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MEMORANDUM

To: Harry Haynsworth, Chair, Harmonization Committee

From: Justin Vigdor, Chair, USTEA Standby Committee
Robert H. Sitkoff, Reporter, USTEA Standby Committee

Re: Trust Law, USTEA, and Harmonization

Date: August 27, 2010

In connection with your ongoing project to harmonize the various uniform acts on alternative entities, you have asked us to explain the trust law underpinnings of certain USTEA provisions flagged by your committee in its distribution at the 2010 Annual Meeting. We are grateful for the opportunity to do so, in part because the Annual Meeting distribution could be read as expressing disapproval of the referenced USTEA provisions. The reporters' notes to the Annual Meeting distribution observe that various USTEA provisions do not follow the usual pattern of alternative entity law, but the notes do not make the necessary additional point that, in such cases, the provisions follow trust law norms. The failure to reference the trust law traditions and prior uniform trust laws on which the identified USTEA provisions are based could give the unwarranted impression that those provisions are deviant from prior law.

The basic point is that USTEA is a hybrid act that draws variously on trust, corporate, and alternative entity law, with trust law as the default source of law (see **section 105**). The difficulty is that trust, corporate, and alternative entity law diverge on certain substantive issues, reflecting principled distinctions in policy. Accordingly, the USTEA drafting committee carefully considered the competing policies as they pertain to statutory trusts, discussed most such issues with the committee of the whole, and in certain respects chose to follow trust law norms. In doing so, the drafting committee was deeply influenced by the success of the Delaware Statutory Trust Act, which likewise blends trust, corporate, and alternative entity law, with trust law as the default.

Let us turn to the identified provisions. **Section 106(a)** provides that "This [act] must be liberally construed to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments." The reporters' notes to the

Annual Meeting distribution observe that the drafting committees for ULPA and Re-ULLCA “considered at length and rejected” this proposition. There is, however, a strong tradition in trust law of giving maximum deference to the donor’s intent, subject only to certain anti-dead-hand and other such public policy limitations. *See* Restatement (Third) of Property: Wills and Other Donative Transfers § 10.1 (2003); *see also* Delaware Statutory Trust Act § 3825(b). The Restatement section just cited provides that this principle is the “controlling consideration” in the interpretation of trusts and other such instruments.

Section 201(e) provides that “A filed certificate of trust, a filed statement of cancellation or change, or filed articles of conversion or merger prevail over inconsistent terms of a trust instrument.” The reporters’ notes to the Annual Meeting distribution point to the “sharp difference between this rule and the rule created in ULLCA and followed in ULPA (2001) and Re-ULLCA.” However, the notes neither explain the difference nor explore possible rationales for that difference.

Under USTEA, insiders and third parties are bound by the entity’s public filings even if those filings conflict with the trust instrument. By contrast, under the other acts, the public filings prevail in matters pertaining to third parties who reasonably relied on the public filing, but the operating agreement prevails over inconsistent public filings in matters pertaining to insiders. The USTEA drafting committee concluded that, because public filings are unknown in the common-law trust tradition, giving preference to the public record in all cases would avoid confusion by providing a clean contrast to the common law and an unambiguous priority of authority.

Section 506 protects a trustee from liability for breach of trust to the extent that the breach resulted from the trustee’s good faith reliance on the terms of the governing instrument. In such circumstances, the court may still issue injunctive relief and may remove the trustee, but the trustee is protected from personal liability. A defense to liability of good faith reliance on the governing instrument is familiar trust law. *See* Uniform Trust Code § 1006 (2000); Uniform Prudent Investor Act § 1 (1994). Although one of us (Sitkoff) pointed to this trust tradition and the relevant prior uniform law provisions in an email to your reporters dated March 17, 2010, the Annual Meeting distribution does not make reference to any of that information. Instead the reporters’ notes observe, correctly but without the explanatory trust law context, that the USTEA rule “differs sharply from” the other alternative entity acts.

Section 509 governs indemnification, advancement, and exoneration. The reporters’ notes to the Annual Meeting distribution observe that subsection (a), which allows for indemnification but leaves it to the parties to make such a provision in the governing instrument, differs from Re-ULLCA, ULPA (2001), and RUPA, all of which require indemnification by default. In departing from the other alternative entity acts, the USTEA drafting committee opted to follow Delaware Statutory Trust Act § 3817.

The reporters’ notes to section 509 also remark upon the difference between the limitation on permissible exoneration as formulated in subsection (c) and the comparable provision in HULLCA. What is lacking is the explanation, namely, that the USTEA formulation derives from the trust law tradition. *See* Uniform Trust Code § 1008

(2000); Restatement (Second) of Trusts § 222 (1959); Austin W. Scott, William F. Fratcher & Mark L. Ascher, 4 Scott and Ascher on Trusts § 24.27.3 (5th ed. 2007).

Section 603 concerns contributions by a beneficial owner. The reporters' notes correctly indicate that there is no provision in USTEА for recapture of distributions made while the entity is insolvent. The notes do not indicate, however, the consequence of this omission. The consequence is this: In the absence of a provision in the governing instrument on distributions while insolvent, under section 105 ordinary trust law will apply. *See* Restatement (Second) of Trusts § 273 (1959); Austin W. Scott, William F. Fratcher & Mark L. Ascher, 4 Scott and Ascher on Trusts § 26.7 (5th ed. 2007).

The reporters' notes to section 603 also point out that the list of remedies in subsection (c) differ "substantially" from the comparable provisions of the Conference's other alternative entity acts, in particular in authorizing penalties. In this regard USTEА follows Delaware Statutory Trust Act § 3802(c). *See also* Delaware Limited Liability Company Act § 18-502(c).

Finally, we come to the charging order provisions in **section 606**. Following the trust law tradition, *see* Uniform Trust Code §§ 501-502 (2000); Restatement (Third) of Trusts §§ 56, 58 (2007); Austin W. Scott, William F. Fratcher & Mark L. Ascher, 4 Scott and Ascher on Trusts §§ 14.1, 15.2 (5th ed. 2007), under USTEА a beneficial interest in a statutory trust is presumptively freely transferable, but the governing instrument may restrict the transferability of the beneficial interest. When the beneficial interest is freely transferable, a creditor of the beneficial owner can levy the beneficial interest, just as a creditor of a shareholder in a corporation can levy the debtor's shares. But what if the governing instrument provides that the beneficial interest is not freely transferable? In providing a charging order for such circumstances, USTEА is more protective of creditors of beneficial owners than ordinary trust law and the existing statutory trust acts such as in Delaware.

The challenge in adapting the charging order concept from alternative entity law for application in USTEА was reconciling the trust and alternative entity models of creditor protection. Section 606 reflects the USTEА drafting committee's careful reconciliation of trust and alternative entity law. For example, under section 606 a charging order is available only when the beneficial interest is not freely transferable. For as we have said, when the beneficial interest is freely transferable, a creditor of a beneficial owner could levy the beneficial interest itself. In a similar vein, the charging order provision under USTEА does not include a foreclosure remedy, but rather a more direct protection derived from trust law. Under USTEА, the judgment creditor can enforce for the creditor's benefit the distribution rights of the beneficial owner. Giving certain creditors the power directly to enforce the beneficiary's rights to a distribution is familiar trust law. *See* Uniform Trust Code §§ 501, 503(c), 504(c)(2) (2000); Restatement (Third) of Trusts §§ 56, 59-60 (2007).

The reporters' notes do not take notice of any of the foregoing trust traditions, nor of the carefully considered determination of the USTEА drafting committee to blend the trust and alternative entity models. The reporters' notes do, however, point to a few ambiguities in section 606 as originally drafted, and several of the proposed technical

revisions to section 606 make improvements. With the goal of maintaining the technical corrections and fixing the noted ambiguities while preserving the original drafting committee's careful balance of the trust and alternative entity models, we offer the attached revision to your committee's revision of section 606. For clarity, our changes to the version in the Annual Meeting distribution are indicated in red; we have not disturbed the original strike and score of the Annual Meeting distribution.

As we discussed at the Annual Meeting, a further lesson of the harmonization project is that the USTEA comments should be revised to provide additional comparison with alternative entity law and deeper explanation of the preference for trust norms in the sections identified above. We look forward to consultation with you on those revised comments, a project we plan to undertake in connection with any other revisions to the comments that we judge are needed in view of your final harmonization revisions.

1 **SECTION 606. CHARGING ORDER.**

2 (a) If a beneficial interest is not freely transferable by a beneficial owner ~~so such~~ that the
3 transferee ~~has all rights of the transferor~~ becomes a beneficial owner, a judgment creditor of a
4 beneficial owner may, in the capacity of judgment creditor, satisfy the judgment against the
5 beneficial owner's beneficial interest only as provided in this section.

6 (b) On application by a judgment creditor of a beneficial owner, the [appropriate court]
7 may ~~issue~~ enter a charging order against the beneficial owner's right to distributions from the
8 trust for the unsatisfied ~~part~~ amount of the judgment, ~~and:~~ A charging order constitutes a lien on
9 the beneficial owner's right to distributions and requires the ~~limited liability company~~ statutory
10 trust to pay over to the ~~person~~ judgment creditor to which the charging order was issued any
11 distribution that would otherwise have been paid to the beneficial owner.

12 (c) To the extent necessary to effectuate the collection of distributions pursuant to a
13 charging order in effect under subsection (b), the court may:

14 (1) appoint a receiver of the distributions subject to the charging order, with the
15 power to ~~enforce the beneficial owner's right to a distribution~~ make all inquiries the beneficial
16 owner may have made enforce the beneficial owner's right to distributions; and

17 (2) make all other orders necessary to give effect to the charging order.

18 ~~(c) A charging order issued under subsection (b) is a lien on the beneficial owner's right~~
19 ~~to distributions and requires the statutory trust to pay over to the judgment creditor any~~
20 ~~distribution that would otherwise be paid to the beneficial owner until the judgment has been~~
21 ~~satisfied.~~

22 ~~(d) Upon a showing that distributions under a charging order will not pay the judgment~~
23 ~~debt within a reasonable time, the court may foreclose the lien and order the sale of the beneficial~~

1 ~~owner's rights to distribution from the trust. The purchaser at the foreclosure sale obtains only~~
2 ~~those rights and does not thereby become a beneficial owner.~~

3 ~~(e) At any time before foreclosure under subsection (d), the beneficial owner whose~~
4 ~~rights to distributions are subject to a charging order under subsection (b) may extinguish the~~
5 ~~charging order by satisfying the judgment and filing a certified copy of the satisfaction with the~~
6 ~~court that issued the charging order.~~

7 ~~(d) (fd) At any time before foreclosure under subsection (d),~~ A ~~a~~ statutory trust or a
8 beneficial owner ~~that is~~ owner whose rights to distributions ~~are~~is not subject to ~~a charging order~~
9 ~~issued under subsection (b) the charging order~~ may pay to the judgment creditor the full amount
10 due under the judgment lien and thereby succeed to the rights of the judgment creditor, including
11 the charging order.

12 ~~(e) (gc)~~ This [act] does not deprive a beneficial owner ~~or a transferee of the beneficial~~
13 ~~interest~~ of any exemption applicable to the beneficial interest.