Trusts and Surety Indemnification

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Our Roadmap Today

- Discuss the increasing use of Trusts and the challenges posed to Sureties.
- Identify and evaluate risks associated with the most common types of Trusts.
- Set forth the steps to properly underwrite and secure the indemnity obligations of the Trust.
Trust:

A relationship created at the direction of an individual, in which one or more persons hold the individual’s property subject to certain duties to use and protect it for the benefit of others.
Why are Trusts Created?

- **Advantages to Indemnitors**
  - Estate and Tax planning
  - Continuity
  - Protect assets
  - Provide maintenance and support for Beneficiaries
  - Privacy of Trust ownership
  - Charitable giving

- **Disadvantages to the Surety**
  - Poses challenges to ascertaining and accessing Trust assets
  - Challenges to obtaining indemnity
Basic Definitions

- **Settlor:** Person who establishes the Trust (a/k/a Trustors, Grantors, Testators, Transferors)
- **Trustee:** Person or entity that holds property in trust; administers all aspects of the Trust. Often the Settlor also serves as the Trustee.
- **Res:** Trust property, assets
- **Beneficiary:** Person for whose benefit the Res is being held in trust
- **Revocable/Amendable vs. Irrevocable/Non-Amendable:** Changeable vs. Unchangeable
- **Discretionary Powers:** Trustee has wide latitude and makes all decisions
- **Spendthrift/Asset Protection Trust:** Places Trust assets beyond the reach of Creditors of Beneficiaries and Settlors
How are Trusts Created?

- **Testamentary** – Trust is created by a valid will that comes into existence upon the Settlor’s death.

- **Living Trust** – An *inter vivos* trust created during the Settlor’s lifetime.
The Most Common Forms of Trusts

- **Family Trust**
  - Typically established for the purpose of passing assets to children/heirs
  - Most likely form you will see from individual indemnitors
    - **Potential Pitfalls to Indemnity:** If your indemnitor is the Settlor of an irrevocable Family Trust, execution of the indemnity agreement may be subject to attack by the Beneficiaries as contrary to the purpose of the Trust.

- **Life Insurance Trusts**
  - Primary asset is life insurance policies and/or proceeds therefrom
  - Utilized for estate tax planning and tax avoidance
    - **Potential Pitfalls to Indemnity:** Cash surrender values and proceeds of life insurance policies may be protected from creditors.

- **Dynasty Trusts**
  - Trust designed to protect family assets generation after generation
  - May be unenforceable as a violation of Rule Against Perpetuities, but certain DAPT states have legalized
    - **Potential Pitfalls to Indemnity:** This type of Trust is typically designed to shield assets from creditors.
Asset Protection Trusts

- Assets shielded for the protection from the Settlor’s creditors
- Settlor is the Beneficiary and maintains control over the Trust for his/her own support
- Domestic Asset Protection Trusts (DAPTs): Legitimized in several states (AK, DE, MO, NV, OK, RI, SD, TN, UT)
- Foreign Asset Protection Trust (FAPTs): Trusts established in foreign offshore jurisdictions to avoid reach of creditors (Anguilla, the Bahamas, Barbados, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, the Cook Islands, Cyprus, Gilbralter, the Isle of Man, Jersey, Mauritius, Saint Christopher, Saint Kitts, Nevis, the Turks and Caicos Islands).

⚠️ Potential Pitfalls to Indemnity: Designed to shield assets from creditors, or includes “fleeing trust” provisions that move assets offshore if threatened. Execution against a FAPT is near impossible and prohibitively costly.
The Most Common Forms of Trusts, continued

Spendthrift

- Protection from Beneficiary’s creditors and his/her own “excesses”
- Provides for the maintenance and support of Beneficiaries
- Statutes and case law vary widely among the States as to validity and limitations

⚠️ Potential Pitfalls to Indemnity: If your indemnitor is the Beneficiary, it may be difficult to argue that obligating the Trust to a Surety creditor falls within the intent of the Settlor in protecting the assets.
The Most Common Forms of Trusts, continued

Business Trusts
(a/k/a Unincorporated Business Organization “UBOs” or Massachusetts Trust)

- Growing trend of construction firms moving to this structure
- Functions like a traditional corporation but with limited liability to Trustees and Beneficiaries
- Beneficiaries considered “investors” who hold transferable “trust certificates” much like shares
- If structured properly, UBO’s avoid double taxation on profits to the corporation and the shareholders
- “Beneficiaries” have no management authority, or otherwise deemed to be a partnership

⚠️ Potential Pitfalls to Indemnity: Your principal is owned by the Trust, so be wary of language limiting liability to only the Trust estate, or limitations on personal liability of the Trustee(s).
Does the Principal and/or the Indemnitors Hold any Assets in a Trust?

Contractor Questionnaire:

Are any shareholder assets held in Trusts
☐ Yes ☐ No

If Trusts exist, will they indemnify surety?
☐ Yes ☐ No

If no, explain:
Types of Assets That May be Placed in Trusts

[Contractor / Principal:
• Company Stock
• Building
• Equipment
• Cash / Securities]

[Individual Indemnitor:
• Company Stock
• Building
• Primary Home
• Vacation Home
• Stocks/Bonds
• Cash Accounts
• Life Insurance Policies]
Potential Pitfalls

- Consider the case of a road contractor that goes into default and has placed all of its equipment into a trust.
  - If the surety does not have the indemnity of the trust, access to the contractor’s equipment will be problematic, which will in turn likely increase a completing surety’s loss significantly.
Evaluating the Trust Agreement

- Obtain complete copy of all related Trust documents
  - Including the schedule of Trust Assets and any Trust amendments

- Determine the relationship of the party you are seeking indemnification from
  - Are you seeking indemnification from the Settlor and/or a Beneficiary?

- Underwriting Due Diligence
  - Indemnification within the stated purpose of the Trust?
  - Does the Trustee have the authority to obligate the Trust?
  - What assets are you securing: Trust assets or only distributions to Beneficiaries?

- Verify whether Trustee is authorized to pledge and bind the Trust for indemnity obligations
  - Don’t assume!
Evaluating the Trust Agreement

- Determine the type of Trust and origin
  - Revocable/Amendable or Irrevocable/Non-Amendable?
  - Testamentary or Living?

- Determine whether the Trust is established in a problematic jurisdiction (DAPT or FAPT)

- Determine the amount of Trust assets
  - What assets does the Trust control?
  - Current valuations, financial statements, tax returns, bank/investment statements, appraisals, etc.
Evaluating the Trust Agreement

Typical Revocable / Amendable Trust Provision

Settlors reserve and retain the right at any time, by an instrument in writing, signed, acknowledged and delivered to the trustees: (1) to alter, amend and modify this trust in any and every respect, provided that the duties responsibilities and obligations of any trustees (other than settlors) shall not be increased without their consent; and (2) to revoke, cancel, and annul this trust and the trust or trusts hereby created, in whole or in part. These rights are personal to [settlors] and may not be exercised by any person having a power of attorney or by a conservator or guardian of the settlors.
Steps to Securing Trust Indemnity

✓ Ultimate goal is to avoid a challenge to the enforceability of the Trust’s indemnification

✓ Getting the correct signatories (Trustee, Beneficiary, Settlor)
  • Who is authorized to pledge the Trust’s assets

✓ Amendments to Trust Agreement clarifying Trustee authority for indemnity obligations
  • Revocable/amendable and ambiguous

✓ When is it appropriate to get opinion letter from counsel?
  • Irrevocable/non-amendable and ambiguous

✓ Do you need the consent of Beneficiaries for the Trustee to execute the Indemnity Agreement?

✓ Should Beneficiaries also execute the Indemnity Agreement (i.e., distributions)?
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<th>Amendments to Trust Clarifying Authority for Indemnity Obligations</th>
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<td>If a trust is revocable/amendable and the trust does not clearly authorize the trustee to bind the trust under an indemnity agreement, the surety should request an amendment to the Trust Agreement that clearly sets forth that execution of an indemnity agreement falls within the purpose of the trust, and further specifically identifies the trustees’ authority to execute the indemnity agreement on behalf of the trust.</td>
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Steps to Securing Trust Indemnity
When is it Appropriate to Get Opinion Letter from Attorney?

If a trust is not revocable/amendable and the trust does not clearly grant the trustee authority to bind the trust under an indemnity agreement, the surety may consider obtaining an opinion letter from the attorney that drafted the trust documents and/or the attorney representing the trustee as to whether the execution of the indemnity agreement falls within the scope of the trustee’s authority. While this letter will not guarantee that a court will ultimately agree with the legal opinion, it provides the surety with additional assurances and potential recourse if the indemnity obligations are voided. The opinion letter should state the following:
Steps to Securing Trust Indemnity

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**Attorney Opinion Letter Provisions**

(i) The Trustee’s Attorney is licensed to practice law and that he/she represents the Trustee in his/her capacity as Trustee of the Trust to which you are seeking indemnity;

(ii) The transactions to which surety has requested an opinion letter relate to the Trustee’s execution of the Agreement incident to the issuance of bonds by surety; and

(iii) The terms of the Trust and applicable state law empower the Trustee to pledge or obligate Trust assets for liabilities resulting from the execution of the Agreement.
Summary

• Trusts have become more commonplace among construction accounts.
• Understanding why the Trust was established, the type of Trust, and reviewing the Trust agreements are critical to the underwriting process.
• Be sure to review and understand the assets held by the Trust.
• Not all Trusts allow for indemnification. Never assume!
• Obtain Trust Amendments, Opinion Letter from Counsel, and appropriate signatures (Settlor, Trustee, Beneficiary) as needed to obtain proper indemnity of Trusts.
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