



The Delaware advantage

Delaware offers captive owners the synergistic confluence of captive risk management and business and family capital planning through the 'Delaware advantages'

by **Edmond M Ianni**

*Well Georgia Sam he had a bloody nose
Welfare Department they wouldn't give
him no clothes*

*He asked poor Howard where can I go
Howard said there's only one place I know
Sam said tell me quick man I got to run
Ol' Howard just pointed with his gun
And said that way down on Highway 61*

— from Bob Dylan's *Highway 61 Revisited*. Copyright © 1965 by Warner Bros. Inc; renewed 1993 by Special Rider Music

Although Bob Dylan wrote those lyrics 45 years ago, those verses can be seen today as a risk management metaphor. With the financial crisis that has befallen our economy and affected businesses and families across the US, capital and risk management needs

have intensified. Georgia Sam symbolises the contemporary challenge.

Having encountered risk (bloody nose), and without third-party coverage (no clothes from the welfare department), Georgia Sam resorts to self-help for his retained risk. Ol' Howard suggests to hapless Sam an optimal solution – “only one place” that Howard judiciously knows is a path, within Sam's reach, to refuge, security and ultimate self-help. Today, many businesses and families face similar challenges. Preserving and managing business and family capital are heightened needs and, therefore, planning priorities in this debilitated economic environment.

A holistic approach to developing an interdisciplinary solution to this capi-

tal and risk management challenge is evolving. In Delaware, this approach utilises many of the captive, trust, tax, legal, asset protection, business entity, capital management, financial, regulatory, corporate governance and structural benefits that the state offers – collectively called the 'Delaware advantages'.

Let's take the example of a fictitious family, the Astutewicks. Nelia Astutewick is the COO of a publicly held alternative energy company. Her husband, Franklin Astutewick, partly owns and is a manager of the family owned business, Recessionproof Manufacturing (ReMan). Nelia and Franklin have three adult children – two daughters and one son. All of them reside in an income-taxing

“Preserving and managing business and family capital are heightened needs and, therefore, planning priorities in this debilitated economic environment”

state outside the State of Delaware.

Franklin is interested in cost-effective risk management solutions for ReMan, and Nelia is interested in capital-preserving management of her executive compensation. Both are also mindful of the need to protect and preserve their family capital. While there are several possible options, Nelia and Franklin choose the following multiple-part strategy.

The DSST Captive

ReMan is an expansive, closely held business with manufacturing facilities in four states. It employs over 200 workers. As a family-owned business, ReMan has found commercial insurance in the market to be rather expensive. After careful analysis, Franklin learns that it would be more cost-effective for ReMan to insure, through a captive, certain of its enterprise risks – specifically, its property and casualty, product liability, business interruption, warranty and employer-provided health insurance risks. Franklin settles on a serialised entity, namely, a Delaware serialised statutory trust (DSST). He chooses that form of captive because it provides certain advantages:

Customised series business units

This form requires the expense of establishing only one legal entity, compared to the expense of establishing multiple legal entities such as, for example, a sponsored captive insurance company with separate incorporated protected cells thereunder. The DSST gives Franklin the flexibility to establish one or more series therein without the need or expense to create multiple standalone entities or incorporated subsidiaries.

Selected independent trustee

Although a Delaware limited liability

company can also be serialised as a captive insurance company, Franklin chooses the DSST because he prefers an independent trustee (specifically, an independent corporate trustee) to oversee the management of the captive. Such a trustee will ensure good fiduciary governance of the business and affairs of the new captive.

Tailored fiduciary duties

The DSST provides other structuring flexibility that Franklin desires. Delaware allows the fiduciary duties of the officers and other managers of a DSST captive to be eliminated or restricted. Considering that some of the officers and managers of this captive also will be among its beneficial owners as well as owners of ReMan (typical for closely held businesses), Franklin sees the practical advantage of, for example, eliminating their fiduciary duties of loyalty, up-front in the DSST's governing instrument.

Cost-effective centralised governance

The DSST structure enables the cost-effective use of centralised governance, notwithstanding its multiple serialisation. Franklin estimates that this feature substantially will reduce the expenses of operating and managing the captive, especially when compared to the O&M expenses of separately incorporated captives or captive cells.

Income tax advantages

Franklin sees other capital-saving opportunity with the DSST. Anticipating that the new captive will need to write less than \$1.2m of annual business-interruption premium in the foreseeable future, Franklin understands from his professional tax counsel that he business inter-

ruption series business unit of the new DSST may qualify for favourable federal income-tax treatment.

Favourable premium tax treatment

Franklin also likes the fact that Delaware caps its payable annual premium tax, regardless of future premium growth and provides other related incentives in this regard. Furthermore, Franklin appreciates Delaware's advantageous premium-tax calculation for a serialised Delaware captive which is calculated on the aggregate premium of the entire captive enterprise (including all its series) and treats such an enterprise, for premium-tax purposes, as a single entity.

Business flexibility

The DSST structure can accommodate business expansion in several ways. While certain ReMan enterprise risks initially will be covered by this new DSST captive, the DSST can be expanded – by creating additional series thereunder – to accommodate other ReMan risks, should Franklin's family so desire.

Integrated family capital planning

Like many of her counterparts in corporate America, Nelia, the COO of a public company, receives most of her executive compensation in non-cash form, namely, restricted 144 stock and non-qualified stock options (NSOs). That non-cash compensation over the years now represents a substantial portion of her personal wealth. The current financial crisis and push for heightened scrutiny of executive compensation and insider-trading have accentuated the need for Nelia to undertake proper planning with respect to her accumulated corporate wealth.

To accomplish her objectives of asset protection, prudent diversification, tax saving and family-wealth planning, Nelia chooses to utilise a Delaware blind-asset protection trust (BAPT) as a key component of her planning strategy, to incorporate some of the Delaware advantages.

Nelia's customised BAPT

A BAPT is both a blind trust and an asset-protection trust. Blind trusts enable business executives to protect, diversify or otherwise manage their public-company stock holdings and/or NSOs without being restricted by window periods and without committing insider-trading or breaching corporate-fiduciary duty. In the private

sector, a blind trust typically involves the entrustment by a business person of personal investment assets (such as restricted 144 company stock and NSOs) with an independent (usually corporate) trustee who manages and otherwise disposes of those assets without the insider's participation, influence or knowledge.

A distinguishing feature of this kind of trust is its 'mutual blindness' (a sort of gag order included in the governing trust instrument). As a properly created and administered blind trust, Nelia's Delaware BAPT can accomplish her desired diversification in compliance with federal and state securities laws and good corporate governance practice.

Nelia's Delaware BAPT is also an asset protection trust. Only 12 states, including Delaware, currently offer asset-protection trust structures – self-settled spendthrift trusts established in accordance with applicable state statutes, intended to protect assets placed in such trust against creditor claims (subject to certain statutory exceptions and limitations) while giving the settlor the ability to retain an interest therein.

To meet the basic requirements of Delaware's statutes (the Qualified Dispositions in Trust Act), Nelia's BAPT is structured, among other things, to be irrevocable, contain a spendthrift clause, appoint a Delaware trustee of Nelia's choosing and provide for Delaware law to govern.

Professional capital management

Nelia's Delaware BAPT will also be customised to meet her other objectives. First, as Nelia desires professional asset management of her trust assets, on an 'open architecture' basis, by a financial advisor other than her BAPT's trustee, her BAPT will be structured as a Delaware direction trust. This means that the responsibility for investment management of the trust's assets will be assigned to the separate financial advisor (who also must be bound by the 'mutual blindness' requirements of the BAPT) while the responsibility for the administration of the trust, other than investment management, will rest with the BAPT's blind trustee.

Implementation of different financial strategies second, Nelia will be able to pursue several desired financial strategies through the use of her customised Delaware BAPT for her current and future holdings:

- monetisation of an initial tranche of her restricted stock placed in the BAPT;

- immediate equity diversification of another tranche of stock by subscription of that stock to an exchange fund;
- value protection of a certain amount of retained stock holdings with a hedging strategy; independently selected by the trust's direction advisor (such as a costless collar or prepaid forward arrangement); and
- gradual sell-and-reinvest diversification of additional restricted stock placed in her BAPT, as well as an exercise-sell-and-reinvest strategy for her NSOs.

State income tax advantages

Nelia's BAPT will be structured as a non-grantor trust for income-tax purposes because she wants to save state income tax. Delaware does not impose any state tax on the accumulated income or recognised capital gains of an irrevocable Delaware trust where the remainder beneficiaries are not Delaware residents.

To qualify as a non-grantor trust for income-tax purposes, Nelia agrees that her BAPT should be structured so that discretionary distributions to her and her husband from the trust will require the approval of their oldest adult child. All three of Nelia's and Franklin's adult children, as well as their two grandchildren, are also named beneficiaries in her BAPT in accordance with her integrated family-wealth plan. Structured this way, Nelia's BAPT is an irrevocable non-grantor trust; as such, the BAPT's income and capital gains will not be subject to Delaware income tax.

Estate planning

As part of her family-wealth planning, Nelia wants to exclude the assets placed in her Delaware BAPT from her taxable estate. The Economic Growth and Tax Relief Reconciliation Act of 2001 temporarily repealed federal estate tax and generation-skipping transfer tax (GST tax) and provides that it will be restored in 2011, unless Congress takes contrary action.

For the purposes of this article, we will assume that both federal estate tax and GST tax exist. Accordingly, among other things, her BAPT will not include Nelia's reservation of a special testamentary power of appointment. The resulting benefit in Nelia's case will be the exclusion of her BAPT assets from her taxable estate and the consequential saving

of substantial federal estate tax, thereby preserving more capital to be transferred to her desired family beneficiaries.

Additional family capital planning

Nelia can use her BAPT for her other assets. Nelia owns a minority equity interest in the Astutewick family's business, ReMan, which was organised as a Delaware limited liability company (LLC). Nelia wishes to transfer these minority LLC interests into her Delaware BAPT. By doing so, she not only will provide an additional layer of asset protection around those interests but also will be able to reduce her federal gift tax liability on that transfer through the use of valuation discounting (for non-controlling and illiquid interests). She will also be able to exclude those assets, placed into her BAPT, from her eventual taxable estate, thereby preserving more capital for her desired family beneficiaries.

Other transfer tax advantages and DSST planning

Desiring to exempt her BAPT from the federal GST tax, Nelia creates her BAPT as a perpetual or 'dynasty' trust. Delaware has repealed the rule against perpetuities for personal property, thereby allowing the creation of dynasty trusts. One practical, capital-preserving advantage of a dynasty trust is to permit the settlor the opportunity to properly save GST tax. As a dynastic Delaware BAPT, Nelia's trust assets will be exempt from GST tax. Furthermore, as Nelia will own a beneficial interest in the new DSST captive, she wants to include that interest (a personal property interest) in her Delaware BAPT. Consequently, that beneficial ownership interest transferred into her BAPT similarly will enjoy GST tax-exemption.

Planning for Franklin's DSST interest

Franklin needs to plan for the small beneficial ownership interest that he will acquire in the new DSST captive. With a comprehensive plan in place already, Franklin desires to simply shield from probate his new DSST beneficial interest. Accordingly, he intends to place that asset into his revocable living trust, fully knowing that such asset will not be excluded from his taxable estate. By doing so, however, that asset will not be probatable property and, therefore, will not be subject to the expense or delay of the probate process. **CR**