

Nonjudicial Settlement Agreements: The Many Uses and Potential Pitfalls

Kelly M. Preteroti and Lindsay R. DeMoss D'Andrea

I. Introduction

Effective October 1, 2016, Maryland law allows interested persons to enter into binding nonjudicial settlement agreements (“NJSAs”) with respect to matters involving trusts. Md. Code Ann., Est. & Trusts § 14.5-111. Maryland’s NJSA statute is identical in every material respect to Section 111 of the Uniform Trust Code (“UTC”).

NJSAs encourage resolution of disputes relating to trusts by nonjudicial means by giving them the same effect as if approved by the court. Unif. Trust Code § 111, comment (2010). Indeed, an NJSA is only valid to the extent the agreement does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court under the MTA or other applicable law. Md. Code Ann., Est. & Trusts § 14.5-111. With that said, lawyers are creative and because the many uses are not defined by statute, the non-exhaustive list in § 14.5-111 merely provides a guideline.

A. Who are “Interested Persons”?

§ 14.5-111 of the Maryland Trust Act (“MTA”) defines “interested person” as a person whose consent would be required in order to achieve a binding settlement were the settlement to be approved by the court. This definition is intentionally vague due to the great variety of matters to which an NJSA could be applied. Unif. Trust Code § 111, comment (2010).

As a practical matter, an NJSA is only binding against parties to the agreement, whether acting on their own behalf or bound through representation. So, in addition to the parties to the lawsuit, practitioners should consider the persons against whom they would seek to enforce the agreement when determining who to include as interested persons. For instance, what if there are adult heirs of interested persons who have an interest in the trust, but who were not a part of the underlying litigation or mediation? In a planning context, the parties will ordinarily include the trustee, current beneficiaries, and remainder beneficiaries, in addition to any other persons interested in the subject of the NJSA.

B. The Role of Representation

A practitioner drafting an NJSA must consider the role and importance of representation in binding all parties with an interest in the subject of the agreement. *See*, Md. Code Ann., Est. & Trusts, § 14.5-301, *et seq.* The concept of representation in judicial proceedings is not new. *See* Restatement (First) of Property §§ 180-186 (1936). However, the coverage and scope of representation both under the UTC and MTA is more comprehensive.

The MTA provides that “notice to a person that is authorized to represent and bind another person under this subtitle has the same effect as if notice were given directly to the other

person unless the person represented objects to the representation by notifying the trustee and the representative before the notice would otherwise have become effective.” Md. Code Ann., Est. & Trusts § 14.5-301(a). Additionally, “consent of a person that is authorized to represent and bind another person under this subtitle is binding on the person represented unless the person represented objects to the representation by notifying the trustee and the representative before the consent would otherwise have become effective.” *Id.* at 14.5-301(b).

The MTA makes clear that representation is available in judicial proceedings and in other nonjudicial contexts. *Id.* at 14.5-301(d).

There are different types of representation within the MTA, including representation of certain persons by (i) the holder of a qualified power of appointment, (ii) the guardian of the property of a minor or disabled person, (iii) the guardian of the person of a minor or disabled person (if no guardian of the property has been appointed), (iv) an agent with specific authority to act with respect to trust matters, (v) the trustee of a trust that is the beneficiary of another trust, and (vi) a parent if no guardian of the person or property has been appointed. *Id.* at §§ 14.5-302-14.5-303. Additionally, a grandparent or more remote ancestor may represent and bind a minor, an incapacitated, unborn, or unknown individual or an individual whose location is unknown and not reasonably ascertainable who is not otherwise represented. *Id.* at § 14.5-303(7). Except for the case of a holder of a qualified power of appointment, representation is only permitted to the extent there is no conflict of interest between the representative and person being represented.

Virtual representation is addressed under § 14.5-304 of the MTA, which provides that “unless otherwise represented, a minor, an incapacitated or unborn individual, or an individual whose identity or location is unknown and not reasonably ascertainable, may be represented by and bound by a representative having a substantially identical interest with respect to a particular question or dispute, but only to the extent that there is no conflict of interest between the representative and the individual represented with respect to the question or dispute.”

The MTA also provides for court-appointed representatives where an interest is not represented or the otherwise available representation might be inadequate. Md. Code Ann., Est. & Trust § 14.5-305.

New § 14.5-306 of the MTA, effective October 1, 2017, now permits the settlor of a trust to:

- (1) Designate one or more persons who may serve as a representative or successor representative of a beneficiary of the trust;
- (2) Designate one or more other persons who may designate a representative or successor representative of a beneficiary of the trust; and
- (3) Specify the order of priority among two or more persons who are authorized under this title to serve as a representative or successor representative of a beneficiary of the trust.

A trustee may not serve as the representative of a beneficiary of the trust. *Id.* at 14.5-306(b).

This new provision provides an opportunity in the estate planning stage for a settlor to designate representatives or name a person who can designate representatives, especially if the settlor knows or has suspicions that a beneficiary may later cause trouble. The following is an example provision for a trust agreement that would allow the trustee to designate representatives:

“REPRESENTATIVES. The trustee may designate a representative or successor representative to act on behalf of any beneficiary of any trust established under this agreement, other than the trustee of such trust, whether or not a judicial proceeding concerning the trust is pending. Notice to the representative shall have the same effect as if notice were given directly to the beneficiary represented, unless the beneficiary objects to the representation by notifying the trustee and representative in writing before the notice would otherwise have become effective. Consent of the representative is binding on the beneficiary represented, unless the beneficiary objects to the representation by notifying the trustee and the representative in writing before the consent would have otherwise become effective. In making decisions on behalf of a represented beneficiary, the representative may consider the general benefit accruing to the living members of the beneficiary’s family. Any representative or successor representative who undertakes or agrees to represent a beneficiary shall not be liable to the beneficiary represented while acting in good faith, but shall only be liable to the beneficiary for action or inaction resulting from intentional wrongdoing by the representative or made with reckless indifference to the purposes of the trust or the interests of the represented beneficiary.”

It is important to note that while appointed representatives can be a useful tool in binding beneficiaries, a representative appointed under § 14.5-306 would be liable for intentional wrongdoing and actions taken in bad faith or with reckless indifference to the purposes of the trust or the interests of the represented beneficiary. *Id.* at § 14.5-306(c).

II. How can NJSAs be used?

NJSAs are a powerful tool in resolving fiduciary litigation matters. NJSAs have also found increasing utility in trust administration, even in the absence of a bona fide dispute.

§ 14.5-111 of the MTA provides a non-exhaustive list of the matters that may be resolved through an NJSA, including:

- (1) The interpretation or construction of the terms of the trust;
- (2) The approval of a report or accounting of a trustee;

- (3) Direction to a trustee to refrain from performing a particular act or the grant to a trustee of a necessary or desirable power;
- (4) The resignation or appointment of a trustee and the determination of the compensation of a trustee;
- (5) Transfer of the principal place of administration of a trust; and
- (6) Liability of a trustee for an action relating to the trust.

In practice, we have seen NJSAs used in the following ways:

1. To resolve litigation (or threatened litigation) involving trusts, such as -
 - Challenges to the conduct of a fiduciary (*see* § 14.5-901 (To remedy a breach of trust by the trustee that has occurred or may occur, the court may compel certain action, including surcharging));
 - Challenges to the trust instrument (i.e. claims of lack of capacity, undue influence, fraud, etc.) (*see* § 14.5-402 (A trust is created only if: (1) The settlor has capacity to create a trust; (2) The settlor indicates an intention to create the trust); *see also* § 14.5-405 (A trust is void to the extent that the creation of the trust was induced by fraud, duress, or undue influence));
 - Actions to remove a trustee (*see* § 14.5-706 (The settlor, a cotrustee, or a beneficiary may request the court to remove a trustee, or a trustee may be removed by the court on the court's own initiative));
 - Disputes over distribution to or treatment of beneficiaries (*see* § 14.5-203 (A court may review an action by a trustee under a support provision or a mandatory distribution provision in the trust));
 - Partition actions involving real property owned in whole or in part by a trust (*see* 14.5-411 (The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust)); and
 - Questions surrounding the proper interpretation of a trust provision (§ 14.5-201 (A judicial proceeding involving a trust may relate to a matter involving the administration of the trust, including a request for instructions and an action to declare rights)).

2. To resolve issues in trust administration, such as -
- Trust terminations (*see* Md. Code Ann, Est. & Trusts § 14.5-410(a)(1) (noncharitable irrevocable trust may be terminated on consent of the trustee and all beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust); *Id.* at § 14.5-410(b) (existence of a spendthrift provision does not prevent a termination of a trust)).
 - Parties may wish to have trust beneficiary(ies) own trust assets outright upon their deaths to obtain a step-up in basis under IRC §1014(a) (this could also be accomplished through a trust modification granting the beneficiary a general power of appointment over trust assets, as discussed below).
 - At any given time, the value of trust assets may be small relative to the costs of trust administration.
 - The beneficiary may simply need the assets.
 - The NJSA could also include a waiver of formal accounting and a release of the trustee.
 - Trust modifications (*see* Md. Code Ann., Est. & Trusts § 14.5-410(a)(2) (noncharitable irrevocable trust may be modified on consent of the trustee and all beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust), including:
 - Division of single trust with multiple beneficiaries into one or more separate trusts:
 - When one beneficiary has substantially greater needs than another, or through his or her actions causes the trust to expend assets, a division of the trust into separate shares for each of the various beneficiaries promotes equity for all beneficiaries.
 - Qualified severance under IRC § 2642(a)(3).
 - Changes to provisions relating to the trustees, including: resignation of trustees; appointment of successor trustees; appointment of co-trustees; compensation of trustees; require fewer or more trustees to serve; grant or eliminate powers of the trustee (power to appoint own successor, power to grant general power of appointment); give a person the right to remove and replace the trustee.

- Modify distribution provisions and beneficial interests.
 - Any settlement that modifies distribution provisions or shifts the beneficial interests of the parties must take into account the transfer tax consequences of doing so. There may also be resulting income tax consequences. Furthermore, in the absence of a controversy appealed to the highest appeals court in the state, a Federal authority may ignore any resolution approved by a state trial court or via settlement. *See, e.g., Comr. v. Est. of Bosch*, 387 U.S. 456 (1967) (holding that where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such property interest by a state trial court). Parties may wish to obtain a private letter ruling in cases where certainty regarding the transfer tax aspects of a settlement is critical.
 - In bona fide disputes, parties may fall under the exception for “a sale, exchange or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free from any donative intent),” which would be “considered as made for an adequate and full consideration in money or money’s worth.” Treas. Reg. § 25.2512-8; *but see, e.g.,* PLR 9308032 (taxable gift results where parties surrender rights to benefit adversaries in excess of what local law would have provided).
 - Where an NJSA is used outside of a litigation context to shift beneficial interests, a gift will likely occur absent an exception. Treas. Reg. § 25.2511-1. Also use caution when modifying a grandfathered GST exempt trust to avoid jeopardizing the trust’s exempt status. Treas. Reg. § 26.2601-1(b)(4) (providing four “safe harbors” for modifications that will not affect the exempt status of a grandfathered trust).

These are just a few examples of the many ways NJSAs can be used to resolve issues related to trusts. As the MTA generally, and specifically § 14.5-111, has not been around long enough for meaningful appellate case law to have developed on the use of NJSAs, we expect that parties will test the limits of the statute.

III. Anticipating and Dissipating Disputes Using NJSAs

One creative way to use an NJSA may be in cutting off disputes before they occur. That is exactly what testators seek to accomplish in antemortem probate proceedings¹. In short, antemortem probate is a judicial proceeding in which an interested person seeks a declaratory judgment confirming the validity of a testator's last will and testament *while the testator is still alive*. If the proceeding is successful, then upon the testator's death, her will must be admitted to probate.

The procedure provides some certainty to the testator that her last will and testament will be shielded from challenges after she dies. In the same way that antemortem probate provides this certainty, an antemortem NJSA may provide certainty for a settlor that her trust agreement will not be subject to litigation.

A. Availability

Most states, including Maryland, have enacted the UTC or another form of statutory trust law, and 38 states have enacted a statute permitting the use of NJSAs. The comment to UTC § 111 states that its purpose is to facilitate the making of NJSAs by giving the agreements the same effect as if approved by a court. So, if an NJSA has the same effect as an agreement approved by the court, can an NJSA be used to bind the parties to the validity of the trust instrument in the same manner as a declaratory judgment in an antemortem probate proceeding?

B. Advantages

An antemortem NJSA has many of the same advantages of antemortem probate. If all the necessary parties were included, the NJSA would serve as a basis to dismiss an action by a signatory to the agreement attempting to challenge the validity of the trust instrument. Thus, establishing a trust's validity prior to the settlor's death by agreement would prevent a challenge to the trust in the same way antemortem probate prevents a will caveat after the testator's death.

Additionally, an antemortem NJSA could resolve evidentiary issues relating to the settlor's capacity, whether there was any undue influence surrounding the execution of the trust, and issues relating to the settlor's intent. The best witness – the settlor – is available at the time of the NJSA to state that the trust document is his trust agreement, that he knows what it says, that it reflects his wishes, and that he signed it according to law.

Furthermore, if the anticipated challenger(s) has entered into the agreement, an antemortem NJSA ensures that the settlor's wishes remain intact. If the settlor knows in advance that a particular beneficiary could upset his intent, binding that beneficiary to the trust agreement through an antemortem NJSA could stop a challenge before it has an opportunity to fully ripen.

¹ For a fuller discussion on antemortem probate, see Preteroti, Kelly M. and Lindsay R. DeMoss D'Andrea, *Where There Is a Will, Is There a Way? Getting the Last Word on Your Estate Plan*, Tax Management Estates, Gifts, and Trusts Journal, Vol. 46, 11, 314, 11/09/2017.

Finally, an antemortem NJSA can be done without the involvement of the court, yet have the same effect as if the issues determined in the agreement were decided by the court.

C. Viability

An antemortem NJSA presents some of the same challenges as antemortem probate, along with some new challenges. While less adversarial than a court proceeding, an antemortem NJSA could still be perceived as adversarial. Additionally, the settlor would have to disclose the terms of his trust agreement (something that many settlors seek to avoid) in order to achieve a binding agreement. Having relatives weigh in on the settlor's plans may cause turmoil and resentment within the family.

Additionally, an antemortem NJSA would only resolve disputes related to the trust agreement and any amendments in existence at the time of the NJSA. Subsequent changes to the trust agreement would not be addressed by the prior NJSA, unless an amendment to the NJSA is executed as well.

Furthermore, obtaining the consents of each interested person could present problems. Unlike an antemortem probate or declaratory judgment proceeding, where parties can be bound through service of process, you cannot force parties to enter into a contract. Consequently, difficult family members who are would-be challengers may simply refuse to sign.

Still, for a settlor who is concerned that the terms of his trust agreement could become subject to challenge, an antemortem NJSA could be a powerful tool to use before disputes arise.

IV. Conclusion

NJSAs are and will continue to be a vital tool in resolving disputes relating to trusts and solving problems in trust administration. Practitioners should look to NJSAs where a court proceeding would normally be required and ask whether the situation is ripe for a resolution through nonjudicial means. If so, due consideration should be given to the parties who must be involved and the tax consequences that may arise. Lastly, in cases where a settlor anticipates a dispute, consider using an antemortem NJSA to prevent a later challenge.