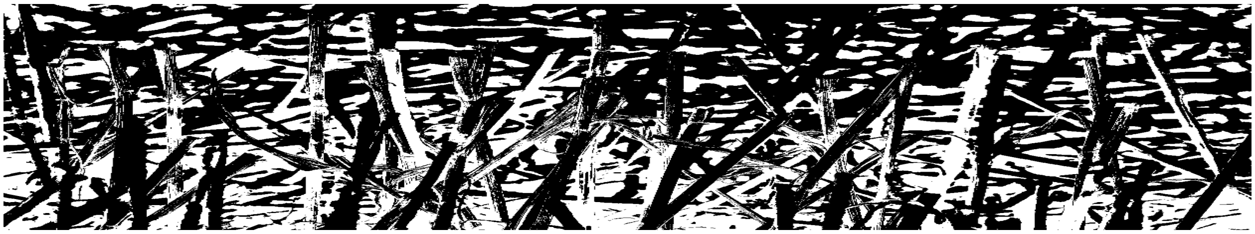

Jack Straw Fortnightly*

Decant this

A few weeks ago, a divided panel[fn. 1] of the New Hampshire supreme court affirmed the decision of a probate court to set aside a series of purported decantings from two irrevocable trusts and remove the co-trustees. The decision may prove to have far-reaching effects on the emerging law relating to decanting. Or perhaps not.[fn. 2]

The decantings at issue would have excluded two of the settlor's stepchildren, an estranged son, and his spouse, who had petitioned for divorce, from the class of discretionary beneficiaries for whom the trusts had been established years before those relationships went south. The trial court stopped just short of finding the settlor himself had directed the decantings, but the inference was quite clear.

At this writing there is still pending a motion for rehearing, but assuming the decision stands, it might be seen as a setback to a sustained lobbying effort on the part of a handful of bankers and lawyers over the past dozen or so years to advance legislation to make New Hampshire ever more competitive as a situs for private trusts.

Recent changes to the state's trust code have among other things abrogated the rule against perpetuities as to trusts where the trustee has a power of sale, enabled the creation of self-settled spendthrift trusts, and -- as relevant here -- facilitated decanting as a mechanism for altering the dispositive terms of an irrevocable trust.

Nonexercise is abuse

The thrust of the majority opinion *in Hodges v. Johnson*, No. 2016-0130 (N.H. 12/12/17), is that in decanting to a trust for the benefit of fewer than all beneficiaries of an existing trust, the trustee must give at least some minimal "consideration" to the beneficial interests of those who are being excluded -- even if those interests are contingent, or entirely discretionary.

What the requisite "consideration" might look like the court did not elaborate. In the case at hand, it was not "necessary" to reach that question, as the trial court had found, and the supreme court determined there was sufficient evidence to support the finding, that the trustees had simply given no consideration at all to the interests of the excluded beneficiaries. Both courts treated the complete failure to exercise discretion as itself an abuse of discretion.

But in affirming the result -- the decantings were set aside, and the co-trustees were removed --, the supreme court rejected the logic of the lower court's ruling and substituted a somewhat different rationale, framing the question in terms of a trustee's duty to act impartially with respect to the competing interests of multiple beneficiaries.

The trial court had avoided resting its decision on that ground, presumably because the duty of impartiality might be waived in a trust document, whereas the duty to "consider" the interests of the beneficiaries, whatever that means, cannot.

The dissent would have remanded for proceedings to develop the arguments on which the majority decided the case, or would at least have asked the parties for supplemental briefing.

The setup

In 2004, the settlor funded two irrevocable trusts with nearly all of the nonvoting stock in a closely-held real estate development and management company. One trust was to have a zero inclusion ratio for generation-skipping transfer tax purposes, and the other was to be non-exempt. These trusts were themselves decanted from trusts created in 1998, but those decantings were not at issue here.

The dispositive provisions of the two trusts were essentially identical, though the trustees were urged to make any distributions to non-skip persons first from the non-exempt trust. During the settlor's life, the trustees were given absolute discretion to accumulate income or to distribute income or principal among a class of beneficiaries comprised of the settlor's then spouse and his three children and two step-children and their respective descendants -- or to one or more "distributee trusts" for the benefit of one or more members of that class.

In other words, there was a non-statutory decanting mechanism already built into these trusts some years prior to the enactment in 2008 of the first iteration of the New Hampshire decanting statute, section 564-B:4-418, and by its terms that mechanism contemplated a decanting into one or more trusts that might exclude some of the class of beneficiaries.

If the settlor's spouse survived him, the trustees were to treat her as the "primary" beneficiary, favoring distributions to her over the preservation of corpus for the other beneficiaries. After her death, the remainder was to be divided into equal shares for each of the five children and their respective descendants, but if disproportionate distributions had been made in the meantime, there was no requirement to equalize.

Throughout, until the expiration of the common law perpetuities period, distributions were entirely discretionary.

The gathering storm

Between 2009 and 2013, the settlor had a series of fallings out, first with two of his stepchildren, then with his son, and ultimately with his spouse. He asked his lawyer in 2009 what, if anything, could be done about the provisions he had made for the stepchildren in these irrevocable trusts. The lawyer told him it would be possible to decant to trusts that reduced or eliminated the benefit to one or more beneficiaries, but that this would require action on the part of the trustees.

What happened next was, shall we say, unfortunate.

The lawyer persuaded one of the co-trustees to resign, so that the settlor could appoint him successor co-trustee. The other co-trustee then delegated to the lawyer his authority to decant. The lawyer then singlehandedly executed documentation purporting to decant the trusts to similar trusts that greatly reduced the shares in which the two stepchildren could participate. He then resigned as co-trustee, allowing the settlor to re-appoint the co-trustee who had stepped aside.

A similar process was repeated twice as difficulties arose with the settlor's son and then with his spouse. Apparently the idea was to insulate each of the co-trustees, other than of course the lawyer, from responsibility for the decantings.

In each case, the co-trustees relied on the lawyer's advice, though he was invoicing the settlor for his services and did not seek a written waiver of the conflict of interest.

Each of the decantings by its terms was to take effect only at the settlor's death, and each superseded the previous -- that is to say, no actual transfers were made. Among the issues both the trial court and the supreme court declined to reach, because lawyers for the excluded beneficiaries did not develop arguments on the question, was whether this fact in itself might have invalidated the purported decantings.

The settlor died while the matter was still pending in the trial court.

Analogy to limited power

In the absence of a statute, where a trustee is given express or implied discretion to make distribution in further trust for the benefit of one or more beneficiaries, rather than outright, courts have analogized this to a limited power of appointment -- see, for example, *Morse v. Kraft*, 466 Mass. 92 (2013) -- but with the significant difference that the holder of a limited power in a nonfiduciary capacity may exercise the power arbitrarily, whereas a trustee is limited in exercising the power by its fiduciary responsibilities.

But what exactly is a trustee's responsibility with respect to a contingent or discretionary beneficiary?

Here, the co-trustees argued, in effect, that they had no responsibility at all in light of section 564-B:8-814(b) of the New Hampshire statutes, which literally says the interest of a beneficiary of a discretionary trust "is neither a property interest nor an enforceable right, but a mere expectancy" -- even if the trustee's discretion is limited by an ascertainable standard.

But even that rather extraordinary language, enacted in 2008 as part of the launch of this ongoing legislative push we mentioned a few paragraphs back, is limited by the phrase "subject to the provisions of paragraph (a)," which requires the trustee to exercise its discretion "in good faith and in accordance with the terms and purposes of the trust and" -- and this is the phrase the trial court seized on -- "and the interests of the beneficiaries."

In oral argument before the supreme court, the lawyer for the excluded beneficiaries pointed out that literally all of the beneficiaries of these trusts were discretionary -- any or all of them might be excluded by a decanting --, and suggested that if the trustees had no responsibility to any of them, "we don't even have a trust." He noted section 564B:1-105(b)(3), which provides that a trust document cannot override the basic requirement that a trust be "for the benefit of its beneficiaries."

Somebody has to have "an enforceable right," he argued, even if in the end that right might not translate to a participation in discretionary distributions. Similarly, the trial court had said it would be "absurd" to read a decanting power as somehow relieving the co-trustees of any fiduciary responsibility at all to discretionary beneficiaries. "This is not, and cannot be, the law," the court said.

The shifting rationale

In its 38-page decision, the trial court detailed evidence from which it might have found that the co-trustees had acted in bad faith, or at the behest of the settlor, or under improper financial inducement, but then made a point of not entering findings on any of those questions.

Instead, noting "the astonishing lack of any even modestly selective or self-serving documentation revealing the thought processes, reasoning and content of other discussions relating to and predating each decant," the court rested its decision to set aside the decantings entirely on the co-trustees' "failure to consider the interests of the beneficiaries."

The author of the majority opinion for the supreme court was not satisfied simply to affirm the result without "clarifying" the rationale. The trial court, she said, had mistakenly read the statutory requirement that a trustee administer a trust in accordance with "the interests of the beneficiaries" as imposing "the same duty" as the statutory and common law duty of impartiality.

But the quoted phrase is defined elsewhere in the trust code to refer only to "the beneficial interests provided in the terms of the trust" -- which would seem to support the argument the co-trustees were making: they need only "consider" that a discretionary beneficiary has no "enforceable right," case closed.

Instead, the majority said, the relevant portion of the statute on which the lower court had relied requires a trustee to administer a trust "in accordance with this chapter," thereby incorporating the statutory duty of impartiality by reference. It was this duty to treat beneficiaries with diverse interests "equitably" the co-trustees had violated by ignoring the interests of the excluded beneficiaries.

The dissent agreed that the lower court had misread the statute, but disagreed that its decision could be recast as having determined that the co-trustees had violated the duty of impartiality. Whether and under what circumstances a trustee exercising a decanting power might violate that duty had not been sufficiently developed at trial, nor in the briefing on appeal, the dissent said, and it was a mistake to decide a question of first impression on this record, given "[t]he possibility -- indeed the virtual certainty -- of unintended and unknown consequences."

Where this leaves us

The *Hodges* decision does not reach the question what exactly the duty of impartiality might require where a trustee is contemplating a decanting in favor of fewer than all beneficiaries. What is clear is that the duty can be waived in the trust document.

Here, the co-trustees argued that the fact that distributions among the class of beneficiaries were entirely discretionary, and the fact that the trust documents expressly contemplated that some members of the class might get nothing, amounted to a waiver.

The majority of a panel of the supreme court rejected this argument. The dissent seemed willing to accept it, but not without further fact-finding and briefing. The probate court had sought to rest its decision on a more fundamental, albeit amorphous, "duty of care" that cannot be waived. None of the panel was ready to go that route.

The decision might be seen as limited to its egregious facts. If the co-trustees had documented a deliberative process that at least purported to show good faith, independence from the settlor, etc., the trial court would have had to make findings on those questions, and if those findings were supported by credible evidence, the supreme court would have been confronted directly with the more nuanced question the dissent said was not sufficiently developed here.

The trial court did find that the trustees had failed to produce any evidence that they acted out of concern that the excluded beneficiaries might disrupt the management of the closely-held business in which the trusts held nonvoting stock, or if this was their concern, that they had explored any alternatives to disinheriting these beneficiaries altogether.

To the contrary, as both the trial court and the supreme court observed, by excluding these beneficiaries, the decantings had rendered ineffective an "in terrorem" clause that would have discouraged litigation.

So the takeaways appear to be:

(1) neither the fact that distributions from a trust are entirely discretionary nor the fact that distributions to some beneficiaries might have the effect of excluding others is in itself a waiver of the duty of impartiality, and

(2) the duty of impartiality requires a trustee, in exercising a power to decant in favor of fewer than all discretionary beneficiaries, to give at least some minimal "consideration" to the "future beneficial interests" of those who would be excluded.

But since the decanting statute on its face says "the second trust may exclude one or more of the beneficiaries of the first trust," we are still left with the question what "consideration" is required.

Threading the needle

Absent any other justification, the inference is quite clear that the co-trustees were acting at the settlor's direction in executing these decantings. But the trial court stopped short of making that finding. Why? Certainly this would have simplified matters.

An explanation of sorts can be found in footnotes 10, 18, and 21 of the trial court's decision: if the decantings were allowed to stand, a finding that the settlor had retained a power to alter the beneficial interests in these trusts would have caused the value of the trust corpus to be includible in his gross estate under section 2038. By not making a finding, the trial court was leaving the executor, who at least in that capacity was not a party to the present proceeding, some room to maneuver in the event of an audit of the settor's estate tax return.

Similarly, the trial court stopped short of finding that the co-trustees had acted in bad faith or under improper financial inducement. Again, why?

An explanation here is a bit more speculative. In the text accompanying footnote 6 of its decision, the trial court indicated it would ask the successor trustee to ascertain whether lawyers' fees incurred by the co-trustees in defending the decantings had been paid out of the trust, and if so to advise the court whether the co-trustees should be surcharged for those amounts. The footnote itself noted that lawyers' fees are to be allowed only at the court's discretion, and only "where the litigation is conducted in good faith for the primary benefit of the trust as a whole," etc.[fn. 3]

But all of that is for another day. Any successor trustee was not yet a party, had not had an opportunity to engage in discovery, etc. The excluded beneficiaries had not raised the question whether the co-trustees were paying their lawyers from trust assets, and the court had heard no evidence on the subject.

In short, the co-trustees had not been put on notice they might need to defend their actions on this front. A finding that they had acted in bad faith in executing the decantings would certainly limit them in framing that defense.

Speculative, as I say, but these details are characteristic of an extraordinarily well-written opinion by Judge Gary R. Cassavechia, issued just two days before his mandatory retirement from the bench at age 70.

Some stray notes

[fn. 1]

My use of the word "panel" here is inexact. The New Hampshire supreme court does not sit in panels except on nonprecedential, expedited appeals, which are to be decided unanimously.

There are five justices on the court, the chief and four associates. Two recused themselves from the present case after the lawyer for the excluded beneficiaries sent a letter to the court mentioning the name of a lawyer who had testified as an expert witness for the co-trustees.

In such a situation, it is not uncommon for the chief justice to designate one or more retired judges to fill out the bench. It is not clear why that did not occur here.

[fn. 2]

In the 2017 session, the legislature enacted an entirely new chapter enabling the creation or domestication of a "civil foundation," a limited liability entity in which any discretionary beneficiaries would have essentially no rights at all. The concept is based on the Dutch *stichting*.

Apparently it is intended that these *stichtingen* will be treated as complex trusts for income tax purposes. But it is by no means clear that that analysis is correct.

Treasury Reg. section 301.7701-4(a) says "an arrangement will be treated as a trust," rather than as a corporation or a partnership, etc., "if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit." But if there are no "beneficiaries" in any traditional sense, the arrangement might not meet this definition.

Further, a fundamental difference between a common law trust and a civil law *stichting* is that the latter is itself a juridical entity, whereas a trust is not an entity, but a relationship. Follow me here.

A trust cannot sue or be sued. It does not "own" property. It is the trustee who holds legal title to trust assets, on behalf of the beneficiaries. And it is the trustee who is the proper party, in her fiduciary capacity, to enter into contracts and to initiate or defend litigation affecting the trust.

When the issue inevitably arises, IRS may take the position that a civil law *stichting* more closely resembles a corporation or partnership than a common law trust.

[fn. 3]

These observations on a question that neither party had raised provoked some pushback by the co-trustees. In a footnote in their motion to stay that portion of the trial court's order removing them, pending the appeal, the co-trustees claimed they were "reserv[ing]" unspecified "rights" with respect to the issues mentioned in footnote 6.

The trial court did grant the motion to stay, with conditions, but rejected the idea the co-trustees could "reserve" a right, for example, to file a motion for reconsideration outside the ten-day limit prescribed by procedural rules.

The co-trustees sought permission belatedly to add this issue to their notice of appeal, and the supreme court granted the motion.

In briefing the question, the co-trustees sought only clarification that no determination had yet been made on their right to be indemnified for fees and expenses incurred in defending the present action.

The court did include such a clarification in the closing sentences of the majority opinion.

About the asterisk

I really do not know whether to expect we will have enough material at any given moment to hold to a "fortnightly" schedule. If not, the asterisk can signify "or occasional."

And/or it may be that something comes up for which I will want to put out a two-pager within the fortnight.

Just as we were going to press, the 10th Circuit federal appeals court issued its opinion in *Green v. United States*, No. 16-6371 (10th Cir. 01/12/18), reversing an Oklahoma district court that had allowed a trust an income tax charitable deduction under section 642(c) at fair market value for a contribution of appreciated property that had been purchased, it was said, from prior years' income.

At least for the moment, the government has prevailed in its argument that the deduction should be limited to adjusted basis, which seems intuitively correct, one might almost say obvious -- section 642(c) seems to say distributions must be sourced to "gross income" to be deductible, and of course unrealized appreciation has not been taken into "gross income." But it has been surprising to see the extent to which the argument is not solidly grounded in the statute, the interpretive regulations, or prior caselaw.

As I mentioned in my pre-launch message, I have been following *Green*, and I intend to write it up in these pages. Right now my target is January 30.

Jack says, "we are all intermediaries on this bus."