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The Bankruptcy Advantages of Delaware Statutory Trusts

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When you select an entity for your clients going through a bankruptcy proceeding, you should consider a Delaware Statutory Trust (DST), one of several special purpose entities (SPE) created by a state with a long history of corporate-friendly law.

Statutory trusts in general may be described as “deals,” in John Langbein’s words, arrangements that arise in a business setting, as opposed to those arising from a desire to give property to others. Yet the traditional fiduciary standards of loyalty and impartiality that arise from donative trusts can be applied to statutory trusts merely by characterizing them as such.

Evolving from prior business trust legislation, Delaware statutory trusts offer much more certainty than trusts based on common law. Statutory trusts are defined as a type of voluntary, unincorporated business association created by a written governing instrument to which property is transferred for management for the beneficial owners. Delaware recognized statutory trusts in 1988 (12 Del C 3801, et. seq.) and improved the initial legislation by passing amendments in succeeding years. Formation is simple: the trustee files with Delaware’s Secretary of State a one-page certificate of trust signed by all trustees, one of which must be a Delaware resident trustee. No additional or future public filings other than amendments or statements of termination are required.

Since Delaware law states that “it is the policy of this subchapter to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments,” the parties write the governing provisions themselves. Basic issues of importance to all business entities such as creditors’ rights; the rights of each party to the agreement; taxation; capital structure, jurisdiction, and the like, are defined in an agreement that is not filed with any governmental or regulatory authority. DSTs are subject to minimal limitations; for example, DSTs can eliminate annual shareholder meetings as well as a shareholder’s right to inspect the books.

The instrument, not the statute, covers all aspects of the relationship among the trustee, beneficial owners, and others, including the delegation of management responsibilities and liabilities; fiduciary responsibilities; procedures for amending the trust; provision for creating several classes of ownership with different rights and responsibilities; and the delineation of voting rights.

Here are some general features of a Delaware Statutory Trust of importance to bankruptcy professionals:

- DSTs may be perpetual. As a separate legal entity, creditors of beneficial owners cannot force the trust’s termination except in accordance with the instrument. Thus, the death, incapacity, dissolution, termination or bankruptcy of a beneficial owner does not cause the termination of the trust.
 - The trust may be taxed as a trust, association, limited partnership, or corporation at the discretion of the trust’s management, based on the tax advantages desired. Most DSTs are taxed as pass-through entities akin to partnerships.
 - Unlike a corporation, no Delaware franchise taxes are imposed on DSTs.
 - It may sue or be sued.
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- It is under the jurisdiction of the Court of Chancery of Delaware, a court of equity that does not handle criminal or tort actions.

“Beneficial owners” named in the trust instrument, unless otherwise provided:

- Contribute cash, property, services, promissory notes or other obligations to provide cash, property or services to the trust, or become a beneficial owner without contributing anything.
- May serve as trustee or advisor to the named trustee.
- Are personally liable only to the statutory trust.
- Are entitled to the same limitation of personal liability extended by Delaware law to stockholders.
- Own an undivided beneficial interest in trust's corpus and share in profits and losses.

A trustee, unless otherwise provided in the trust instrument:

- May be any person or persons named in the governing instrument, including a beneficial owner.
 - May take direction from a beneficial owner or third party named in the instrument.
- Is personally liable only to the statutory trust.

Specific DST Advantages for Bankruptcy Use

- Depending on its purpose and provisions, a DST may not always be able to initiate a bankruptcy case as a debtor under the Federal Bankruptcy Code, an advantage available to corporations but not special purpose entities.
- Beneficial owners may direct the trustee without risking personal liability for the debts of the trust or that a beneficial owner's creditors could reach the DST's assets.
- DSTs may indemnify and hold harmless all the parties to the trust – beneficial owner, trustee, and other -- as its governing agreement provides.
- DSTs avoid the issue of whether a "liquidating trust" under federal bankruptcy rules is considered to be an issuer of equity securities. DSTs are under no obligation to issue securities or any other evidences of ownership.
- An unrelated trustee, such as the requirement of a Delaware trustee, eliminates or lessens control by the sponsor, which in turn gives credence to a nonconsolidation analysis.
- Delaware does not impose state taxes of any kind on DSTs.
- Jurisdictional responsibility of Delaware's Court of Chancery offers access to one of the most esteemed judiciaries in the country, a court with long experience and expertise in corporate matters. As a corollary, Delaware has a developed body of law that offers a high degree of predictability.

Services Offered by the Delaware Trustee

Bankruptcies involve many standard services offered by institutional trustees such as the custody of assets, recordkeeping, and disbursements according to the written direction of another, albeit, in a slightly different context because many of these duties may extend beyond the dissolution and/or reconstitution of the original entity.

Example: Hospital A was forced into bankruptcy because of mismanagement but wanted to emerge from the situation with a clean slate. A DST was selected using a Delaware trustee like Christiana Bank & Trust Company, and assets sufficient to satisfy the existing claims against it were transferred to it. The bank invests the funds and will continue to pay out claims at the written directive of a third party until all claims are satisfied, regardless of the corporate status of Hospital A. Neither the hospital directors nor the hospital itself face liability for the DST assets, nor can the assets be diverted from their stated purpose. For so many reasons, a Delaware statutory trust is ideal entity for bankruptcy situations.

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