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Directed Trusts

Structuring Trusts, Bifurcating Functions and Converting Existing Trusts Into Directed Trusts

TUESDAY, MARCH 27, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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WILMINGTON TRUST

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INTRODUCTION

- Clients sometimes want to appoint a corporate trustee for a trust but also want to have a cotrustee, adviser, committee, or protector (not the Corporate trustee) control certain trust decisions.
  - If a client funds an inter vivos trust with stock in the family company, he or she might want to continue to make decisions regarding the purchase, sale, and voting of such stock.
  - A family that has a long-standing relationship with a successful money manager might want that manager (not the corporate trustee) to make investment decisions for trust assets.
  - A client might want someone other than the corporate trustee to decide when to make income or principal distributions to beneficiaries.
- A 2008 article observes that (Gilman, 35 Est. Plan. at 23 (Mar. 2008)):

> “Despite the fact that there is no perfect solution to the question of trustee appointment and supervision, it is the author’s opinion that the best course of action for our clients and their families is to appoint a single trustee—a trustee who is trained for the job—preferably a corporate institution, who will be responsible for all trust administration issues, and then appoint an advisor or a committee of advisors who will provide the corporate fiduciary with the necessary insight into the clients’ family members and will provide meaningful oversight of the trustee’s administrative services.
>
> The combination of a corporate trustee with a competent group of advisors should produce the best results for clients’ families. The approach combines the strength of the corporate trust department and the personal touch that we humans demand and expect. While the use of an advisory committee might not solve all the problems, the recommended action has substantial merit and should be thoroughly evaluated with clients.”

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INTRODUCTION (cont'd.)

- In these situations, the client wants to minimize the corporate trustee's involvement in such decisions and wants such trustee to lower its fees to reflect its reduced duties.
- Unfortunately, even if a trust ("directed trust") directs the corporate trustee to make investments or distributions on the direction of someone else ("directing person") and relieves it from liability for following such directions, such trustee might have considerable monitoring or other responsibilities under applicable state law.
- Thus, the corporate trustee might be in the unenviable position of being pressured to charge low fees while being subject to substantial potential liability.
- For directed trusts, some states follow the approach of § 185 of the Second Restatement of Trusts, other states follow § 808(b) of the UTC, still other states have statutes that greatly limit a trustee's liability, and other states have no relevant statute.
- The appendix contains citations for the foregoing statutes.

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SECOND RESTATEMENT OF TRUSTS APPROACH

- Section 185 of the Second Restatement of Trusts provides as follows:

  "If under the terms of the trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of such power, unless the attempted exercise of the power violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power."

  – A trustee usually must follow the directions of someone who is given a power to direct in the trust instrument and may be held liable for not doing so.

  – If the power on which the trustee is directed is for the sole benefit of the directing person (e.g., a power in a widow to direct the sale of trust real estate), the trustee's sole responsibility is to ensure that the direction is within the terms of the trust.

  – If the power on which the trustee is directed is held by the directing person in a fiduciary capacity for the beneficiaries of the trust, however, the trustee might have to make sure that the directing person does not violate that duty and might have to petition a court for instructions in certain cases.

  – Ordinarily, the trustee may await instructions from the directing person but, in certain situations, might have to suggest that the directing person take action or to petition a court for instructions.

- As shown in the appendix, only two states—Indiana and Iowa—have statutes based on § 185.

- Section 185 is not comforting to directed trustees because they must devote resources to ensuring that the directing person is not violating the terms of the trust or a fiduciary duty.

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UTC APPROACH

- For the most part, the UTC is not more helpful to directed trustees than Restatement § 185.
- Subsection (b) of UTC § 808 provides as follows:

> "If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust."

- Section 808's comment discusses subsection (b) as follows:

> "Powers to direct are most effective when the trustee is not deterred from exercising the power by fear of possible liability. On the other hand, the trustee does have overall responsibility for seeing that the terms of the trust are honored. For this reason, subsection (b) imposes only minimal oversight responsibility on the trustee. A trustee must generally act in accordance with the direction. A trustee may refuse the direction only if the attempted exercise would be manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty owed by the holder of the power to the beneficiaries of the trust."

- The comment to § 808 does continue, though, that:

> "The provisions of this section may be altered in the terms of the trust. . . . A settlor can provide that the trustee must accept the decision of the power holder without question. Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary."

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UTC APPROACH (cont'd.)

- Again, unless the governing instrument provides otherwise, a directed trustee must devote considerable resources to ensure that the directing person's action is not "manifestly contrary to the terms of the trust" or "a serious breach of a fiduciary duty."
- Section 808's comment describes this as "minimal oversight responsibility," but my colleagues, who would provide such oversight, assure me that it would be far more challenging to review someone else's investment and distribution decisions than to make those decisions themselves.
- As shown in the appendix, 19 states—Alabama, Arkansas, the District of Columbia, Florida, Kansas, Maine, Michigan, Missouri, Nebraska, New Mexico, North Carolina, North Dakota, Oregon, Pennsylvania, South Carolina, Texas, Vermont, Virginia, and West Virginia—have statutes based on UTC § 808(b).
- Section 75 of the Third Restatement of Trusts, which was issued in 2007, contains comparable rules.

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PROTECTIVE APPROACH

- As shown in the appendix, 15 states—Arizona, Colorado, Delaware, Georgia, Idaho, Indiana, Kentucky, Nevada, New Hampshire, Ohio, Oklahoma, South Dakota, Tennessee, Utah, and Wyoming—afford more protection to directed trustees than Restatement § 185 or UTC § 808(b).
  - A Delaware trustee is liable for following a distribution or investment direction only if it engages in wilful misconduct.
  - Some other states only extend protection to directed trustees in investment matters, some require the directed trustee to carry out the direction properly, and some place no restrictions on the directed trustee's conduct.

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NO STATUTE

- As shown in the appendix, 16 states—Alaska, California, Connecticut, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, Mississippi, Montana, New Jersey, New York, Rhode Island, Washington, and Wisconsin—have no directed trust statute, and the effectiveness of directed trust language in trusts governed by the laws of these states is questionable.
  - In re Estate of Rubin (143 Misc. 2d 303, 308 (Surr. Ct. Nassau Co. 1989)), aff'd, 570 N.Y.S.2d 996 (2d Dept. 1991)):

    "[T]he designation of advisors . . . to make directives controlling the actions of the coexecutors in any disputes is a valid limitation upon the powers of such executors."

  - Matter of Rivas (2011 N.Y. Misc. Lexis at 18 (Surr. Ct. Monroe Co. 2011)):

    "[T]his Court cannot allow the proposed investment of the Helen Rivas Trust corpus, as such investment in the LTIP is contrary to the Agreement and the intent of the settlor, may give rise to an impermissible division of fiduciary loyalties among the majority of the Advisory Committee, and would also violate the Prudent Investor Act."

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DELAWARE'S EXPERIENCE

- Delaware's long-standing directed trustee law (12 Del. C. § 3313) permits someone other than the trustee to make distribution decisions and investment decisions for particular assets (e.g., closely held stock) or with the hope of maximizing the trust's investment performance and makes it clear that a trustee may follow the direction of an adviser authorized by the governing instrument to give such direction without breaching the trustee's fiduciary responsibility.
  - To recognize this diminished responsibility, Delaware corporate trustees customarily charge less to administer directed trusts than trusts over which they have investment duties.
  - An unreported 2004 case upheld the Delaware statute (<u>Duemler v. Wilmington Trust Co.</u>, 2004 Del. Ch. Lexis 206 (Del. Ch. 2004)).

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CASELAW

- Two courts have considered directed trust statutes.
- In Duemler v. Wilmington Trust Co.(2004 Del. Ch. Lexis 206), just mentioned, a Delaware Vice Chancellor ruled that a corporate trustee was not liable for the failure of a sophisticated (i.e., securities lawyer) investment adviser to direct it on an investment decision where the trustee forwarded relevant information to the adviser.
- The Vice Chancellor held:

> "It Is Hereby Ordered this 24th day of November, 2004, that:
>
> 1. Judgment is entered in favor of defendant Wilmington Trust Company ("Wilmington Trust") and against plaintiff R. Leigh Duemler ("Plaintiff");
> 2. The Court finds that Wilmington Trust did not breach its fiduciary duty, as co-trustee of a trust dated May 29, 1985 between Robert F. Duemler as trustor and R. Leigh Duemler and Wilmington Trust Company as trustees (the "Trust"), to Plaintiff as co-trustee, investment advisor and remainder beneficiary of the Trust by allegedly not forwarding to Plaintiff materials related to an exchange offer for certain securities held in the Trust (the "Exchange Offer");
> 3. The Court further finds that even if Wilmington Trust had been negligent in not forwarding to Plaintiff materials related to the Exchange Offer, which the Court has not found, such negligence would not have been the proximate cause of the loss to the Trust resulting from Plaintiff's decision not to tender the securities in the Exchange Offer; and
> 4. The Court further finds that section 3313(b) of title 12 of the Delaware Code insulates fiduciaries of a Delaware trust from liability associated with any loss to the trust where a governing instrument provides that the fiduciary is to follow the direction of an advisor, the fiduciary acts in accordance with such direction and the fiduciary did not engage in willful misconduct. The trust agreement involved in this case appointed Plaintiff as the investment advisor to the Trust and, at all times, Plaintiff made all of the investment decisions for the Trust, including not to tender the securities in the Exchange Offer. In connection with Plaintiffs decision not to tender the securities in the Exchange Offer, Wilmington Trust acted in accordance with Plaintiff's instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information concerning the Exchange Offer. Accordingly, 12 Del. C. § 3313(b) insulates Wilmington Trust from all liability for any loss to the Trust resulting from plaintiff's decision not to tender the securities in the Exchange Offer."

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CASELAW (cont'd.)

- Rollins v. Branch Banking & Trust Co. of Va. (2001 Va. Cir. Lexis 146 (Va. Cir. Ct. 2001)), a Virginia trial court held that a trustee was not liable for the $25 million loss caused by the retention of stock as directed by the beneficiaries.

- The court did not dismiss the beneficiaries' claim that the trustee had violated a duty to warn them about the deteriorating condition of trust investments, and the case was settled on this issue.

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COMMENTARY

- A 2008 article observes that (Clarke & Zeydel, 35 Est. Plan. at 22–23 (Sept. 2008)):

  "[W]e would suggest the following guidelines in drafting a directed trust statute to achieve the settlor's objectives of having a directed trust while at the same time protecting the interests of the directed trustee and the beneficiaries:

  1. Limit liability of directed trustee and advisor. If the settlor wishes to have a true directed trust in which the trustee will follow the direction of an advisor, who may or may not be a co-trustee, without the trustee being required independently to evaluate the prudence of those directions, then the Delaware approach under which the trustee is liable for losses only in the event of "wilful misconduct" would appear optimal. By a "true directed trust," we mean a trust over which the advisor has authority to direct or prevent actions of the trustee. This should be distinguished from a trust that requires a trustee to obtain the consent of an advisor, which is more in the nature of a co-trustee relationship, and would be subject to different obligations and liabilities on the part of the trustee.

     In the case of a true directed trust that exonerates the directed trustee, the advisor should be held to a fiduciary standard of good faith that may not be waived in the governing instrument. Otherwise, it seems to us that the trust might fail, as no one would be acting in a fiduciary capacity with respect to the decisions in the hands of the advisor. Section 105 of the UTC provides that the trustee's duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries may not be waived. This principle seems to us fundamental to the existence of a trust. Therefore, if the advisor effectively takes on certain aspects of the trust administration by directing or preventing certain actions of the trustee, the advisor should become a fiduciary to that extent and be subject to a minimum fiduciary standard of good faith.

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COMMENTARY (cont'd.)

2. Scope of authority of the advisor. We believe the South Dakota approach of defining certain types of trust advisors is very helpful because it permits a settlor to incorporate those definitions by reference, thus adding certainty to the scope of the advisor's authority. Any definition should make clear that the advisor may be designated for all or any part of the statutorily defined scope of duties. Thus, for example, an investment trust advisor should be permitted to act with respect to the entire trust estate, or with respect to only one asset or category of assets, such as interests in entities that are not publicly traded. Similarly, a distribution trust advisor should be permitted to act exclusively with respect to distributions to a particular beneficiary or with respect to a particular trust asset, such as an interest in a closely held business.

   If the advisor is also a co-trustee, we believe the Florida approach of expressly excluding all other trustees from authority over and liability for following the directions (except in the case of willful misconduct) of the advisor is optimal. We believe this will encourage settlors to name multiple trustees, each particularly suited to one or more tasks of trusteeship, and allow each to be exclusively responsible as a trustee in his, her or its area of expertise. Accordingly, in the case of a trustee/advisor, all other trustees would be defined as excluded trustees and substantially exonerated from liability. If, on the other hand, the advisor is not a co-trustee, then we suggest that the approach in paragraph 1 above be followed.

3. We believe any directed trustee statute should clarify the ambiguity in the UTC with respect to an advisor who is also a beneficiary. If a beneficiary is the advisor, the beneficiary should not be subject to a fiduciary standard only if the beneficiary is the only person whose interest in the trust (as defined under state law taking account of virtual representation) is affected by directions given by the advisor. So, in Florida, for example, where a beneficiary with a special power of appointment may represent the interests of the takers in default, if the beneficiary were the investment advisor of a trust for the exclusive lifetime benefit of that beneficiary over which the beneficiary has a testamentary special power of appointment, then the beneficiary, as investment advisor, would not have a fiduciary duty to anyone else. But if the beneficiary is only an income beneficiary or is only one of multiple permissible income and principal beneficiaries, then the beneficiary, acting as advisor, should be held to a minimum fiduciary standard of good faith."

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COMMENTARY (cont'd.)

- A 2011 article identifies the following five requirements for clarity as to legal and risk parameters in a multi-participant trust (Duncan & Sarafa, 36 ACTEC L.J. at 796–797 (Spring 2011)):

"1. Where the trust will be administered and therefore the law of administration (which must be ascertained despite trust participants located and acting in multiple states).

2. Whether each non-trustee participant is a fiduciary or not and whether a fiduciary or not, certainty as to:

   a. the standard, if any, for the performance of its responsibilities and whether losses due to a failure to meet that standard attract liability; and
   b. what if any duties of trustees adhere to its assigned responsibilities.

3. The potential liability, if any, of the trustee or a non-trustee participant for the known or unknown acts or omissions of another participant.

4. Whether a trustee or non-trustee participant must follow a direction provided by another participant within the scope of the directing participant's responsibilities but which the receiver knows, reasonably believes or should have known would violate the instrument, law or the direction giver's or the receiver's fiduciary responsibility.

5. More generally, whether a directed trustee is relieved of any responsibility with respect to a function assigned to a non-trustee participant other than to follow that participant's directions."

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COMMENTARY (cont'd.)

- The same article identifies the following seven requirements for an effective multi-participant trust management structure (Duncan & Sarafa, 36 ACTEC L.J. at 797–798 (Spring 2011)):

"1. Communication among the fiduciary participants as to, among other things, what they have done, what they have been told by beneficiaries or others, the assets in the trust from time to time and, in particular, the distributions requested, approved or made or of an election to convert to a unitrust or exercise a power to adjust.

2. Coordination among the trust participants, such as speaking with a consistent voice to beneficiaries, investing and liquidating assets according to the liquidity needs of the trust for expenditures and distributions, taking a consistent view as to the legal obligations of the trust to beneficiaries and others or the tax obligations of the trust.

3. Filling vacancies in trust participant positions and determining who if anyone must perform a vacant participant's functions pending appointment of a successor.

4. Time limits for a trust participant to exercise an approval or veto right or obligation, and whether after the expiration of such time, the action will be deemed approved or vetoed.

5. When more than one participant has the power to act or decide on a matter, certainty as to whether action must be taken unanimously, by majority vote or by anyone of the empowered participants, and whether a dissenting participant need do more than voice an objection to the other participants to protect himself/herself from liability.

6. Expeditious, competent and final out-of-court resolution of any disagreement among trust participants.

7. Certainty as to the amount of compensation and reimbursement of expenses, if any, the non-trustee participants are entitled to receive."

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CAVEAT

- The relief provided to a directed trustee by even the most protective statute is not unlimited.
  - A directed trustee statute is a state-law creation and will protect a directed trustee only from state-law claims.
  - Specifically, it will not shield a directed trustee from claims arising under federal law (e.g., tax laws, anti-money laundering penalties).

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APPLICABLE LAW

- The operation of a directed trust and the directed trustee's liability to beneficiaries under it are matters of trust administration (See Restatement (Second) of Conflict of Laws § 271 cmt. a (1971)).

- A testator's or trustor's designation of a state's law to govern administration matters for a trust that holds movables almost always is respected (See Restatement (Second) of Conflict of Laws §§ 271 cmt. h, 272 cmt. f).

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VALIDITY OF TRUST; APPLICABLE LAW

- With attorneys increasingly drafting trusts that remove investment, distribution, and other decision-making from a corporate trustee and bestow such responsibilities on advisers, committees, and protectors, some practitioners have begun to express concern as to whether the testator or trustor has created a valid trust and whether the law of the desired jurisdiction will in fact apply.
  - As a general rule, the more duties are given to the corporate trustee the more likely it is that the trust will be valid and the desired law will be used.
  - Conversely, if the corporate trustee is directed on virtually every decision, the testator's or trustor's wishes might not be accomplished.
- In Lewis v. Hanson (128 A.2d 819 (Del. 1957), aff'd, 357 U.S. 235 (1958)), the Supreme Court of Delaware considered whether a Florida resident had validly exercised a power of appointment over a revocable trust that she, while a Pennsylvania resident, had created in Delaware with Wilmington Trust Company in 1935.
  - The court described its task as follows (128 A.2d at 825):

    "W]e think a more logical approach to what has now become a headlong jurisdictional collision between states is to consider first the question of what law governs the basic validity of the trust agreement and the exercise of the power of appointment, and whether or not under the applicable law the instruments are legally effective as such. We therefore take up first the question of essential validity of the trust and the exercise of the power of appointment."

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VALIDITY OF TRUST; APPLICABLE LAW (cont'd.)

– The Supreme Court first found that Delaware law rather than Florida law should determine whether Mrs. Donner had validly exercised her power of appointment (128 A.2d at 826):

> "In determining the situs of a trust for the purpose of deciding what law is applicable to determine its validity, the most important facts to be considered are the intention of the creator of the trust, the domicile of the trustee, and the place in which the trust is administered.
>
> Generally speaking, a creator of an inter vivos trust has some right of choice in the selection of the jurisdiction, the law of which will govern the administration of the trust. This trust agreement was signed and the securities delivered to a trustee doing business in Delaware. We think that this circumstance clearly indicates the intent of Mrs. Donner to have the trust administered and governed according to the law of Delaware.
>
> Formerly, some courts emphasized the domicile of the settlor in deciding what law governed, but the more recent trend of decisions has placed considerably more emphasis on the location of the trust property and its place of administration. The manifest intention of Mrs. Donner to create a Delaware trust with a Delaware trustee, the deposit of the trust assets in Delaware, and the administration of the trust in Delaware, make it clear that the situs of the trust created by the agreement of 1935 is Delaware, and that, therefore, its law determines its validity.
>
> Not only is it the rule that the essential validity of an inter vivos trust having its situs in Delaware is governed by its law, but it is equally the rule that the validity of the exercise of a power of appointment reserved in such a trust agreement is to be determined in accordance with Delaware law. This is so because the appointments made by the exercise of the power are regarded in law as though they had been embodied in the original trust instrument, and as such as having been created by it.
>
> We, therefore, hold that the law of Delaware determines the essential validity of this trust agreement and of the exercise of the power of appointment."

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VALIDITY OF TRUST; APPLICABLE LAW (cont'd.)

- Next, the court rejected an argument that the trust and the exercise of the power of appointment were invalid as testamentary in character for failing to create present interests in persons other than the trustor at the outset (128 A.2d at 827) and an argument that the trustor had created an agency relationship rather than a trust relationship with Wilmington Trust Company given the array of her retained powers.
- The court then arrived at the critical issue for present purposes (128 A.2d at 828):

"[T]he main thrust of the argument of the Lewis Group is directed to the provisions of the agreement providing for the designation of a trust advisor and the limitations on the power of the trustee to act only with the consent of or at the direction of the advisor.

By the agreement, Mrs. Donner reserved the right to change the original advisor named and, in fact, she did so on two separate occasions. The agreement, however, specifically confines the powers of the trust advisor as limitations on the exercise of the trustee's powers to (1) the power to sell trust property; (2) the power to invest the proceeds of any sale of trust property, and (3) the power to participate in any plan of merger or reorganization of any company in which trust proceeds have been invested. With respect to the exercise of all of the other specific powers granted to the trustee the consent of the trust advisor is not required."

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VALIDITY OF TRUST; APPLICABLE LAW (cont'd.)

– Finally, the Supreme Court sustained the validity of the trust and the exercise of the power of appointment (128 A.2d at 828):

"If it be assumed that the exercise by the trustee of the above enumerated powers had been conditioned solely upon the consent of Mrs. Donner herself, it is clear that that limitation would not have made the trust testamentary in character. It follows logically, therefore, that if Mrs. Donner could have limited the power of the trustee to act only with her consent without making the trust testamentary, the same limitation could have been imposed by requiring the consent of a third party. . . Furthermore, a trust advisor is a fiduciary, somewhat in the nature of a co-trustee, and is sometimes described as a quasi-trustee. The resulting situation fundamentally is not unlike the appointment of co-trustees whose joint action is required in trust matters.

The agreement of 1935 by its terms reserves no power to Mrs. Donner herself over the control or management of the trust property, except such power as may come from her right to revoke the trust, change the trustee and change the advisor to the trustee. As far as the terms of the agreement itself are concerned, the trustee and the advisor were required to use their independent judgment in reaching decisions relating to the administration of the trust.

The terms of the agreement, therefore, do not compel the conclusion that Mrs. Donner retained such a measure of control over the management of the trust property that, as a matter of law, the Wilmington Trust Company, and the trust advisor named were actually her agents. The entire management of the trust is vested by the terms of the instrument in the trustee and the advisor. We think, therefore, that under the law of Delaware the agreement of 1935 created a valid inter vivos trust and not an agency relationship as the Lewis Group contends."

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DIRECTED TRUST AVAILABLE AS ALTERNATIVE TO PRIVATE TRUST COMPANY

- Families sometimes explore creating private trust companies (“PTCs”) to serve as trustees of trusts for family members.
- PTCs are very expensive to form, involve potential registration with and regulation by the Securities and Exchange Commission (“SEC”) and other state and federal agencies, and are vulnerable to disruption if key personnel depart.
- By establishing directed trusts with a corporate fiduciary, such families may avoid that expense and those regulatory headaches.
  - An appropriate corporate fiduciary may offer access to a number of investment, trust, tax, estate-planning, and other officers so that if one of them leaves, the administration of trusts will not be harmed.
  - The appointment of family members as direction investment or distribution advisers will minimize the corporate trustee’s fees and provide the control that is so important to many families.

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CRTS AND ADVISERS

- PLR 8041100 – Use of a direction investment adviser will disqualify a CRT.
- PLR 9442017 – Use of a direction investment adviser will not disqualify a CRT in certain circumstances.

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THE PROTECTOR

- Since the turn of the 21st Century, the "protector," which long has been a feature of offshore trusts, has begun to appear in trusts created in the United States.
  - States (e.g., Alaska, Arizona, Delaware, Idaho, Michigan, Nevada, New Hampshire, South Dakota, Vermont, and Wyoming) have enacted statutes defining the protector's role.
  - The protector sometimes becomes involved in decisions (e.g., directing investments or distributions) that traditionally have fallen within the domain of the adviser or committee.
  - At other times, the protector is charged with responsibilities (e.g., replacing trustees and advisers, amending trust provisions, changing situs) that used to require court involvement.
- In what may be the first reported U.S. case considering a protector, a Missouri intermediate appellate court refused to grant a protector's motion for summary judgment that he had no duty to monitor the trustee's conduct (McLean Irrev. Trust v. Davis, 283 S.W. 3d 786 (Mo. Ct. App. 2009)).

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DIRECTED TRUSTS:
Drafting Considerations
and Effectively Bifurcating Trustee Functions

Strafford Publications Webinar
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A Directed Trust Is NOT A Delegation

- A directed trust is NOT a delegation. A good directed trust effectively bifurcates the function between two fiduciaries and gets the fiduciary that is acting at direction out of the way.
- Trustee should have no duty to monitor or supervise the adviser.
- Trustee should have no ability to exercise discretion with respect to the directions under the instrument or pursuant to the direction letter.
  - For example, the direction letter should not just say that the Trustee shall enter into a note upon such terms as the Trustee may determine.
- Trustee should not have the power to remove or appoint the adviser. This may effectively create a delegation arrangement and make the Trustee responsible for the decisions to hire and fire the adviser and the advisability of maintaining the adviser.

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Always Draft "Direction" Language

- The adviser could be given the authority to direct, consent or disapprove investment decisions, distribution decisions or any other decision of the fiduciary.
- Make sure that the document *only* provides for direction.
- The adviser provision should not enable the adviser to toggle between consent or direction. This could shift unwanted responsibility onto the Trustee.

Why Consent Does Not Work

- The Trustee should always act either (a) solely at direction, or (b) in its sole and absolute discretion, but not with the consent or prior approval of the adviser.
- If the Trustee must act with the consent of an adviser, then the Trustee possesses all of the fiduciary responsibility and liability for the trust investments, yet the Trustee can only implement its strategies and decisions after obtaining the consent of some third-party adviser who may or may not grant its consent. The result is that the Trustee must go through the administrative task of seeking, obtaining and documenting consents, and the Trustee will responsible and liable for a portfolio that does not necessarily reflect it's own decisions unless the consent adviser always agrees with the Trustee.
- The consent adviser structure is fraught with a high degree of administrative hassle and risk. It is an untenable arrangement.

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Trustee Must Act SOLELY At Direction

- Trustee must act *solely* at direction.
- Frequently, drafters use language that is too loose, such as providing that the Investment Adviser "shall have the power to direct the Trustee" without actually stating that the Trustee shall act "solely" or "exclusively" upon the written direction of the Investment Adviser.
- A provision in the trust instrument that merely provides that the adviser may direct the Trustee, without expressly providing that the Trustee shall only act upon direction, arguably sets up a simultaneous duty for the Trustee to take directions and also to act in its own discretion.

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The Adviser Does NOT Take on The Trust Power and Authority – It Directs the Trustee to Exercise Them

- Often, drafters take the approach that all of the investment power and authority is to be held by the adviser, and the Trustee shall have no trust power and authority over investments. This is not how a directed trust is structured.
- The Trustee holds the trust power and authority to take actions and the direction adviser directs the Trustee to exercise those powers.

Always Set Trustee Liability When Acting At Direction To "Willful Misconduct"

- Trustee should only be liable for willful misconduct, not gross negligence or any other standard.
- It is the willful misconduct standard that enables the Trustee to follow direction without monitoring or second guessing the decisions of the Investment Adviser. This is critical for effective bifurcation.
- For example: Section 3301(g) of Title 12 of the Delaware Code defines the term "willful misconduct" as "intentional wrong doing, not mere negligence, gross negligence or recklessness" and "wrong doing" means malicious conduct or conduct designed to defraud or seek an unconscionable advantage."

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The Duemler Case

- Delaware has a Chancery Court opinion that upholds the willful misconduct statutory defense under Section 3313(b).
- R. Leigh Duemler v. Wilmington Trust Company, C.A. 20033, V.C. Strine (Del. Ch. Oct. 28, 2004) (Trans.)
- In this case, Vice Chancellor Strine explained that if the Trustee were liable for the failure to provide information or to make sure that the Investment Adviser knew what it is doing, it would "gut the statute". If the Investment Adviser does not make the investment decisions alone, the Investment Adviser's role would not work, as the Trustee would always "second guess" the Investment Adviser's decisions.

CONTRAST OTHER CASE LAW

- *Rollins v. Branch Banking, Trust Company of Virginia*, 2001 Va.Cir.Lexis 146 (Va. Cir. Ct. 2001) which upheld the statute but held that the Trustee was liable and could not "rid himself of this duty to warn".

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Don’t Just Rely on a Statutory Definition Or Short Generic List Of Investment Decisions

- Section 3313(d) defines the term “investment decision”. An investment decision means “with respect to any investment, the retention, purchase, sale, exchange, tender or other transaction effecting the ownership thereof or rights therein and with respect to non publicly traded investments, the valuation thereof, and an adviser with authority with respect to such decisions is an investment adviser.”
- The Investment Adviser provision in the trust instrument should be detailed and all-inclusive. Additionally, the direction letter must be specific and detailed. The letter should basically say “buy this asset” or “signed the attached document”.
- The Investment Adviser provision in the trust instrument should not merely include a short generic description of investment decisions or simply limit the scope of the direction power to “investment decisions” under Section 3313(d) – it should be as specific and inclusive as possible and should ideally cross reference all investment trustee powers in the instrument. The trust instrument will generally include a long list of every conceivable investment power granted to the Trustee. Use that list by cross-reference.
- Without a clear, complete detailed list of powers to be exercised at direction, there will be ambiguities during the administration of the trust. Questions will arise about whether a particular action falls within the direction provisions.

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Expressly Limit The Trustee's Duty To Monitor

- 12 Del. C. § 3313(e) clarifies that a fiduciary that follows the direction of an adviser with respect to any decision shall have no duty to monitor, advise with respect to, warn or otherwise interfere with the decisions of the adviser and that any such actions taken by the fiduciary shall be presumed to be administrative actions taken solely to allow the fiduciary to perform the duties assigned to the fiduciary acting at direction.
- The trust instrument should expressly limit these duties as well.

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Specifically Address Special Holdings

- Special Holdings could include any of the following:
  - closely held companies
  - limited liability companies
  - restricted stock
  - real estate
  - life insurance
  - private equity
- Special Holdings present unique issues for the Trustee concerning management, valuation and risk. The governing instrument should include specific language addressing these unique issues.
- For example, the Trustee has the duty to provide account statements to the beneficiaries, including asset positions and values. Yet an LLC or closely hold company under the authority of an Investment Adviser may be difficult for the Trustee to value and thus make it difficult for the Trustee to carry out its duty to report. Consequently, the direction language should provide that the Trustee shall value nonpublicaly-traded assets only as directed by the adviser.

Tax Issues

- The drafting attorney should be aware of potential adverse transfer tax issues:
- For example, if the Settlor holds the role of Investment Adviser, consideration should be given to whether the Settlor should control life insurance (potential Section 2042 issues) or control over a controlled corporation (potential Section 2036(b) issues).
- Additionally, special care must be taken with respect to the power of a Settlor beneficiary as a Distribution Adviser or member of a Distribution Committee to avoid adverse estate and gift tax issues.

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What Happens If There Is No Longer An Investment Adviser?

- The trust instrument should expressly provide that at any time that there is no Investment Adviser serving, the Trustee shall exercise all powers theretofore exercised at direction in its own discretion. Or if the Trustee never wants to possess that power, care should be taken to ensure that there is never a lapse in the role of Investment Adviser.
- If the Trustee assumes investment responsibility from an Investment Adviser, the Trustee will immediately be left holding and managing a portfolio of investments that it did not select and with which it may not agree. The trust instrument should provide exculpation for the Trustee when it assumes investment responsibility.
  - The Trustee should have no duty to review, investigate or remedy any decisions of the Investment Adviser that served previously.
  - The Trustee should have no liability for retention of assets selected by the previous Investment Adviser and should have the power and discretion to retain, sell and invest and reinvest assets as it deems appropriate in its sole discretion and without liability.

Direction In The Governing Instrument

- 12 Del. C. § 3304 now provides that a direction to retain property in the governing instrument shall be deemed to waive any duty of diversification and shall exonerate the fiduciary from liability for retaining the property except in the case of willful misconduct.
- Thus, a settlor who creates a trust with a specific investment strategy in mind may effectively carry out that strategy like a directed trust using Section 3304.

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DIRECTED TRUSTS:

Perspectives of the trustees and those advising trustees

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Uses for directed trusts

- Depending on the given state law, there are various possible uses for directed trusts. The most common use is investment directions, but if the statute covers other areas, the following are common uses of directed trusts:

  - Distributions
  - Valuations
  - Tax matters including positions on given topic, reporting, and compliance
  - Change of situs and governing law
  - Amendment of trust instrument

- The trust instrument should be clear as to what is covered under the direction power, and how these directions are to be implemented.

- Given our limited time today, we will focus mostly on investment directions and briefly discuss distribution directions.

Know your directed trust statute

- As noted in an earlier segment, directed trust statutes generally follow one of three categories:
  - The ability to completely bifurcate responsibilities – trustee has no duty to monitor, inquire, advise, or warn beneficiaries, e.g., 12 Del. C. §3313
  - UTC §808 approach where trustee can follow the directions of the advisor, unless the direction is manifestly contrary to the terms of the trust or would constitute a serious breach of fiduciary duty
  - Statutes that provide ability to be directed, but still have some residual responsibility left with the trustee or another party - e.g., bad faith or reckless indifference by the trustee, Ariz. Rev. Stat. §14-10808; willful misconduct by the party directing the trustee, Fla. Stat. § 736.0703(9).

- As a trustee, or someone advising a trustee, it is important to know the “rules of the road” under the statute.
  - What type of direction is allowed?
  - What responsibilities does the trustee have, once receiving the direction?
  - What if the trustee doesn’t agree with the direction?

- Understanding these issues will determine the format of the direction letter and the procedures the trustee has in place regarding directed trusts.

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Directions on investments

- If the trustee is being directed on investments, does this cover the following?
  - Purchase
  - Sale
  - Retention
  - Any voting rights
  - Valuation of the assets held
  - Providing any “reps and warranties”
  - Execution of investment documents such as subscription documents

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Structuring the ownership of assets in directed trusts

- Becoming more common to see assets held in a single member LLC, where the trustee is directed to hold that LLC.
  - Administrative activity is done by the LLC manager, not the trustee
  - Allows even more control by the advisor

- Consider various logistics of this arrangement, e.g., determine who will prepare any necessary tax returns for the LLC.

- Be mindful of minimum requirements for nexus. As discussed earlier Lewis v. Hansen, (128 A.2d 819 (Del. 1957), aff'd, 357 U.S. 235 (1958)), details minimum requirements for nexus.

- Even with nexus to the state of the trustee, possible to have a party in the state of the trust advisor bring a claim in that state, conflicts of laws issues possible.

Holding real estate in a directed trust

- The trust instrument and / or the letter of direction needs to clearly outline duties such as payment of real estate taxes and insurance.
- Real estate should only be held in an LLC or similar entity
- Isolates liability to that assets
- If asset held in another state, should limit that state's jurisdiction over the trust.
- If a Delaware trust, LLC provides mechanism for real property to be held in perpetuity, 25 Del. C. § 503(e).

Directions on distributions

- Having a distribution advisor directing the trustee can be useful when knowledge of the family's needs is with that person.

- Although the trustee is directed, the trustee must fully understand all terms of the trust agreement and how any direction might impact other terms.

- If the trustee is being directed on distributions, does this cover the following?
  - Interaction with investments and investment powers
  - Interaction with notice provisions of the state law or trust instrument
  - Any other provisions of the trust that might be violated or frustrated

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The direction letter

- Know your statute when determining what type of direction letter is needed.
- Directions should always be in writing.
- When is a blanket direction appropriate?
- If the direction letter is regarding investment documentation such as subscription agreements:
  - Does the investment advisor complete the documents and direct the trustee to sign?
  - Does the investment advisor direct the trustee to complete the documentation – be sure this is considered an administrative action and not an action that could elevate the trustee to an investment advisor.
- Consider having an annual letter signed by the advisor confirming:
  - He or she is still in that role.
  - The direction remains in place.
  - And if an investment direction, the current value of the asset.

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Long term considerations for the role of the trust advisor

- What happens if there is no longer an investment advisor?
  - Will the trustee be holding a portfolio of assets it does not follow?
  - Does the trustee have the resources to monitor, evaluate, and follow the property?

- The trust instrument needs to provide how succession is determined for trust advisors.
  - Does the trustee pick the successor?
  - Does trust protector pick the successor (but who picks the successor trust protector)?
  - Does a committee of beneficiaries or other parties pick the successor?
  - Is an automated succession plan established, e.g., a majority of beneficiaries

- What if the trustee has questions about the trust advisor's mental capacity at a later date?

- Same considerations as acting with a co-trustee.
  - However, the need to act quickly is important as the trustee's role is to timely execute the directions of the trust advisor.
  - Know your state statute. Is there some residual responsibility on the trustee to determine if the direction is a breach of fiduciary duty?

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DIRECTED TRUSTS:

Converting an existing trust into a directed trust

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Methods for converting a trust to a directed trust

- Decanting
- Judicial modification
- Consent Settlement
- Amendment

Issues to consider in decanting

- Trustee is exercising its discretion.
- Is there any residual liability to the trustee since it used its discretion to become directed?
- What state law applies?
- Does the state law require judicial action, and notice to beneficiaries?
- Are there any potential tax implications under IRS Notice 2011-101?
- Is there a cost savings as compared to judicial modification?

Issues to consider in judicial modification

- Generally all interested parties are on notice.
  - Positive – should prevent party from questioning later.
  - Possible negative – are there parties that do not yet know about the trust?

- Can be less cost effective than decanting or consent settlement.

- State law is determined as part of the proceedings, which gives comfort to trustee relying on state's trust advisor statute.

- Is the court likely to entertain the modification to add a direction advisor, and will the court impose any requirements on who is qualified to serve in that role?

Issues to consider in consent settlement

- Also referred to as non judicial modification in some jurisdictions.
- Cost effective method.
- All interested parties generally have to participate.

Issues to consider in amendment

- Cost effective method.
- All interested parties do not necessarily have to participate. Whoever has the power to amend can act.
- This may not preclude beneficiaries from bringing a cause of action at a later date since they are not necessarily on notice, as compared to judicial modification or consent settlement.