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NON-JUDICIAL SETTLEMENT AGREEMENTS FOR TRUSTS

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I. INTRODUCTION: NON-JUDICIAL SETTLEMENT AGREEMENTS FOR TRUSTS.

A. Agreements Designed to Resolve Differences Between Beneficiaries.

1. Family settlement agreements can be used to resolve legitimate disputes between beneficiaries, the trustee and others. However, there is a justifiable concern that such agreements are only effective and binding as to those interested persons who actually sign the agreement.

2. Public policy favors the settlement of disputes among family members by agreement rather than by litigation. *Altemeier v. Harris*, 403 Ill. 345, 86 N.E.2d 229 (1949). A family settlement agreement requires the following:

a) A reasonable or substantial basis for believing that litigation will result if an agreement is not entered into;

b) That the trust will be materially depleted if no agreement is entered into;

c) That family relationships will be injured if no agreement is reached;

d) That the parties are entitled to enter into a settlement agreement;

e) That the settlement agreement is impartial;

f) That the settlement agreement is obtained without fraud or deception. *Anderson v. Anderson*, 380 Ill. 488, 44 N.E.2d 43 (1942); *Wolf v. Uhlemann*, 325 Ill. 165, 156 N.E. 334 (1927).

3. Family settlement agreements also require consideration. Mutual promises not to litigate claims are valid consideration, but said claims must have reasonable or substantial basis in order to serve as consideration. *Anderson v. Anderson*, 380 Ill. 488, 44 N.E.2d 43 (1942).

4. Property disposed of by a true family settlement agreement does not constitute a gift for estate tax purposes.

B. Agreements Designed to Resolve Differences Between Trustee and Beneficiaries.

1. Consents. A beneficiary who consents to an act of a trustee cannot subsequently object to the act. *McCormick v. McCormick*, 180 Ill.App.3d 184, 536 N.E.2d 419 (1 Dist. 1988).

a) A consent allowing the trustee to deviate from the trust's terms is binding if the beneficiary is shown to have acted freely, deliberately and advisedly, with the intention of confirming a transaction which he knew or should have known to be impeachable. *In re Hartzell's Will*, 43 Ill.App.2 118, 192 N.E.2d 697 (1963).

2. Releases. Beneficiary releases are enforceable in Illinois. The intent of the parties, determined from the release's express language as well as the surrounding circumstances, control the scope and effect of a release. *Fuller Family Holdings, LLC v. The Northern Trust Company*, 371 Ill.App.3d 605, 863 N.E.2d 743 (1 Dist. 2007). The party opposing release bears burden of attacking validity.

a) Reasons release would be ineffective include:

(1) fraud in the execution;

(2) fraud in the inducement;

(3) mutual mistake;

(4) mental incompetence. *McCormick v. McCormick*, 118 Ill.App.3d 455, 455 N.E.2d 103 (1 Dist. 1983); *Janowiak v. Tiesi*, 402 Ill. App.3d 997, 932 N.E.2d 569 (5 Dist. 2010).

b) Any release signed by the beneficiary will be strictly construed against the benefiting party, and releases between a trustee and a beneficiary are subject to the closest scrutiny. *Fuller Family Holdings, LLC v. The Northern Trust Company*, 371 Ill.App.3d 605, 863 N.E.2d 743 (1 Dist. 2007); *McCormick v. McCormick*, 118 Ill.App.3d 455, 455 N.E.2d 103 (1 Dist. 1983); *Janowiak v. Tiesi*, 402 Ill.App.3d 997, 932 N.E.2d 569 (5 Dist. 2010).

(1) In order for the release to be valid, the trustee bears the burden of proving full disclosure of all relevant facts. *Peskin v. Deutsch*, 134 Ill.App.3d 48, 479 N.E.2d 1034. In *Peskin*, a partner sought an accounting of a law practice because of the defendant's receipt and retention of payments from clients of fees and commissions. The court held that because there had not been full disclosure by the trustee, none of the defenses of laches, release or ratification applied to bar the partner's right to an accounting. *Peskin v. Deutsch*, 134 Ill.App.3d 48, 479 N.E.2d 1034 (1 Dist. 1985). In *Obermaier v. Obermaier*, 128 Ill.App.3d 602, 470 N.E.2d 1047 (1 Dist. 1984), both the trust and the trustee personally owned stock in the same company. The trustee offered to buy the trust's shares and the beneficiary of the trust agreed. However, the trustee hid the fact that he was negotiating the sale of his personal stock for a higher price than the trust's shares. The court held that the trustee's conduct was fraudulent and the release signed by the beneficiary in the stock purchase agreement was not enforceable. *Obermaier v. Obermaier*, 128 Ill.App.3d 602, 470 N.E.2d 1047 (1 Dist. 1984).

(2) If the beneficiary has a valid claim that was not within the contemplation of the parties at the time the agreement was executed, then the release will not serve to defeat the claim. *Fuller Family Holdings, LLC v. The Northern Trust Company*, 371 Ill.App.3d 605, 863 N.E.2d 743 (1 Dist. 2007). Where the releasing party is unaware of other claims, general releases are restricted to the specific claims contained in the release agreement. *Janowiak v. Tiesi*, 402 Ill.App.3d 997, 932 N.E.2d 569 (5 Dist. 2010). Knowledge of a possible claim by one party, but not the other, when parties sign a release does not bring the claim within the contemplation of the parties.

Janowiak v. Tiesi, 402 Ill.App.3d 997, 932 N.E.2d 569 (5 Dist. 2010).

(3) In order to be effective, a release must be based upon consideration. *White v. Village of Homewood*, 256 Ill.App.3d, 623 N.E.2d 616 (1 Dist. 1993). Valuable consideration for a contract consists either of some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss of responsibility given, suffered or undertaken by the other. *Id*.

II. VIRTUAL REPRESENTATION AGREEMENTS.

A. Virtual representation agreements are similar in spirit to ordinary settlement agreements. The difference is that with a virtual representation agreement, certain unborn, minor, disabled or missing beneficiaries can be "virtually represented" by other persons in the execution and enforceability of the agreement. Among other things, this eliminates the need to go to court and have a guardian ad litem appointed for those beneficiaries that lack capacity to sign. Virtual representation agreements may only be used in the trust context, as they are a creature of the Trusts and Trustees Act. 760 ILCS 5/16.1.

B. According to 760 ILCS 5/16.1, issues that may be resolved by a non-judicial settlement agreement include but are not limited to:

1. Validity, interpretation or construction of the terms of the trust;

2. Approval of a trustee's report or accounting;

3. Exercise or non-exercise of any power by a trustee;

4. The grant to a trustee of any necessary or desirable administrative power as long as it presents no conflict with a material purpose of the trust;

5. Questions relating to property or an interest in property held by the trust as long as it presents no conflict with a material purpose of the trust;

6. Resignation or appointment of a trustee or trust protector;

7. Determination of a trustee's compensation;

8. Transfer of a trust's principal place of administration, including the selection of governing law for trust administration;

9. Liability or indemnification of a trustee for an action relating to the trust;

10. Resolution of disputes or issues related to administration, investment, distribution, or other matters;

11. Modification of terms of the trust pertaining to administration of the trust; and

12. Termination of the trust, provided that court approval of such termination must be obtained on a petition filed within 60 days of the effective date of the agreement, and the court must conclude continuance of the trust is not necessary to achieve any material purpose of the trust; upon such termination the court may order the trust property distributed as agreed by the parties to the agreement or otherwise as the court determines equitable consistent with the purposes of the trust. Spendthrift provisions

do not necessarily state a material purpose of the trust.

a) The court would not allow a brother to claim that a settlement agreement between him and his siblings was illegal because it attempted to terminate a trust, which is an action that beneficiaries are not allowed to take. Instead, the court stated that the material purposes of the trust had been accomplished and the beneficiaries were allowed to voluntarily change or alter the distribution of the trust. *Gutman v. Schiller*, 187 N.E.2d 315, 39 Ill.App.2d 58, 66 (1 Dist. 1963).

13. Any other matter that could be approved by a court under applicable law.

C. A virtual representation agreement can also be used to convert a trust to a total return trust by agreement in accordance with the total return trust provisions of Subsection (b) of the Act. 760 ILCS 5/16.1(b).

D. The implementation of the virtual representation statute does not necessarily reflect a change in Illinois policy as to virtual representation, as there is support for this notion.

1. Judicial. "Where it appears that a particular party, though not before the court in person, is so far represented by others that his interests receive actual and efficient protection, the decree may be held to be binding upon him. It must appear that he stands in the same situation as parties before the court and that he has a common right or interest with them, the operation and protection of which will be for the common benefit of all and cannot be to the injury of any." *Ludwig v. Sommer*, 53 Ill.App.2d 72, 76, 202 N.E.2d 337, 338–39 (3 Dist. 1964), quoting *Weberpals v. Jenny*, 300 Ill. 145, 155, 133 N.E. 62, 65 (1921); 755 ILCS 5/6-12.

2. Non-judicial. Where a parent and child hold the same interest, the parent fairly represents the interests of themselves and their children, where there is no conflict between the parent and the child, and then the parent can effectively bind their children to a settlement agreement. *See Estate of Mayfield v. Estate of Mayfield*, 680 N.E.2d 784, 288 Ill.App.3d 534 (4 Dist. 1997).

E. Application of the Virtual Representation Statute. The statute has two basic parts. First, the statute defines the circumstances in which virtual representation may occur. 760 ILCS 5/16.1(a)-(c). Second, the statute describes how to use that virtual representation to create an agreement that is binding not only on those signing the agreement, but also on those beneficiaries who are virtually represented.

1. Virtual Representation. Generally, when a named beneficiary or

member of a named class of beneficiaries of a trust is either unknown and not reasonably ascertainable, whose location is unknown and not reasonably ascertainable, adjudicated as a "disabled person," a minor or unborn, that beneficiary may nonetheless be bound by an agreement with the trustee provided that the agreement is signed by a person who is qualified to represent the beneficiary under the statute. 760 ILCS 5/16.1(a). 760 ILCS 5/16.1(a)(1). Nothing in the statute limits the court's discretionary power to appoint a Guardian ad Litem, but no such appointment is necessary if the statute is properly followed. 760 ILCS 5/16.1(a)(8).

a) Priority of Virtual Representative Status. Absent a court order that deviates from this list, the following persons, in the order listed, have priority in acting as a representative under the statute and the existence of a potential representative with higher priority will prohibit another from acting:

(1) The Court (appointment of Guardian ad Litem) (760 ILCS 5/16.1(a)(8));

(2) Agent on Power of Attorney for Property (but not for healthcare) (760 ILCS 5/16.1(a)(4));

(3) Guardian of the Estate (760 ILCS 5/16.1(a)(4));

(4) Guardian of the Person (760 ILCS 5/16.1(a)(4));

(5) Parent of minor, disabled or unborn beneficiary (760 ILCS 5/16.1(a)(5));

(6) An agent, guardian or parent of another beneficiary who has a substantially similar interest with respect to the dispute (760 ILCS 5/16.1(a)(6));

(7) Any other beneficiary having a substantially similar interest with respect to the question or dispute. (760 ILCS 5/16.1(a)(1));

(8) An agreement by all "Primary Beneficiaries" or their representatives. (760 ILCS 5/16.1(a)(2));

(a) "Primary Beneficiaries" consist of beneficiaries that:

(i) Are currently entitled or eligible to receive any portion of the trust income or principal; or

(ii) Qualify as a "Presumptive Remainder Beneficiary," which is defined as a person who, assuming non-exercise of all powers of appointment, would either: (a) be eligible to receive a distribution of income or principal if the trust terminated on that date, or (b) be eligible to receive a distribution of income or principal if the interests of all beneficiaries currently eligible to receive income or principal from the trust ended on that date without cause the trust to terminate.

(b) Does this include named recipients of specific gifts? Yes.

(c) Does this include all remainder beneficiaries? Yes.

(d) Does this include all named beneficiaries? No, it doesn't appear so. Take for example a trust that is paying income and principal to Child. The trust agreement provides that upon Child's death, the trustee is to retain the principal and pay discretionary payments to Grandchild for Grandchild's life. Upon Grandchild's death, the trustee is to retain the trust principal and make discretionary payments to Grandchild's surviving spouse, if any. If Grandchild leaves no surviving spouse, then the trustee is to distribute out to Great Grandchild. It would appear that Child is a person currently entitled to receive income or principal of the trust (number 1 above). Grandchild would be a person eligible to receive a distribution of income or principal if the interests of all beneficiaries currently eligible to receive income or principal from the trust (Child's interest) ended on that date without cause the trust to terminate (number 2(b) above). Great Grandchild would be a person eligible to receive a distribution of income or principal if the trust terminated on that date (number 2(a) above). However, if Grandchild is living at the time of the virtual representation agreement, it would appear that Grandchild's spouse would not be a Primary Beneficiary under this definition.

b) Conflicts of Interest. In all cases, the representative may only be a person with whom the beneficiary has no conflict of interest with respect to the particular question or dispute.

c) Charitable Beneficiary Representation – Attorney General. If the trust benefits a charity or a charitable purpose, where no specific charity is named, then "the Illinois Attorney General may, in accordance with this Section, represent, bind, and act on behalf of the charitable interest with respect to any particular question or dispute, including without limitation representing the charitable interest in a non-judicial settlement agreement or in an agreement to convert a trust to a total return trust." 760 ILCS 5/16.1(c). This appears to be a permissive and not mandatory provision, but Subsection (d)(4.5) requires notice and opportunity to object. 760 ILCS 5/16.1(d)(4.5).

2. Creating Binding Agreements. Subsection (d)(2) is where we find the actual grant of authority to certain persons to enter into a binding non-judicial settlement agreement. 760 ILCS 5/16.1(d)(2). This authority is only given "Interested Persons." *Id*. The term "Interested Persons" is defined in the preceding section as "the trustee and *all* beneficiaries, or their respective representatives determined after giving effect to the preceding provisions of this Section, whose consent or joinder would be required in order to achieve a binding settlement were the settlement to be approved by the court. 760 ILCS 5/16.1(d)(1) (emphasis added). Depending on the action the parties are trying to take, one might assume that the Interested Persons necessary to create a binding agreement would consist of all Primary Beneficiaries or their representatives as defined in Subsection (a). 760 ILCS 5/16.1(a).

III. DISTRIBUTION OF TRUST PRINCIPAL IN FURTHER TRUST – "DECANTING."

A. 760 ILCS 5/16.4. Distribution of Trust Principal in Further Trust ("Decanting").

1. "Decanting." When a trustee "pours" trust principal into a *different* trust.

a) Conceptually, the second trust can be:

(1) New or old;

(2) Created by the trustee or any other person.

B. Basis.

1. A trustee's discretionary power to make distributions for the benefit of a current beneficiary includes the lesser power to make distributions in trust for the benefit of the beneficiary.

2. A trustee's absolute discretion to make distribution to a beneficiary is akin to the trustee having a limited power of appointment in favor of that beneficiary.

C. When can a trustee Decant?

1. Under the Statute:

a) Applies to Irrevocable Trusts only.

b) "Authorized Trustee." Any person, other than the settlor, who has the authority under the first trust to distribute the principal for the benefit of one or more current beneficiaries.

(1) This could include a Distribution Trust Advisor of a Directed Trust.

c) Decanting may be done whether or not there is a current need to distribute principal under the Terms of the First Trust.

d) The transfers made by the Decanting process must be documented in writing.

2. As otherwise allowed by law (e.g. Virtual Representation Agreements).

D. Discretion.

1. The terms of the second trust are limited by the scope of the discretion given to the Authorized Trustee in the First Trust. For this purpose, a distinction is drawn between:

a) Absolute discretion, or

b) No absolute discretion.

2. Absolute Discretion. Absolute Discretion means the trustee has the right to distribute principal that is not limited or modified in any manner to or for the benefit of one or more beneficiaries of the trust, whether or not the term "absolute" is used. A power to distribute principal that includes purposes such as "best interests," "welfare," or "happiness" is considered to confer absolute discretion (760 ILCS 5/16.4(a), (c)).

a) The second trust may be for the benefit of one, more than one or all of the current beneficiaries of the first trust and for the benefit of one, more than one or all of the successor and remainder beneficiaries of the first trust.

b) A trustee who has absolute discretion may grant general or limited powers of appointment to one or more current beneficiaries of the first trust if those current beneficiaries were entitled to

outright distribution under the first trust.

c) A power of appointment granted to a beneficiary of the second trust may include a broader or different class of permissible appointees than the beneficiaries of the first trust.

3. No Absolute Discretion. An authorized trustee who has the power to distribute the principal of a trust but does not have the absolute discretion to distribute the principal of the trust may distribute part or all of the principal of the first trust in favor of a trustee of a second trust, provided that (760 ILCS 5/16.4(d)):

a) The second trust has the same current beneficiaries and the same successor and remainder beneficiaries as the first trust;

b) The second trust includes all beneficiary class members as in the first trust; and

4. The second trust includes all of the powers of appointment of the first trust.

E. Supplemental Needs Trusts. In general, 760 ILCS 5/16(d)(4) allows for decanting into a special needs, pooled or OBRA payback trust. Because the authorized trustee may decant into a special needs trust regardless of the level of discretion, this is the only decanting provision that could potentially allow an expansion of the trustee's distributive discretion from the first trust to the second trust.

1. Example: An income only trust with a beneficiary that develops a disability can be converted to a special needs trust, thereby increasing the potential distributions to the beneficiary.

2. Remainder beneficiaries. A supplemental needs second trust may name remainder and successor beneficiaries other than the disabled beneficiary's estate, provided that the second trust names the same presumptive remainder beneficiaries and successor beneficiaries to the disabled beneficiary's interest, and in the same proportions, as exist in the first trust.

3. Disabled beneficiary as grantor or with control. Where the first trust was created by the disabled beneficiary or the trust property has been distributed directly to or is otherwise under the control of the disabled beneficiary:

a) the authorized trustee may distribute to a "pooled trust" as defined by federal Medicaid law for the benefit of the disabled beneficiary, or

b) the supplemental needs second trust must contain pay back

provisions complying with Medicaid reimbursement requirements of federal law.

F. Additional Uses. Fundamentally, Decanting is a form of non-judicial irrevocable trust modification that can be used even in certain cases where virtual representation agreements cannot, for example:

1. Correct, add, delete or modify administrative and investment provisions.

2. Correct, add, delete or modify fiduciary appointment and succession provisions.

3. Change situs or applicable law.

4. Convert to a grantor trust or qualified sub-chapter S trust.

5. Lengthen the duration of the trust.

6. Add or remove spendthrift provisions.

7. Adjust to changing tax law and/or environment.

G. Specific Limitations on Second Trust.

1. Purpose of the First Trust. The terms of the second trust must further the purposes of the first trust.

2. Term. A second trust may have a term longer than that of the first trust; however, the second trust must have the same permissible period of the rule against perpetuities as the first trust (760 ILCS 5/16.4(n)).

3. Assets. Assets belonging to the first trust that are discovered after decanting must be included in the decanting, whereas assets *acquired* by the first trust after decanting remain assets of the first trust (760 ILCS 5/16.4(i)).

4. Express Prohibition. Decanting is not permissible if expressly prohibited by the first trust; however, a spendthrift provision by itself does not prohibit decanting (760 ILCS 5/16.4(v)).

5. Mandatory Rights of Distributions. Except as to second supplemental needs trusts, the second trust cannot reduce, limit or modify a beneficiary's mandatory distribution or right of withdrawal (760 ILCS 5/16.4(n)).

6. Trustee Liability. A trustee cannot be exonerated from liability for failure to exercise reasonable care, diligence, and prudence, except for the limitation of liability that results from the use of a Direct Trust (760 ILCS 5/16.4(n)).

7. Removal of Decanting Trustee. An individual's right to remove the trustee cannot be eliminated; however, replacing that individual with another having such a right is permissible if the replacement is non-subservient to the trustee (760 ILCS 5/16.4(n)).

8. Tax Status. Tax status must be preserved as follows:

a) Decanting must preserve all minimum distribution treatment, tax exempt status and S-Corp status as had originally applied to the first trust (760 ILCS 5/16.4(p)) (except for Grantor Trust status).

9. Trustee Fees. The level of the trustee's fees cannot be increased beyond what would be considered a reasonable level (760 ILCS 5/16.4(q)).

H. Trustee Liability and Remedies.

1. No Duty to Decant. A trustee has no duty to decant and no inference of impropriety shall be made as a result of an authorized trustee not decanting (760 ILCS 5/16.4(k)).

2. Liabilities. A trustee who reasonably and in good faith acts under the decanting statute is not liable to any person interested in the trust (760 ILCS 5/16.4(u)).

3. Presumption. An act or omission by a trustee under the decanting statute is presumed taken or omitted reasonably and in good faith unless it is determined by the court to have been an abuse of discretion (760 ILCS 5/16.4(u)).

4. Remedies. If a trustee reasonably and in good faith takes or omits to take any action under the decanting statute, and a person interested in the trust opposes the act or omission, the person's exclusive remedy is to obtain an order of the court directing the trustee to exercise authority in accordance with the law or as the court determines necessary or helpful for the proper functioning of the trust (760 ILCS 5/16.4(u)).

5. Statute of limitations. Any claim by any person interested in the trust is barred if not asserted in a proceeding commenced by or on behalf of the person within 2 years after the individual received the notice of the decanting (760 ILCS 5/16.4(u)).

a) Exception: The statute of limitations does not run for a person who was under a legal disability at the time the notice or report was sent and who then had no personal representative.

I. Process of Decanting. If an authorized trustee wishes to decant, the exercise must be made by written instrument, signed and acknowledged by the trustee, and filed with the records of the first trust and the second trust (760 ILCS 5/16.4(r)).

1. No Court Involvement.

a) Notice Requirement. An authorized trustee may decant without the consent of the settlor or the beneficiaries of the first trust and without court approval if notice is given to all legally competent current and presumptive remainder beneficiaries specifying the manner in which the trustee intends to exercise the decanting power and the date of the decanting (760 ILCS 5/16.4(e)).

(1) A recipient of the notice must object in writing delivered to the trustee within 60 days after the notice is sent.

(2) The Attorney General's Charitable Trust Bureau must receive notice if a charity is a current beneficiary or presumptive remainder beneficiary of the trust.

2. Court Involvement. If an objection to the decanting is received or

if the trustee for any reason is insecure about the election to decant, the trustee may petition the court to order the decanting (760 ILCS 5/16.4(f)).

a) A trustee is deemed not to have breached the duty of impartiality unless the court finds that that trustee acted in bad faith.

J. Applicability. After the effective date of January 1, 2013, the Decanting statute will apply to existing trusts and future trusts that are administered in Illinois or under Illinois law, or governed by Illinois law.

IV. TAX CONSEQUENCES OF DECANTING.

A. Uncertainties. The IRS has recognized that decanting is a new technique that may have tax consequences that are not clear under current law.

1. Tax Implications.

a) GST Tax. Whether a trust that has received property from another trust that is grandfathered for GST purposes or the trust that is GST exempt as a result of the allocation of the GST exemption through decanting continues to maintain its grandfathered or GST exempt status.

b) Gift Tax. Whether a beneficiary whose interests are diminished as a result of the decanting has made a taxable gift.

(1) Modifications to Administrative Provisions – Generally, trust modifications to purely administrative provisions should not be deemed gifts by trust beneficiaries.

(2) Modifications Which Shift Beneficial Interests – However, if decanting results in a shifting or transfer of beneficial interests in a trust, then a taxable gift may result. The gift tax applies to *voluntary* transfers.

c) Gift/Estate Tax.

(1) Marital Deduction. Whether the existence of a decanting power in a trust that otherwise qualifies for an estate or gift tax marital deduction under IRC §2056(b)(7) will cause the trust to fail to qualify for the marital deduction.

(2) Testamentary Limited Power of Appointment. If a beneficiary's failure to object is deemed a gift but the gift is incomplete as a result of the beneficiary's limited power of appointment in the second trust, then it looks as though the trust property will be includible in the beneficiary's gross

estate for estate tax purposes under IRC §§ 2036(a) and 2038.

d) Income Tax: Whether the existence of a decanting power causes the trust to be treated as a grantor trust under IRC §671.

(1) Decanting from a Non-Grantor Trust to a Grantor Trust – The IRS has provided that the conversion is not a transfer for income tax purposes and therefore not a taxable event. Chief Counsel Memo 200923024.

(2) Decanting from a Grantor Trust to a Non-Grantor Trust – If a trust owns assets that have liabilities in excess of the asset's income tax basis, a conversion of a grantor trust to a non-grantor trust may cause the grantor to recognize gain to the extent of that excess.

(3) Beneficiary Recognition of Gain – The IRS could argue that a beneficiary recognizes the gain if the decanting changes the beneficiary's interest and the beneficiary's consent is required for the decanting.

2. Opting Out. Similar to the Directed Trust concerns, if a trust agreement directly prohibits some of the transfers provided for in the Decanting statute, has the grantor completely opted out of the statute? Or may decanting still be used to a certain extent?

V. DIRECTED TRUSTS.

A. 760 ILCS 5/16.3. Directed Trusts.

1. "Directed Trust." A trust which separates specified trust functions from the trustee's administrative duties (e.g., separating investment and distribution decisions that a trustee typically would make and allocating those responsibilities to a "Directing Party", who will then advise the administrative trustee).

2. "Directing Party." Any investment trust advisor, distribution trust advisor, or trust protector (760 ILCS 5/16.3(a)(1)).

3. "Excluded Fiduciary." Any fiduciary that by the trust agreement (or "governing instrument") is directed to act in accordance with the exercise of specified powers by a directing party, in which case such specified powers shall be deemed granted not to the fiduciary but to the directing party and such fiduciary shall be deemed excluded from exercising such specified powers (760 ILCS 5/16.3(a)(3)).

B. Purpose.

1. The statute creates a statutory framework allowing a trust

instrument to exclude a trustee from one or more fiduciary powers and exempt the trustee from the liabilities associated with those powers during the administration of a trust.

2. Generally, the statute provides for the division of trusteeship by allocating fiduciary powers and liabilities between more than one person or group of persons best able to handle certain duties.

C. Uses. A Directed Trust can be used for a variety of purposes, such as:

1. Dealing with special assets or high investment concentrations;

a) Exonerating corporate trustees for certain decisions to induce their participation;

b) Using the investment expertise or philosophy of particular persons for some or all trust assets;

c) Expand the practical expertise of the controlling fiduciary

2. Giving certain persons the power to make distribution decisions;

a) Use of family members to make decisions without giving them investment control;

b) Deal with changing needs;

c) Keep the purpose of the trust “in the family;”

3. Provide a balance of power between controlling fiduciaries;

4. Create a mechanism allowing future amendments to the trust instrument or termination of the trust to adjust to changing circumstances, objectives or law;

D. Directing Parties. Directing Parties can be created to exercise a wide array of powers, including but not limited to the following:

1. Investment Trust Advisor ("ITA") –760 ILCS 6/16.3(b)

a) The ITA can consist of one or more persons.

b) The ITA has the authority to direct, consent to, veto or otherwise exercise all or any portion of the investment powers of the trust, but does not necessarily need to be called an ITA.

c) The powers may be exercised or not exercised in the sole and absolute discretion of the ITA.

d) The decisions of the ITA are binding on all other persons, including the beneficiaries and other fiduciaries.

e) Default Powers of the ITA if not provided for in the trust agreement:

(1) Direct the trustee on retention, purchase, transfer, assignment, sale or encumbrance of trust property and the investment of principal and income;

(2) Direct the trustee with respect to management, control and voting powers, including proxies;

(3) Select one or more advisors, managers, consultants or counselors, including the trustee, to determine their compensation and to delegate to them any investment Trust advisor powers;

(4) Determine frequency and methodology for valuing any asset for which there is no readily available market value.

2. Distribution Trust Advisor ("DTA") –760 ILCS 6/16.3(c)

a) The DTA can consist of one or more persons.

b) The DTA has the authority to direct, consent to, veto or otherwise exercise all or any portion of the distribution powers of the trust, including discretionary distributions.

c) The powers may be exercised or not exercised in the sole

and absolute discretion of the DTA.

d) The decisions of the DTA are binding on all other persons, including the beneficiaries and other fiduciaries.

e) The DTA may direct the trustee with regard to all decisions relating directly or indirectly to discretionary distributions to or for one or more beneficiaries.

3. Trust Protector ("TP") –760 ILCS 6/16.3(d)

a) The TP can consist of one or more persons.

b) The TP is given by the trust agreement one or more of the statutory powers listed in subsection (d) of the statute, regardless of whether the title "trust protector" is used in the trust agreement.

c) The powers may be exercised or not exercised in the sole and absolute discretion of the TP.

d) The decisions of the TP are binding on all other persons, including the beneficiaries and other fiduciaries.

e) The powers of the TP listed under subsection (d) are as follows:

(1) Amend the trust instrument to achieve favorable tax status or to respond to changes in the law;

(2) Increase, decrease or modify the interest of any beneficiary or beneficiaries of the trust;

(3) Modify the terms of any power of appointment granted by the trust (but not to the benefit of a non-beneficiary);

(4) Remove and appoint any other fiduciary of the trust;

(5) Terminate the trust, including determination of how to make final distributions consistent with the purposes of the trust;

(6) Change the situs or governing law of the trust;

(7) Appoint successor Trust Protectors;

(8) Interpret the terms of the trust instrument at the request of the trustee;

(9) Advise the trustee on matters concerning a beneficiary;

(10) Amend the trust instrument to take advantage of laws governing restraints on alienation, distribution of trust property or to improve the administration of the trust.

E. Directing Party Liabilities. The Directing Parties are fiduciaries subject to the same duties and standards applicable to a trustee – but only as to matters within the scope of the Directing Parties' powers (760 ILCS 5/16.3(e)).

1. The Directing Party must act in the best interests of the trust.

2. In the exercise of sole and absolute discretion, a trustee's discretion will be upheld if not "wholly unreasonable and arbitrary," or the product of fraud or bad faith (*Laubner v. J.P. Morgan Chase Bank, N.A.*, 386 Ill.App.3d 457).

3. By accepting office, Directing Parties submit themselves to the laws and jurisdiction of the State of Illinois and can be made parties to any action relating to the Directing Party's actions – even if the investment advisory or other agreements state otherwise ((760 ILCS 5/16.3(g)).

4. The Directing Party must keep the Excluded Fiduciary reasonably informed throughout the administration of duties to allow the Excluded Fiduciary to perform its duties ((760 ILCS 5/16.3(h)).

5. Actions or inactions by the Directing Party do not affect the limitation from liability of Excluded Fiduciary ((760 ILCS 5/16.3(h)).

F. Excluded Fiduciary. An Excluded Fiduciary, consisting of one or more persons, is required to act at the direction of a directing party as to any matter (760 ILCS 5/16.3(f)).

1. The Excluded Fiduciary does not need to be called an "Excluded Fiduciary."

2. The Excluded Fiduciary is relieved of both power and liability as to the specified matter assigned to the Directing Party.

G. Excluded Fiduciary Liabilities. An Excluded Fiduciary must act in accordance with the trust agreement and as directed by the Directed Parties (760 ILCS 5/16.3(f)).

1. The Excluded Fiduciary has no duty to:

a) Monitor, review, inquire, investigate, recommend, evaluate or warn with respect to any Directing Party's exercise or failure to exercise power.

b) This includes the acquisition, disposition, retention, management or valuation of any asset.

2. When carrying out a directive, the Excluded fiduciary maintains no liability unless there is willful misconduct.

3. The Excluded Fiduciary may rely on an opinion of counsel for any matter relevant to this Section.

H. Applicability and Limitations. After the effective date of January 1, 2013, the Directed Trust statute will apply to all existing and future trusts that appoint or provide for a Directing Party under applicable law, the terms of the instrument, court order, or virtual representation agreement.

1. Prohibitions. A trust agreement may expressly prohibit the use of the Directed Trust statute.

I. Potential Issues with Directed Trusts.

1. Uncertainties. There are many uncertainties regarding the new statute and uses of Directing Parties. Such issues include:

a) Fiduciary status. Section (e) of the Directed Trust statute states that "[a] directing party is a fiduciary of the trust [and is] subject to the same duties and standards applicable to a trustee of a trust… unless the governing instrument provides otherwise, but the governing instrument may not, however, relieve or exonerate a directing party from the duty to act or withhold acting as the directing party in good faith reasonably believes is in the best interests of the trust."

b) Trustee/Grantor/Beneficiary as a Directing Party? The definitions of the directing parties, explained under Subsection II(D) above, would imply that not only can a trustee serve as a DP, but a grantor or beneficiary could serve as a DP. If this is the case, what is the appropriate standard? Is the grantor or beneficiary acting as a DP now considered a fiduciary of the trust? If so, the grantor or beneficiary serving as a DP now has significantly different duties.

c) Potentially conflicting standards of review: good faith reasonable belief v. wholly unreasonable and arbitrary.

(1) The descriptions of the Directing Party roles, as set forth in Paragraphs (b), (c), and (d) of the statute provide that the powers of the DP may be "exercised or not exercised in the sole and absolute discretion" of the DP. Further, paragraph (e) of the statute states that DP's are subject to the same standards as a trustee of the trust. Separately, Illinois courts have ruled that a trustee's exercise of absolute discretion will be upheld if not *wholly unreasonable or arbitrary*. *Laubner v. J.P. Morgan Chase*

Bank, N.A., 898 N.E.2d 744, 751 (4 Dist. 2008) (emphasis added).

(a) "If a trustee is vested with the power to exercise discretion… chancery will not interfere so long as he is acting bona fide, and in an wholly unreasonable and arbitrary manner." *Chicago Title & Trust Co. v. Chief Wash Co.*, 13 N.E.2d 153, 155 (1938) (citing 26 R.C.L., Trusts, §234).

(2) Paragraph (e) also states that the DP cannot be relieved from the obligation to act as he or she in *good faith reasonably believes is in the best interests of the trust*.

(a) "Best interests of the Trust?" If the DP is charged with acting as he or she in good faith reasonably believes is in the best interest of the trust, what would be considered in the trust's best interests?

(b) The trustee's interests would focus on the collection and retention of assets in the trust.

(c) The beneficiary's interests would be to have all of the assets distributed to the beneficiary.

(3) What is the appropriate standard?

(a) Must a DP act in a way that is not wholly unreasonable or arbitrary? OR

(b) Must a DP act as he or she in good faith reasonably believes is in the best interests of the trust?

2. Notice to Attorney General. Section (d) of the Directed Trust statute provides that "[i]f a charity is a current beneficiary or a presumptive remainder beneficiary of the trust, a trust protector must give notice to the Attorney General's Charitable Trust Bureau at least 60 days before taking any of the actions authorized under item (2), (3), (4), (5), or (6) of this subsection. The Attorney General's Charitable Trust Bureau may, however, waive this notice requirement."

a) If notice is not provided to the Attorney General according to this requirement, what are the consequences? Are the proposed actions by the trust protector void? Are the actions suspended? Or are the actions simply subject to challenge by the Attorney General?

b) If notice is provided and the Attorney General responds that the action may not be taken, is the trust protector completely prohibited from taking further action?

c) Does the 60-day requirement mean that the trust protector may not take any action during that time?

d) Will this requirement deter grantors from naming charities as remainder beneficiaries?

3. Opting Out. What statute or document governs?

a) 760 ILCS 5/3(1) provides that "[t]he provisions of [the Trust & Trustees] Act apply to the trust to the extent that they are not inconsistent with the provisions of the instrument.

b) 760 ILCS 5/16.7 provides that a grantor can "opt out" of the direct trust provisions by expressly prohibiting the use of the statute in the governing instrument. Without such a prohibition in the governing document, Section 16.7 provides that 16.3 shall be available to administer any trust governed by Illinois law.

c) Subsection (e) of 16.3, as mentioned earlier, states that a directing party cannot be limited below the standard of acting as he or she in good faith reasonably believes is in the best interest of the trust.

(1) Example: An existing trust states that a Trust Protector is not a fiduciary of the trust.

(a) Must the grantor or trustee opt out of the Directed Trust statute completely?

(b) Can 16.7 be used to modify an existing trust to opt out of the use of the Directed Trust statute?

(c) Or is it possible to simply opt out of the part of the statute that states that a Trust Protector is a fiduciary?

(2) Section 3(1) of the Trust & Trustee's Act provides that a grantor may specify in the instrument provisions that, where not contrary to the law, shall control. Therefore, it would appear that any limitation placed on a DP in the trust instrument would govern, whether partially limiting the directing party or completely eliminating the directed trust statute.