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# Nonjudicial Settlement Agreements under the CUTC

What Are the Limits?

BY CAROL WARNICK

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*This article considers how to use nonjudicial settlement agreements in connection with trust administration, estate planning, and related disputes.*

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In 2018, the Colorado Legislature passed Colorado's version of the Uniform Trust Code (UTC), the Colorado Uniform Trust Code (CUTC), with an effective date of January 2, 2019. A previous *Colorado Lawyer* article covered a range of ways to modify irrevocable trusts, including the use of methods set forth in the CUTC.<sup>1</sup> This article digs deeper into one of the more exciting areas of the CUTC, the CRS §

15-5-111 provision for a nonjudicial settlement agreement (NJSAs), which states that "any person may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust, regardless of whether the settlement agreement is supported by consideration"<sup>2</sup> unless an NJSAs violates a material purpose of the trust or includes terms that could not be properly approved by a court.<sup>3</sup>

The CUTC's NJSAs provision opens up a world of new opportunities for trustees and beneficiaries who discover during a trust administration that the trust isn't working as intended and needs to be modified. This may be due to factors such as changed circumstances, changes to state or federal law, or just plain bad drafting. Moreover, the CUTC encourages using NJSAs to resolve trustee and beneficiary disputes by

giving NJSAs the same credence as if they were approved by a court. This article provides an overview of NJSAs and their uses.

### The Parameters

CRS § 15-5-111 defines the required parties to an NJSA and describes the terms and conditions required for a valid NJSA.

### Required Parties

CRS § 15-5-111 specifies the parties who are required to sign an NJSA as “those persons whose interests in the trust would be materially affected by its provisions”<sup>4</sup> if the agreement had instead been approved by the court. The comments to corresponding UTC § 111 state that the definition of “interested persons” is intentionally vague because of the wide variety of matters that might be handled by an NJSA. As a practical matter, because non-signatories to an NJSA are not bound by it, anyone against whom enforcement of the agreement might be sought should be included as a signatory. Typically, the parties to the NJSA are the trustee, the beneficiaries (both current and remainder), and anyone else interested in the issues covered by the agreement.

### Material Purpose

As stated above, an NJSA is valid in Colorado only if it does not violate a material purpose of the trust.<sup>5</sup> The CUTC does not define a trust’s material purpose, but this is generally the settlor’s intent in creating the trust. Unless the settlor is alive, the terms of the trust must be examined to determine the material purpose. The drafting attorney may also be able to help by expounding on the material purpose through the attorney’s notes, recollections, extrinsic evidence, and comments from family members. Under the CUTC, a spendthrift clause is not presumed to be a material purpose of a trust.<sup>6</sup>

When crafting an NJSA, drafters should consider the pros and cons of stating the trust’s material purpose in the trust document itself. While stating the trust’s material purpose in the document might make it easier to argue that a proposed modification does not violate such material purpose, it may also limit the use of an NJSA if the stated material purpose is too narrow.



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### Terms and Conditions

An NJSA cannot contain terms and conditions that a court could not properly approve, such as provisions that would terminate a trust prematurely (e.g., if the termination violated a material purpose of the trust) or that might be against public policy. The specific matters that are resolvable under the statute include, but are not limited to:

- the interpretation or construction of the trust terms;
- the approval of a trustee’s report or accounting;
- the direction to a trustee to refrain from performing a particular act, or the grant to a trustee of any necessary or desirable power;
- a trustee’s resignation or appointment, and the determination of a trustee’s compensation;
- the transfer of a trust’s principal place of administration; and
- a trustee’s liability for an action relating to the trust.<sup>7</sup>

By explicitly stating that these factors are non-exhaustive, the CUTC is arguably more expansive than the UTC, which does not contain the “but are not limited to” language in its list of factors. In addition, because NJSAs are applicable to “any matter involving a trust,”<sup>8</sup> Colorado practitioners have an open door to be creative when determining when to use an NJSA. The CUTC’s NJSA provision was clearly enacted to save interested parties the time and expense of going to court for matters that they can easily decide themselves.

The CUTC NJSA statute also allows any person whose interest in the trust is affected by the NJSA to request court approval or disapproval of the NJSA. However, the court’s scrutiny is limited to determining “whether the representation as provided in Part 3 of this code was adequate,” and “whether the agreement contains terms and conditions the court could have properly approved.”<sup>9</sup> Part 3 deals with representation of a person by another, and among other things, specifically approves virtual representation.

Therefore, a court is not permitted to examine the NJSA to approve or disapprove the result; it may only determine whether the

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representation of the parties is adequate and the NJSA's terms and conditions could have been properly approved by the court.

### Relevant Probate Code Provisions

The NJSA remedy in the trust context is similar to existing Colorado Probate Code remedies. CRS § 15-12-912 provides that private agreements may be made among the decedent's successors to alter the interests, shares, or amounts to which they are entitled under the decedent's will or the intestacy statutes, as set forth in a written agreement. Such an agreement could also include the termination of a testamentary trust. These agreements bind the personal representative subject only to "his or her obligation to administer the estate for the benefit of creditors, to pay all taxes and costs of administration, and to carry out the responsibilities of his or her office for the benefit of any successors of the decedent who are not parties."<sup>10</sup> A decedent's successors are generally the heirs and devisees but also include, for purposes of CRS § 15-12-912, trustees of a testamentary trust. However, this statute does not relieve trustees of any duties owed to trust beneficiaries in the context of implementing the agreement. Similar to the CUTC, the statute also states that the agreement does not have to be supported by consideration. Colorado case law also supports the idea that the personal representative is bound by an agreement among the parties that is approved by the court.<sup>11</sup>

Another Colorado Probate Code provision allows courts to approve a compromise of a controversy related to admission to probate of a document offered for formal probate as the will of a decedent.<sup>12</sup> It also covers controversies over the construction, validity, or effect of any probated will; the rights of any successor in the decedent's estate; or the estate's administration. The statute states that such compromise is binding on all parties (including those who are unborn, unascertained, or who could not be located) if approved in a formal court proceeding for that purpose. The compromise is also binding even if it affects a trust or an inalienable interest; however, it will "not impair the rights of creditors or taxing authorities who are not parties to it."<sup>13</sup>

These statutes offer useful remedies where a trust is involved with a will that is being probated. But what if all the estate assets are included in a revocable trust when the decedent dies and no probate is required or desired? An NJSA can provide the remedy.

### Using NJSAs for Trust Modifications

NJSAs also offer another means to handle trust modifications. They have an advantage over trust modifications under CRS § 15-5-411 in that court approval is not required. And in some instances, using an NJSA might be preferable to decanting a trust because an NJSA could be simpler to accomplish, and it applies in a broader range of circumstances.<sup>14</sup>

NJSA statutes in other states vary concerning the use of NJSAs for trust modifications. Some states have an exclusive and limited list of matters that are permitted to be handled under an NJSA,<sup>15</sup> while others specifically authorize NJSAs for trust modifications.<sup>16</sup> A few states prohibit the use of NJSAs for a trust modification.<sup>17</sup> It appears that the Colorado statute's expansive language allows Colorado practitioners to use NJSAs for trust modifications, including

- removing and replacing trustees;
- changing trustee provisions, including appointing a distribution trustee, an investment trustee, or a special purpose trustee;
- changing dispositive provisions to set up a beneficiary's share as a third-party special needs or self-settled trust, to enable a beneficiary who recently became disabled to receive assistance yet not lose governmental benefits;
- terminating a trust that is no longer necessary;
- giving a beneficiary a general power of appointment, or distributing certain trust assets outright to obtain a step-up in basis under IRC § 1014(a);
- dividing a single trust with multiple beneficiaries into separate trusts, or vice versa;
- providing for trustee succession;
- revising administrative provisions to conform to rules imposed by corporate fiduciaries;

- providing for unanticipated circumstances in a beneficiary’s life, such as divorce, drug abuse, medical illness, or mental illness;
- allowing the trustee to hold a concentrated stock position;
- modifying a trust to avoid the creation of a credit shelter trust when it is no longer needed for estate tax purposes;
- fixing a scrivener’s error;
- modifying a trust so uneconomical or unneeded sub-trusts may be distributed to the beneficiaries outright;
- allowing the trustee to hold a portion of a family business and provide guidelines therefor;
- overcoming traditional common law self-dealing rules if the trust is silent on the issue;
- allowing a change of situs if the trust is either silent on the issue or has untenable situs provisions, or for tax advantages; and
- granting a limited power of appointment to an independent trustee or trust protector to modify the dispositive terms or interests of the trust, which could be an alternative to decanting.

This list is illustrative of some possible uses for NJSAs. The drafter could also state the settlor’s preference that disputes be resolved or changes be allowed using an NJSA, or on the other hand, forbid their use with regard to that particular trust. Undoubtedly, more uses for NJSAs will emerge over time.

#### *Example of an NJSA in Action*

The following example illustrates the benefits of using an NJSA for trust modification purposes by featuring some well-known characters.

Imagine a trust created by the Wicked Witch of the West, who gave her trustee, Glinda the Good Witch, the trust power to name her successor trustee. As we all know, the Wicked Witch of the West was melted when Dorothy threw a bucket of water on her. Unfortunately, Glinda the Good Witch was condemned unjustly at the Salem witch trials before she had a chance to name a successor trustee, and the trust was silent on appointing a trustee when no successor was named.

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 (2) there was no  
 undue influence  
 surrounding the  
 execution of the  
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In *flew the Winged Monkeys*, the trust beneficiaries. The trust clearly stated that its material purpose was to take care of the Winged Monkeys, but what could they do to manage the trust administration?

The Winged Monkeys could simply agree on the appointment of a new trustee and a trustee compensation arrangement.<sup>18</sup> Or they could go

further and use an NJSA to comprehensively modify the trust to provide them more flexibility without having to go to court. In addition to naming a successor trustee and working out a compensation agreement, they could, for example,

- add a provision to provide for the appointment of a successor trustee to fill future vacancies;
- modify the trust to clarify any ambiguous language to avoid issues in the future; or
- provide that the trustee could continue to hold a concentrated stock position in the Wicked Witch of the West’s company, OZ, Inc., which the Wicked Witch of the West held in her trust before her death and that was paying a substantial dividend.

#### *Pre-Mortem Proceedings*

A settlor might also use an NJSA to preclude disputes similar to the way a declaratory judgment confirms the validity of a testator’s estate plan while the testator is still alive. The settlor could request that everyone who could potentially contest the estate plan sign an NJSA. Because a court may determine the validity of a trust document, using an NJSA to make that same determination meets the requirement that an NJSA include terms and conditions that a court could properly approve. In addition, having the living settlor sign the NJSA attesting to the trust’s material purpose militates against the filing of a future contest on this issue. And a potentially disgruntled beneficiary may be less likely to refuse to sign the NJSA or bring an action contesting the trust while the settlor is still alive and competent.

The Wyoming trust code provides for pre-mortem proceedings to ascertain the validity of a revocable trust and to prevent future contests.<sup>19</sup> Because the CUTC provides that an NJSA has the same effect as an agreement approved by a court, an NJSA could similarly be used in Colorado before the settlor’s death to achieve the same result in validating the settlor’s estate plan. Assuming that all interested parties were signatories to it, the NJSA should preclude a later challenge by a signatory, or at a minimum, provide the basis for a post-death motion to dismiss.

The pre-mortem NJSA could be particularly useful in foreclosing post-death arguments about the settlor's capacity where the signatories agree that (1) the settlor has the capacity to sign the trust documents, and (2) there was no undue influence surrounding the execution of the documents. It would be hard later to dispute the evidence of the best witness—the settlor—that there was no undue influence, that the settlor signed the document, that it reflects his or her desires, and that he or she signed it according to applicable law.<sup>20</sup> Moreover, a beneficiary's refusal to sign the NJSA would signal to the settlor a likely future challenge. The settlor could then respond accordingly by, for example, adding a no contest provision that forfeits a devise to the contesting party.

Thus, using an NJSA for a pre-mortem court determination can help settlors reduce the risk of a trust contest after their death and secure their estate plans.

### Tax Issues

Drafters must consider possible transfer taxes and/or income taxes when creating an NJSA. While the NJSA is considered as binding as a court decision on the signatories, it is not a decision by the highest court in the state. Therefore, the IRS may not be similarly bound by its terms.<sup>21</sup>


Gift tax may result when an NJSA is used to resolve a dispute. Generation-skipping transfer (GST) tax can also result from modifications to trust terms, as can income tax if there is a gain recognition event. Treas. Reg. § 25.2511-1(c) states that a gift tax may result from a transaction "in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed." The key is whether the conferral of the asset was gratuitous. In a private letter ruling (PLR) concerning the income, gift, estate, and GST tax consequences of a settlement agreement,<sup>22</sup> the IRS focused on (1) whether a viable dispute existed under state law; (2) whether the transfer of the asset from one beneficiary to another was part of a settlement based on a valid and enforceable claim asserted by the parties; and (3) whether, to the extent feasible, the settlement produced an economically fair

result reflective of applicable state law that would be applied by the highest court in the state.<sup>23</sup> The matter came before the IRS after an adversarial process before the court and extensive settlement negotiations in which the trustees and beneficiaries of a trust agreed to a settlement under which the trust would terminate and its assets be divided into two trusts. The IRS determined that the issues were bona fide and resulted from enforceable claims by both parties; therefore, there was no application of income, GST, or gift tax.<sup>24</sup>

### Conclusion

NJSAs are a versatile new tool for handling trust administration and related disputes and helping secure estate plans. They enable settlors to fend off potential trust contests and allow

beneficiaries and administrators to resolve disputes in a cost-efficient manner.

Attorneys assisting clients with a trust should include NJSAs as an option when considering all possible ways to facilitate the administration and modification of trusts and related disputes. 



**Carol Warnick** is a partner with Holland & Hart in Denver. She focuses her practice on estate and wealth transfer planning and administration, and probate and trust litigation. Warnick also mediates trust and estate related disputes. She practices in Colorado, Utah, and Wyoming—[cwarnick@hollandhart.com](mailto:cwarnick@hollandhart.com).

**Coordinating Editors:** David W. Kirch, [dkirch@dwkpc.net](mailto:dkirch@dwkpc.net); Emily Bowman, [ebowman@dwkpc.net](mailto:ebowman@dwkpc.net)

### NOTES

1. Gardner and Wiener, "Is the Irrevocable Trust Really Irrevocable?" 47 *Colo. Law.* 56 (Oct. 2018).
2. CRS § 15-5-111(1).
3. CRS § 15-5-111(3).
4. CRS § 15-5-111(2).
5. CRS § 15-5-111(3).
6. CRS § 15-5-411(3).
7. CRS § 15-5-111(4).
8. CRS § 15-1-111(1).
9. CRS § 15-5-111(5).
10. CRS § 15-12-912.
11. *Estate of Masden*, 24 P.3d 634 (Colo.App. 2001).
12. CRS § 15-12-1101.
13. *Id.*
14. However, decanting is sometimes preferable. As discussed in Gardner and Wiener, *supra* note 1 at 58, one such example is where a beneficiary receives a reduced interest pursuant to an NJSA to which he or she has consented and may be deemed to be making a taxable gift to the other beneficiaries. The advantage to decanting in this circumstance is that the beneficiary would not be required to give consent and thus could avoid a taxable transaction.
15. *E.g.*, North Carolina, N.C. Gen. Stat. § 36C-1-111(b); and South Carolina, S.C. Code Ann. § 62-7-111(b).
16. *E.g.*, New Hampshire, N.H. Rev. Stat. § 565-B:1-111(d)(7); and Oregon, Or. Rev. Stat. Ann. § 130-045(5)(i).
17. *E.g.*, Iowa, Iowa Code § 663A.6308.2; and Michigan, Mich. Comp. Laws § 700.7111(2).
18. CRS § 15-5-111(4)(d).
19. W.S. § 4-10-604. Six other states have similar pre-mortem statutes: Alaska, Arkansas, New Hampshire, North Carolina, North Dakota, and Ohio. However, these statutes deal with wills, not trusts. See Preteroti and D'Andrea, "Where There is a Will, Is There a Way? Getting the Last Word on Your Estate Plan," *Tax Mgmt. Estates, Gifts and Trusts J.*, vol. 46, 11, 314 (Nov. 9, 2017), <https://www.bakerlaw.com/webfiles/Tax/2019/Articles/D'Andrea-Bloomberg-Article.pdf>.
20. Of course, the NJSA could be subject to challenge based on allegations of the settlor's lack of capacity or subjection to undue influence related to the signing of the NJSA.
21. *Comm'r v. Estate of Bosch*, 387 U.S. 456 (1967).
22. A PLR only binds the parties to the ruling, but PLRs are often indicative of how the IRS might react to a similar situation.
23. PLR 201530008, <https://www.irs.gov/pub/irs-wd/201530008.pdf>.
24. *Id.* at 8.