction over a partnership because it is the partner who is taxed on income, not the partnership. The simplicity of this rule cannot be fully appreciated without comparing state income taxation of trusts.

#### a. State Taxation of Trust Income

Trust income subject to taxation inside the trust for federal purposes will likely also be subject to trust income taxation for state purposes. Tax rates imposed on trust income vary among states,

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100. See generally Treas. Reg. §§ 1.7701-1–1.7701-3 (2016).

101. I.R.C. § 704(e) (2018).

102. *Id.* § 704(e)(1).

103. Treas. Reg. § 1.704-1(e)(2)(ii)(d).

104. *Id.* § 1.704(e)(1)(iii).

105. *Id.* § 1.704-1(e)(2)(iv)-(v).

sometimes significantly, ranging from 2.9% to 13.3%.<sup>106</sup> Changing the situs of the trust can sometimes lead to substantial overall income tax savings after considering both federal and state tax costs.<sup>107</sup>

Because of differences among state laws, trust income may be subject to income taxation in more than one state or may avoid state income taxation all together with careful planning. The leading commentator on planning to minimize state taxation of trust income, Richard Nenno, warns that failure to take state income taxation into the planning equation may lead to claims for malpractice or breach of fiduciary duty.<sup>108</sup> Nenno's exhaustively detailed analysis highlights that in 2017, eight states did not tax non-grantor trust income: Alaska, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington and Wyoming.<sup>109</sup> The planning matrix, however, is not as simple as ensuring trust situs in one of these states.

States that impose income tax on trust income do so on the basis of a variety of factors including, for testamentary trusts, the testator's or trustor's state of residence, the trust situs for administration purposes, the location of trust assets, the residence of the trustee, and the state of residence of the beneficiary or beneficiaries.<sup>110</sup> It is not always possible to control these factors, especially the residence of the beneficiary, due to the ease of moving to a different state. Given the differences between state income tax jurisdictions, it is possible that more than one state will tax trust income.<sup>111</sup> It is also possible to avoid state income taxation of a trust with careful planning. The law continues to evolve as states grapple with the constitutionality of imposing taxes based on some or all of these factors.

The United States Supreme Court, in *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*,<sup>112</sup> limits the ability of states to tax trust income based solely on residence of the beneficiary. The *Kaestner* decision addressed the constitutionality of North Carolina's claimed jurisdiction to tax income of a non-grantor trust. North Carolina taxes the income of non-grantor trusts that "[are] for the benefit of" its residents.<sup>113</sup> The Court begins by noting:

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106. See Richard D. Nenno, *Minimizing or Eliminating State Income Taxes on Trusts*, WILMINGTON TRUST 1, 3 (May 2018), [https://www.wilmingtontrust.com/repositories/wtc\\_sitecontent/PDF/Minimizing-or-Eliminating-State-Income-Taxes-on-Trusts.pdf](https://www.wilmingtontrust.com/repositories/wtc_sitecontent/PDF/Minimizing-or-Eliminating-State-Income-Taxes-on-Trusts.pdf).

107. See *id.* at 8.

108. *Id.* at 2.

109. *Id.* at 6.

110. *Id.* at 6-10.

111. See N.C. Dep't of Revenue v. Kimberley Rice Kaestner 1992 Family Tr., 139 S. Ct. 2213, 2221-22 (2019) (acknowledging the possibility of trust income subject to state income taxation in multiple states).

112. 139 S. Ct. 2213 (2019).

113. *Kaestner*, 139 S. Ct. at 2217.

The North Carolina courts interpret this law to mean that a trust owes income tax to North Carolina whenever the trust's beneficiaries live in the State, even if—as is the case here—those beneficiaries received no income from the trust in the relevant tax year, had no right to demand income from the trust in that year, and could not count on ever receiving income from the trust.<sup>114</sup>

The opinion of the Court, delivered by Justice Sotomayor, pointedly limits the opinion's reach: "We hold that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it."<sup>115</sup> To be subject to state income taxation, the trust must have a "minimum connection" with the state.<sup>116</sup> For the beneficiary to have the requisite minimum connection, the taxing authority must show "the in-state beneficiary's right to control, possess, enjoy, or receive trust assets."<sup>117</sup> The court further indicated in the course of its opinion that in-state residence of a trustee, in-state administration of the trust, and distribution of income to an in-state resident beneficiary also demonstrate the necessary minimum connection for the state to tax trust income.<sup>118</sup> For a holding intended by the court to be narrow, the opinion offers substantial guidance as to when a state may exert taxing authority over a trust. Given the mobility of beneficiaries, to avoid state taxation by states who tax on the residency of a beneficiary, the trust should use wholly discretionary beneficial interests. For clients, who prefer to avoid placing discretion in a non-family member trustee, it may be difficult to avoid the possibility of multiple states asserting jurisdiction to tax income of the trust.

#### b. State Taxation of Partnership Income

For clients who wish to avoid the complex planning needed to minimize state income taxation of trusts, the limited partnership offers a comparatively simple solution. The partnership is not a tax paying entity. Partnership income is passed through to partners, reported on the partners' personal tax returns, and taxed at the level and rate applicable to the partners. None of the income is susceptible to being trapped and taxed at the entity level. In an investment limited partnership, one that does not operate an active business, a beneficiary living in one of the several states without an individual income

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114. *Id.*

115. *Id.* at 2221.

116. *Id.* at 2219-20.

117. *Id.* at 2221.

118. *Id.* at 2220.

tax could avoid state income taxation altogether on partnership income taxed to the partner. The simplicity of partnership taxation has great appeal for clients.

### C. ATTAINING CLIENTS' Creditor Protection Objectives

Clients often choose to place property in trust, as opposed to making outright transfers to beneficiaries, for the primary purpose of protecting the trust assets from creditors. Clients especially express creditor concerns if the intended beneficiaries practice a profession susceptible to malpractice lawsuits. Other clients may simply not have confidence in the beneficiary's ability to manage money. These concerns encourage clients to use a trust or a limited liability entity to protect family assets from creditors.

#### 1. Trusts

Most states allow a client to protect trust assets from a beneficiary's creditors by including spendthrift provisions in the trust agreement. Essentially, a spendthrift clause protects assets until such time as a distribution is due or discretion to distribute exercised.<sup>119</sup> The Uniform Trust Code limits effectiveness of spendthrift provisions and allows children, spouses, and former spouses to reach trust assets despite a spendthrift provision.<sup>120</sup> It also exempts claims by the United States or a state government from application of the spendthrift provision.<sup>121</sup> Discretionary trusts also provide protection from creditors regardless of whether the trust includes a spendthrift clause, because a creditor may not compel an exercise of discretion.<sup>122</sup> Again, an exception is made for protection, support, and maintenance payments for a child, spouse, or former spouse.<sup>123</sup> Some states have not adopted exceptions from the spendthrift rules for children, spouses, or former spouses. Thus, while spendthrift provisions can provide some protection for a beneficiary's assets until distributed to the beneficiary, the protection is not complete.

A minority of states have also enacted domestic asset protection trust legislation allowing a trust to protect assets from a trustor's creditors. Except in those states which have enacted domestic asset protection trust legislation, typically a trustor's creditors can reach the maximum amount the trustor could receive under the trust as-

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119. See UNIF. TRUST CODE § 502 (amended 2010). The comment to § 502 confirms this reading.

120. *Id.* § 503.

121. *Id.*

122. *Id.* § 504.

123. *Id.*

suming a maximum exercise of discretion in favor of trustor.<sup>124</sup> From a policy perspective, the Uniform Trust Code chooses not to allow an individual to avoid creditors by placing assets in trust for their own benefit.

## 2. Limited Partnerships

Family limited partnerships can provide some creditor protection for partnership assets. Creditors of a limited partner may not access the assets of the limited partnership to satisfy a partner's debt owed to the creditor. It makes sense that assets of the partnership be preserved to pay debts owed to creditors of the partnership, and those assets should not be available to pay debts of the individual partners. The partner's partnership interest, however, does not benefit from similar protection from the partner's creditors. A partner's creditor can reach the partner's transferable interest in the partnership by obtaining a charging order.

Under ULPA, the charging order is the exclusive remedy for the partner's individual creditors to satisfy debts owed by the partner to the creditor from the partner's partnership interest.<sup>125</sup> A judgment creditor can apply for the court to enter a charging order against the partner's interest in the limited partnership. A charging order amounts to a lien on the partner's transferable interest.<sup>126</sup> It requires the partnership pay any distribution directly to the judgment creditor and not to the partner. In much the same way a creditor cannot force a trustee to make a discretionary distribution, the creditor cannot force the partnership to make a distribution.<sup>127</sup> The court can order the foreclosure of the charging order if distributions will not satisfy the debt within a reasonable time. The purchaser at the foreclosure sale only has the rights of a transferee—the right to receive distributions when made.<sup>128</sup> In a partnership for a term, as opposed to one “at will,” the transferee is not able to ask the court for dissolution of the partnership and must wait until the end of the partnership term to receive any distribution of the value of the underlying partnership assets.

Courts can issue orders to enforce a charging order. The current version of ULPA does not speak to what terms may be included in the charging order or in the order enforcing it. Earlier versions precluded a court ordered dissolution of a term partnership until the end of the

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124. *Id.* § 505.

125. ULPA § 703(g).

126. *Id.* § 703(a).

127. *See id.*

128. *See id.* § 703(c).

term. The comments to ULPA, but not the Act itself, specify what the Act means when it grants courts the ability to make those orders necessary to effectuate the charging order. The comments provide a narrow reading precluding the court from interfering with the decision to make a distribution.<sup>129</sup> Some courts have not felt bound by similar comments to ULPA to limit a court's ability to interfere with management decisions.<sup>130</sup> The comments to the Act contemplate that a court would not have authority to order dissolution of the partnership in order to comply with the charging order, but the Act does not specifically limit orders to enforce a charging order. If courts follow the directive of the comments to ULPA, a charging order provides considerable protection in much the same way as a spendthrift clause or discretionary trust.

Neither the trust nor the limited partnership can provide fool-proof protection from a beneficiary's or partner's creditors. Both provide some protection, but the limited partnership, unlike the trust, provides an option to buy out the creditor and thereby protect underlying family assets. This proves especially beneficial when the client wishes to protect a specific asset. The limited partnership provides options for the family to protect that asset through a buy-out arrangement.

#### D. CONSIDERING OTHER CHOICE OF ENTITY FACTORS

Both the trust and the limited partnership allow for obtaining client objectives of ongoing management and control of assets. Trusts prove more adept at ensuring control of assets over multiple generations and have increased flexibility when designing distribution provisions. Careful planning can minimize income taxation and provide creditor protection regardless of the entity chosen. The limited partnership, however, has the added advantage and simplicity of pass-through taxation. It also allows partners or the entity to buy the debt of a creditor in the event of a charging order and thereby protect underlying family assets. The ability of an entity to not only meet these primary client objectives, but to also meet other considerations regarding fiduciary duties of the trustee or general partner and the flexibility to provide for changed circumstances can tip the choice to one or other of the two entities.

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129. The comments to ULPA § 703 specifically cite the narrow reading by the Iowa Court of Appeals in *Wells Fargo Bank, Nat'l Ass'n. v. Continuous Control Sol., Inc.*, 821 N.W.2d 777 (Iowa Ct. App. 2012), as an appropriate interpretation. ULPA § 703(b)(1) cmt.

130. See *Law ex rel Robert M. Law Profit Sharing Plan v. Zemp*, 408 P.3d 1045 (Or. 2018).

### 1. Differences in Duties of Care

Trustees and general partners must adhere to fiduciary duties of loyalty and duties of care. The duty of loyalty requires the fiduciary to refrain from conflicts of interest and from use of the trust's or the entity's property or opportunities for personal gain.<sup>131</sup> The default rules of both entities hold the fiduciary to high standards of loyalty.<sup>132</sup> The primary differences in duties owed by a trustee and a general partner arise in regard to duties of care, specifically investment duties.

#### a. Trustee Duties

In exercising the duty of care when making investments, the trustee in many states must comply with what has become known as the prudent investor rule, set forth in the Uniform Prudent Investor Act, which has been incorporated by reference in the Uniform Trust Code, as Article 9. The Uniform Prudent Investor Act requires trustees to consider a number of factors in determining how to appropriately invest trust assets.<sup>133</sup> Diversification lies at the heart of the Uniform Prudent Investor Act.<sup>134</sup> The prudent investor rule requires that a trustee follow specific procedures and consider numerous factors in arriving at an appropriate investment plan. Failure to diversify assets, absent offsetting reasons for not doing so, can lead to a breach of duty.

#### b. General Partner Duties

In contrast, the duty of care owed by a general partner is governed by the overarching and more relaxed principles of the business judgment rule, which encourages a measure of risk taking necessary to operate a successful business. The duty of care under ULPA only requires the general partner to avoid grossly negligent acts, intentional wrongdoing, and knowing violation of law.<sup>135</sup> Given the relaxed standard applied in determining whether the general partner has ful-

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131. See UNIF. TRUST CODE § 802 (amended 2010); ULPA § 409(b); *see also*, UNIF. LTD. LIAB. CO. ACT § 409(b) (amended 2013).

132. The limited partnership agreement, while not able to eliminate the duty of loyalty, can modify it to allow certain conflicts if the partners deem it advisable. The Uniform Trust Code, unlike the ULPA, does not specifically prohibit modification or elimination of the duty of loyalty. The fiduciary nature of the trust relationship and the requirement that trust terms must be for the benefit of the beneficiaries, however, should preclude elimination of the duty of loyalty without the need to so specify. *See* UNIF. TRUST CODE § 105(b)(3). Comments to the duty of loyalty as set forth in the Uniform Trust Code, however, acknowledge that the trust agreement may modify the duty to allow specific transactions as not violative of the duty. *See id.* §§ 105, 802 cmt. The ULPA specifically allows for partners to agree that certain transactions do not amount to a breach of duty of loyalty. ULPA § 409.

133. UNIF. PRUDENT INVESTOR ACT § 2 (1994).

134. *See id.* § 3.

135. ULPA § 409(c). *See also*, UNIF. LTD. LIAB. CO. ACT § 409(c) (amended 2013).

filled the duty of care, it is more difficult to succeed in bringing a breach of duty of care claim, provided the general partner takes steps to be reasonably informed regarding investment decisions. In contrast, the prudent investor act, as was the case under predecessor statutes, imposes a higher duty of care regarding investment standards for trust assets. ULPA encourages more flexibility for the general partner to choose investments.

c. Use of Exculpatory Clauses

Exculpatory clauses may protect a trustee and a general partner in very similar fashion. The trust agreement, under certain circumstances, may exculpate a trustee for conduct, except for conduct undertaken with reckless indifference or bad faith.<sup>136</sup> The limited partnership agreement may exonerate a general partner for conduct, except conduct done in bad faith, wrongdoing done with intent, or for laws knowingly violated.<sup>137</sup> The critical difference in exculpation provisions as between trustees and general partners lies in the partners' ability to bargain for exculpation. In contrast, the Uniform Trust Code calls on courts to determine if the insertion of the exculpatory clause resulted from the trustee's abuse of a fiduciary or confidential relationship and, if so, to declare the clause invalid.<sup>138</sup> Even if found not to be a result of abuse of the relationship, a court must also find the clause fair and clearly communicated to the settlor of the trust to avoid invalidity. Similar language is not found in ULPA. A fiduciary, responsible for investment decisions, may prefer acting as a general partner to acting as a trustee, given the more relaxed duty of care standard applicable to limited partnerships.

2. *Differences in Ability to Respond to Changed Circumstances*

Passage of time brings changes in circumstances. The need to respond to changed circumstances often requires amending governing documents. Historically, it has been more difficult to modify a trust than to amend a partnership agreement. The need to keep up with continual change in the areas of taxation, creditor protection, and entity laws has generally increased the need for entities to flexibly adapt.

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136. UNIF. TRUST CODE § 1008(a)(1) (amended 2010).

137. Compare ULPA § 105(c)(8), with MODEL BUS. CORP. ACT § 2.02(b)(4) (amended 2016) (stating that relief from liability may be provided for acts other than intentional inflictions of harm or violations of law, or an inappropriate financial benefit or distribution).

138. UNIF. TRUST CODE § 1008.

## a. Trusts

Statutes giving heed to the principle of freedom of testation encourage deference to a testator's or trustor's intent. Historically, these statutes have required court intervention to amend or modify trust terms absent the consent of the settlor and all beneficiaries.<sup>139</sup> A trust, however, can be drafted with an eye towards easy modification. Judicious granting of powers of appointment in a non-fiduciary capacity can allow for appointment of assets in further trust, thereby allowing the power-holder to modify trust terms. Trustees holding wholly discretionary powers may, under certain circumstances, “decant” to a new trust. Many states have adopted what have come to be known as “decanting” statutes.<sup>140</sup> The advantage of the Uniform Trust Decanting Act is the ability to decant without the need to obtain representation of unknown or unascertained beneficiaries as must occur when a trust is reformed or modified. The Act provides for court approval of decanting to protect a trustee who remains subject to fiduciary duties when decanting.<sup>141</sup> State statutes set forth specific standards and procedures for modification of trusts or decanting.

## b. Limited Partnerships

Limited partnerships, in contrast, may be amended as provided in the partnership agreement.<sup>142</sup> The limited partnership agreement, thus, can specify the terms for amending the agreement. There is no requirement for court approval of an amendment. The provisions for amending the partnership agreement provide great flexibility. Clients may view this flexibility as a positive or negative, depending on the client's preference to exercise a greater or lesser degree of control over partnership terms. The advantage, however, is that amendment can occur without the need to obtain court approval or to meet the prerequisites for decanting. If the partnership agreement so provides, amending can even occur with fewer than all partners agreeing to the change.

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139. UNIF. TRUST CODE §§ 411-416 (amended 2010).

140. See *A Few Facts About the Uniform Trust Decanting Act*, UNIF. LAW COMM'N (Jan. 22, 2020), <https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=639ebb5f-8668-f959-1c7e-94901abd9227&forceDialog=0>. A Uniform Trust Decanting Act approved in 2015 has been adopted by six states according to the Legislative Fact Sheet provided by the Uniform Law Commission.

141. UNIF. TRUST DECANTING ACT § 4 (2015).

142. ULPA § 105(a).

## IV. SUMMARY OF FACTORS IN CHART FORM

The family limited partnership compares favorably to the trust as a wealth management entity. Whether the limited partnership or the trust provides a more appropriate choice of entity depends on the client's specific needs and assets. The following chart evaluates the ability of each entity to achieve client objectives. A "✓" means the entity adequately achieves the objective, with a "✓+" meaning the entity has an advantage in achieving the objective. A "—" indicates the entity is not able to easily achieve the client objective without complex planning.

	TRUST	FAMILY LIMITED PARTNERSHIP
<b>AVOIDING POSSIBILITY OF MULTIPLE STATE TAXATION</b>	—	✓
<b>ABILITY TO MINIMIZE FIDUCIARY DUTIES</b>	✓	✓+
<b>ABILITY TO AMEND AND MODIFY TERMS</b>	✓	✓+
<b>OPTION FOR DONOR/FAMILY MANAGEMENT</b>	✓	✓
<b>OPTION FOR PROFESSIONAL MANAGEMENT</b>	✓+	✓
<b>ABILITY TO REMOVE/REPLACE MANAGER</b>	✓	✓
<b>ABILITY TO TAILOR DISTRIBUTION STANDARDS</b>	✓+	✓
<b>ABILITY TO ASSURE CONTINUANCE OVER MULTIPLE GENERATIONS</b>	✓+	—
<b>ABILITY TO PROVIDE FOR MULTIPLE BENEFICIARIES</b>	✓+	✓
<b>ABILITY TO OBTAIN A STEP-UP IN BASIS</b>	✓	✓
<b>ABILITY TO PROVIDE CREDITOR PROTECTION FOR ASSETS</b>	✓	✓

## V. CONCLUSION

In choosing a vehicle to meet clients' estate planning goals, planners should consider the effectiveness of the limited partnership in addition to the traditional trust. The limited partnership can achieve many important client objectives and, at the same time, avoid some of the administrative disadvantages of a trust. When appropriate, the latest version of the Uniform Limited Partnership Act makes room to appoint a professional financial manager as general partner. The effective repeal of the estate tax for more than 99.9% of Americans, in conjunction with recent changes to the Uniform Limited Partnership Act, makes the limited partnership a viable choice of estate planning entity for some clients.



# RETHINKING DISPOSITION PROVISIONS OF TRUSTS: RECENT TRENDS AND APPROACHES TO TRUST DESIGN WITH AN ASSET PROTECTION FOCUS

MARY E. VANDENACK†

## I. RECENT DEVELOPMENTS AND TRENDS AFFECTING TRUSTS IN ESTATE PLANNING

### A. FEDERAL TRANSFER TAX DEVELOPMENTS

The Tax Cuts and Jobs Act<sup>1</sup> (“TCJA”) was passed in late 2017. The TCJA made significant changes to the federal estate and gift tax rules. The TCJA allows an individual to transfer ten million dollars (adjusted for inflation) in asset value by transfers during life or at death. The exemption applies to gifts made during tax years 2018 through 2025. As the law currently stands, the exemption will revert to \$10 million per person (adjusted for inflation in 2026). For 2020, the exemption amount (adjusted for inflation) is \$11.58 million per person.

Early on, a concern of many practitioners about the increased exemption was whether gifts made between 2018 and 2025 would be grandfathered based on the exemption amount that applied when the gift was made. That is, if Client Jane makes a lifetime gift of \$11 million in 2020 and dies in 2026, when the estate tax exemption has reverted to \$5 million (adjusted for inflation), the concern was whether some of Jane’s 2020 gift would be taxable by being limited to the 2026 exemption amount. Fortunately, the Internal Revenue Service (“IRS”) issued final regulations in November of 2019 that indicate a special rule will apply to gifts made in the years 2018 to 2025—there will be no clawback.<sup>2</sup> The final regulations also confirmed that the amount that will be eligible for the special rule will be the exemption amount as adjusted for inflation.

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† Founding and Managing Member, Vandenack Weaver LLC.

1. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (codified as amended in scattered sections of 26 U.S.C.).

2. Treas. Reg. § 20.2010-1(c) (2019).

B. SHIFT TO INCOME TAX FOCUS AND BASIS PLANNING IN ESTATES  
NOT SUBJECT TO ESTATE TAX

Because the current federal estate tax exemption results in a very limited number of estates being subject to federal estate tax planning, many estate planners have shifted the tax focus aspects of estate planning to income tax planning. When considering gifts and use of trusts, basis planning becomes an important income tax consideration. Many income tax considerations apply in the context of business succession planning.

C. CHANGING TRUST PROVISIONS USING REFORMATION,  
MODIFICATION, AND DECANTING

It is not uncommon that an older irrevocable trust might require, or at least significantly benefit from, some modernization. Depending on state law, various strategies to change trust provisions include reformation, modification, or decanting. To the extent that asset protection is an objective of a settlor in creating a trust, careful consideration should trend towards making it easier to change trusts after they have become irrevocable.

The historic doctrine in the United States prohibited modification or termination of a trust if such modification was contrary to a material purpose of the settlor in establishing the trust. That rule was established in *Clafin v. Clafin*.<sup>3</sup> In that case, a beneficiary sought to terminate a trust prior to the date for termination provided in the trust. The court held that a settlor's intention should be effectuated absent such intention being contrary to a rule of law or public policy.

The *Restatement Third of Trusts* acknowledges a trend towards flexibility. The test is restated: "A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee."<sup>4</sup> The concept of material purpose of the settlor survives in *Restatement Third*. Section 65 provides for modification or termination, but such modification or termination cannot be inconsistent with a material purpose of the trust.<sup>5</sup>

The Uniform Trust Code includes provisions allowing nonjudicial settlement agreements as long as such an agreement does not violate a material purpose of the trust.<sup>6</sup> Most states have enacted the Uni-

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3. 149 Mass. 19, 20 N.E. 454 (1889).

4. RESTATEMENT (THIRD) OF TRUSTS § 50 (2003).

5. Diana S.C. Zeydel, *What's Happened to Settlor's Intent?*, TR. & EST. 16 (2019).

6. UNIF. TRUST CODE § 111 (2000).

form Trust Code and a majority of states provide for non-judicial settlement agreements.<sup>7</sup>

The Uniform Trust Code also contains provisions regarding modification and termination of trusts.<sup>8</sup> Some states require that the ability to modify a trust be included in the trust document at creation. Other states do not have such a requirement. If the settlor and all the beneficiaries consent, a modification can be made even if the same is inconsistent with a material purpose.<sup>9</sup>

In a private letter ruling, the Internal Revenue Service (“IRS”) ruled that judicial reformation of a trust to correct a scrivener’s error with respect to Crummey withdrawal powers will not result in estate tax inclusion in the gross estate of the spouse. It will also not result in the exercise or release of a general power of appointment for gift tax purposes.<sup>10</sup> In another private letter ruling, the IRS ruled that a modification of an irrevocable trust effectively eliminated incidents of ownership of the trustee or beneficiary.<sup>11</sup>

Decanting a trust is a process whereby the assets in one trust are “decanted” from an existing trust and poured into another trust. Decanting has evolved into a significant tool to modify a trust. Decanting is particularly useful in dealing with an outdated trust. Consider an irrevocable life insurance trust created in the first year that the strategy evolved. There are significant differences between an irrevocable trust drafted twenty-five years ago and one drafted today. Decanting might be used to modify powers of appointment, strengthen spendthrift provisions, add or remove grantor trust provisions, reduce state and local taxes, extend the term of a trust, change governing law provisions, and revise a trust to better address a beneficiary with special needs. The Uniform Law Commission has promulgated a Uniform Trust Decanting Act. The act, in some form, has been adopted in eight states and is being considered in several others.<sup>12</sup>

In a private letter ruling, the IRS ruled that the modification of a trust to allow for appointment of an independent special trustee who would have the power to create a testamentary general power of appointment in any of grantor’s descendants; convert a general power of appointment to a non-general power; and eliminate a power of ap-

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7. See, e.g., NEB. REV. STAT. § 30-3811 (2020).

8. UNIF. TRUST CODE § 411.

9. *Id.*

10. I.R.S. Priv. Ltr. Rul. 201920000–201920003 (May 10, 2019); *id.* 201941008–201941023.

11. *Id.* 201919002; *id.* 201919003.

12. See *Trust Decanting Act*, UNIFORM L. COMMISSION, <https://www.uniformlaws.org/committees/community-home?CommunityKey=5b248bac-9251-47fb-bad8-57a23f3df540> (last visited Mar. 14, 2020). The Uniform Decanting Act is presently before the Nebraska legislature. *Id.*

pointment in whole or part, did not result in a change or transfer of the interests of the primary beneficiary during the primary beneficiary's lifetime.<sup>13</sup> Generally, the exercise or release of a general power of appointment is deemed a taxable gift<sup>14</sup> and a power released by a powerholder during his or her lifetime may result in such release being subject to estate or gift tax.<sup>15</sup> The IRS also concluded that the exercise by the special trustee of the powers would not be an exercise or release of a general power of appointment under the Internal Revenue Code section 2514(b).

#### D. MATERIAL PURPOSE

The Comments to Uniform Trust Code section 65 state:

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 the 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 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.<sup>16</sup>

In *In re Fenske*,<sup>17</sup> a trust beneficiary sought to remove a bank trustee and have the beneficiary's husband appointed as trustee. The beneficiary acknowledged that one of her goals in changing the trustee was to ultimately terminate the trust. The deceased settlor's attorney testified that the settlor's specific intentions included keeping the assets in trust for an additional generation while providing income to the interim generation. The court addressed the concept of material purpose and quoted a comment to section 411 of the Uniform Trust Code which stated "Material purposes are not readily to be inferred. A finding of such 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, judgement or level of maturity."<sup>18</sup> The court noted that there was substantial evidence of the settlor's objectives in establishing the trust and selecting a trustee to

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13. I.R.S. Priv. Ltr. Rul. 201845006.

14. I.R.C. § 2514(b) (2018).

15. *Id.* § 2041(a)(2).

16. RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. d (2003).

17. 303 Neb. 430, 930 N.W.2d 43 (2019).

18. UNIF. TRUST CODE § 411 (2000); RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. d (2003).

achieve those objectives. The court concluded that permitting a change of trustee would be inconsistent with a material purpose of the trust.

#### E. STATE DEATH TAXES

Some states still have a state estate tax or some form of inheritance tax. Connecticut has a separate estate tax. District of Columbia has a pick-up estate tax. Hawaii has a modified pick-up tax. Illinois has a modified pick-up estate tax. Iowa, Kentucky, and Nebraska have inheritance taxes. Maine has a pick-up estate tax. Maryland caps the exemption at \$5 million. Massachusetts, New York, Rhode Island, and Minnesota have pick-up taxes. New Jersey has an inheritance tax. Oregon has a separate estate tax. Pennsylvania has an inheritance tax. Vermont has a modified pick-up estate tax. Washington has a separate estate tax.<sup>19</sup>

#### F. STATE INCOME TAXATION OF TRUSTS

In general, states actively seek to tax trust income if any connection to the state can be claimed. In *North Carolina Dep't of Revenue v. Kaestner 1992 Family Trust*,<sup>20</sup> the United States Supreme Court held that North Carolina could not tax an out-of-state trust based solely on a beneficiary's residence. The trust at issue was governed by New York law. The Trustee was a resident of Connecticut. Although the beneficiary resided in North Carolina, the beneficiary did not receive any distributions, had no right to demand distributions, and had no certainty of ever receiving any income from the trust. The ruling noted that a trust has a separate existence from its beneficiary. This case leaves open other issues about when states can tax an out-of-state trust based on an in-state beneficiary.

The *Kaestner* case cited various precedents that remain intact related to the state taxation of non-resident trusts. One such precedent is *Safe Deposit & Trust Co. of Baltimore v. Virginia*,<sup>21</sup> which notes a common governing principle: The Due Process Clause demands an inquiry into the nature of what is controlled or possessed by the beneficiary and how that relates to the state's attempt to tax.

State income tax rules are often an important consideration for settlors in selecting trust situs, particularly for a non-grantor trust. Alaska, Florida, Nevada, South Dakota, Washington, and Wyoming

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19. See *McGuireWoods LLP State Death Tax Chart*, JD SUPRA (Jan. 3, 2018), <https://www.jdsupra.com/legalnews/mcguirewoods-llp-state-death-tax-chart-52446/>.

20. 139 S. Ct. 2213 (2019), *aff'g* 371 N.C. 133, 814 S.E.2d 43 (2018).

21. 280 U.S. 83 (1929).

are the six states that currently have perpetual or near perpetual trusts and no state income tax.<sup>22</sup>

#### G. DEALING WITH DIGITAL ASSETS

Digital asset is defined as “an electronic record in which an individual has a right or interest. The term does not include an underlying asset or liability unless the asset or liability itself is an electronic record.”<sup>23</sup> Essentially, a digital asset can be viewed as an online account.

The challenge in dealing with digital assets is that the accounts are governed by “terms of service” and “privacy policies.” Many of these terms of service seek to control what can and should be done with an account after someone dies.

Most of the fifty states have now passed some version of the Revised Uniform Fiduciary Access to Digital Assets Act (“RUFADAA”). RUFADAA seeks to provide executors, trustees, or court appointees with complete access to the digital assets of a deceased person. RUFADAA uses an approach that gives priority to directions given via an online tool over those in a will, trust, or power of attorney. In the absence of an online tool, then directions in a will, trust, or power of attorney will prevail. Otherwise, the terms of service will prevail.

In *In re Scandalios*,<sup>24</sup> the decedent’s will did not include any specific provisions concerning digital assets. The executor was trying to access digital photos stored in the decedent’s Apple accounts. Apple required a court order to authorize access. The court issued an order requiring Apple to provide access to the decedent’s photos, which included family pictures. The court made a distinction between access to electronic communications and the photographs, and it noted that the executor sought only digital property.

In *Matter of Coleman*,<sup>25</sup> the parents of a twenty-four-year-old who died in his sleep sought access to their son’s iPhone. The court denied the request and limited access to “non-content” information.

#### H. RULE AGAINST PERPETUITIES AND THE EVOLUTION OF LEGACY TRUSTS

The rule against perpetuities is a concept from common law that sought to prevent trust settlors from tying up assets in trust for lengthy periods beyond the settlor’s death. Where the rule against

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22. Daniel Worthington, Mark Merric, Ryan Thomas & John Sullivan, *Which Trust Situs Is Best in 2020?*, TR. & EST., Jan. 2020, at 75.

23. REVISED UNIF. FIDUCIARY ACCESS TO DIGITAL ASSETS ACT § 2-10 (2015).

24. No. 2017-2976/A (N.Y. Sur. Ct. Jan. 14, 2019).

25. 63 Misc. 3d 609 (2019).

perpetuities applies, the rule involves limiting the length of future interests that can be created by a trust settlor. In recent years, the trend has been for states to repeal the rule against perpetuities and allow perpetual trusts or to modify the rule to allow near perpetual trusts. Many states have adopted the Uniform Statutory Rule Against Perpetuities, which provides that a trust can continue for the greater of the rule against perpetuities or ninety years. As of early 2020, thirty-four states permit perpetual or near perpetual trusts. The ability to create perpetual or nearly perpetual trusts has resulted in many settlors adopting “dynasty” or “legacy” trusts.

#### I. SPENDTHRIFT CLAUSES

A spendthrift clause in a trust is a provision that seeks to protect beneficiaries from losing their inheritance to creditors. Generally, such a clause prohibits a beneficiary from assigning the beneficiary’s interest in the trust, and it prevents creditors from being able to reach the trust assets. The Uniform Trust Code requires that a spendthrift clause must restrain both voluntary and involuntary transfers.<sup>26</sup> A trust settlor might create a third-party trust (a trust created by a settlor for the benefit of someone else) and include a spendthrift clause to provide protection for the beneficiary from creditors. When a settlor creates a trust for a beneficiary, he or she typically has no obligation to do so.

Spendthrift provisions are viewed differently by different states and some states allow certain “exception creditors.”<sup>27</sup> A typical spendthrift clause might read as follows:

No rights of any of the beneficiaries of this trust estate shall be subject to assignment or to anticipation, or liable for any indebtedness or obligation of any beneficiary, or subject to any attachment or order, decree, judgment or process of any court on account of, or for the purpose of collecting, any such indebtedness or obligation. The Trustee shall not be required to make any disbursements to any assignee or creditor of any beneficiary or otherwise than into the hands of the beneficiary in person.

Exception creditors pursuant to the Uniform Trust Code include a beneficiary’s child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance; a judgment creditor that has provided services for the protection of a beneficiary’s interest in the trust; and a claim of State or the United

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26. UNIF. TRUST CODE § 502 (2000).

27. *Id.* § 503.

States.<sup>28</sup> Typically, to qualify as an exception creditor, the creditor must show that the beneficiary does not have other resources from which to make payment. The Uniform Trust Code provides that a spendthrift provision will be presumed to constitute a material purpose of a trust.<sup>29</sup>

In *In re Cameron Gift Trust*,<sup>30</sup> the South Dakota court ruled that a California court order requiring the trustee of a South Dakota trust to make child support payments in contravention of the Trust's spendthrift provisions was not entitled to full faith and credit. The trust had originally been created in California by the father of Cleopatra. Cleopatra got divorced and a California court ordered that spousal support, child support, and attorneys' fees be paid directly from the trust. The trust situs was changed to South Dakota. South Dakota does not have irrevocable third-party trust spendthrift clause exception creditors. Thus, the court ruled that enforcement of the California court rule would violate South Dakota law. It is important to note that the trust at issue was not a self-settled spendthrift trust case.

In *United States v. Harris*,<sup>31</sup> the court ruled that the beneficiary of two support trusts had a property interest subject to garnishment. The ruling was based on the premise that the beneficiary had a property interest in the trusts and given that interest, a spendthrift clause did not operate to prevent a creditor from reaching the beneficiary's interest in the trust. The parents of the beneficiary had created two support trusts for Michael Harris. One trust provided that the trustee "shall" make discretionary distributions of income for the beneficiary's support and "may" make discretionary distributions for the health, maintenance, education and best interest of the beneficiary. The second trust provided that the trustee may distribute income or principal for the beneficiary's support. In concluding that the beneficiary had a property interest, the court noted that the beneficiary had the right to compel distribution.

*In re Testamentary Trust of King*<sup>32</sup> is a case that should be noted because Nevada is a state that is well-known to be an asset protection trust. The opinion was issued by an Oregon court. The trustee of the trust was the surviving spouse of the settlor. The surviving spouse was also a beneficiary of the trust. The trustee made a loan to her son from a prior marriage. Suit was filed by the remainder beneficiaries. The Oregon court applied Nevada law and concluded that damages

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28. *Id.* § 503; see NEB. REV. STAT. § 30-3848 (2020).

29. UNIF. TRUST CODE § 411.

30. 2019 S.D. 35, 931 N.W.2d 244 (2019).

31. 854 F.3d 1053 (9th Cir. 2017).

32. 259 Ore. App. 176, 434 P.3d 502 (2018).

could be attributed to the trustee beneficiary's interest in the trust regardless of a spendthrift clause in the trust.

The validity of a spendthrift clause is an important aspect of asset protection in a trust. A spendthrift can be undermined in any trust where applicable law results in the beneficiary being treated as having ownership of trust assets. To the extent a beneficiary has a right over assets, a creditor will often be able to obtain access to such assets. As a result, careful consideration should be given to the design of a spendthrift trust as well as to the laws that will govern interpretation of the trust.

#### J. ASSET PROTECTION

Asset protection is about arranging access, ownership, control and management of assets in a manner that reduces exposure of assets to the risk of claims from creditors. Asset protection makes sense for almost anyone, but it should be considered for individuals in high risk professions, for individuals with substantial wealth (who are often targets), and to address family issues such as divorce, alcoholism, excessive spending habits, and possible disability.

Basic asset protection considers the state of residence of an individual and considers what assets can be protected from attachment by creditors. This is called exemption planning. Bankruptcy exemptions are a different matter and are not considered in this article. Asset protection may also involve consideration of moving to a state with more protective laws regarding asset protection.

Another basic form of asset protection is the use of a limited liability company ("LLC") to hold assets. A resident in one state can form an LLC in another state that provides more favorable asset protection for LLC members. Various states provide for various types of remedies against LLCs owned by a debtor.<sup>33</sup> Some states limit the remedies of creditors to a charging order, which allows a creditor to seize any distributions made to a member. Other states allow judicial foreclosure or dissolution. The goal of using an LLC in a protective state is to seek to create a structure whereby the creditor's sole remedy is a charging order.

#### K. DOMESTIC ASSET PROTECTION TRUSTS

Domestic asset protection trusts are self-settled trusts of which the settlor of the trust is a permissible beneficiary. Nineteen states currently allow the creation of self-settled trusts for asset protection

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33. NEB. REV. STAT. § 21-142 (2020) (allowing creditors to obtain a charging order or to seek judicial foreclosure).

purposes. The latest jurisdictions to enact legislation authorizing such trusts are Connecticut and Indiana. Such trusts are mentioned in this article only for purposes of identifying a trend to create such trusts. The focus of this paper, however, is on creating and taking advantage of various possibilities for improving the asset protection of a third-party trust—that is, a trust created by a settlor for someone else.

A domestic asset protection is sometimes used in lieu of, or in conjunction with, a premarital agreement. A settlor can create such a trust and be a potential beneficiary. Creating such a trust prior to marriage can avoid the need to disclose assets that is required with respect to premarital agreements. A domestic asset protection tool created during marriage (rather than before) will generally not work.

#### L. DISCRETIONARY TRUSTS

Trust law involves a dynamic tension between the right of the settlor of a trust to direct and protect the assets that the settlor places in trust via the design of the trust and the rights of the beneficiaries of the trust. Under common law, the beneficiary of a discretionary trust had no property interest in a trust or a right to a distribution. In addition, the discretionary power of a trustee could only be challenged for abuse of discretion.<sup>34</sup>

State statutes and case law have resulted in differing standards as to what will be considered a discretionary trust. Some states limit the definition of a discretionary trust to one that provides sole discretion to the trustee with no standards or guidelines. Other states define a discretionary trust as any trust which provides the trustee any discretion in making a distribution.

A third-party discretionary trust can provide asset protection that is different from the kind furnished by spendthrift provisions. The asset protection value of a discretionary trust is premised on the basis that a beneficiary has no enforceable right to a distribution. States seeking to preserve the absence of an “enforceable distribution right” model legislation on the *Restatement Second of Trusts (Restatement Second)*. The *Restatement Third of Trusts (Restatement Third)*, however, has changed the analysis in such a manner that a discretionary trust is likely to be considered to have created an enforceable right on the part of a beneficiary.<sup>35</sup>

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34. See RESTATEMENT (THIRD) OF TRUSTS § 50 (2003).

35. Worthington, *supra* note 23, at 82.

State laws defining a discretionary trust are an important consideration when creating a trust and determining situs. Changing situs can change the dispositive provisions of a trust.<sup>36</sup>

#### M. TRUST INTERESTS IN DIVORCE

One issue that arises with respect to marital estates is whether a beneficiary's interest in a trust is included in the marital estate. Historically, a settlor could create a third-party trust for his or her beneficiary and have a fair degree of confidence that the assets of such trust would be treated as assets acquired by gift that would be treated as separate property and would not be available to a divorcing spouse of a beneficiary. Recently, there has been a trend in divorce law that expands the types of interests that are considered property for division in a divorce. Jurisdictions vary widely in analysis of this issue, but more and more states are considering, in some manner, a beneficiary's interest in a third-party trust in making equitable division. The factors considered in determining whether a beneficiary has a property interest or mere expectancy include beneficiary's present possessory interest, distribution terms and standards, and the ability of the beneficiary to withdraw his or her interest.

A beneficiary may have different types of interests in a trust, including an income interest or an interest in principal. With respect to an income interest, a mandatory distribution will likely be considered a property interest. An income interest where the trustee has sole discretion to distribute will be considered an expectancy. With respect to a remainder interest in a third-party trust, some states consider whether the beneficiary's interest is vested or unvested. Other states look to whether the beneficiary's interest can be reduced to possession.

In *Levitan v. Rosen*,<sup>37</sup> the Massachusetts Court of Appeals ruled that an enforceable right to a distribution in a third-party trust was marital property. The trust was created by the parent of the beneficiary and the beneficiary had a life estate with a five percent annual power of withdrawal. The court viewed the effect of a spendthrift clause as limiting assignment to the divorcing spouse. It is noteworthy that the trust specified Florida as governing law. Because the divorcing beneficiary was a Massachusetts resident involved in a divorce under Massachusetts law, the court concluded that the trust interest was subject to Massachusetts law defining marital property.

In *Pfannenstiehl v. Pfannenstiehl*,<sup>38</sup> an appellate court ruled that a trust with an ascertainable standard was a marital asset. Ulti-

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36. *Id.* at 79.

37. 95 Mass. App. Ct. 248, 124 N.E.3d 148 (2019).

38. 88 Mass. App. Ct. 121, 37 N.E.3d 15 (2015).

mately, the Massachusetts Supreme Court ruled that such trust was not a marital asset.<sup>39</sup> Some states take the position that income interests are considered in a divorce proceeding.<sup>40</sup>

#### N. DIRECTED TRUSTS

Directed trusts are not a new concept but have become more popular in recent years. A directed trust typically divides the historic roles of the trustee into components that include such roles as investment committee, trust protector or advisor, and distribution committee. These various committees or roles have certain responsibilities and right to direct the trustee, which is typically an administrative trustee. This is different from a delegated trust, where the trustee typically holds significant authority but has the ability to delegate certain functions to third parties.

In the directed trust context, the administrative trustee typically holds title to assets, maintains a trust bank account, provides trust statements, and prepares trust tax returns. The administrative trustee will take direction from the investment committee and distribution committee.

Most states have adopted directed trust legislation. Legislation was initially adopted based on section 808 of the Uniform Trust Code or *Restatement Third of Trusts*. Some states have followed *Restatement (Second) of Trusts* section 185. In 2017, the Uniform Law Commission finalized the Uniform Directed Trust Act (“UDTA”)<sup>41</sup> in an effort to address issues raised by existing statutes. The UDTA has been adopted in ten states and introduced in several others. Adopting estates include Nebraska,<sup>42</sup> Arkansas (substantially similar), Colorado, Connecticut, Indiana, Maine, Michigan, Rhode Island, and Utah.<sup>43</sup>

#### O. TRUST PROTECTORS, ADVISORS, & DIRECTORS

The concept of a trust protector remains a relatively new concept. Generally, a trust protector is an individual, or a group, appointed and provided certain powers with respect to a trust. The trust protector has a variety of possible functions. One of those may involve simply providing third-party oversight. The key to the role of trust protectors

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39. *Pfannenstiehl v. Pfannenstiehl*, 475 Mass. 105, 115, 55 N.E.3d 933, 942 (2016).

40. *See Fox v. Fox*, 1999 N.D. 68, ¶ 17, 592 N.W.2d 541, 547 (1999).

41. UNIF. DIRECTED TRUST ACT (2017).

42. NEB. REV. STAT. § 30-4319 (2020).

43. *See Directed Trust Act*, UNIFORM L. COMMISSION, <https://www.uniformlaws.org/committees/community-home?CommunityKey=ca4d8a5a-55d7-4c43-b494-5f8858885d8> (last visited Mar. 15, 2020).

is how the roles are defined in the governing document creating the role.

Typical powers given to a trust protector might include: the ability to modify or amend a trust so that the trust remains consistent with the tax objectives of the settlor in the face of changes to tax laws, the ability to amend for a scrivener's error, the ability to add or eliminate the interests of trust beneficiaries; the power to change the trustee, the authority to veto or direct trust distributions, the power to change the trust situs, the authority to interpret trust provisions, and the ability to advise the trustee with respect to a beneficiary.

States vary widely on statutes related to trust protectors. Some have adopted specific trust protector statutes. Others have not. In some states that have not adopted specific trust protector statutes, the concept may be recognized by courts based on the creation of the role in a trust document.

The Uniform Directed Trust Act seeks to address the issues that arise when a power is given to someone other than the Trustee.<sup>44</sup> The Act includes a list of powers contemplated for a Trust Director.

The Uniform Trust Code does not include specific trust protector provisions but does provide some vague guidance about the power to direct. Uniform Trust Code section 808(b) states that:

If the terms of a trust confer upon a person other than the settlor of a revocable trust, power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise 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.<sup>45</sup>

Section 808(b) specifies that the terms of a trust may confer upon a person other than the trustee the power to direct modification or termination of the trust.

An issue regarding trust protectors and trust advisors has been the fiduciary duty of the role; however, a detailed discussion is beyond the scope of this article. It is worthy of note that the Uniform Trust Code states that a non-beneficiary with the power to direct has a fiduciary duty.<sup>46</sup> The Uniform Directed Trust Act provides that a trust advisor has a fiduciary duty.<sup>47</sup> The Act also provides a list of exclusions.<sup>48</sup>

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44. UNIF. DIRECTED TRUST ACT Prefatory Note (2017).

45. UNIF. TRUST CODE § 808(b) (2000).

46. *Id.* § 808(d).

47. UNIF. DIRECTED TRUST ACT § 8.

48. *Id.* § 5.

#### P. HISTORIC DISTRIBUTION STANDARDS

Historically, estate planning attorneys often worked with clients to decide the age at which trust assets should be distributed to beneficiaries as well as how much income and principal should be distributed. When parents are first considering ages of distribution for their children, it might be typical that the children are minors at the time of planning. A typical historic trust might provide that trust assets be held in trust for the life of the spouse and then be divided and distributed to the children at various ages. A typical provision might specify something like:

One third of the principal shall be distributed outright to my child when such child attains the age of 30; one half of the balance of the principal shall be distributed outright to my child when such child attains the age of 35; and the remainder of the trust assets when my child attains the age of 40. Prior to final distribution, the Trustee shall distribute such amounts of income to my children as the Trustee deems necessary for the health, education, maintenance and support ("HEMS") of my children.

The assumptions behind the ages of distribution were intended to consider such factors as likely maturity level and life stages. Unfortunately, it is extremely difficult to predict the right age for distribution of significant assets. What happens if, on the day after distribution is made to the beneficiary, a large judgment is entered against the beneficiary? What if the beneficiary becomes disabled shortly after distribution? What if the beneficiary's spouse chooses the day after distribution to file for divorce?

Most trusts provide distribution standards for both income and principal. The standards may vary. A trust might use the HEMS standard noted earlier or provide a percentage or a specific dollar amount. To the extent that a standard exists other than sole discretion on the Trustee, income and principal may be subject to the claims of creditors.

#### II. RECENT DEVELOPMENTS AND TRENDS AFFECTING TRUSTS IN ESTATE PLANNING

My personal approach to drafting trusts differently resulted less from the trends and more from having fifty-plus-year-old clients in my office say such things as: "Can you please tell my mom that I don't want a distribution outright? She wants to distribute my share outright to me because I have done well and am financially successful. That is exactly why I want her to create a trust for me that doesn't distribute outright. I want asset protection." Trends and changes in

the law are what allow drafters to create trust vehicles that can provide asset protection.

A. ASSET PROTECTION SPECTRUM

Some clients are very focused on asset protection. Others like the idea, but only to the extent that the asset protection does not unduly limit the access of a beneficiary to assets. Drafting a trust with the possibility of asset protection requires a balance between the settlor's desire to protect assets from creditors or predators of the beneficiary and the settlor's desire to allow the beneficiary access.

B. CONSIDERATIONS IN CREATING A TRUST WITH ASSET PROTECTION

1. *Create a Trust for the Life of the Beneficiary*

Rather than distributing assets to beneficiaries at certain ages, create a trust that lasts for the life of the beneficiary. Settlers worry about the beneficiary's ability to ultimately give assets to their spouse and children. That is readily resolved by providing the beneficiary a testamentary power of appointment.

When designing a life trust, the asset protection spectrum comes into play. If the settlor would have had the assets distributed outright to the beneficiaries without a discussion about asset protection, the trust design might be on the less protective end of the spectrum. The less protective end of the spectrum might include scenarios where the beneficiary can be trustee using other strategies to avoid such a trust being considered a vested interest or self-settled trust. The settlor can include provisions direction a trust protector to make changes to the trust in the event scenarios arise that threaten the asset protection purposes of the trust.

A settlor creating a life trust will often be concerned about the beneficiary's ability to provide for his spouse, children, or other beneficiaries. That is readily resolved by a general testamentary power of appointment. The type of any power of appointment should be carefully considered depending on overall objectives of the settlor and the related tax issues, but that discussion is beyond the scope of this article.

2. *Divide a Beneficiary's Share into More Than One Share*

A balance between access and asset protection can be achieved by creating two shares for the same beneficiary. One share can be designed to focus more on beneficiary access, while the other share can be focused on asset protection. The share providing access will have more exposure to creditors, but the second share can be very protec-

tive. This approach can provide a healthy balance between a settlor's interest in beneficiary access and in asset protection.

### 3. *Use a Sole Discretion Distribution Standard*

Provide that the trustee has the sole discretion to make distributions. Stop there. A trust that provides sole discretion regarding the distribution of income and principal will be treated as a discretionary trust in almost any state. A settlor may want assurance that the beneficiary will be able to receive income. A simple modification of the sole discretion standard is to add the historic and well-respected ascertainable standard of distribution for the Health, Education, Maintenance, and Support ("HEMS") of the beneficiary but this modification may subject a trust to creditors. To the extent that a trust provides specific standards, the more likely that, in some jurisdictions, the trust will be treated as a property interest. Given that the HEMS standard is a well-known ascertainable standard, some courts consider the amount to be calculable.

### 4. *Identify Asset Protection as a Material Purpose*

Avoid using a template "material purpose" clause. Consider the objectives of the settlor. If one of the settlor's objectives is to create asset protection for his or her beneficiaries, then be sure to indicate the same. Also specify any desire of the settlor to have the assets remain in trust for the longest period of time possible.

### 5. *Consider Trustee and Trustee Succession*

For the settlor who wants the beneficiary to have as much control as possible, such beneficiary can be named as trustee. For the settlor who wants to prevent a beneficiary from dissipating assets or subjecting the assets to creditors, consider who to name as trustee and how to create succession. Avoid giving a beneficiary (that the settlor is seeking to protect) the ability to successively name trustees until he or she gets the trustee that will do what he or she wants.

If the beneficiary is named as trustee, create a mechanism (other than appointment by the beneficiary trustee) to add a co-trustee. Also create a mechanism to remove the beneficiary as trustee.

To the extent that any beneficiary is acting as a trustee with respect to a trust share created for such beneficiary, the more likely it is that the assets of the trust will be considered a property interest of the beneficiary. Thus, it is typically best to use a trustee other than the beneficiary.

6. *Use a Trust Protector*

A trust protector can have the right to veto and compel distributions. This power can be used by a trust protector to direct that distributions be made to a beneficiary or to discontinue them. The trust protector can also be directed to make changes that protect the trust in the event that a beneficiary of the trust becomes disabled, goes through a divorce, or is being pursued by a creditor. For example, if the beneficiary is a trustee or co-trustee of a trust, a trust protector can be directed to remove the beneficiary as a trustee and take such other actions as may be necessary to protect the spendthrift protection of the trust and to ensure that the trust is not treated as a property interest. It is important that the trust protector be directed to act by the settlor's direction to the trust protector in the trust document, and not by the beneficiary.

A trust protector can also have the right to add or change beneficiaries of a trust. If a trust protector can eliminate a beneficiary from a share or add a beneficiary to a share, the interest becomes more of an expectancy.

7. *Include Provisions in a Trust that Contemplate Divorce*

Include provisions that eliminate any rights that a spouse of a beneficiary might have in the event of a filing for divorce. Treat a divorcing spouse and all issue who are not also issue of the settlor as deceased on the date of a filing.

8. *Provide a Mechanism to Allow for Delay of Distribution*

Create the ability of someone other than the beneficiary to delay distribution. Specify the reasons for which distribution can be delayed and indicate the material purpose connection for any delay.

9. *Avoid Template Spendthrift Provisions*

Many trust drafters have a standard spendthrift provision in their trust documents. Instead of simply using the template, add additional and unique language clarifying the settlor's objectives regarding the inclusion of the spendthrift clause. Although the Uniform Trust Code specifies that a spendthrift clause constitutes a material purpose, state laws vary. Thus, state that the spendthrift clause is a material purpose of the trust rather than relying on how a particular jurisdiction might be treating such provisions.

10. *Include Language Permitting or Preventing Modification or Decanting*

Most states allow trust modification, non-judicial settlements or decanting. Some states require language in the trust allowing these actions to be taken. Given the possibility of changing trust situs, a settlor should carefully consider any language that is included allowing modification or decanting. Rather than simply specifying a broad power to make changes to the trust, specify the reasons for which a modification can be made. Consider including a provision that prevents early termination. Such a provision will enhance asset protection.

11. *Consider a Clause that Disinherits a Beneficiary Who Seeks to Modify a Trust*

Limiting the power of a beneficiary to make changes will generally limit the ability of creditors to step into the shoes of the beneficiary. When drafting such a provision, consider the applicable state law and apply the law of a state that will enforce the provision.

12. *Consider Trust Situs and Governing Law*

Many trust drafters automatically make the current state of residence the trust situs and governing law. The best situs for a trust depends on a multitude of factors.<sup>49</sup> Make trust situs and governing law a conscious decision in trust drafting. Include provisions which allow for a change of situs and change of governing law. Some states routinely modify their laws to make their states more competitive in attracting trusts. Changes to the state rules on trusts are a constant. Create the ability for the trust to be moved to a state where the laws are consistent with settlor objectives of asset protection. Do give consideration to connections of the trust to jurisdictions and be careful to avoid subjecting the trust to state laws unwittingly by such issues as naming an individual trustee in a state that will use that status to connect the trust to the state.

Although the Uniform Trust Code provides that governing law shall be that specified in the trust, there is an exception if that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue.<sup>50</sup>

Note that the Uniform Directed Trust Act provides that the act applies to any trust that has its principal place of administration in

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49. Worthington, *supra* note 23, at 79.

50. UNIF. TRUST CODE § 107 (2000).

the state.<sup>51</sup> The provision is included to link conflict of laws rules to the principal place of administration.<sup>52</sup>

*13. Create a Directed Trust and Bifurcate Duties*

Directed trusts bifurcate the duties among a variety of entities or individuals. The more that duties and control is allocated to those other than the beneficiary, the more the beneficiary's trust interest is an expectancy.

*14. Consider State Income Tax Issues in Trust Design*

State income taxes can also diminish the assets of a trust. States have gotten very aggressive in pursuing trusts as being taxable based on any type of connection to the state. Carefully consider residence of settlor, trustees, beneficiaries and location of assets when creating a trust.

*15. Create a Perpetual or Near Perpetual Trust*

A trust that lasts for a longer period of time and has more beneficiaries is less likely to be considered a property interest of any one of the beneficiaries. A settlor who prefers to ensure that his primary beneficiary has as much benefit from the trust as possible will likely not choose this approach, but for the settlor focused on long term protection, dynasty trusts improve asset protection prospects.

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51. UNIF. DIRECTED TRUST ACT § 3(a) (2017).

52. *Id.* § 3 cmt.



**A MORE SUITABLE VESSEL:  
TRUST DECANTING AND THE FUTURE  
OF TRUST MODIFICATION  
IN NEBRASKA**

BY ALEXANDER J. WOLF,<sup>†</sup> ANTHONY P. DELUCA,<sup>†</sup>  
AND NICHOLAS W. O'BRIEN<sup>†</sup>

I. INTRODUCTION

The fact that a trust is “irrevocable” does not actually mean it cannot be changed. This is a widely-known secret in the estate planning world. Indeed, practitioners have the luxury of utilizing an increasing number of tools to modify irrevocable trusts. Historically, parties have relied on courts, non-judicial settlement agreements, or the exercise of special powers of appointment to achieve such modification. Today, however, another tool—that of “decanting”—has emerged as an increasingly popular method of achieving many of the same irrevocable trust modification goals. The specific trust modification tools available, and the breadth of their utility, largely depends on the trust situs and the laws of that jurisdiction. In Nebraska, a bill currently working its way through the Legislature would make decanting available to Nebraska practitioners for the first time. With decanting legislation coming into focus in Nebraska, now is an ideal time for local practitioners to take a closer look at the history of decanting; the status of uniform decanting laws, both nationally and under state law; the uses and benefits of decanting; and examples of the technical and practical considerations attorneys and fiduciaries should consider when seeking to decant.

The classic metaphor for trust decanting, and the namesake for the procedure, is wine decanting. If a person has average or unfit wine, it may be desirable to pour the wine through a decanter and into another container, thereby preserving or improving the quality and taste of the wine. Decanting in the context of trusts allows the trustee to “pour” the assets of an ill-fitting, inflexible, or otherwise deficient trust into a new trust with modified or improved terms intended to better suit the needs of the involved parties. In other words, the process of decanting allows for changes and corrections to a trust, with the added benefit of streamlining the sometimes-cumbersome process

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<sup>†</sup> President and Shareholder, Koley Jessen.

<sup>†</sup> Senior Associate, Koley Jessen.

<sup>†</sup> Associate, Koley Jessen.

of entering into a non-judicial settlement agreement or pursuing judicial modification.

The use of decanting during a trust administration has become increasingly common as trustees and beneficiaries look for ways to modify the terms of an otherwise irrevocable trust due to circumstances that have changed or were not adequately contemplated at the time the trust was executed. State enactments and uniform law proposals now provide a set of decanting rules that are designed to (i) permit increased flexibility to further a settlor's intent and protect the beneficiaries' interests and (ii) prevent abuses by a decanting fiduciary.

## II. A BRIEF HISTORY OF DECANTING LAWS NATIONALLY

The birth of decanting can be traced back to the common law. The common law of trusts recognized decanting, as a conceptual power of a trust fiduciary, for decades before formal legislation was enacted to define the power. The Restatement (Second) of Property recognized that a trustee who has discretionary authority over trust principal has the authority to vest the beneficial interests in the property of a trust.<sup>1</sup> If the trustee is not limited in the exercise of its powers to direct the distribution of trust property, the exercise of its discretion may properly be characterized as a special power of appointment which the trustee may use to distribute property to a trust beneficiary in further trust.<sup>2</sup> The Restatement (Third) of Property further clarified the use of this power by explicitly stating that the holder of a special power of appointment may exercise such power by appointing property in trust, unless indicated otherwise.<sup>3</sup> This understanding of trustee discretion led courts in a number of states to find that the common law supported a trustee's authority to appoint property in a way that allowed for the trustee to effectively decant the assets of the trust.<sup>4</sup> Despite this, the ability of a trustee to decant has not been specifically addressed under the common law in a vast majority of the states, leaving the availability or scope of trust decanting in question. This uncertainty prompted the introduction of state decanting legislation.

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1. Restatement (Second) of Prop.: Donative Transfers § 11.1 cmt. d (1986).

2. See *In re Estate of Mayer*, 176 Misc. 2d 562, 672 N.Y.S.2d 998 (Sur. Ct. 1998); RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 19.4(1), cmt. a.

3. RESTATEMENT (THIRD) OF PROP.: WILLS AND OTHER DONATIVE TRANSFERS § 19.14 (2011).

4. *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940); *Wiedenmayer v. Johnson*, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969); *In re Estate of Spencer*, 232 N.W.2d 491 (Iowa 1975); *Morse v. Kraft*, 992 N.E.2d 1021 (Mass. 2013).

Decanting legislation was slow to appear, but has expanded rapidly over the last decade through a movement initiated by New York, which was the first state to enact a formal decanting statute, effective as of July 1992.<sup>5</sup> Although originally intended to allow a trustee to extend the term of a grandfathered generation-skipping transfer trust to take advantage of the trust's exemption from the generation-skipping transfer tax, the statute ultimately permitted broader action. The New York statute, as now amended, allows an expansion of the trustee's special power of appointment, authorizing the trustee to invade trust principal and to appoint such principal to the trustee of an appointed trust for the current beneficiaries of the invaded trust.<sup>6</sup> Further, the New York statute allows a trustee—even one without unlimited discretion—to appoint principal in further trust, so long as the current, successor, and remainder beneficiaries of the appointed trust are the same as the current, successor, and remainder beneficiaries of the original trust.<sup>7</sup>

New York's legislation began a slow-burning movement to adopt trust decanting legislation throughout the nation. By 2009, seven other states had adopted state decanting statutes. Today, nearly thirty years after enactment of the New York statute, a majority of states permit decanting in some form. In twenty-nine of the jurisdictions that permit decanting, the power is provided by legislation that directly defines the decanting power.<sup>8</sup> Other states provide a more general power for a trustee to appoint assets in favor of the trustee of another trust based upon the discretionary authority granted to the trustee or, alternatively, allow the trustee to exercise powers of modification in a way that allows for appointment of trust assets to a new trust.<sup>9</sup> As a result of the relative patchwork of decanting approaches among the states, the powers granted to trustees and the accompany-

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5. N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2015).

6. *Id.* § 10-6.6(b).

7. *Id.* § 10-6.6(c).

8. ALA. CODE § 19-3D-1 *et seq.* (2019); ALASKA STAT. § 13.36.157 *et seq.* (2019); ALASKA STAT. § 13.36.215 (2019) (definitions); CAL. PROB. CODE § 19501 *et seq.* (West 2019); COLO. REV. STAT. § 15-16-901 *et seq.* (2019); FLA. STAT. § 736.04117 (2019); GA. CODE ANN. § 53-12-62 (2019); 760 ILL. COMP. STAT. 3/1201 *et seq.* (2019); IND. CODE § 30-4-3-36 (2020); KY. REV. STAT. ANN. § 386.175 (West 2014); MICH. COMP. LAWS § 556.115a (2012); MICH. COMP. LAWS § 700.7820a (2012); MINN. STAT. § 502.851 (2020); N.C. GEN. STAT. § 36C-8B (2019); N.M. STAT. ANN. § 46-12-101 *et seq.* (2019); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2015); NEV. REV. STAT. § 163.556 (2019); N.H. REV. STAT. ANN. § 564-B:4-418 (2017); OHIO REV. CODE ANN. § 5808.18 (2013); S.C. CODE ANN. § 62-7-816A (2014); S.D. CODIFIED LAWS §§ 55-2-15 to -21(2020); TEX. PROP. CODE ANN. §§ 112.071 – .087 (West 2017); VA. CODE ANN. § 64.2-779 (2019); WASH. REV. CODE § 11.107 (2017).

9. ARIZ. REV. STAT. ANN. § 14-10819 (2018); DEL. CODE ANN. tit. 12, § 3528 (2019); MO. REV. STAT. § 456.4-419 (2019); N.D. CENT. CODE § 59-16.1-01 *et seq.* (2019); 18 R.I. GEN. LAWS § 18-4-31 (2020); TENN. CODE ANN. § 35-15-816(b)(27) (2020); § 701.0418;

ing restrictions placed on the decanting power differ substantially depending upon the law of the relevant jurisdiction.<sup>10</sup>

In an attempt to create a more uniform and approachable set of decanting rules, and in response to the increase in the multijurisdictional practice of law, the National Conference of Commissioners on Uniform State Laws, also known as the Uniform Law Commission (“ULC”), enacted the Uniform Trust Decanting Act (“UTDA”) in 2015.<sup>11</sup> The ULC’s uniform laws allow for rules and procedures to remain consistent between states in areas of law where uniformity is beneficial to individuals and businesses who may operate between the various states.<sup>12</sup> Although the UTDA is still less than five years old, it has now been enacted in eight states.<sup>13</sup> Furthermore, UTDA legislation has been introduced in three states, including Nebraska, illustrating a quickly growing national movement to achieve uniformity with regard to trust decanting powers.<sup>14</sup>

### III. DECANTING LEGISLATION IN NEBRASKA

In Nebraska, decanting legislation is currently before the state Unicameral. Spearheaded by Senator Patty Pansing Brooks, Legislative Bill 902 was introduced on January 9, 2020 urging the Nebraska legislature to adopt a version of the Uniform Trust Decanting Act (“UTDA”).<sup>15</sup> The bill also includes a related amendment to NEB. REV. STAT. § 76-902 to ensure that transfers of property completed pursuant to the decanting power will be exempted from Nebraska documentary stamp tax. Although based on the UTDA, it is anticipated the Nebraska Uniform Trust Decanting Act (“NUTDA”), if adopted, will deviate from the version adopted by the ULC in three key respects.

First, the NUTDA, as proposed, includes provisions requiring delivery of notice in accordance with the recently-enacted Nebraska Uni-

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WYO. STAT. ANN. § 4-10-816(a)(xxviii), (b) (2019); N.H. REV. STAT. ANN. § 564-B:4-419 (2017).

10. Compare, e.g., CAL. PROB. CODE §19501 *et seq.* (West 2019) (enacting the Uniform Trust Decanting Act, including detailed descriptions of the decanting power and specific restrictions), with MO. REV. STAT. § 456.4-419 (2019) (providing generally that a trustee with discretion to make distributions may appoint trust property in further trust).

11. UNIF. TRUST DECANTING ACT (2018).

12. *Id.*

13. ALA. CODE 1975 § 19-3D-1 *et seq.* (2019); CAL. PROB. CODE § 19501 *et seq.* (West 2019); N.C. GEN. STAT. § 36C-8B (2019); WASH. REV. CODE § 11.107 (2017); VA. CODE ANN. § 64.2-779 (2019); N.M. STAT. ANN. 1978 § 46-12-101 *et seq.* (2019); COLO. REV. STAT. § 15-16-901 *et seq.* (2019).

14. L.B. 902, 106th Leg., 2d Sess. (Neb. 2020); S. 668, 2020 Leg., Reg. Sess. (W. Va. 2020); S. 896, 2019 Leg., 191st Gen. Court (Mass. 2019).

15. Neb. L.B. 902.

form Directed Trust Act.<sup>16</sup> The Nebraska Uniform Directed Trust Act authorizes and governs irrevocable “directed trusts”—those trusts over which a “trust protector,” “trust advisor,” or other non-trustee has authority over some facet of the trust’s administration.<sup>17</sup> Specifically, the proposed NUTDA ensures that persons serving in these additional roles receive appropriate notice.<sup>18</sup>

Second, it is anticipated that the NUTDA, if enacted, will include provisions intended to avoid circumventing the intent of NEB. REV. STAT. § 77-2008.03, which addresses the manner of assessing Nebraska Inheritance Tax on assets subject to a special power of appointment.<sup>19</sup>

Lastly, the NUTDA includes language prohibiting a trustee from decanting assets from a trust with a spendthrift provision to a trust without one.<sup>20</sup> This provision is intended to preserve the protection of an irrevocable trust against potential creditors of a trust beneficiary. Inclusion of this language is intended to harmonize the NUTDA with the general rule that, under Nebraska law, a beneficiary’s creditor or assignee may reach the beneficiary’s interest in a trust that is not subject to a spendthrift provision.<sup>21</sup> Further, existing Nebraska law prohibits a beneficiary from transferring an interest in trust in violation of a spendthrift provision.<sup>22</sup>

As of writing this article in early March 2020, the proposed NUTDA (LB 902) has passed through the Banking, Commerce, and Insurance Committee of the Nebraska Legislature with no negative comment and has been placed on the general file.<sup>23</sup> While not yet enacted, and still pending suggestions for amendment before a final reading and first vote, the legislation is supported by the Nebraska State Bar Association and is expected to be enacted.

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16. NEB. REV. STAT. §§ 30-4301 to 30-4319 (2020).

17. *Id.* The Nebraska Uniform Directed Trust Act, effective January 1, 2021 (with prospective applicability for trusts that (i) were created prior to September 7, 2019 and (ii) have a principal place of administration in Nebraska, but only as related to decisions or actions occurring on or after September 7, 2019), is based upon the Uniform Directed Trust Act.

18. Neb. L.B. 902.

19. NEB. REV. STAT. § 77-2008.03 (directing that a special power of appointment, if present as of the donor’s date of death, shall be not be deemed a transfer from the donor to the donee of the power, but shall be deemed a transfer of the interest in property subject to the power from the donor of the power to the specific beneficiary or class of beneficiaries as of the date of the donor’s death).

20. Neb. L.B. 902.

21. NEB. REV. STAT. § 30-3846.

22. *Id.* § 30-3847(c).

23. Neb. L.B. 902.

#### IV. RATIONALE FOR DECANTING

With local decanting legislation on the horizon, practitioners are undoubtedly eager to understand the potential uses and practicality of trust decanting. Through the expansion and growing uniformity of decanting laws, the decanting power has evolved to permit a broader range of acts which permit practitioners and fiduciaries to reform irrevocable trusts—within reasonable limits—to ensure the settlor's original intent is achieved while also accounting for potential change in beneficiary circumstance or applicable laws. As an added benefit, decanting is often far easier to accomplish when compared to irrevocable trust modification pursued through the courts or non-judicial settlement agreements.

##### A. USES AND BENEFITS OF DECANTING

Through exercise of its decanting powers, a trustee may distribute property of a trust (“first trust”) to one or more other trusts (“second trusts”) to correct administrative and dispositive terms which are outdated, impractical, or not necessary to carry out the settlor's intent.<sup>24</sup> As a result, if the terms of the first trust have become obsolete due to changing circumstances, or if tax laws have been amended in a way such that administration of the first trust will yield an undesired or un contemplated result, decanting may be employed to (i) adjust and modify the terms of the first trust or (ii) transfer the assets of the first trust to one or more second trusts containing terms better suited to achieve the original settlor's intent in the context of evolving beneficiary circumstances and law.

In the most basic sense, decanting provides the flexibility and opportunity to “clean up” many aspects of a trust's administrative terms. Often, a decanting may simply correct drafting errors in the first trust, preserving the interests of the beneficiaries while ensuring that the administrative terms of the trust can be administered without mistake. A decanting may also divide and reallocate the responsibilities of the trust's fiduciaries, allowing more than one person to split the responsibilities formerly placed on a single fiduciary's shoulders by the original document. The decanting power may also be used to modify the rights of the trust's beneficiaries in material ways by accelerating or delaying distributions or by affecting a beneficiary's powers of appointment.

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24. *But see* Neb. L.B. 902 § 2(10) (defining “decanting power” to include simple modification of the terms of the first trust and instances where property of a first trust is actually distributed to one or more second trusts). *See also id.* § 23 (defining “second trust” to mean (i) a first trust after modification or (ii) a trust to which distribution of property from a first trust is or may be distributed).

Looking broadly, trust decanting can be carried out to (i) change administrative provisions; (ii) further settlor intent; (iii) change or modify fiduciaries; (iv) divide, merge, or consolidate trusts; (v) correct scrivener's errors or drafting ambiguities; (vi) modify beneficiary rights (e.g., accelerating or delaying distributions or eliminating mandatory income distributions); or (vii) add or eliminate powers of appointment.<sup>25</sup>

## B. COMPARATIVE EASE

A decanting power generally allows a trustee to modify a trust through the relatively simple actions of providing the required notices and adopting a resolution. In situations where the trustee seeks to effectuate a decanting by transferring the assets of a first trust to one or more second trusts, the additional steps of drafting such second trust(s) and arranging for property to be transferred accordingly will be required. Despite these potential additional actions, decanting is still a comparatively streamlined mechanism for modifying irrevocable trusts. The decanting procedure allows for efficient modification of irrevocable trusts, which generally cannot be changed by a settlor's declaration alone and often involve the increased administrative expense and time associated with court involvement. For example, under current Nebraska law, most methods of trust modification require court approval.<sup>26</sup> While not without significant utility, modifying a trust through judicial modification will require consent of all of the trust beneficiaries (and could also require settlor consent) or a court determination regarding the legal permissibility of the proposed modification.<sup>27</sup> The Nebraska Uniform Trust Decanting Act ("NUTDA"), by contrast, would generally allow a fiduciary to decant—within limits—without approval of a court and with fewer active participants.<sup>28</sup>

In this respect, decanting is particularly useful in the context of administering "special-needs trusts" established for the benefit of an

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25. The authors note that caution should be exercised when modifying beneficial interests or adding or eliminating general powers of appointment as there can be unintended tax consequences.

26. NEB. REV. STAT. § 30-3837 (2020) (allowing modification of an irrevocable trust by consent of the beneficiaries); *id.* § 30-3838 (allowing modification because of unanticipated circumstances or inability to administer the trust effectively); *id.* § 30-3839 (allowing modification to accomplish charitable purposes); *id.* § 30-3840 (allowing modification of trusts with insufficient value to justify administration); *id.* § 30-3841 (allowing reformation to correct mistakes); *id.* § 30-3842 (allowing modification to achieve tax objectives).

27. *Id.* § 30-3837(a)-(e).

28. L.B. 902 § 7(b), 106th Leg., 2d Sess. (Neb. 2020); *see also* UNIF. TRUST DECANTING ACT § 7(b) (2018).

individual receiving means-tested government assistance benefits. In these instances, decanting can permit a trustee to correct or adapt the terms of a special needs trust to ensure more reliable preservation of benefits eligibility for the trust beneficiary or, if necessary, decant a trust that may otherwise endanger benefits eligibility to a second trust containing provisions intended to preserve such eligibility.<sup>29</sup> In this regard, the NUTDA, as proposed, specifically allows for expanded decanting powers to modify special needs trusts through decanting.<sup>30</sup> This allows great flexibility where an individual with particular needs but limited resources may otherwise be unable to bear the administrative cost of court modification. Additionally, the proposed NUTDA provides increased decanting powers for special needs trusts, which allows a trustee to decant regardless of the level of discretion the trustee is provided in the trust instrument.<sup>31</sup>

Comparatively, decanting also provides a less restrictive alternative to irrevocable trust modification through non-judicial settlement agreements, which have been the primary alternative to court modification in states like Nebraska. Under existing law, the matters that can be addressed or resolved by non-judicial settlement agreements are limited in Nebraska.<sup>32</sup> Further, modification through a non-judicial settlement agreement requires the agreement of all interested persons, which can create practical hurdles and delays.<sup>33</sup>

## V. PRACTICAL CONSIDERATIONS

Although the Nebraska Uniform Trust Decanting Act (“NUTDA”), if enacted, will provide practitioners with greater planning flexibility, it will neither eliminate the need to comply with statutory formalities nor absolve the trustee from complying with their underlying fiduciary duties. The fiduciary role is at the heart of the Uniform Trust Decanting Act (“UTDA”) and proposed NUTDA.

### A. AN INHERENTLY FIDUCIARY POWER

Under the NUTDA, decanting is viewed as an inherently fiduciary power—that is, only a fiduciary, subject to fiduciary duties, may decant a trust. As a result, a non-fiduciary such as a “distribution advisor” who is not subject to fiduciary duties, may not exercise the power to decant. Further, the NUTDA gives fiduciaries the *power* to decant but does not create or imply a *duty* to decant, still requiring a

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29. Neb. L.B. 902 § 13(b)-(c); *see also* UNIF. TRUST DECANTING ACT § 13.

30. Neb. L.B. 902 § 13(b)-(c).

31. *Id.*

32. NEB. REV. STAT. § 30-3811(d).

33. *Id.* § 30-3811(a)-(b).

fiduciary to comply with its fiduciary duties when pursuing trust modification through decanting.

The decanting power cannot be used to undermine the trustee's fiduciary duties to the beneficiaries. The trustee should only exercise its decanting power in furtherance of the trust purposes and in furtherance of the interests of the beneficiaries. As a mechanism to prevent abusive use of the decanting power, the NUTDA and other state laws provide for specific statutory limitations on the scope of a fiduciary's decanting authority. For example, the NUTDA prohibits a trustee from using the decanting power to increase its own compensation without court approval.<sup>34</sup> The proposed NUTDA also prevents the trustee from reducing his liability for breaches of trust or to otherwise reduce fiduciary liability for the trustees in the aggregate.<sup>35</sup>

#### B. IDENTIFYING THE SCOPE OF DECANTING

Generally speaking, the scope of a trustee's decanting authority is tied to the distributive discretion granted to the trustee under the terms of the first trust. In this regard, the proposed NUTDA draws a distinction between the decanting authority granted to fiduciaries whose distributive discretion over principal is subject to an ascertainable standard or reasonably definite standard ("limited distributive discretion") and those fiduciaries with broader distribution authority ("expanded distributive discretion").

Logically, a fiduciary with expanded distributive discretion is granted a correspondingly expansive power to modify beneficial interests.<sup>36</sup> Conversely, a fiduciary subject to limited distributive discretion is granted a much narrower decanting power. In these instances, the NUTDA requires that the second trust(s), in the aggregate, must grant each beneficiary of the first trust beneficial interests which are "substantially similar" to the beneficial interests present in the first trust.<sup>37</sup> In practicality, this means that a trust containing an ascertainable standard (or similar) cannot be decanted to remove that standard or to impose additional distribution restrictions. Decanting will only extend to modification of administrative provisions in such instances.

#### C. COMPLIANCE WITH ACT REQUIREMENTS AND FORMALITIES

If enacted, the NUTDA will provide a roadmap for exercising the decanting power. While more straightforward than other statutory ir-

34. L.B. 902 § 9(b)(1), 106th Leg., 2d Sess. (Neb. 2020).

35. *Id.* § 17(a); *see also* UNIF. TRUST DECANTING ACT § 17(a).

36. L.B. 902 § 2(11), 106th Leg., 2d Sess. (Neb. 2020); *id.* §§ 11, 13.

37. L.B. 902 § 12, 106th Leg., 2d Sess. (Neb. 2020).

revocable trust modification mechanisms, practitioners and fiduciaries still must pay careful attention to the act requirements and formalities. Good practice will necessitate preparation of a formal resolution containing background information and recitals setting forth the specific decanting actions that will be taken, delivery of notice in accordance with the statutory requirements, and, in instances involving a second trust, careful effectuation of the asset transfers to be completed as part of the decanting process.

A decanting fiduciary must ensure that proper written documentation is prepared to record the decanting.<sup>38</sup> In doing so, a fiduciary should begin by preparing a resolution with background information and recitals presenting the reason for the decanting. In instances where the decanting will involve creation and funding of a second trust, the second trust should be clearly documented through a new trust instrument or, alternatively, by clear reference to the provisions which are to be different from the first trust. The trustee should also acknowledge that the terms of the second trust may be limited by state law or the terms of the governing instrument.

Of particular importance is compliance with the statutory notice requirements. “Private decanting”—decanting without a requirement that notice be provided to the trust beneficiaries—is permitted in seven states, not including Nebraska.<sup>39</sup> The NUTDA, as proposed, will require the fiduciary seeking to exercise a decanting power to deliver notice of the exercise of such decanting power not later than sixty days prior to the exercise to a class composed of (i) each settlor of the first trust, if living; (ii) each qualified beneficiary of the first trust; (iii) each holder of a presently exercisable power of appointment over any part or all of the first trust; (iv) each other fiduciary of the first trust; (v) each fiduciary of the second trust (to include the fiduciaries of a modified first trust); (vi) each person acting as a trust advisor or protector of the first trust; (vii) each person holding an adverse interest who has the power to consent to a revocation of the first trust; and (viii) the Attorney General in certain circumstances involving determinable charitable interests.<sup>40</sup>

Finally, and perhaps obviously, in situations where the decanting involves the creation of a separate second trust, the fiduciary must ensure that the transfer of property from the first trust to the second trust is actually completed, including changes to all titling arrange-

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38. *Id.* § 10; *see also* UNIF. TRUST DECANTING ACT § 10 (2018).

39. ARIZ. REV. STAT. ANN. § 14-10819 (2018); DEL. CODE ANN. tit. 12, § 3528 (2019); N.H. REV. STAT. ANN. § 564-B:4-419 (2017); NEV. REV. STAT. § 163.556 (2019); S.D. CODIFIED LAWS §§ 55-2-15 to -21 (2020); TENN. CODE ANN. § 35-15-816(b)(27) (2020); WYO. STAT. ANN. § 4-10-816(a)(xxviii), (b) (2019).

40. L.B. 902 § 7, 106th Leg., 2d Sess. (Neb. 2020).

ments applicable to trust assets. While the proposed NUTDA contains remediation provisions to help rescue “imperfect” decantings, it does not appear to contemplate an attempted decanting where the assets were not transferred.<sup>41</sup> If a proposed decanting is documented, the provisions of the first trust remain unchanged, and the assets of the first trust are never transferred to the intended second trust, there is risk that the decanting could be moot, yielding the same result as if no decanting had been pursued.

#### D. TAX CONSIDERATIONS

Trust decanting, when done thoughtfully, generally does not result in adverse income tax, gift tax, or estate tax consequences subject to some *very* notable exceptions. While a detailed analysis of the associated tax rules is beyond the scope of this Article, the information below contains a high-level summary of some of the most relevant considerations.

Generally speaking, trust decanting will not trigger federal income tax consequences.<sup>42</sup> From a federal income tax standpoint, the grantor of the first trust will generally be considered the grantor of the second trust in the context of decanting.<sup>43</sup> Further, if both the first trust and second trust are grantor trusts as to the same person, then, generally speaking, there will not be federal income tax consequences to the decanting.<sup>44</sup> There are two prominent exceptions to this general rule. First, if decanting causes a beneficiary’s interest in the second trust to be “materially different” than that present in the first trust, the decanting may be deemed a sale or exchange for federal income tax purposes<sup>45</sup> unless the change is authorized under state law and does not require beneficiary consent.<sup>46</sup> Second, if the decanting involves the transfer of assets having liabilities in excess of tax basis,

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41. *Id.* § 22.

42. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 201722007 (Feb. 16, 2017).

43. *See* Treas. Reg. § 1.671-2(e)(5) (2019).

44. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

45. *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554 (1991); *Evans v. Comm’r*, 30 T.C. 798 (1958); *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969) (holding that an exchange of property results in realization of gain or loss under I.R.C. § 1001 if the properties exchanged are materially different and the transfer requires the approval of the beneficiaries).

46. I.R.S. Priv. Ltr. Rul. 200013015 (Dec. 22, 1999) (ruling that a partition of trust and changes to administrative provisions would not cause beneficiaries to realize gain when beneficiaries’ interests were the same as in the first trust); Treas. Reg. § 1.1001-1(h) (2019); I.R.S. Priv. Ltr. Rul. 200810019 (Nov. 30, 2007) (ruling that conversion of an income interest to a unitrust interest did not result in adverse income, gift, or generation-skipping tax consequences); *but see* Treas. Reg. § 1.643(b)-1 (providing that a switch from an income interest to a unitrust interest may cause the trust or its beneficiaries to recognize gain if such switch is “not specifically authorized by state statute, but valid under state law”).

the decanting could trigger recognition of gain to the extent such liabilities exceed such basis.<sup>47</sup> Further, if the decanting results in the conversion of a grantor trust to a non-grantor trust, the modification may result in a taxable exchange and trigger a recognition event as to the transferring trust.<sup>48</sup>

When considering federal gift tax in the context of decanting, practitioners and fiduciaries should pay close attention to the beneficial interests in the first and second trusts, as well as the parties to the decanting transaction. Federal gift tax consequences may result if the decanting results in (i) a shift in beneficial interest and (ii) one or more of the following is true: (a) the trustee exercising the decanting power has a beneficial interest in the first trust;<sup>49</sup> (b) a beneficiary can prevent a decanting that reduces or eliminates such beneficiary's interest in the first trust, but does not do so; or (c) the decanting eliminates or reduces a trust beneficiary's presently exercisable general power of appointment over the assets of the first trust.<sup>50</sup>

Looking through a federal estate tax lens, decanting will generally not trigger federal estate tax consequences unless, with regard to the settlor of the first trust, the settlor (i) participates in the decanting in a manner that demonstrates the settlor had implied authority to control the trust assets (e.g., by directing the first trust be decanted to effectuate modifications similar to modifications being made to the settlor's revocable trust)<sup>51</sup> or (ii) is granted powers described in I.R.C. §§ 2038 or 2042 and such powers were not included in the first trust. Additionally, decanting may yield federal estate tax consequences if, with regard to a trust beneficiary (i) the second trust provides a trust beneficiary a general power of appointment under I.R.C. § 2041 or

the decanting was considered to be a gift by the trust beneficiary and the terms of the second trust include a power that would trigger inclusion under I.R.C. §§ 2035-2039 or 2042. While keeping a close eye on unintentional federal estate tax consequences of decanting, under the current federal estate tax environment, decanting may serve to provide creative opportunities to intentionally include assets

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47. *Crane v. Comm'r*, 331 U.S. 1 (1947); I.R.C. § 752(d) (2018); Treas. Reg. § 1.1001-2(a)(4)(v).

48. Treas. Reg. § 1.1001-1.

49. *Id.* § 25.2511-1(g)(1)-(2).

50. *Cerf v. Comm'r*, 141 F.2d 564 (3d Cir. 1944) (holding that a beneficiary's consent to a trust amendment eliminating the beneficiary's income interest constituted a taxable gift when the amendment could not be completed without the beneficiary's consent); *see also* Treas. Reg. § 25.2514-3(a), (c)(4).

51. I.R.C. § 2038 (governing powers of appointment includable in a decedent's estate); *id.* § 2042 (including incidents of ownership of life insurance policies in a decedent's estate).

in a settlor or beneficiary's estate to achieve basis step-up under I.R.C. § 1014.

Particular caution and diligence should be exercised with regard to decanting involving trusts exempt from generation-skipping taxes as such modifications may result in the loss of the exemption. By way of example only, a "grandfathered" generation-skipping transfer tax exempt trust may lose its exempt status if the modification shifts the terms of a trust to change the generation in which the beneficial interests of the trusts will vest.<sup>52</sup> Decanting trusts made exempt by allocation of generation-skipping tax exemption may also result in adverse tax consequences as certain exercises of the decanting power that affect the beneficial interests of the beneficiaries may also be treated as actual or constructive additions to the trust, thereby triggering the loss of generation-skipping transfer tax exempt status.<sup>53</sup>

#### E. PREVENTING UNWANTED DECANTING

For a variety of reasons, a settlor of a trust may wish to prevent decanting. While the NUTDA provides built in limitations on decanting power, the power can be further limited (or completely prohibited) by the terms of the governing instrument. The NUTDA states that where the language of the first trust expressly prohibits exercise of (i) the decanting power or (ii) a power granted by state law to the trustee to distribute part or all of the principal of the first trust to another trust or to modify the trust, trust decanting is prohibited.<sup>54</sup> If a settlor wishes to allow decanting but limit the applications where it may be used, the terms of the trust controlling the trustee's discretion may be carefully drafted to limit the trustee's powers under the UTDA.<sup>55</sup>

### VI. CONCLUSION

The mechanisms for modification of irrevocable trusts are undergoing rapid modernization. The Nebraska Uniform Trust Decanting Act ("NUTDA") would help Nebraska keep pace with the broader na-

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52. Treas. Reg. § 26.2601-1(b)(4)(i)(D) (providing that a generation-skipping tax exempt trust may lose its exempt status if a modification shifts a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person who held the beneficial interest prior to the modification or if the modification extends the time for vesting any beneficial interest in the trust beyond the period provided for in the original trust).

53. *Id.* § 26.2601-1(b)(1) (revoking exempt status for additions to a generation-skipping tax exempt trust after the effective date).

54. L.B. 902 § 15(a)-(b), 106th Leg., 2d Sess. (Neb. 2020); *see also* UNIF. TRUST DECANTING ACT § 15(a)-(b) (2018).

55. *Id.*

tional movement and provide Nebraska estate planners and fiduciaries with another flexible estate planning tool to adapt to unforeseen circumstances, further settlor intent, and enhance existing benefits inherent in irrevocable trusts. The NUTDA would not affect existing processes for trust modification, but would instead create an additional trust modification avenue. The NUTDA promotes uniformity among the states by bringing the opportunity to provide Nebraska trustees with a set of trust modification tools already in place in many other jurisdictions. Going forward, with a careful understanding of the restrictions and consequences applicable to its use, decanting may serve to overcome the limitations present in existing irrevocable trust modification mechanisms in Nebraska.