Directed Trusts: Managing the Administration and Risks of a Rapidly Growing Segment of Trust Business

U.S. TRUST

Bank of America Private Wealth Management

Disclosure

IMPORTANT: This brief summary is for discussion purposes only. It does not contain legal, tax, investment, or insurance advice and cannot be relied upon for implementation and/or protection from penalties. Always consult with your independent attorney and tax advisor for legal and tax advice.

IRS Circular 230 Disclosure: Pursuant to IRS Regulations, neither the information, nor any advice contained in this communication (including any attachments) is intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax related penalties or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

U.S. Trust, Bank of America Private Wealth Management operates through Bank of America, N.A., and other subsidiaries of Bank of America Corporation. Bank of America, N.A., Member FDIC.

Directed Trusts: Managing Administration and Risks

What is a directed trust?

- **A directed trust is a trust in which certain of the powers traditionally vested exclusively in a trustee are instead divided among the trustee and other parties who may or may not be deemed to be fiduciaries, such as:**
  - **an investment advisor with the exclusive power to direct trust investments;**
  - **a distribution advisor with the exclusive power to direct trust distributions; or**
  - **a trust protector with amendatory and/or a broad range of directive powers.**

- **A trust is not a directed trust simply because:**
  - **the trust is administered by more than one trustee (*i.e.*, co-trustees);**
  - **the trustee has delegated investment or other authority to another;**
  - **a person other than the trustee is granted a power of appointment under the terms of the governing instrument.**

Directed Trusts: Managing Administration and Risks

<u>Traditional "Non-directed" Functions of a Trustee</u>

The trends with directed trusts impact the traditional functions of a trustee.

Custodial Function

- Holding title to the trust property.

Administrative Functions

- Managing trust property, including preparing, transmitting and/or filing accountings, tax returns and notices to beneficiaries.

Distribution Functions

- Distributing trust income and principal to the beneficiaries in accordance with distribution standards set forth in the governing instrument.

Investment Functions

- Making and implementing investment decisions for the trust, including retaining, purchasing and selling trust assets for investment purposes.

Directed Trusts: Managing Administration and Risks

Duties of a Trustee with Respect to Co-Trustees

Restatement (Third) of Trusts
Section 81. Duty with Respect to Co-Trustees

(1) If a trust has more than one trustee, except as otherwise provided by the terms of the trust, each trustee has a duty and the right to participate in the administration of the trust.

(2) Each trustee also has a duty to use reasonable care to prevent a co-trustee from committing a breach of trust and, if a breach of trust occurs, to obtain redress.

Comment b:

b. *Effect of the terms of the trust*. The duties of multiple trustees, as discussed in this Section, may be reduced, modified, or specially allocated by the terms of the trust.

Even in matters for which a trustee is relieved of responsibility, however, if the trustee knows that a co-trustee is committing or attempting to commit a breach of trust, the trustee has a duty to take reasonable steps to prevent the fiduciary misconduct. See Comments *d* and *e*. Furthermore, absent clear provision in the trust to the contrary, even in the absence of any duty to intervene or grounds for suspicion, a trustee is entitled to request and receive reasonable information regarding an aspect of trust administration in which the trustee is not required to participate.

Directed Trusts: Managing Administration and Risks

Duties of a Trustee with Respect to Delegations of Authority

Uniform Prudent Investment Rule
Section 9. Delegation of Investment and Management Functions

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances.

The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

Directed Trusts: Managing Administration and Risks

Creation of Directed Trusts

Directed trust provisions can be included in the terms of a trust agreement as originally drafted or can be incorporated into an existing trust agreement by court order or by nonjudicial modification, such as by use of a statutory power, nonjudicial settlement agreement, decanting power, exercise of power of appointment or amendatory power of a trust protector.

- **Conversion by statute**
  - Directed trust statutes provide mechanisms for converting a non-directed trust into a directed trust.
    - Nonjudicial settlement agreement statutes provide a means to modify an existing trust to incorporate directed trust provisions.
    - Decanting statutes provide a mechanism whereby the assets of an existing non-directed trust can be distributed ("decanted") to a new separate trust with directed trust provisions.

- **Conversion via governing instrument**
  - Some trust agreements have provisions that expressly allow a non-directed trust to be converted into a directed trust.
  - Some trust instruments have provisions that can be exercised in a manner to convert the trust to a directed trust.
    - Decanting
    - Exercise of Power of Appointment
    - Amendatory power of trust protector

Directed Trusts: Managing Administration and Risks

Risk Issues

- **System Coding Risks**
  - Application of Oversight Procedures
    - Risks associated with too little or too much oversight
    - Issues associated with Reg 9.6(c) annual review obligations
  - Impact of co-trustee/directed trustee coding
    - Co-Trustee v. Direction Advisor (e.g., Investment Advisor, Distribution Advisor, etc.)
    - Delegation v. Direction
    - Portfolio Manager's understanding of fiduciary relationship and obligations
  - Examples
    - NIR – No Investment Responsibility (default investment authority code for custody and "directed trust" account types)
    - Mennen (danger of coding errors)

U.S. TRUST

Directed Trusts: Managing Administration and Risks

Risk Issues -continued

- **Standards of Liability Associated with Advisor Oversight**
  - Varies by governing instrument
    - Standards of fiduciary liability embedded in trust agreement provisions.
  - Varies by state
    - Standards of fiduciary liability dictated by state statute
    - Uniform Trust Code v. Illinois law v. Delaware law

Directed Trusts: Managing Administration and Risks

Risk Issues -continued

- Uniform Trust Code

  UTC 808 (b): 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.

  UTC 808(d): A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty.

- Illinois

  760 ILCS 5/16.3(f): Duty and liability of excluded fiduciary. The excluded fiduciary shall act in accordance with the governing instrument and comply with the directing party's exercise of the powers granted to the directing party by the governing instrument. Unless otherwise provided in the governing instrument, an excluded fiduciary has no duty to monitor, review, inquire, investigate, recommend, evaluate, or warn with respect to a directing party's exercise or failure to exercise any power granted to the directing party by the governing instrument, including but not limited to any power related to the acquisition, disposition, retention, management, or valuation of any asset or investment. Except as otherwise provided in this Section or the governing instrument, an excluded fiduciary is not liable, either individually or as a fiduciary, for any action, inaction, consent, or failure to consent by a directing party. . .

Directed Trusts: Managing Administration and Risks

Risk Issues -continued

- Delaware

  12 Del. 3313(b): If a governing instrument provides that a fiduciary is to follow the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of wilful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act.

  12 De. 3301(g): The term “wilful misconduct” shall mean intentional wrongdoing, not mere negligence, gross negligence or recklessness and "wrongdoing" means malicious conduct or conduct designed to defraud or seek an unconscionable advantage.

Directed Trusts: Managing Administration and Risks

Administrative Issues

- **Loans/pledges/guarantees**
  - Determining whether decisions pertaining to loans/pledges/guarantees constitute investment decisions within the exclusive purview of the investment advisor
- **Tax reporting for LLCs**
  - Ascertaining whether LLCs (owned by the trust) are "look through" entities for income tax purposes
- **Signing subscription and other documents for underlying businesses**
  - Attesting to unknown facts
  - Regulatory filings
- **Valuation of assets**
  - Relying on investment advisor so long as values are current
  - Receiving requests for discretionary distributions that exceed amounts reports by investment advisor
  - In cases of asset substitutions, addressing the inability to verify assets of equal value without appraisal (assuming non-marketable asset on one or both sides of swap)

Directed Trusts: Managing Administration and Risks

Administrative Issues -continued

- **Equitable adjustments – coordination with investment/distribution advisor**
  - Determining and monitoring the prudence of investments for adjustment
- **Fees/taxes/expenses - coordination with investment/distribution advisor**
  - Maintaining liquidity to pay trust expenses (*e.g.*, when trust holds interests in an LLC or stock of a corporation that does not make distributions/pay dividends (and distributions/dividends cannot be compelled))
- **Real estate held indirectly**
  - Dealing with leases where trustee becomes landlord
  - Maintaining insurance and ensuring proper maintenance

Directed Trusts: Managing Administration and Risks

Components of a Risk Management Approach

- **System Coding**
  - Account type
    - Use and restrictions on use of "directed trust" code
  - Capacity code
    - Is "directed trustee" a separate capacity?
  - Investment authority code
    - "Fiduciary Oversight" v. "No Investment Responsibility"

- **Account Acceptance**
  - Establishing a risk appetite for directed trusts
  - Type of bank charter
  - Limits on acceptance

- **Oversight Protocol**
  - Reg 9 status
  - Annual fiduciary oversight
    - Oversight considerations
    - Need for action
  - Coordination with other reviews
    - Administrative reviews

U.S. TRUST

Directed Trusts: Managing Administration and Risks

Components of a Risk Management Approach - continued

- **Fiduciary Oversight Review Process**
  - Committee/work group make-up
    - Multidisciplinary
      - Fiduciary specialist
      - Investments specialist
      - Risk organization
      - Compliance
      - Legal
  - Review consideration
    - Type and purpose of trust
    - Does the portfolio make sense
      - Broad asset allocation
      - Asset concentrations
    - Are there apparent conflicts
  - Governance escalation issues and reporting