

Trust Act 2011 Changes to the Delaware Code

On July 13, 2011, Delaware Governor Jack Markell signed Trust Act 2011 into law, effective August 1, 2011. Trust Act 2011 provides advancements in Delaware trust law that will provide settlors, beneficiaries and fiduciaries of trusts with more tools and greater flexibility to accomplish their objectives.

Morris Nichols' Trusts, Estates and Tax Group is pleased to share our eighth annual Delaware legislative update with you. This newsletter addresses the material provisions of the new legislation affecting trusts and estates in the State of Delaware and it is not intended to be a complete discussion of any of the topics addressed herein. If you would like to discuss any of the issues raised in this newsletter in greater detail, please feel free to contact any member of Morris Nichols' Trusts, Estates and Tax Group. In addition, all of our previous legislative updates, as well as other client updates, are available on our website.

Exemption of Life Insurance and Annuity Contracts from Execution or Attachment (10 Del. C. § 4915)

Subsection 4915(a) of Title 10, which exempts certain assets from execution or attachment, was amended to provide an exemption for life insurance contracts and annuity contracts. Section 4915 provides an exemption for retirement accounts. The new statute defines life insurance contracts and annuity contracts by cross-reference to the Internal Revenue Code. An annuity contract is defined as a contract which may be payable during the life of the annuitant in installments and may include a qualified long-term care insurance contract as a part of the contract. A

life insurance contract is defined as a contract for insurance which is not payable in full during the lifetime of the insured and may include a qualified long-term care insurance contract as a part of the contract. Other Sections within Chapter 49 of Title 10 provide exemptions for an unusual list of personal property such as, a family bible, school books, church pews, wearing apparel, tools for a trade, sewing machines and pianos. Chapter 49 also provides exemptions from attachment for certain wages, exemptions for certain property in bankruptcy and exemption of Delaware College Investment Plan accounts.

Definition of "Wrongdoing" (12 Del. C. § 3301)

Section 3301 of Title 12 defines certain terms used in Chapter 33 of Title 12. Section 3301 also provides rules for construing terms appearing in trust instruments.

Last year, Section 3301 was amended to add a definition of the term "wilful misconduct". The definition applies both for purposes of defining the term "wilful misconduct" in each place where that term appears in Chapter 33 and for purposes of defining the term "wilful misconduct" when it appears in a trust instrument (unless a contrary statement appears in the trust instrument).

Within Chapter 33, the term "wilful misconduct" is used in Section 3303 which provides generally that the terms of a trust instrument are enforceable as written, except that a provision purporting to exculpate or indemnify a fiduciary from liability for wilful misconduct or purporting to preclude a court from removing a fiduciary on account of the fiduciary's wilful misconduct is not enforceable. The term "wilful misconduct" is also used in Section 3313 which states that if a trust instrument provides that a fiduciary is to follow the direction of an adviser, and the fiduciary acts in accordance with such a direction, then, except in cases of wilful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act.

The definition of “wilful misconduct” that was added to Section 3301 last year (in two places so as to apply both for purposes of Chapter 33 and for purposes of construing trust instruments) states that “wilful misconduct” means intentional wrongdoing, not mere negligence, gross negligence or recklessness.

Following the enactment of the foregoing definition, some institutional fiduciaries expressed a concern that the new definition might result in fiduciary liability when a fiduciary undertook an action that the fiduciary knew to be “wrong” in the sense of being incorrect. These institutional fiduciaries pointed out that one dictionary definition of “wrongdoing” is an instance of doing wrong and one definition of the word “wrong” is incorrect. So, for example, if a trustee failed to redeem a corporate bond because the trust’s investment adviser failed to direct the trustee to do so, it might be said that the trustee was engaged in “intentional wrongdoing” in the sense that the trustee knew that failure to redeem the bond was an incorrect investment decision in a case where the trustee knew that the bond’s value would decline far below the redemption price if not redeemed.

The other dictionary definition of “wrongdoing” is evil or improper behavior or action. Section 2 of Trust Act 2011 added a definition of “wrongdoing” to Section 3301 so as to make it clear that the term “willful misconduct”, as used in Chapter 33 and trust instruments that do not otherwise define the term, means intentionally malicious conduct or conduct intended to defraud or seek an unconscionable advantage rather than simply conduct that the fiduciary knows to be “incorrect” in the sense that some other course of conduct would have been better.

Expansion of the Definition of “Investment Decision” Under the Directed Trustee Statute (12 Del. C. § 3313)

Section 3313 of Title 12 of the Delaware Code is Delaware’s so-called “directed trust” statute. The statute provides that an “adviser” may direct a trustee with respect to any investment decision, distribution decision or any other decision of the trustee. Subsection 3313(d) of Title 12 provides a definition of “investment decision”. Trust instruments sometimes reference this statutory definition in a direction provision. Trust Act 2011 added valuation

of non-publicly traded investments to the definition of “investment decision”. When a trustee acts only at the direction of an adviser, it is common for the trust to hold interests in non-publicly traded entities that are difficult to value. This can be a particular problem if the trustee is acting only at direction, but must nevertheless report on the value of trust assets to the beneficiaries or regulators. This amendment clarifies that trustees acting at direction with respect to “investment decisions” as defined in the statute, shall value the trust investments in the manner directed by the adviser.

Creditor Protection for Tenancy by the Entireties Property Held in Trust (12 Del. C. § 3334)

Last year, a new Section 3334 was added to Title 12. The new Section 3334 provides that when a husband and wife contribute property to a revocable trust, if the property contributed to the trust was held by them as tenants by the entireties, the sole remedy available to a creditor of either or both spouses, who is seeking to satisfy the debt out of trust property, is an order directing the trustee to transfer the property to both spouses as tenants by the entireties. Under the laws of many states, only a creditor of both spouses can make a claim against property owned by the spouses as tenants by the entireties. The purpose of the statute enacted last year is to permit married couples to contribute tenancy by the entireties property to a revocable trust without losing whatever creditor protection they enjoyed when holding the property as tenants by the entireties.

Section 4 of Trust Act 2011 revised Section 3334 to make it clear that the two spouses may contribute their respective joint interests in the property to different revocable trusts, as is commonly done in estate planning, without losing the creditor protection afforded by the statute.

Update to Formula Clause Statute (12 Del. C. § 3335)

In 2010, Delaware enacted Section 3335 of Title 12 of the Delaware Code. Section 3335 created a presumption as to the construction of certain tax formula clauses. Generally, wills and trust instruments include tax formula clauses that allocate assets among trusts and bequests on

the basis of a formula that references estate and generation skipping transfer (“GST”) tax exemptions under Federal law. Section 3335 provides rules of construction for these tax formula clauses for decedents dying during 2010 when the estate and GST tax were repealed and there was considerable uncertainty about how and when those taxes would be reintroduced. On December 17, 2010, Congress enacted a new tax law that provides, in part, that a \$5 million estate and GST tax exemption with a 35% estate and GST tax rate and step-up in basis will apply to decedents dying at any time during 2010. However, the estate of a 2010 decedent may elect to have no estate tax or GST tax apply to the estate and apply carry-over basis rules as provided under the original 2001 tax act. Delaware’s formula clause statute has been updated to reflect the timing and nature of the actual tax laws that were enacted, now that these rules have been clarified by Congress and estates have been given an optional election to have one of two different tax regimes apply. In addition, this amendment clarifies that the personal representative shall have the flexibility to opt out of the statute’s rules of construction with respect to all or a part of a will or trust instrument.

Revisions to Delaware’s Decanting Statute (12 Del. C. § 3528)

Section 3528 of Title 12 is Delaware’s so-called “decanting statute”. The statute permits trustees authorized to make outright principal distributions from a trust to one or more beneficiaries to instead distribute principal to another trust for the benefit of one or more of the beneficiaries to whom the trustee could have made an outright distribution. The statute is patterned after an earlier New York statute and is similar to statutes subsequently enacted in a number of other states.

Section 6 of Trust Act 2011 revised the statute in an effort to make the statute’s operative provisions more understandable. In addition, Section 6 revised the statute to address how the statute applies in cases where the trustee is authorized to make outright principal distributions among an open class of beneficiaries (meaning a class to which new members may be added in the future; for example, a class comprised of the children of a living person or the descendants of a deceased person having at least one living descendant). One possible interpretation of the current decanting statute is that the trustee can only

distribute trust principal to a new trust for the benefit of the current living members of the open class because they are the permissible objects of the power to distribute principal currently. Another possible interpretation is that the trustee can distribute trust principal to a new trust for the benefit of some or all of the class members including persons added to the class after the new trust is funded. Section 6 of Trust Act 2011 revised the decanting statute to expressly permit the trustee to distribute to a trust for the benefit of some or all of the class members including persons added to the class after the trust is funded. This approach greatly increases the utility of the statute.

Further Revisions to the Decanting Statute (12 Del. C. § 3528)

Section 7 of Trust Act 2011 also amended Delaware’s decanting statute by adding two new subsections to the decanting statute.

A new Subsection (e) was added to provide that the trustee shall be held to the same standard of care and standard of liability when distributing trust property from one trust to another pursuant to the statute as would apply to the trustee when making outright distributions from the trust.

A new Subsection (f) was added to provide that a trustee is authorized to make a trust-to-trust distribution pursuant to the decanting statute whenever Delaware is the place of administration of the trust from which the distribution is made.

Notice Procedure (12 Del. C. § 3534)

Trust Act 2011 added a new Section 3534 to Title 12 of the Delaware Code to establish a statutory notice provision for fiduciary communications in the absence of a contrary provision in the trust instrument. The statute provides that notice may be given by (1) U.S. mail, or commercial carrier, sent to the address reasonably determined to be the person’s address or the address last consented to by the person to receive notice, (2) fax sent to the number last consented to by the person to receive notice, (3) email sent to the email address last consented to by the person to receive notice, (4) posting to an electronic network, provided notice of such posting is delivered to

such person, (5) any other form of electronic transmission as to which such person last consented to receive notice, or (6) such other manner reasonably suitable under the circumstances and likely to result in receipt. The statute also relieves a trustee of the duty to confirm the reliability of an approved address and clarifies that a trustee may withhold notice while it exercises reasonable diligence to confirm an address. The statute also clarifies that any person may waive in writing the right to receive notice of a trust or other communications and may thereafter rescind the waiver of notice.

Clarification of Trust Contest Statute (12 Del. C. § 3546)

Section 3546 of Title 12 provides for a limitation on a person's ability to bring a judicial proceeding to contest a trust or any amendment to a trust. Trust Act 2011 revised the language of the original statute to clarify that the statute applies to both revocable and irrevocable trusts.

Clarification of Virtual Representation By Parents or Guardians of Minor (12 Del. C. § 3547)

Subsection 3547(c) of Title 12 of the Delaware Code provides generally that if a minor or incapacitated beneficiary may not be otherwise represented under Subsection 3547(a) or (b), the living, competent parents of the beneficiary or the guardian of the property of the beneficiary may represent and bind the beneficiary, so long as there is no material conflict of interest between the beneficiary and either parent. Trust Act 2011 revised Subsection 3547(c) to clarify that if a minor or incapacitated beneficiary has two parents that are living and competent, then both parents are required to represent the beneficiary, unless only one parent is the sole custodial parent.

Clarification of Asset Protection Trust Spendthrift Clause Requirement (12 Del. C. § 3570)

Trust Act 2011 deleted the word "qualified" from both places where the word appears in Subsection 3570(11)c of Title 12 of the Delaware Code. This Subsection sets forth the requirement for a spendthrift provision in an

asset protection trust agreement. The spendthrift provision that is set forth in this Subsection referred to restrictions on transfers by a beneficiary prior to distribution by the "qualified trustee". However, following a 2010 amendment to the statute, the statute allows for distributions to be made by either a qualified trustee or another trustee that is not a "qualified trustee". This Subsection was amended to conform with the 2010 amendment.

Clarification of Asset Protection Trust Exclusion For Property Settlements (12 Del. C. § 3573)

Delaware's asset protection trust statute provides generally that a creditor of the settlor of an asset protection trust may not recover the debt from the trust unless the settlor's creation and funding of the trust was a fraudulent transfer within the meaning of Delaware's fraudulent transfer laws. Section 3573 of Title 12 excludes certain specified claims from the creditor protection generally afforded by the asset protection trust statute. Accordingly, persons holding such specified claims generally are able to recover the debt from the trust. One of the specified claims is a claim for a division or distribution of property held by a spouse or former spouse of the settlor. Section 3573 was revised by Trust Act 2011 to clarify that the division or distribution of property must be made incident to a separation or divorce proceeding.

Additional Revisions to the Asset Protection Trust Statute (12 Del. C. § 3574)

Section 13 of Trust Act 2011 made two changes to Section 3574 of Title 12. Section 3574 is part of Delaware's asset protection trust statute.

The first change is intended to clarify that in actions brought by creditors seeking to recover a debt from an asset protection trust, if the trustee has acted in good faith, any fees incurred by the trustee in defending the trust against the claim (such as attorneys fees) as well as the trustee's own fees shall be paid from the trust before any amounts are paid from the trust to the creditor in satisfaction of the debt.

The second change made by Section 13 of Trust Act 2011 is analogous to the change made by Section 4 of Trust Act 2011 except that Section 4 concerns revocable trusts and Section 13 concerns asset protection trusts. Last year, a new Subsection (f) was added to Section 3574. New Subsection (f) closely tracks the language of Section 3334 in that Subsection 3574(f) provides that when a husband and wife contribute property to an asset protection trust, if the property was held by them as tenants by the entireties, the sole remedy available to a creditor of either or both spouses, who is seeking to satisfy the debt out of the trust property, is an order directing the trustee to transfer the property to both spouses as tenants by the entireties. Section 13 of Trust Act 2011 revised Subsection 3574(f) to make it clear that the two spouses may contribute their respective joint interests in the property to different asset protection trusts.

Releases by Incapacitated Trust Beneficiaries (12 Del. C. § 3588)

Section 3588 of Title 12 provides that a consent, release or ratification is enforceable if a beneficiary, while having capacity, consents to the trustee's conduct and certain other conditions described in the statute are satisfied. Section 3588 is patterned upon a similar provision appearing in the Uniform Trust Code. Following the enactment of Section 3588, the Uniform Trust Code was revised to delete the requirement that the beneficiary must have capacity at the time of the consent because that requirement arguably precluded enforcement of a consent executed by an incapacitated beneficiary through a representative such as someone authorized to represent the incapacitated beneficiary under a virtual representation statute (such as 12 Del. C. § 3547) or otherwise authorized to represent the beneficiary, for example, an attorney-in-fact under a durable power of attorney or a court-appointed guardian of the property.

Section 14 of Trust Act 2011 revised Section 3588 by deleting the requirement that the beneficiary must have capacity at the time of the consent so as to make it clear that a consent executed by a person authorized to represent an incapacitated beneficiary is enforceable if the other conditions described in Section 3588 are satisfied.

Statements By An Entity As to the Source and Character of Distributions (12 Del. C. § 61-401)

Section 61-401 of Delaware's Uniform Principal and Income Act provides default rules for allocating distributions received by a trust from an entity between trust income and principal. In general, distributions received from an entity are allocated to trust income, unless the distribution is described in Subsection 61-401(c), in which case the distribution is allocated to principal. Subsection 61-401(f) provides that a trustee may rely on a statement made by an entity's board of directors or similar body regarding the source or character of a distribution from an entity, which will determine how the distribution is categorized between income and principal under the Section. Trust Act 2011 revised Subsection 61-401(f) to eliminate the requirement that the statement must be made at or near the time of the distribution and also adds additional flexibility to enable the trustee to rely on statements from not only the board or other persons authorized to exercise the power to pay money or transfer property to the trust, but also from a person authorized by such board to make such a statement. In other words, the board may delegate the authority to make the statement to another person, regardless of whether the person making the statement has the authority to make the distribution.

Trustee's Discretion to Make Property Productive of Income (12 Del. C. § 61-413)

Section 61-413 of Delaware's Uniform Principal and Income Act provides that if a trust consists substantially of property that does not provide an income beneficiary with reasonable income from or use of the trust assets, and the trustee cannot make allocations from principal to income to provide sufficient beneficial enjoyment to the income beneficiary, the income beneficiary may require the trustee to make the trust property productive of income, convert property, or exercise the power to allocate from principal to income, and the trustee may decide which option to exercise. Trust Act 2011 revised this statute to provide that upon the "request" of the income beneficiary, if the trustee determines that the trust property is underproductive of income, then the trustee shall take one of the options

available under the Section in the trustee's discretion. This amendment shifts the determination from the income beneficiary requiring the trustee to take an action, to the trustee taking an action in its discretion at the request of the income beneficiary. An income beneficiary will continue to have the ability to file a judicial action to compel a trustee to make trust property productive if a trustee does not respond to a request from the beneficiary.

**Clarification of Current Law Concerning
When a Trust Has An Insurable Interest
(18 Del. C. § 2704)**

Section 2704 of Title 18 provides, in relevant part, that the trustee of a trust established by an individual has an insurable interest in the life of that individual. Notwithstanding the plain language of the statute, a U.S. District Court, applying Delaware law, recently held that a trust did not have an insurable interest in the life of the person who established the trust because the trust's settlor intended to sell the beneficial interest in the trust. Section 17 of Trust Act 2011 is intended to clarify that a trust has an insurable interest in the life of the person who "establishes" (that is, creates and initially funds) the trust without regard to whether beneficial interests in the trust are subsequently sold or otherwise transferred. It perhaps should be noted that neither Section 17 of Trust Act 2011 nor Section 2704

addresses the question of whether a sale or other transfer of a beneficial interest in a trust would be effective if the trust owns a life insurance policy that is unassignable by its terms.

**Rule Against Perpetuities
for Real Estate
(25 Del. C. § 503)**

Delaware has a 110-year rule against perpetuities for real estate held directly in trust. Subsection 503(e) of Title 25 makes it clear that real estate held in an entity (such as a corporation, limited liability company or partnership) owned by a trust is not subject to the 110-year rule against perpetuities. Trust Act 2011 amended this statute to provide that if an entity owned by a trust holds real estate and the entity ceases to exist so that the trust becomes the direct owner of the real estate, the trust shall not become void or subject to termination by reason of the rule against perpetuities and, except as otherwise provided in the governing instrument, the trustee may either distribute the interest in real estate as provided in Subsection 503(b) (that is, at the end of the 110-year period beginning when the trust first acquires a direct ownership interest in the real estate) or convey the real estate to another entity prior to the expiration of that 110-year period or otherwise transfer the real property out of the trust within that 110-year period.

Morris Nichols
Trusts, Estates and Tax Group

Thomas R. Pulsifer
(302) 351-9226
tpulsifer@mnat.com

Todd A. Flubacher
(302) 351-9374
tflubacher@mnat.com

Kimberly M. Gill
(302) 351-9102
kgill@mnat.com

Scott D. Goodwin
(302) 351-9462
sgoodwin@mnat.com

Randolph K. Herndon, Jr.
(302) 351-9664
rherndon@mnat.com

Morris, Nichols, Arsh & Tunnell LLP combines a broad national practice of corporate, intellectual property, business reorganization and restructuring and commercial law and litigation with a general business, tax, estate planning and real estate practice within the State of Delaware. The firm's clients include Fortune 500 companies, smaller firms and partnerships, financial institutions, government agencies, commercial law and litigation firms and not-for-profit organizations.