

MORRIS, NICHOLS, ARSHT & TUNNELL LLP

[REDACTED]
[REDACTED]
WILMINGTON, DELAWARE 19899-1347

[REDACTED]
[REDACTED] **FAX**

**OVERVIEW OF
DELAWARE STATUTORY TRUSTS**

By: Thomas R. Pulsifer, Esq. and Todd A. Flubacher, Esq.

A. Overview of Delaware Statutory Trusts

A Delaware statutory trust is an unincorporated association formed pursuant to a trust agreement. To obtain the benefits of the Delaware Statutory Trust Act, 12 Del. C. §§ 3801 et seq. (the “Trust Act”), a statutory trust files a short-form certificate of trust with the Delaware Secretary of State. Upon such filing, the statutory trust constitutes a separate legal entity. The equity owners of a statutory trust are referred to as beneficial owners. Generally, the rights and obligations of beneficial owners, as well as issues of governance, voting and control, are as defined in the applicable trust agreement. A beneficial owner’s property interest in a statutory trust, like shares in a corporation, constitutes personal property, and a beneficial owner has no interest in specific statutory trust property. Beneficial owners are generally entitled to the same limitations on personal liability as that extended to stockholders of Delaware corporations. Further, trustees have no liability to third parties for obligations of a statutory trust. A Delaware statutory trust may be organized to carry on any lawful business or activity, whether or not conducted for profit and whether active or custodial. Delaware statutory trusts are not subject to the Delaware corporate franchise tax, and there is no annual filing fee applicable to Delaware statutory trusts.

Typically, a statutory trust is managed by one or more trustees for the benefit of one or more beneficial owners. The Trust Act requires at least one trustee, generally a bank or trust company, who is resident in the State of Delaware. Alternatively, management duties may be vested in a person other than a trustee, such as a management company, or management may be vested in, or made at the direction of, one or more of the beneficial owners. The trustees and beneficial owners may have differing powers, and different trustees and beneficial owners may have responsibility for different trust assets. Statutory trusts may have officers and employees just as would exist in a corporation or other alternative entity form. Also like other alternative entity forms, but unlike corporations, there are no mandatory voting requirements for beneficial owners (although certain default voting rights exist under the statute, such as the right to approve mergers, unless otherwise provided in the statutory trust agreement). To the extent voting rights are granted, complete flexibility is provided for establishing voting procedures, proxy rules, quorum requirements, record dates or special class rights.

Under the Trust Act, a statutory trust constitutes a separate legal entity. Importantly, the Trust Act provides that no creditor of any beneficial owner has the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the statutory trust. While statutory trusts may carry on any purpose or activity, whether or not for profit, they are typically used for the organization of mutual funds, as investment vehicles, as collateral retention vehicles, for asset securitization transactions, as real estate investment trusts or in connection with the establishment of certain financing subsidiaries that issue so called “trust preferred securities” to public beneficial owners for whom “grantor trust” tax treatment is important.

B. Taxation of Delaware Statutory Trusts

For Delaware and federal income tax purposes, under the check-the-box regulations, a statutory trust that is a business entity could be classified as a corporation or a partnership. While corporations typically pay federal and state income tax at the entity level and their stockholders pay a second tax on the receipt of distributions (i.e., double taxation), statutory trusts can be structured to be taxed as pass-through entities for both federal and Delaware income tax purposes. Generally, pass-through tax treatment should be available for Delaware statutory trusts nationwide, subject to limited exceptions. Alternatively, a statutory trust may be designed to be taxed as a trust under the Kintner regulations. The Trust Act expressly provides that Delaware tax treatment will follow federal tax treatment.

C. Features of a Delaware Statutory Trust

The dynamic nature of the Trust Act is that, on the one hand, it statutorily prescribes certainty as to matters that are uncertain for common law or Massachusetts business trusts -- such as limitations on liability of trustees and beneficial owners and the statutory shielding of the assets of one “series” of a statutory trust from the liabilities of other series. On the other hand, the Trust Act, unlike a complex corporation law, leaves full contractual flexibility to establish the management and economic rights of the parties pursuant to the trust agreement. Thus, these matters are controlled by the terms of the trust agreement, which can be freely amended in accordance with the terms of the agreement, rather than rules established pursuant to a corporation law that requires legislative action to change. The Trust Act provides that except to the extent addressed by the Trust Act or the applicable governing trust agreement, the trust laws of the State of Delaware shall apply. Some of the more significant features of the Trust Act are as follows:

» Limitations on Liability to Third Parties. Pursuant to the Trust Act, beneficial owners enjoy limited liability to the same extent as do shareholders of Delaware corporations. Similarly, trustees, officers, managers or employees of a statutory trust are exempt from personal liability to third parties for the statutory trust's obligations.

» Fiduciary Duties/Indemnification. The Trust Act specifically provides that any duties otherwise owed by a trustee, officer, manager or employee of a statutory trust

under general principles of law or equity (including fiduciary duties and liabilities relating thereto), may be expanded or restricted by the terms of a trust agreement. The Trust Act further permits a trust agreement to provide indemnification to trustees or other persons against any and all claims and demands whatsoever. Accordingly, a trust agreement may provide broad protections to trustees, officers, managers and employees in connection with the performance of their duties.

» Series. The Trust Act explicitly provides that a trust may be organized into separate series of beneficial interests having separate rights and powers with respect to specified property or obligations, which series may have separate business purposes or investment objectives. Further, subject to compliance with certain minimum requirements, the Trust Act creates limitations on liability between series such that, as a matter of statute, the liabilities of one series are enforceable against only the assets held by that series, and not against other assets held by the trust. This is a protection not afforded at common law.

» Management. The flexibility embodied in the Trust Act carries through to the provisions governing the management of the trust. Generally, the trustees manage the trust. However, it is possible to structure the trust so that fewer than all of the trustees discharge management duties or to provide for management at the direction of the beneficial owners or by a manager or management company other than a trustee. Just as separate series of beneficial interests may exist, the governing instrument may also provide for separate series of trustees.

» Voting. The Trust Act affords the ability to either grant or withhold voting rights for beneficial owners. To the extent voting rights are granted, complete flexibility is provided for establishing voting procedures, proxy rules, quorum requirements, record dates and special class or series rights. Also, because of the absence of statutory voting requirements, a trust agreement can provide for amending the trust agreement, disposing of trust assets, moving the domicile of a trust, merging the trust or the taking of any other like actions solely by determination of the trustees.

» Access to Fund Records. The Trust Act provides for the contractual regulation of beneficial owners' rights to access information and documents of the trust. In this regard, trustees are given the freedom under the Trust Act to establish reasonable standards with respect to beneficial owners' access to trust books and records, including standards governing what information and documents are to be furnished, at what time and location, and at whose expense. Trustees are also given the right to keep confidential from beneficial owners, for such a period of time as the trustees deem reasonable, any information that the trustees reasonably believe to be in the nature of trade secrets or other information the disclosure of which the trustees believe in good faith is not in the best interests of the trust or could damage its business.

» Merger. Under Delaware law, a statutory trust may merge or consolidate with or into another statutory trust or a corporation or most any other type of business entity, whether such other entity is established in Delaware or elsewhere. This feature facilitates the movement of mutual funds to or from the state. The trust agreement may establish any percentage of beneficial owners to vote on such a merger or provide for no vote by beneficial owners.

» Court of Chancery. A significant reason why corporations and other business entities choose to organize in Delaware is the reputation of the Delaware Court of Chancery for the resolution of sophisticated corporate and business issues. Consistent with centering business disputes in the Court of Chancery, the Trust Act vests the Court of Chancery with jurisdiction over litigation involving statutory trusts, including jurisdiction over any disputes relating to rights, duties and liabilities of trustees, internal affairs and questions of interpretation of trust agreements. The Delaware Court of Chancery has a national reputation for expedited and expert resolution of business disputes. Although most commonly known for its corporation law decisions, the court has developed an extensive case law in the area of alternative entity law and has the ability to act quickly and effectively in resolving disputes because of distinct procedural rules and its relatively narrow jurisdiction. These attributes have made access to the Delaware Court of Chancery a significant factor in the determination to choose Delaware law to govern a statutory trust.

D. Governance

With regard to governance issues, in most circumstances it is desirable to include in the trust agreement specialized provisions regarding such matters as (i) management of the business, (ii) votes required for major decisions (such as transfer of interests, capital expenditures, adoption of annual budgets, adoption of medium or long-term strategic plans, the appointment of senior officers, sales of assets, amendments to governing documents or mergers or other changes in entity form or domicile), (iii) allocations of income and expenses, (iv) income distribution policies, (v) restrictions on transfers of beneficial interests, (vi) admission of new beneficial owners or the permissibility of withdrawal of existing beneficial owners, (vii) obligations of beneficial owners to make supplemental capital contributions, (viii) the delineation of the fiduciary duty of trustees or beneficial owners (and entitlement to indemnification and advancement of expenses), (ix) events of termination and the manner for distribution of assets on termination and (x) mechanisms for settling disagreements among beneficiaries.

Issues such as the foregoing are most easily dealt with in the contractual setting of the trust agreement. When compared to a corporation, it is true that most of these objectives can be achieved through the corporate form. However, it is typically more cumbersome to achieve these objectives under the framework of a general corporation law. For example, special director management or appointment rights may require the establishment of multiple classes of stockholders and directors; specialized voting rights usually require a combination of provisions in the certificate of incorporation, coupled with a separate shareholder agreement; and specialized distribution agreements regarding various amounts or types of income may require further division of stock ownership rights. Moreover, there are requirements of the corporation law that are not subject to variation in charter provisions or by voting agreement such as circumstances in which indemnification may be granted, the extent to which transfers of ownership interests may be restricted, the degree to which the liability or fiduciary obligations of directors may be altered or limited and the closely related issue of the extent to which a director elected by certain stockholders may represent the interest of those stockholders as against the interest of the corporation as a whole.