

# TEACHING YOUR OLD TRUST NEW TRICKS

## HOW TO MODIFY AN IRREVOCABLE TRUST

Irrevocable trusts drafted with built-in inflexibility could leave the trustee unable to cope with changing family circumstances or investment challenges.

### WHY MODIFY?

**Scenario 1:** You are the beneficiary of a trust over which the trustee has full investment authority. You would like to exercise investment control over the trust but the trustee wants to know it will not have potential liability if it cedes its investment authority to you.

**Scenario 2:** Your mother established a trust for the benefit of you and your siblings. The trust agreement allows the trustee to make principal distributions to any of the beneficiaries for their health, education, welfare and support. Whenever one of your siblings receives a principal distribution, it comes out of a single “pot” and reduces the overall beneficial interest of all of the siblings.

**Scenario 3:** You established a discretionary trust for the benefit of your children, who are currently minors. You now understand that the trustee will have to give your children notice of their interest in the trust when they become adults. Your strong preference is to delay any notice to your children until they turn 40 years of age, on the premise they will then be sufficiently mature to handle their wealth responsibly.

You are not alone. At Northern Trust, we have seen countless irrevocable trusts that were drafted with built-in inflexibility, leaving the trustee unable to cope with changing family circumstances or a challenging investment problem. Or consider the case of the trustee that is unwilling to adopt modern practices of trust administration and is equally unwilling to resign its position. There are, however, techniques for improving upon a seemingly hopeless situation.<sup>1</sup>

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## Six Modification Options

### 1. ADMINISTRATIVE POWER TO AMEND

The starting point for any trust modification is the trust instrument itself, because it may empower the trustee, a protector or some other fiduciary to amend certain aspects of the trust. While such amendatory authority does not typically extend to modifying beneficial interests, at least not in American-style trusts, it may give the trustee broad discretionary power to amend administrative provisions of the trust, change the situs or governing law of the trust or ensure that the settlor's tax objectives are fulfilled. If there is an amendatory power that fits the particular situation, and a party who is willing to exercise the power, follow the designated procedure for an amendment and accomplish your goal.

Even though a trustee is subject to liability only for an abuse of discretion of its amendatory power, the trustee will often seek releases from all beneficiaries of the trust before it will exercise its discretion to amend. This is especially the case if the administrative modification (such as appointing an investment advisor and giving the advisor the exclusive authority to direct the trustee in the investment of the trust assets) could be considered self-serving or protective of the trustee's interests. It is often a more favorable circumstance for an amendment if the power to amend is vested in a protector, because the protector will not have a personal stake in the consequences of the amendment.

### 2. DECANTING

The process of decanting is a common method for dealing with problems arising in the administration of a trust. Beginning in 1992 with New York's enactment of its EPTL § 10-6.6, at least 28 states have adopted legislation to allow trustees with discretion to distribute trust principal to appoint some or all of such principal in favor of a new trust.<sup>2</sup> This process, known as "decanting" a trust, offers trustees the ability to modify the terms of an irrevocable trust.

Delaware's decanting statute, 12 Del. C. § 3528, was first enacted in 2003. In the current form of § 3528, a trustee who has authority under the terms of a trust instrument, whether acting at the trustee's discretion or at the direction or with the consent of an advisor, to invade the principal of a trust may instead exercise such authority by appointing all or part of the principal subject to the power in favor of a trustee of a trust under a new trust instrument (or even the existing trust instrument). Unlike the law in some other states, the Delaware statute does not require notice to, or consent from, the beneficiaries before the decanting becomes effective. Despite that latitude, most corporate fiduciaries will request releases from the beneficiaries, unless there is good reason to forego releases. Similarly, § 3528 does not require the trustee to have absolute discretion to invade principal as long as the decanting satisfies the standard for distributions.

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"Decanting" a trust offers trustees with discretionary distribution authority the ability to modify the terms of an irrevocable trust.

In general terms, the process of decanting may be useful any time an irrevocable trust agreement does not readily permit modifications under the authority of the trustee or a trust protector. Those modifications might include:

- Modifying a trust's dispositive provisions (e.g., eliminating mandatory principal distributions or placing a cap on fully discretionary distributions)
- Modernizing a trust's governance procedure by appointing trust advisors and protectors
- Enlarging a beneficiary's power of appointment to enable the beneficiary to appoint trust assets to an individual or a class of takers who were not in the settlor's original contemplation
- Dividing an existing trust to achieve tax benefits, such as maximizing GST-exempt assets, or to separate a pot trust into separate shares for each family branch
- Transferring the situs of a complex trust from a high income tax state to one without an income tax on fiduciary income
- Converting a non-grantor trust into a grantor trust, or a grantor trust to a non-grantor trust, for fiduciary income tax purposes

### 3. NONJUDICIAL SETTLEMENT AGREEMENT

In 2013 Delaware enacted 12 Del.C. § 3338 to provide a method for "interested persons" of a trust to resolve matters concerning the administration of a trust through a nonjudicial settlement agreement (NJSA) without the need for any judicial involvement. Under § 3338 "interested persons" are those persons whose consent would be necessary to achieve a binding settlement if the settlement were approved by the Court of Chancery, including:

- (1) Trustees and other fiduciaries;
- (2) Trust beneficiaries with a present interest in the trust or whose interest would vest if the trust terminated currently;
- (3) The settlor, if living; and
- (4) All other persons having an interest in the trust pursuant to the express terms of the trust instrument, such as holders of powers and persons with other rights held in a nonfiduciary capacity.

The statute provides that interested persons may enter into a binding nonjudicial agreement with respect to any matter involving a trust.

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The Delaware statute provides a non-exclusive list of six matters that may be resolved by a nonjudicial settlement agreement. These include:

- (1) Interpreting or construing the terms of a trust;
  - (2) Approving the report or accounting of a trustee;
  - (3) Directing a trustee to refrain from exercising a power or granting a power to a trustee;
  - (4) Resignation, appointment, or determination of compensation of a trustee;
  - (5) Transferring the principal place of administration of a trust; and
  - (6) Determining the liability of a trustee for an action relating to the trust.
- Absent from the list of matters an NJSA may address is the modification of an irrevocable trust.

The ability to use § 3338 to modify the terms of a trust will depend on whether the trust's settlor is living. If the settlor of the trust is not living, an NJSA may not violate a "material purpose" of the trust. Importantly, if the settlor is living and participates in an NJSA, the "material purpose" limitation on NJSAs does not apply and the NJSA may modify the trust in any fashion.

#### 4. MODIFICATION OF TRUST BY CONSENT WHILE SETTLOR IS LIVING

A more recent Delaware statute, 12 Del.C. § 3342, permits a modification of any trust if the new trust provision is permitted under Delaware law at the time of the modification and it has the written consent (or non-objection) of the settlor, all fiduciaries and all beneficiaries. For the modification to be effective, the interests of all beneficiaries must be represented directly or by virtual representation under Delaware's virtual representation statute, 12 Del.C. § 3547.

It is not possible to overstate the breadth of changes in existing trusts that § 3342 facilitates. A consent modification can change beneficial interests in a trust, adopt new provisions that were not valid at the time of the trust's execution and even trump an express provision that the trust is not subject to amendment or modification. Of course, the key to any such consent modification lies in the availability of the settlor and the willingness of all beneficiaries to consent to the change.

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## 5. MODIFICATION BY MERGER

Another method of modifying a trust is the use of Delaware's merger statute, 12 Del.C. § 3325(29). Although this provision has long been one of the enumerated specific powers of a Delaware trustee, in recent years it has gained additional utility as a method for modifying trusts. A merger of trusts is closely analogous to a decanting except it does not involve a distribution of assets into a new trust. Rather, a new trust is created and the trustee merges the original trust into the new trust. Trust merger is particularly useful if a trustee does not have discretionary distribution authority over trust principal and cannot rely on the decanting statute to implement prophylactic changes in the original trust.

Delaware's merger statute gives a trustee the power to merge any two or more trusts, whether or not created by the same trustor, and whether or not created under the same instrument, as long as the merger does not result in a material change in the beneficial interests of the trust beneficiaries under the resulting merged trust. The power to merge trusts is available even when a trustee creates one of the trusts in order to participate in the trust merger, and a trustee may act as the declarant of a trust for the purpose of merging an existing trust with that new trust. The merger power exists even if one or both of the trusts are not funded prior to the merger.

Section 3325(29) does not define what constitutes a material change in the beneficial interests of trust beneficiaries. The accepted wisdom is as long as the resulting change is only administrative, such as adding an investment advisor, there is not a material change in the beneficial interests under the merged trusts.

## 6. MODIFICATION BY COURT ORDER

At one time it was a tried and true practice for Delaware practitioners to seek trust modifications through a judicial consent order. Essentially, the trustee or other party would file a petition to the Delaware Court of Chancery seeking to modify the subject trust in a specified manner. The petition would include the written consents of all beneficiaries to the trust (either directly or virtually) and any other parties to the trust (such as advisors). With such consents in hand, court review of such petitions was prompt and usually favorable. It was, moreover, ideal from a trustee's perspective because the modification would have the Court's imprimatur, thus relieving the trustee of any potential liability for initiating the modification.

With its promulgation of Chancery Rules 100 -103 (the "Rules") in April 2012, the Court sharply curtailed the practice of using consent petitions. Among other things, the Rules require substantially more detail in the petition regarding the effects of the modification on the beneficial interests in the trust, the personal interest of any fiduciary in the proposed modification, and the potential conflicts of any party virtually representing any minor or contingent beneficiary. The Rules transformed what had been an efficient, straightforward process into a more complex and more expensive exercise.

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The Court of Chancery gave consideration to a new element for granting a judicial modification of a trust – whether the relief sought is consistent with the settlor's probable intent at the creation of the trust.

The Court of Chancery cast even more doubt on the efficacy of judicial consent modifications with its decision in *In re Trust Under Will of Wallace B. Flint FBO Katherine Shadek*, C.A. No. 10593-VCL (June 17, 2015) (“Flint”). The petitioner in *Flint* sought by way of consent petition to add an investment advisor who would have authority to manage the trust investments and give investment directions to the trustees. In its review of the petition the Court gave consideration to a new element for granting a judicial modification of a trust – whether the relief sought is consistent with the settlor’s probable intent at the creation of the trust. Finding that the testator’s choice of trustees to exercise investment authority signified his intent to have his trust benefit from their investment wisdom, the Court concluded that the trustees’ abdication of investment authority in favor of an investment advisor would violate the testator’s intent. On that basis, the Court denied the requested modification to the trust. If the stringent nature of the Rules is not enough to deter consent petitions, the risk of a petition running contrary to a settlor’s intent will almost certainly discourage many petitions for a judicial modification of a trust.

#### DISCUSS YOUR OPTIONS

Simply because the instrument governing your trust states that it is irrevocable and cannot be amended does not mean it cannot be modified to serve your family’s needs in a better fashion. Delaware law offers an array of options – administrative amendment, decanting, a nonjudicial settlement agreement, consent modification, trust merger, and judicial modification – to facilitate alteration of an existing trust. Before you despair over the current governance of your trust, you should sound out your counsel to determine whether one of these remedies will suit your purpose and achieve lasting improvement in your trust’s operation.

<sup>1</sup> This paper assumes that your trust is governed for the purposes of administration under Delaware law. If the law of another state governs your trust’s administration, you will need to determine if that state’s laws are comparable to Delaware law or, if not, whether you can change the situs of administration of your trust to Delaware.

<sup>2</sup> As of July 2015 there is a Uniform Decanting Act to serve as a prototype for states to consider in enacting decanting statutes. Two states – New Mexico and California – have enacted decanting statutes based on the Uniform Decanting Act.

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#### LEARN MORE

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