DIRECTED TRUSTS IN TODAY'S FIDUCIARY WORLD

A PRESENTATION TO FIDUCIARY & INVESTMENT RISK MANAGEMENT ASSOCIATION, INC.

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Materials and Presentation by:

Todd A. Flubacher, Partner
Morris, Nichols, Arsht & Tunnell LLP
1201 North Market Street
P.O. Box 1347
Wilmington, DE 19899-1347
Phone: 302-351-9374
E-mail: tflubacher@morrisnichols.com

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DIRECTED TRUSTS

1. **What is a Directed Trust?** Over the last decade, trust law has undergone a transformative evolution. It is now commonplace for trust settlors to design so-called "directed trusts" and existing trusts are frequently being transferred to new jurisdictions to be modified so they can become directed trusts.[1] A trust instrument of a directed trust includes provisions that allow for an adviser, co-trustee or other fiduciary to direct the trustee to exercise a variety of ministerial and discretionary responsibilities, such as investment decisions pertaining to all or a portion of the assets, tax reporting, distributions, transfer of trust situs, amendments to the trust instrument and how and when beneficiaries receive notice and information. In other words, a directed trust is a trust in which some of the duties traditionally held by a trustee are held by a separate adviser. Note that it is not the direction adviser that possesses and executes those powers. The direction adviser directs the trustee to exercise the powers. The trustee continues to possess the trust power and authority that the direction covers, but the trustee executes those powers only at the direction of an adviser. Depending on applicable law, a trustee can be directed with respect to any ministerial or discretionary function.

   Today, there are only five states that haven't enacted some form of directed trust statute (California, Hawaii, Louisiana, New York and Rhode Island). Section 808 of the Uniform Trust Code (UTC) implements the concept, and the Uniform Law Commission formed a Uniform Directed Trust Act Committee to draft a modern uniform directed trust statute and amendments to the existing provisions of the UTC. In the leading trust jurisdictions, such as Delaware, Alaska, South Dakota, Nevada and New Hampshire, directed trusts are a major motivation for creating trusts and migrating existing trusts to those jurisdictions and converting them to directed trusts. As an added bonus, directed trusts often result in lower fees, because the trustee who has been relieved of the responsibility for making investment decisions will charge a lower fee, and overall the trust may pay lower fees. With a directed trust, a settlor can choose to utilize different fiduciaries for investment functions or for making distribution decisions, and remove and replace the person or entity that performs those roles, without actually changing the trustee that performs administrative functions.

   This evolution in trust law was both necessary and long overdue. Why should it be necessary for a single trustee or the co-trustees of a trust to control every single

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[1] For further discussion of directed trusts, see Todd A. Flubacher and Cynthia D.M. Brown, If You Can't Beat 'Em, Join 'Em, Trusts & Estates Magazine (Nov. 2018); Todd A. Flubacher, Directed Trusts: Panacea or Plague?, Trusts & Estates Magazine (Feb. 2015); Todd A. Flubacher and David A. Diamond, The Trustee's Role in Directed Trusts, Trusts & Estates Magazine (Dec. 2010); Richard W. Nenno, Good Directions Needed When Using Directed Trusts, Estate Planning Journal (Dec. 2015); Mary Clarke and Diana S.C. Zeydel, Directed Trusts: The Statutory Approaches to Authority and Liability, Estate Planning Journal, (Sep. 2008).

ministerial and discretionary function for a trust instead of allocating those responsibilities among multiple fiduciaries who may be better qualified or more willing to perform those functions? By dividing the duties, the grantor is able to use separate specialized advisers to administer the trust. Settlors today often use common law trusts as complicated wealth transfer vehicles with specific objectives that often involve closely held entities, start-up companies, concentrated positions, real estate, art or other unique assets. Because of the historic development of the law of common law trusts and a trustee's general fiduciary duties that impose a duty of care and a duty to diversify, and a set of prudent investor or prudent person rules which come in direct conflict with holding such specialized assets.[2] The settlor might even live in a jurisdiction in which such duties are not waivable. As settlors have used common law trusts more frequently to carry out specific and unique investment, tax and dispositive objectives that conflict with traditional fiduciary limitations and pose unacceptable risks, obligations and duties on fiduciaries in such circumstances, today settlors are seeking to accomplish these strategies by bifurcating those responsibilities from the rest of the traditional trust administration functions, and assigning them to a separate adviser who will carry out those specific objectives.

A directed trust is not merely a delegation of duties among fiduciaries. In order to effectively bifurcate responsibilities, the settlor will need to ensure that: (1) the governing instrument of the directed trust is properly drafted, (2) the jurisdiction selected as the situs of the trust has a strong directed trust statute, and (3) the trustee is familiar with how to administer a directed trust. A well-drafted governing instrument of a directed trust will effectively bifurcate the directed function between two (or more) fiduciaries and eliminate the trustee, who is acting solely at direction, from the decision-making and monitoring of directed decisions. If the governing instrument is not properly drafted, leaving any ambiguity about which trustee powers are (and are) not exercised only upon direction, a trustee could be exposed to unnecessary liability. The governing instrument and the applicable statute should make it clear that the trustee has no duty to monitor or supervise the direction adviser. The trustee should have no ability to exercise independent discretion with respect to the directions under the instrument or pursuant to the direction letter. The trustee should not have the power to select, remove or appoint the adviser, which 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. The trustee should only be liable for willful misconduct when acting at direction and should not have liability for breaches of fiduciary duties committed by the direction adviser, who is the fiduciary solely responsible for making directed decisions.

Shifting accountability from a corporate trustee to an individual investment adviser could have a significant impact on the beneficiaries' ability to hold a fiduciary accountable. An individual, like a family member or friend, is often designated as the investment adviser

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2 See generally W. Curtis Elliott, Jr. & Briani L. Bennett, Closely Held Business Interests And the Trustee's Duty to Diversify, Trusts & Estates, (Mar. 2007) for a discussion of the risks of holding concentrated positions of closely held business interests in trusts.

responsible for investments that a corporate trustee may find too risky. An individual doesn't have the deep pockets of a corporate trustee. Thus, appointing an individual investment adviser could reduce the beneficiaries' ability to have recourse against the fiduciary if things go wrong. For example, in Mennen v. Fiduciary Trust Int'l of Del., the Chancery Court entered a separate summary judgment order holding that as creditors, the beneficiaries were prohibited from attaching the assets of the direction adviser's trust under that trust's spendthrift clause and Delaware's spendthrift statute, 12 Del. C. § 3536.[3]

2. **Why Create A Directed Trust?** Why would anyone want a directed trust? Isn't this just used to protect the trustee? The general answer is simple: the settlor, beneficiaries and/or trustee want a directed trust in those circumstances where they want someone other than the trustee to possess responsibilities and liabilities traditionally associated with the trustee function. If the settlor chooses to have a directed trust, then the settlor will want the trustee to be excluded from that area of decision-making. The settlor will not want the trustee to be second-guessing or interfering with the investment decisions. Likewise, the trustee will also want to ensure that those responsibilities are truly bifurcated, so that the trustee is not exposed to unexpected fiduciary risk.

   A. **Investments.** The most common use of a directed trust is a structure that utilizes a so-called investment adviser. The investment adviser directs the trustee with respect to all or some sub-set of investment decisions. Often, a settlor wishes to create a trust that holds special assets, such as a concentrated position in the stock of a family-controlled business, a limited liability company (LLC), real estate or stock that will soon be sold in an initial public offering. Settlors and beneficiaries may have specific preferences about how the trust assets should be invested and managed, or they may contemplate a specific transaction in the foreseeable future. The prudent investor rule, prudent person rule, rules requiring diversification and rules prohibiting self-dealing may put pressure on a trustee, or indeed require a trustee, to abandon these objectives.[4] Alternatively, the beneficiaries may have a special relationship with a local investment manager other than the corporate fiduciary that has an office close to their residence and is better equipped to manage the family's investment needs in the trust. An individual with specialized expertise in running the family business that's held in a trust may possess the special skills required to make business decisions for that investment. The settlor may want to pass wealth down to successive generations through the use of a trust, but isn't yet ready to turn over the investment management. Here, the settlor can retain the power to manage the trust investments by serving as the investment adviser and directing the trustee. In any of these situations, a directed trust can

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[3] Mennen v. Fiduciary Trust Int'l of Del., C.A. No. 8432 (Del. May 17, 2017) (order affirming final judgment of the Delaware Court of Chancery).

[4] See generally "Closely Held Business Interests And the Trustee's Duty to Diversify," W. Curtis Elliott, Jr. & Briani L. Bennett, *Trusts & Estates*, March 2007 for a discussion of the risks of holding concentrated positions of closely held business interests in trusts.

help facilitate the objectives of the settlor or beneficiaries where the trustee is unable or unwilling to do so. The investment responsibilities and liabilities can be assigned to an investment adviser, named in the trust instrument, and the trust instrument can require the trustee to act solely upon that investment adviser's direction. Without the benefit of a directed trust statute, in many instances the trustee wouldn't be prudent in holding the concentrated position, so the trustee wouldn't be able to meet the settlor's needs. An investment adviser could have responsibility for directing the trustee with respect to all of the trust assets, some portion of the trust assets, or specific assets (sometimes referred to as "Special Holdings" or "Special Assets"). Often, the investment adviser will be responsible for directing the valuation of assets subject to direction, particularly for assets that are not readily valued on a public exchange. There are many reasons why a settlor may wish to allocate responsibility for investment decisions to an investment adviser. One common reason is to enable the trust to hold specialized assets. An individual serving as investment adviser who knows the settlor (or may even be the settlor) may be more willing to hold an interest in a single limited liability company, or a closely held company or other special asset, and may be more in tune with the settlor's plans for future transactions involving a family owned company or start-up. An individual with specialized expertise in running the family business may possess the special skills required to make business decisions for that investment. The settlor may want to pass wealth down to successive generations through the use of a trust, but is not yet ready to turn over the investment management. In such a case, the settlor can retain the power to manage the trust investments by serving as the investment adviser, even though the assets are irrevocably transferred to a trust. Thus, a directed trust can allow for the retention of family control after assets are transferred to the trust. A settlor may also want more than one investment manager for the trust assets. In this case, the trustee could be directed to allocate assets among multiple investment managers. Another common use for directed trusts is where a distribution adviser directs the trustee with respect to distribution powers. Settlors often want the responsibility for making trust distributions to belong to individuals who are close to the family and have personal knowledge of the beneficiaries' needs. This may be particularly desirable where a beneficiary has special needs or where the trust instrument includes lifestyle incentives or prohibitions that require personal knowledge and impose commitments of time and attention.

B. **Distributions.** Settlors often want responsibility for trust distributions to rest with individuals who are close to the family and have personal knowledge of the beneficiaries' needs. This may be particularly desirable where a beneficiary has special needs or where the trust instrument includes lifestyle incentives or prohibitions that require personal knowledge and impose commitments of time and attention. In addition, under the federal income tax grantor trust rules, beneficiaries with interests substantially adverse to the grantor may need to direct the trustee to make distributions to prevent the trust from being treated as a grantor trust.

C. **Other uses.** A trustee's duty to inform beneficiaries can be limited if the trustee is required to provide beneficiaries with notice of the nature and extent of their interests in a trust, or to be notified of the existence of the trust, only in accordance with the direction of an adviser, trust protector or co-trustee. Sometimes a settlor may wish to limit the trustee's obligations to inform beneficiaries of a trust when, for example, the trust is large and the beneficiaries are young or irresponsible. Other possible areas for trustee direction include tax return preparation and reporting, amendments to the trust agreement, change of situs and change of governing law.

3. **Where To Set Up A Directed Trust: Different Statutory Approaches.** Currently there are 46 states (including the District of Columbia) with a directed trust statute, offering varying levels of effective bifurcation. There are 10 states (including the District of Columbia) with directed trust statutes that are based on the UTC (some with variations). There is one State (Iowa) with a directed trust statute based on the Restatement (Second) of Trusts ("Restatement"). There are 35 states with stronger forms of directed trust statutes. There are only 5 states without any directed trustee statute. The Uniform Laws Commission finalized the Uniform Directed Trust Act ("UDTA") in 2017 and 15 states, Arkansas, Colorado, Connecticut, Florida, Georgia, Indiana, Maine, Michigan, Montana, Nebraska, New Mexico, Utah, Virginia, Washington, and West Virginia have already adopted the UDTA. The UDTA has also been introduced in Kansas and New York but has not yet been enacted. The statutes in various states offer varying levels of effectiveness for bifurcation. While many statutes offer very strong and comprehensive statutes, there are several states that have enacted directed trust statutes which are very weak and should generally not be relied upon to implement a direct trust strategy. Some statutes provided limited flexibility, only permitting certain types of direction advisers. Some state statutes specifically lay out the role of an investment adviser or distribution adviser and do not allow for the bifurcation of other functions. Other statutes permit the trust's governing instrument to provide that the trustee can be directed with respect to almost any set of responsibilities. In those jurisdictions, a settlor could name an adviser or trust protector that directs the trustee with regard to how and when to provide notice and information to beneficiaries or the trustee could be directed with respect to responsibilities such as tax reporting, change of situs and governing law, amendment of trust instrument, or virtually any other matter (depending upon the flexibility of the statute). For example, South Dakota doesn't permit advisers to direct the trustee with respect to functions other than investments or distributions.[5] Some states like Oklahoma[6] only allow for investment advisers. New Jersey provides for a gross negligence standard in addition to willful misconduct. The directed trust statutes present many different approaches, and settlors should be attuned to which jurisdiction's laws will produce the desired result.

[5] SDCL § 55-1B-1.

[6] Okla. Stat. Tit. 60 § 175.19.

A statute that provides the best result will enable an adviser to direct any discretionary or ministerial function, limits the trustee's liability to either no liability or willful misconduct, and expressly limits the trustee's duty to monitor decisions or identify breaches of trust. This is the best framework for true bifurcation between the adviser and trustee. In addition, a settlor should weigh other considerations when planning to use a directed trust and selecting a trust jurisdiction as its situs. For example, the strength of the court system, the history of any relevant case law, and options for trustees and legal counsel are all relevant factors.

A. **Restatement of Trusts Approach.** Only Iowa follows the approach set forth in the Restatement (although Virginia, for example, follows the Restatement approach as a default unless the stronger provisions of the statute are expressly incorporated).[7] Section 185 of the Restatement (Second) 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." If a statute follows the Restatement §185 approach, the trustee shall follow direction unless the 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". Thus, the trustee continues to possess the fiduciary responsibility and liability for deciding whether to follow the direction. This does not effectively bifurcate the responsibilities.

B. **Uniform Trust Code Approach.** There are 10 jurisdictions that have adopted the UTC approach to directed trusts, with some variations. Section 808 of the UTC provides: "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." If a statute follows the UTC § 808 approach, the trustee shall follow direction unless the exercise of the power 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". Thus, the trustee continues to possess the fiduciary responsibility and liability for deciding whether to follow the direction. This does not effectively bifurcate the responsibilities.

[7] Iowa Code Ann. §633A.4207(2)

i. **States That Have Adopted the UTC Section 808 Form of Directed Trust Statute**

State	Citation
Alabama	Ala. Code §19-3B-808(b)
District of Columbia	D.C. Code Ann. §19-1308.08(b)
Kansas	Kan. Stat. Ann. §58a-808(b)
Maryland	MD Code, Estates and Trusts, §14.5-808
Massachusetts	Mass. Gen. L. Ch. 203E, §808(b)
Mississippi	Miss Code Ann. § 91-8-808
Oregon	Or. Rev. Stat. §130.685(2)
Pennsylvania	20 Pa. Cons. Stat. §7778(b)
South Carolina	S.C. Code Ann. §62-7-808(b)
Vermont	Vt. Stat. Ann. tit. 14A, §808(b)

C. **Strong-Form Statutes.** There are 35 jurisdictions that have enacted directed trustee statutes that provide stronger forms of bifurcation. The so-called "strong form" statutes vary from state to state, but, generally, the hallmarks of these strong-form statutes include most of the following:

i. **No Liability.** The strong form directed trust statutes have a limited standard of liability applicable to the directed trustee. There are strong-form statutes that provide for a willful misconduct standard of liability and strong-form statutes that provide that the directed trustee shall have no liability at all when acting at the direction of the direction adviser. In order to truly bifurcate the function that is subject to direction, the trustee must not have any liability for acting at the direction of an adviser, or

should only be liable for willful misconduct, not gross negligence or some lesser standard for liability. The crux of a workable directed trustee statute is a willful misconduct standard or no liability at all which applies to a trustee when acting at the adviser's direction. If the trustee is liable for gross negligence or simple negligence in connection with carrying out the adviser's directions, then the trustee will be saddled with the obligation to independently monitor and second-guess the decisions of the adviser because of the threat of liability. In those states that set an outer limit of willful misconduct as the standard of liability applicable to a directed trustee, it is helpful for the jurisdiction to define "willful misconduct" to provide clarity and avoid uncertainty. For example, Section 3301(g) of Title 12 of the Delaware Code defines the term "willful misconduct" as "intentional wrongdoing, not mere negligence, gross negligence or recklessness" and "wrongdoing" means "malicious conduct or conduct designed to defraud or seek an unconscionable advantage."

ii. **No Trustee Duty To Warn or Monitor.** The trustee must not have any duty to monitor the adviser. For example, Delaware's directed trustee statute specifically provides that the trustee shall have no duty to "(1) Monitor the conduct of the adviser; (2) Provide advice to the adviser or consult with the adviser; or (3) Communicate with or warn or apprise any beneficiary or third party concerning instances in which the fiduciary would or might have exercised the fiduciary's own discretion in a manner different from the manner directed by the adviser." The directed trustee provisions in Section 808 of the Uniform Trust Code don't effectively bifurcate the investment function and remove it from the trustee's responsibilities because, from the trustee's perspective, it will continue to be potentially liable for the adviser's decisions.

There's limited case law suggesting that, even if a trustee is exonerated from liability with respect to decisions made by an investment adviser, the trustee may have an overriding duty to warn beneficiaries. A Virginia trial court in Rollins v. Branch Banking & Trust Company of Virginia[8] addressed the liability of a trustee under Virginia's directed trust statute related to the decision not to diversify a concentrated position in closely held stock that experienced a significant decline in value. The beneficiaries were authorized by the terms of the governing instrument to direct the trustee with respect to all investment decisions. In Rollins, the trust held a concentrated position in a closely held stock that experienced a significant decline in value. The beneficiaries sued the trustee for breach of various fiduciary duties. The trust instrument gave the trustee the power to make investments, but that power was limited by the following language: "Investment decisions as to the retention, sale, or purchase of

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[8] Rollins v. Branch Banking & Trust Company of Virginia, 2001 Va.Cir.Lexis 146 (Va. Cir. Ct. 2001)

any asset of the Trust Fund shall likewise be decided by such living children or beneficiaries, as the case may be." The court concluded that "[t]he beneficiaries, alone, had the power to make investment decisions." The court cited the Virginia statute, which provides that whenever a governing instrument reserves to a person other than the trustee the power to make investment decisions, the trustee shall not be liable for any loss resulting from the investment decision made by the other person. Consequently, the court held that the trustee wasn't liable for a failure to diversify. However, the court found the trustee liable for failing to attempt to prevent a breach of trust by failing to warn the beneficiaries about the impending decline in the value of the stock. The court stated that "[t]he legal and equitable obligations of a trustee result from the nature of the relationship between the parties and not the literal words of the trust agreements." The court stated that the trustee can't "rid himself of 'this duty to warn.'" The court found the trustee liable for failing to attempt to prevent a breach of trust by failing to warn the beneficiaries about the impending decline in the value of the stock and held that a trustee that acts at direction can't "rid himself of [the] duty to warn." Many states have enacted specific statutory provisions to address the type of fiduciary liability that arose in the Rollins case.

The Rollins case gave rise to statutory "fixes" in Strong Form statute states, making it clear that the same result would not occur in those states. Strong Form directed trust statutes will generally have a statutory provision stating that the trustee has no duty to warn or monitor beneficiaries.

iii. **Duty To Keep Other Fiduciaries Informed And Provide Information.** Because bifurcation of trustee functions can result in the need to share information among co-fiduciaries, and practical problems can arise when a co-fiduciary refuses to provide information, it is advisable for the trusts governing instrument as well as the applicable state statute to impose a duty to keep co-fiduciaries reasonably informed. These statutes and provisions can usually take one of two approaches: either imposing an affirmative duty to keep co-fiduciaries informed, or imposing a duty to provide information if and when requested by a co-fiduciary.

The difference between the two approaches can be significant. The affirmative duty can create fiduciary risk if issues arise and interested parties argue that more information should have been provided but wasn't. In the case of the duty to provide information only when requested, the requesting party may not even known why or when to request information, thus alleviating co-fiduciaries from the obligation to provide the information unless and until a request is made.

iv. **Overcoming the "Coordination Gap".** Some of the best directed trust statutes include many other bells and whistles that address practical issues

that can arise when functions are bifurcated and a trustee acts only at direction. The issues that can be present in such a bifurcated arrangement have been referred to as the "Coordination Gap."[9] To the extent these requirements are not supplied by mandatory or default state law provisions, they must be supplied by the trust's governing instrument. As we will see below, some strong form statutes rely heavily on the trust's governing instrument to provide these gap-fillers, while other statutes provide a comprehensive rubric that supplies the framework. In those states that rely on the trust drafting, it is imperative that these issues be addressed to provide clarity and avoid pitfalls. For example, many statutes that implement a strong form of bifurcation address the issue of court jurisdiction, providing that an adviser, by agreeing to serve in that capacity, submits him or herself to jurisdiction of the courts in that state. They may also fill the gap of who has responsibility for investment decisions in the event there is a vacancy in the position, and some even provide certain parties with the power to replace the direction adviser if there is a vacancy. They often address the duties of the trustee and the direction adviser to provide one another information. They may address things like the applicable statute of limitations, and applying a trustee's set of fiduciary duties to the direction adviser by default.

[9] The term "coordination gap" was cleverly coined by the authors of an article, John P.C. Duncan and Anita Sarafa, Achieve the Promise – Limit the Risks – of Multi-Participant Trusts, 36 ACTEC L.J. 769 (Spring 2011).

v. States That Have Adopted Strong-Form of Directed Trust Statute

State	Citation	Scope	Off the Rack or Enabling	Liability
Alaska	Alaska Stat. 13.32.072(c)	Any Power	Enabling	No Liability
Arizona	Ariz. Rev. Stat. Ann. §14-10808(B)	Investment Decisions Only	Enabling	Bad Faith/Reckless Indifference
Arkansas	Ark. Code § 28-73-103(19)	Any Power – adopted UDTA	Enabling	Willful Misconduct
Colorado	Col. Rev. Stat. §15-5-101	Any Power – adopted UDTA	Enabling	Willful Misconduct
Connecticut	H.B. 07104 § § 81-98, 2019 Leg. Reg. Sess. (Conn 2019)	Any Power – adopted UDTA	Enabling	Willful Misconduct
Delaware	12 Del. C. § 3313	Investment, Distribution, or Any Other Decisions	Enabling	Willful Misconduct
Florida	Fla. Stat. §736.1401-1416	Any Power – adopted UDTA	Enabling	Willful Misconduct
Georgia	Ga. Code Ann. §53-12-500 et seq.	Any Power – adopted UDTA	Enabling	Willful Misconduct
Idaho	Idaho Code §15-7-501(2),(5)	Investment Decisions or Discretionary Distributions	Enabling	No Liability
Illinois	760 Ill. Comp. Stat. § 5/16.3(f)(1)	Investment Trust Advisor; Distribution Trust Advisor	Off The Rack	Willful Misconduct

State	Citation	Scope	Off the Rack or Enabling	Liability
Indiana	Ind. Code § 30-4-12	Any Power – adopted UDTA	Enabling	Willful Misconduct
Kentucky	Ky. Rev. Stat. Ann. §286.3-275	Applies to Corporate Trustees; Investment Decisions; Authorized Directions Only	Off The Rack	No Liability
Maine	Me. Rev. Stat. Ann. Tit. 18-B § 103	Any Power – adopted UDTA	Enabling	Willful Misconduct
Michigan	Mich. Comp. Laws § 700.7703a	Any Power – adopted UDTA	Enabling	Willful Misconduct
Minnesota	Minn. Stat. A § 501C.0808	Investment Trust Advisor; Distribution Trust Advisor	Off the Rack	Willful Misconduct
Missouri	Mo. Stat. Ann. §456.8-808(8)	Investment, Distribution, or Any Other Decisions	Enabling	No LIability
Montana	MCA 72-40-101-122	Any Power – adopted UDTA	Enabling	Willful Misconduct
Nebraska	Neb. Rev. Stat. §30-3805	Any Power – adopted UDTA	Enabling	Willful Misconduct
Nevada	Nev. Rev. Stat. §163.5549	Investment Trust Advisor; Distribution Trust Advisor	Enabling	No Liability
New Hampshire	N.H. Rev. Stat. Ann. §564-B:8-808(b)	Investment, Distribution, or Any Other Decisions	Enabling	No Liability
New Jersey	N.J. Rev. Stat. Ann. § 3B:31-62	Investment Decisions	Off-The-Rack	Willful Misconduct and Gross Negligence

State	Citation	Scope	Off the Rack or Enabling	Liability
New Mexico	N.M. Stat. Ann. §46-14-1 et seq. (2018)	Any Power – adopted UDTA	Enabling	Willful Misconduct
North Carolina	N.C. Gen. Stat. §§36C-7-703(g1) 32-72(d)(2)(a) 36C-8A-4(a)	Investment, Distribution, or Any Other Decisions	Enabling	Intentional Misconduct
North Dakota	N.D. Cent. Code§§59-16.2-01-08	Investment Trust Advisor, Distribution Advisor	Off the Rack	Willful Misconduct
Ohio	Ohio Rev. Code Ann. §§5808.08(B), 5815.25(B)	Investment, Distribution, or any Other Decisions	Off The Rack	No Liability
Oklahoma	Okla. Stat. Ann. Tit. 60, §175.19	Investment Decisions Only	Enabling	Except to the Extent Negligent in Carrying Out the Execution of the Directed Investment or Other Directed Action
South Dakota	S.D. Codified Laws Ann. §§55-1B-2(1), 55-1B-5	Investment Trust Advisor; Distribution Trust Advisor	Off The Rack	No Liability
Tennessee	Tenn. Code Ann. §§35-15-710-715; 35-3-122	Advisory or Investment Committee, or Any Other Person	Off The Rack	No Liability
Texas	Tex. Prop. Code Ann. §114.0031	Investment, Distribution, or Any Other Decisions	Enabling	Willful Misconduct
Utah	Utah Code Ann. § 75-12-101	Any Power – adopted UDTA	Enabling	Willful Misconduct

State	Citation	Scope	Off the Rack or Enabling	Liability
Virginia	Va. Code Ann. §64.2-779.26-38	Any Power – adopted UDTA	Enabling	Willful Misconduct
Washington	Wash. Rev. Code Ann. § 11.98A.010 through 900	Investment, Distribution, or Any Other Decisions	Enabling	No Liability for Relying on Direction
West Virginia	SB 213	Any Power – adopted UDTA	Enabling	Willful Misconduct
Wisconsin	Wisc. Stat. § 1701-0808	Investment, Distribution, or Any Other Decisions	Off The Rack	Willful Misconduct
Wyoming	Wyo. Stat. Ann. §§4-10-712 through 4-10-718	Investment, Distribution Decisions, or Any Other Matter	Enabling	No Liability

D. **Enabling Statutes v. Off-The-Rack Statutes.** These so-called "strong form" statutes can be categorized as statutes that either (1) "off-the-rack statutes", or (2) "enabling statutes".[10] Off-The-Rack statutes generally provide a detailed statutory rubric that outlines the specific role and responsibilities of the direction adviser – usually an investment adviser and/or distribution adviser, and sometimes require adherence to statutory language to fall within the protections of the statute. Enabling Statutes generally provide a more open-architecture design, which relies heavily on the drafting of the governing instrument and could provide greater flexibility while remaining under the protection of the statute (such as permitting direction for functions beyond investments, distributions or a defined set of trust protector responsibilities).

[10] Credit for the development and popularization of the "off-the-rack) and "enabling statute" nomenclature for directed trust statutes is owed to Professor Robert H. Sitkoff, the John L. Gray Professor of Law at Harvard Law School, who served as the Chair of the Drafting Committee for the Uniform Directed Trust Act.

i. **Enabling Statute Relies on Governing Instrument.** An enabling statute does not limit the scope of permissible directed activities to simply investments or distributions like an off-the-rack statute. It may provide that the adviser may be given authority by the terms of a governing instrument to direct investment decisions, distribution decisions or other ministerial or discretionary decisions of the fiduciary. An enabling statute offers settlors the utmost flexibility and freedom to draft a directed trust structure, and provides for a statutory limitation of liability when the trustee acts in accordance with a proper direction from an adviser in accordance with the terms of the governing instrument. Such statutes can facilitate a wide range of planning and structuring opportunities that allow settlors and beneficiaries of trusts to accomplish their specific goals and the directed nature of the trust could include any decision of the trustee. Enabling statutes rely on the terms of the governing instrument to set forth the directed trust terms, including, for example, whether the trustee at direction, how and in what form directions may be delivered to the trustee, who is the adviser that directs the trustee, whether the adviser acts in a fiduciary capacity, what specific powers are exercised at direction, whether such powers are exercised only upon direction, and what powers are not exercised at direction.

ii. **Allows For Other Uses For A Direction Adviser.** Under an Enabling Statute, an adviser can direct the trustee with respect to any ministerial or discretionary power of the trustee. The direction adviser statute can be used to bifurcate any traditional trustee function. A distribution adviser or committee may be a useful strategy to provide someone with the power to make distribution decisions other than an institutional fiduciary with knowledge of the family needs to make distribution decisions. This may be particularly useful for a special needs trust. It may also be useful to have a distribution committee of adverse persons to achieve nongrantor trust treatment. It is possible to name an adviser that shall direct the trustee how and when to provide notice and information to beneficiaries. When a trust holds a closely-held company, or a restricted entity, yet the trustee is responsible for providing accountings to beneficiaries, it may be useful to provide that the trustee shall only use valuations as directed by an adviser. Other uses for an adviser may include tax reporting, change of situs or governing law or administrative amendments to the trust instrument.

iii. **Example of Enabling Statute.** A statute that defers to the drafter of the governing instrument to define the scope of responsibility and protections of the directed trust structure are referred to as "enabling" statutes. One example of a so-called enabling strong form statute is Delaware[11]. Section 3313(a) of Title 12 of the Delaware Code provides that an "adviser" may

[11] 12 Del. C. § 3313.

direct, consent or disapprove investment decisions, distribution decisions or any other decision of the fiduciary. It also provides that such person shall be a "fiduciary" unless the governing instrument provides otherwise. The subsection of Delaware's directed trust statute that performs most of the statute's "heavy lifting" is Section 3313(b) of Title 12 of the Delaware Code. It simply states that if a trust instrument provides that a fiduciary is to follow the direction of an adviser or is not to take specified actions except at the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of willful 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. The statute is "enabling" because it relies on the drafter (and the settlor's intent) to define what the direction adviser's roles and responsibilities are. If the governing instrument provides that the trustee is to follow the direction of an adviser or is not to take specified actions except at the direction of an adviser, then the trustee is not liable except in cases of willful misconduct.

Section 3313(e) of Title 12 of the Delaware Code clarifies that a fiduciary that follows the direction of an adviser shall not take specified actions except at the direction of an adviser and 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. This subsection is intended to clarify the bifurcation of the investment function from the trustee's duties and was enacted to clarify that issues like those raised in Rollins v. Branch Banking, Trust Company of Virginia,[12] which upheld the statute but held that the trustee was liable and could not "rid himself of this duty to warn", should not apply to a Delaware directed trust. Section 3301(g) of Title 12 of the Delaware Code defines the term "willful misconduct" as "intentional wrongdoing, not mere negligence, gross negligence or recklessness" and "wrongdoing" means "malicious conduct or conduct designed to defraud or seek an unconscionable advantage." Section 3315 of Title 12 of the Delaware Code (not included as a part of the actual directed trust statute) provides that fiduciaries (including an investment adviser) shall have a duty to keep each other informed with respect to matters that may be necessary for the other judiciary to perform its fiduciary duties.

iv. **Example of an Off-The-Rack Statute.** The Illinois directed trust statute[13] is an example of an "off-the-rack" strong-form directed trust statute. It lays out very specific guidelines for the directed trustee

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12 2001 Va.Cir.Lexis 146 (Va. Cir. Ct. 2001).

13 760 Ill. Comp. Stat. 5/16.3.

relationship and the types of matters that can be directed and includes the concepts of: "excluded fiduciary," "distribution trust advisor," "investment trust advisor," and "trust protector." Section 16.3(a)(1) defines "directing party" to include the concepts of "distribution trust advisor," "investment trust advisor," and "trust protector." Section 16.3(e) provides that a directing party is "a fiduciary of the trust subject to the same duties and standards applicable to a trustee of a trust as provided by applicable law unless the governing instrument provides otherwise," although the governing instrument may not exonerate the directing party from the duty to act or not act as such directing party in good faith reasonably believes is in the best interest of the trust. Section 16.3(f) generally provides that the directed trustee, or "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," and that when the excluded fiduciary acts with such direction, then except in cases of willful misconduct on the part of the excluded fiduciary, the excluded fiduciary is not liable for any loss resulting directly or indirectly from following any such direction. The excluded trustee has no duty to monitor, review, inquire, investigate, recommend, evaluate, or warn. The directing party must keep the excluded fiduciary and any other directing party reasonably informed regarding the directing party's administration of the trust to the extent that duty or function would normally be performed by the excluded fiduciary or to the extent providing such information is reasonably necessary for the excluded fiduciary or other directing party to perform its duties, and the directing party shall provide such information as reasonably requested by the excluded fiduciary or other directing party. Also, the statute provides that the directing party submits to the jurisdiction of the courts of Illinois. The Illinois statute seems to specify an "investment trust advisor" as "any one or more persons given authority by the governing instrument to direct, consent to, veto, or otherwise exercise all or any portion of the investment powers of the trust." An investment trust advisor has the power to "direct the trustee with respect to the retention, purchase, transfer, assignment, sale, or encumbrance of trust property and the investment and reinvestment of principal and income of the trust"; and "direct the trustee with respect to all management, control, and voting powers related directly or indirectly to trust assets, including but not limited to voting proxies for securities held in trust". One question that could be raised with regard to statutes that lay out such specific responsibilities of the directing party is whether the statute clearly permits an advisor to direct a trustee with regard to a broader list of trustee powers that not necessarily included within this generic descriptive list, such as the powers to borrow, guarantee, loan, pledge assets, grant options, etc.

E. **States that Have No Directed Trust Statute.** Five states have not yet adopted a directed trust statute: California, Hawaii, Louisiana, New York and Rhode Island.

4. **Uniform Directed Trust Act.** The Uniform Laws Commission finalized the UDTA in October 2017. Legislation to adopt the UDTA has been enacted in 15 states: Arkansas, Colorado, Connecticut, Florida, Georgia, Indiana, Maine, Michigan, Montana, Nebraska, New Mexico, Utah, Virginia, Washington, and West Virginia.

A. **Overview and Defined Terms.** The UDTA expressly seeks to promote settlor autonomy by validating the terms of a trust that seek to grant a trust director a power of direction. Moreover, the UDTA was designed to avoid uncertainty that results from the inadequate statutes that have been enacted in some jurisdictions and a lack of uniformity among the states. The term "directed trust" is defined in Subsection 2(2) of the UDTA as a trust for which the terms of the trust grant a power of direction. Pursuant to Subsection 2(5) of the UDTA, a "power of direction" means a power over a trust granted to a person (the "trust director") by the terms of the trust to the extent that the power is exercisable while the person is not serving as a trustee. A "directed trustee" is defined in Subsection 2(3) as a trustee that is subject to a trust director's power of direction.

B. **Enabling Statute – Directed Trust as to Any Matter.** The powers and duties that can be subject to a power of direction can be defined in the governing instrument and can include anything, including without limitation, a power over the investment, management, or distribution of trust property or other matters of trust administration. Unlike certain "off the rack" statutes, the comments to the UDTA explain that the definition of power of direction is intended to be expansive. The comments to Section 6 of the UDTA describes the breadth of the trust director's powers to direct the trustee under Subsection 6(a) which, without limiting the definition of a "power of direction", may include granting a power to a trust director to:

- direct investments, including the power to:
  - acquire, dispose of, exchange, or retain any investment;
  - make or take loans;
  - vote proxies for securities held in trust;
  - adopt a particular valuation of trust property or determine the frequency or methodology of valuation;
  - adjust between principal and income or convert to a unitrust;
  - manage a business held in the trust; or
  - select a custodian for trust assets;
- modify, reform, terminate, or decant a trust;
- direct a trustee's or another director's delegation of the trustee's or other director's powers;
- change the principal place of administration, situs, or governing law of the trust;
- ascertain the happening of an event that affects the administration of the trust;
- determine the capacity of a trustee, settlor, director, or beneficiary of the trust;

- determine the compensation to be paid to a trustee or trust director;
- prosecute, defend, or join an action, claim, or judicial proceeding relating to the trust;
- grant permission before a trustee or another director may exercise a power of the trustee or other director; or
- release a trustee or another trust director from liability for an action proposed or previously taken by the trustee or other director.

C. **Standard of Liability.** Section 9 of the UDTA provides that a directed trustee shall not be liable for taking reasonable action to comply with a trust director's exercise or nonexercise of a power of direction; provided, however, that a directed trustee must not comply with a trust director's exercise or nonexercise of a power of direction to the extent that by complying the trustee would engage in "willful misconduct". There is no definition of "willful misconduct" in the UDTA. Application of that standard will be left to the states and their varying definitions (or lack of definitions) found mostly in the common law. The decision to utilize the willful misconduct standard for a directed trustee under the UDTA was influenced by Delaware's prominent directed trust statute due to the popularity of directed trusts in Delaware. The drafting committee therefore declined to eliminate completely the fiduciary duty of a directed trustee, even though that is the approach taken by many states described herein as having "strong form" statutes.

D. **Fiduciary Duty and Liability of a Trust Director.** Section 8 of the UDTA addresses the default fiduciary duty and liability of a trust director. Subsection 8(a) imposes the same fiduciary duties and liability on a trust director that would apply to a trustee in like position and under similar circumstances, unless such duties and liability are varied by the terms of the trust. The terms of a trust may not, however, reduce a trust director's duties or liability below the mandatory minimums that would be applicable to a trustee in a like position under similar circumstances. Additionally, Section 10 of the UDTA places a duty upon both the trust director and the directed trustee to share information with one another.

E. **No Duty To Monitor, Inform or Advise.** Section 11 of the UDTA provides "[u]nless the terms of the trust provide otherwise,(1) a trustee does not have a duty to: (A) monitor a trust director; or (B) inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director; and (2) by taking an action described in paragraph (1), a trustee does not assume the duty excluded by paragraph (1)." Whenever the directed trustee is to follow the directions of a trust director, then, unless the terms of the governing instrument provide otherwise, the directed trustee has no duty to (a) monitor the conduct of the trust director, provide advice to the trust director or consult with the trust director, including, without limitation, any duty to perform investment or suitability reviews, inquiries, or investigations or to make recommendations or evaluations with respect to any investments to the extent the trust director has authority to direct

the acquisition, disposition, or retention of any such investment; (b) communicate with or warn or apprise any beneficiary or third party concerning instances in which the directed trustee would or might have exercised the directed trustee's own discretion in a manner different from the manner directed by the trust director; or (c) commence a proceeding against the trust director. Notably, however, the comments provide that this section does not relieve a trustee of its ordinary duties to disclose, report or account under otherwise applicable law, meaning that the directed trustee remains under a duty to make periodic accountings and to answer reasonable inquiries about the administration of the trust to the extent required by otherwise applicable law.

F. **Application to Co-Trustee.** Although a power of direction is expressly defined to mean a power held by a person when not serving as a trustee, Section 12 of the UDTA provides that the terms of a trust may relieve a co-trustee from duty and liability for another co-trustee's exercise or nonexercise of a power to the same extent that in a directed trust a directed trustee is relived from duty and liability with respect to a trust director's power of direction. This section allows a settlor to accomplish the same objectives by selecting a traditional co-trustee relationship or a modern directed trustee relationship.

G. **Trust Director Subject to Jurisdiction.** Under Section 15 of the UDTA, by accepting an appointment to serve as trust director, the trust director submits to the personal jurisdiction of the courts of that particular state with respect to any matter related to a power or duty of the director.

H. **Statute of Limitations and Defenses.** Section 13 of the UDTA provides that the same statute of limitations that would apply to a trustee for breach of trust applies to a claim for breach of trust against a trust director. Similarly, a report or accounting that would trigger or otherwise limit a limitations period with respect to a trustee has the same effect on a claim against a trust director. Consequently, the existing law of the jurisdiction in which the UDTA is enacted will ultimately dictate the limitations period applicable to the trust director. Also, pursuant to Section 14 of the UDTA, a trust director may assert any other defense in an action for breach of trust that a trustee may assert under similar circumstances. Accordingly, defenses including laches or estopple, consent release or ratification, reasonable reliance, and reasonable care may be available to the trust director under the UDTA.

5. Case Law.

A. **Duemler.** In R. Leigh Duemler v. Wilmington Trust Company, C.A. 20033, V.C. Strine (Del. Ch. Oct. 28, 2004) (Trans.), the Delaware Court of Chancery issued an order in a bench ruling validating a statutory defense under Section 3313(b) to a breach of trust suit, providing that Wilmington Trust Company was not liable as trustee for its actions with respect to trust investments in the absence of willful misconduct. Mr. Duemler was the investment adviser of a trust with the express power under the trust instrument to direct Wilmington Trust Company, as the

trustee of the trust, with respect to all investments. Mr. Duemler was a sophisticated investment adviser who was a securities lawyer. The trust invested in "a nondiversified portfolio with extremely risky assets", the kind of portfolio "that requires the most diligent of monitoring." Wilmington Trust Company forwarded a prospectus to Mr. Duemler, while he was on vacation, with respect to which Mr. Duemler should have made an investment decision concerning one of the trust's investments. Mr. Duemler did not provide Wilmington Trust Company with any direction as to the investment and, subsequently, the investment experienced a significant drop in value. The Court stated that in these circumstances, Section 3313 requires the investment adviser to make investment decisions in isolation, without oversight from the trustee, because 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. Duemler at p. 11. The Court found that Wilmington Trust Company did not breach its fiduciary duty, however, Mr. Duemler did breach his fiduciary duty as investment adviser of the trust. Duemler at p. 13. Finding that Wilmington Trust Company did not engage in willful misconduct, the Court upheld a statutory defense under Section 3313(b). The Court further explained that if the trustee were liable in such situations for "the failure to provide information or to make sure that [the investment adviser] making the decision knew what they were doing" it would "gut the statute". Duemler at p. 16. Duemler is the only case in which the Court has specifically addressed the applicability of Section 3313(b). Duemler validates the standard of liability, as well as the proper course of conduct for a trustee, under Section 3313(b). The Morris Nichols' Fiduciary Litigation Group represented the trustee in this case.

B. **Mennen v. Fiduciary Trust Int'l of Del. C.A. No. 8432 (Del. June 21, 20107) (order affirming judgment of the Delaware Court of Chancery).** In Mennen, the beneficiaries of a directed trust (the "Trust") sued the trustee and direction adviser claiming damages in excess of $100 million for breaches of fiduciary duties in connection with the Trust's investments. This is the first decision in which the Court held an adviser within the meaning of 12 Del. C. § 3313 liable for breach of fiduciary duty. In this important decision, the Court contrasted willful misconduct and bad faith standards of fiduciary liability and analyzed the application of virtual representation principles to the statute of limitations defense.

i. **Background.** The Trust in Mennen was created by George S. Mennen under agreement dated November 25, 1970 (the "Trust Agreement") for the benefit of John Mennen (John) and his descendants. John has four children, Kathryn Mennen, Sarah Mennen, Alexandra Mennen, and Shawn Mennen. Wilmington Trust Company was the corporate trustee of the Trust (the Trustee) and John's brother, Jeffrey Mennen (Jeff), was the individual co-trustee (sometimes referred to herein as the co-trustee or adviser). The Trust Agreement provides that the Trustee acts solely at the

direction of the individual co-trustee with respect to the exercise of certain investment powers.

The beneficiaries alleged that Jeff directed the Trustee to invest substantially all of the assets of the Trust in start-up companies in which Jeff was personally interested as an investor, director, or officer resulting in a decline in value from more than $100 million to $25 million over a period of approximately 20 years. The Trustee became increasingly concerned that the beneficiaries would bring claims against it and filed a petition with the Court to remove Jeff, for the appointment of a successor co-trustee, and to access certain investment information that Jeff was allegedly withholding. Shortly thereafter, the beneficiaries brought claims for breach of trust against both the Trustee and Jeff and also brought a claim against a trust that was established by the Settlor for Jeff, seeking a transfer of its assets from that trust to the Trust on equitable grounds. On January 17, 2014, Master LeGrow issued a Draft Master's Report on summary judgment in Mennen, C.A. No. 8432-ML, Master LeGrow (Del. Ch. Jan. 17, 2014) (Master's Draft Report), upholding the enforceability of the spendthrift clause in John's trust and under Delaware's spendthrift statute, 12 Del. C. § 3536. The Trustee also filed a cross-claim against Jeff for indemnification and contribution, and Jeff filed identical counterclaims against the Trustee. The claims brought against the Trustee were ultimately settled out of court and there is no decision regarding the application of 12 Del. C. § 3313 and the protections of the directed trust statute.

On June 21, 2017, the Delaware Supreme Court affirmed a judgment against Jeff, as direction adviser, in the amount of $86,599,200.26, finding that he engaged in an extensive pattern of bad faith.

(1) **Alteration of Standard of Liability Validated.** Importantly, the Court in Mennen acknowledged that settlors are accorded wide latitude to structure their trusts in a manner that varies from the default statutory scheme or the common law, which is a hallmark of Delaware's Trust Act. The Court concluded that the standard of liability applicable to Jeff was constrained in two respects. First, the Trust Agreement exculpates the co-trustee from losses to the trust estate so long as the co-trustee acted in good faith. Second, under 12 Del. C. § 3303, the Trust Agreement may not exculpate the co-trustee for willful misconduct. The Court noted that prior to 2003, Delaware courts were precluded from exculpating a trustee from gross negligent conduct, however, the enactment of 12 Del. C. § 3303 overrides that principle with respect to trusts whenever created, and "[t]his Court is bound by the General Assembly's instructions and the Trust Agreement's exculpatory clauses therefore must be read as excusing grossly negligent conduct." The Court respected these limited standards of liability,

which deviate from the common law, as well as the provisions waiving the prudent investor rule or any duty to diversify. The Court held that a trustee is twice tested under Delaware law, with the Court first considering whether the trustee was empowered under the law of a governing instrument to act in a certain manner, and then considering whether those actions, if permitted, were a breach of the trustee's fiduciary obligations. However, the Court continued, when a grant of powers is combined with an exculpatory provision, a trustee is effectively insulated from liability, even under the twice tested analysis, provided the exculpatory provision in question is enforceable and the trustee's conduct fell within it.

(2) **Distinguishing Willful Misconduct From Bad Faith.** The Court distinguished willful misconduct from bad faith (the Court used bad faith as synonymous with the absence of good faith). It held that willful misconduct applies only a subjective standard that depends on the alleged wrongdoer's state of mind, requiring malicious conduct or conduct designed to defraud or seek unconscionable advantage, as provided in 12 Del. C. § 3301(e). In contrast, good faith is defined as honesty in fact and the observance of reasonable standards of fair dealing. The Court held that bad faith is a standard that includes both a subjective and objective element. The honesty in fact portion of the definition refers to what the fiduciary subjectively believed. In contrast, the Court held that the observance of reasonable standards of fair dealing portion of the definition is objective and requires the Court to consider whether the trustee acted beyond the bounds of a reasonable judgment. The Court held: "[t]o the extent that the record shows as it does that some of Jeff's investment decisions were motivated by Jeff's preference for his personal interests, those decisions are, by definition, bad faith, if not willful misconduct, and are not exculpated by the Trust Agreement."

While the Court found that some of the Trust's bad investments were motivated, in part, by Jeff's personal financial interests, the Court appeared deeply troubled by Jeff's apparent interest in establishing or maintaining his self-created persona as a skilled financier and his fervent desire to prove his unique capabilities and his personal interest in preventing the Mennen family from realizing the extent of his failures. The Court also found that Jeff had deliberately obscured the true value of these investments in a bid to continue his unfettered access to the Trust to further his personal interests. The Court held that Jeff's irrationality and unconsidered and self-interested conduct was so far beyond the bounds of reason that it cannot be explained by anything short of bad faith.

Jeff maintained that he performed extensive and continuous due diligence, demonstrating that he was not motivated solely by self-interest. However, there was no record of his due diligence and, consequently, the Court presumed that no such due diligence occurred in the absence of documented records. The Court noted that "[a] trustee has an independent duty to maintain records for the trust." On this point, it is valuable to note that it is advisable, and could become valuable, for a fiduciary to maintain adequate records of his, her or its due diligence.

(3) **Statute of Limitations and Virtual Representation.** Jeff argued that the claims brought against him by the beneficiaries were barred by the equitable doctrine of laches. The Court noted that it frequently uses an analogous statute of limitations period for the presumptive limitation period when analyzing a laches claim. Jeff argued that, pursuant to 12 Del. C. § 3583, the claims were barred upon the earlier of (i) two years after the date John received a report that adequately disclosed the facts constituting a claim, and (ii) the date the claims were otherwise precluded by a limitations period. Jeff argued that the date such claims were precluded was three years, which is the limitations period for breach of fiduciary duty under 12 Del. C. § 3585(a) and 10 Del. C. § 8106. Notably, all but one of the challenged investments had been disclosed in monthly or quarterly statements received by John since at least 1980. Moreover, all but one of the investments occurred before March 22, 2010 and, consequently, Jeff argued that each such transaction was barred by the applicable three-year limitations period. The Court noted that any statute of limitations applicable to John's children was tolled until they reached an age of majority. John's oldest child, Shawn, was unable to represent his minor siblings because of a disability and John's next oldest child, Katie, did not turn 18 until September 3, 2010. Consequently, the Court noted that the claims against Jeff were not time-barred unless the beneficiaries that turned 18 less than three years before the action could be virtually represented by John under 12 Del. C. § 3547. The Court noted that under 12 Del. C. § 3547(a), Delaware's virtual representation statute unambiguously limits virtual representation to circumstances where the putative representative has no material conflict of interest. The Court found that the beneficiaries' claims were not tolled because John had a material conflict of interest that precluded him from virtually representing his minor children under Section 3547. The Court found that John could not represent his children with respect to the challenged investments because he was unable to overcome the statutory presumption under 12 Del. C. § 3547(e)(3) that he had a material conflict of interest with his children. The Court reached this conclusion based on two factual findings. First, the Court found

that John placed nearly complete emphasis on receiving income from the Trust, without any apparent regard for capital growth or long-term stability of the Trust. Specifically, the preponderance of John's testimony was that he judged Jeff's performance with respect to the Trust by reference to whether he received monthly distributions from the Trust without giving any consideration as to the viability of the Trust in the long-term. The Court concluded that because he placed so much emphasis on his receipt of regular distributions, he had a "differing investment horizon or an interest in present income over capital growth." Second, the Court found that John was so beholden to Jeff emotionally and financially that he could not take action to remedy Jeff's bad faith conduct and was unable or unwilling to consider the interests of the minor beneficiaries. Interestingly, the Court did not use objective criteria, such as the respective beneficial interests of John and his children under the terms of the Trust Agreement, in determining if there was a material conflict. Under the terms of the Trust Agreement, John and his children had an identical interest with respect to receiving discretionary distributions from the Trust. Rather, the Court seemed to evaluate the conflict of interest issue based on what John subjectively valued most about his interest in the Trust. Jeff also argued that certain claims brought against him were barred because John had acquiesced in some of the troublesome investment decisions made by Jeff. However, the Court held that Jeff could not prove that John acquiesced to such transactions because he did not have full knowledge of all of the material facts. Moreover, the Court noted that, even if Jeff could prove that John acquiesced to those investments, the defense would not extend to the other Trust beneficiaries because John had a material conflict of interest that precluded him from representing their interests under 12 Del. C. § 3547.

C. **Mennen v. Wilmington Trust Company, George Jeffrey Mennen and Owen J. Roberts as Trustee, C.A. No. 8432, Master LeGrow (Del. Ch. April 24, 2015) (Master's Final Report) affd. Del. Supr. June 21, 2017.** Exceptions to the Draft Report were submitted to the Court on February 13, 2015. On April 24, 2015, Master LeGrow issued a Master's Final Report (the Final Report) entering a judgment against Jeff in the amount of $96,978,299.93 plus pre-judgment interest of 7.75% compounded quarterly. Notably, the Final Report contains some additional insight regarding the Court's analysis of the definition of good faith and the application of Delaware's virtual representation statute, 12 Del. C. § 3547 (Section 3547).

i. **Definition of Good Faith.** As noted above, the Trust Agreement exculpated the co-trustee from losses to the trust estate so long as the co-trustee acted in good faith. In the Draft Report and Final Report, the Court found that Jeff was liable because he acted in bad faith (which in the

Court's view was synonymous with the absence of good faith). In the Final Report, the Court briefly addressed Jeff's additional argument that the statutory definition of good faith applies only to the use of that term in the Delaware trust code, and not when the same term is used in trust agreements. The Court rejected Jeff's argument as inconsistent with the Delaware trust code and the Court's prior precedent. The Court noted that, if Jeff's position was accepted, the Court may potentially be required to apply two different standards of good faith to a trustee's actions.

ii. **Virtual Representation Under Section 3547.** As noted above, the Court concluded that the claims brought against Jeff were not barred by laches because John could not virtually represent the interests of his minor children, who were the other beneficiaries of the trust. This conclusion was based on the Court determining that John had a material conflict of interest with his children when the challenged investment decisions were made by Jeff. In the Final Report, the Court clarified its analysis and presented two additional arguments made by Jeff regarding John's ability to virtually represent his children under Section 3547. In the Draft Report and Final Report, the Court found that John placed nearly complete emphasis on receiving income from the Trust, without any apparent regard for capital growth or long-term stability of the Trust. In the Final Report, the Court indicated that this fact alone was sufficient evidence of a material conflict of interest for purposes of Section 3547.

First, Jeff presented the additional argument that the Court should apply an objective rather than a subjective test to determine whether a material conflict exists between a putative representative and the other beneficiaries. More specifically, Jeff espoused the theory that if a person of ordinary intelligence could have virtually represented his minor children under similar circumstances, the Court should not consider the specific relationship between the parties before it. The Court rejected this argument in the Final Report for a few reasons. First, the Court stated that if Jeff's argument was the result that the legislature intended when enacting and amending Section 3547, the legislature could have simply defined what constitutes a material conflict and what does not. Second, the Court stated that an objective standard would be ill-suited to address the various relationships between parties that appear before the Court in trust matters. According to the Court, the likely result of applying Jeff's argument to the Court's Section 3547 analysis would be to unduly eliminate virtual representation in some cases where no actual conflict exists, while permitting virtual representation when the factors in a particular case demonstrate that a conflict plainly existed. Finally, the Court construed certain recent statutory amendments to Section 3547 as showing that the legislature intended that the Court rely on subjective factors. The Court indicated that reliance on subjective factors would be the only way to overcome a presumption of a conflict under Section 3547.

Jeff also presented the additional argument that the reference in Section 3547 to a material conflict with respect to the particular question or dispute means that John did not have a conflict with his minor children because his interests are aligned with his children's in the litigation. The Court concluded that this reading ignores the substance of Section 3547 and, instead, construed that language to mean that the interests of John and his minor children must be aligned at the time the alleged representation occurred. The Court continued to state that the issue of virtual representation as it applies to a laches analysis is not whether the parties' interests are aligned in the action in which a laches defense is raised, but instead whether the interests were aligned at the time the representation allegedly occurred.

The Delaware Supreme Court Affirmed this opinion in its entirety in an opinion dated June 21, 2017

6. **Essential Elements for Effective Bifurcation.** The trustee could ultimately be held liable for investment decisions if ambiguities exist regarding which powers are exercised at direction and which powers aren't. Improper drafting or administration could raise questions about whether the trustee has some independent power and authority to act, even though the trustee assumed it was only acting as a directed trustee. These ambiguities could exist if the governing instrument doesn't: (1) clearly state that the trustee shall exercise investment powers *only* at direction, (2) clearly identify the powers the trustee must exercise at direction, and (3) ensure that the investment-related powers covered by the investment advisor provision is complete.

A. **A directed trust is NOT a delegation.** A well-drafted directed trust governing instrument will effectively bifurcate the function between two fiduciaries and eliminate the trustee who is acting solely at direction from the decision making and monitoring of directed decisions. Additionally, the trustee should not have the power to remove or appoint the investment 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.

B. **The trustee possesses the trust power and authority.** In a directed trust arrangement, the trustee technically possesses all trust power and authority, and the investment adviser is a separate fiduciary with the power to direct the trustee to exercise its trust powers. Often, drafters make the mistake of stating that the investment power and authority is to be held by the adviser, and/or that the trustee shall have no trust power and authority over investments. This is not how a directed trust is properly structured.

C. **Willful misconduct standard or no liability standard is necessary.** The trustee should only be liable for willful misconduct, not gross negligence or any other standard. It is the willful misconduct standard (or no liability at all) that enables the trustee to follow direction without monitoring or second guessing the decisions of the adviser. This is critical for effective bifurcation.

i. **Sample Language.** Notwithstanding the foregoing, whenever, pursuant to the terms of this Agreement, the Trustee acts at the direction of the Investment Adviser or any other person authorized by the terms of this Agreement to direct the Trustee in the exercise of the Trustee's powers as to any particular matter, as provided in **[cite the directed trust statute]**, the Trustee shall have no liability with respect to such matter except in cases of the Trustee's own willful misconduct.

D. **The trustee must act solely at direction.** If there's an advisor with the power to direct the trustee, the trustee must be required to follow that direction. The trustee can't have some independent discretion to decide whether to execute the direction. The trustee must also act solely at the advisor's direction. If the trust instrument gives the advisor power to direct the trustee with respect to investments, and requires the trustee to follow those directions, but it doesn't state that the trustee shall act *solely* at the advisor's direction, then the trustee must follow directions but essentially has continuing, simultaneous powers and duties to invest in its own discretion as well. The trust instrument must provide that the trustee shall exercise the investment powers only upon direction, or the responsibilities will not be bifurcated. Frequently, drafters use language that does not clearly provide that the trustee shall only exercise certain powers when acting upon written direction. For example, language such as providing that the adviser "shall have the power to direct the Trustee" or that "the trustee shall follow the direction of the adviser" falls short of actually stating that the trustee shall exercise certain specific trust powers "solely" or "exclusively" upon the written direction of the 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 simultaneous duties for the trustee to take directions and also to act in its own discretion.

E. **The directed trustee provision should not rely upon a generic description of powers.** When drafting the direction language in a trust instrument, it's important to provide a comprehensive and detailed description of the powers to be exercised upon direction. This is critical for the effective administration of the trust. The best solution is to provide a broad and inclusive description of investment activities, and to also specifically cross-reference all of the detailed investment powers in the trustee powers provisions of the document As a matter of trust law, a trustee only possesses the powers specifically granted in the trust instrument as well as any powers granted under applicable trust law. The drafting attorney should take advantage of the broad and detailed list of powers already explained in detail in the document. The investment adviser provision in the trust instrument should be detailed and all-inclusive and should expressly cross-reference all of the detailed trustee powers pertaining to investments within the governing instrument. The Investment Adviser provision in the trust instrument should not merely include a short generic description of investment decisions or, for example, simply limit the scope of the direction power to "investment decisions under Section 3313(d) of Title 12 of the Delaware Code". It should be as specific and inclusive as possible and should ideally cross reference all investment trustee

powers in the instrument. Without a clear, complete, detailed list of powers to be exercised at direction, there may be ambiguities during the administration of the trust and questions may arise about whether a particular action falls within the direction provisions. If the investment adviser provision in the governing instrument does not specifically identify and cross-reference all such powers granted to the trustee, there could be an argument that the trustee independently possesses such trust powers not clearly exercised at direction and that the trustee may have some duty to independently exercise those powers over the investments without following the directions of the investment adviser. For example, assume the direction language merely says that the trustee shall act only upon direction of an investment advisor with respect to the "investment of the trust assets," or perhaps it includes a short, generic description of investment activities, like "retention, purchase, sale, lending and voting" of trust assets. When it comes time for the trustee to enter into a transaction involving complicated contractual arrangements like a stock purchase agreement, security agreement and loan and guarantee documents, including representations and warranties, the ambiguities in the scope of the direction language will immediately become apparent. What trustee powers relating to the legal documents does the direction language in the trust instrument specifically cover? Can the trustee rely on the direction letter? The parties may all agree that the trustee should just sign the documents that it's directed to sign, and the trustee will obviously want to limit its liability to willful misconduct as it blindly follows directions. But it's important to determine whether the direction language covers the various investment powers being exercised. The investment advisor provision should also cover things like valuation of interests in closely-held and nonpublic entities. Trustees often find that when they are directed to hold an interest in an entity, like a limited liability company, and they don't have any information about the entity, issues arise with reporting the asset in account statements. It's often helpful to provide that the trustee shall follow all directions with respect to executing documents, including representations and warranties included within them.

i. **Sample Language.** Notwithstanding any other provision of this Agreement, the Trustee shall exercise all investment powers granted to it under Subsections [cite any statutory trustee powers], all powers described as an "investment decision" in [cite any description of investment decisions found in the directed trust statute], all powers granted in subparagraphs __ through _____ of [cross-reference all investment-related trustee powers granted in the governing instrument] and all other powers relating to the acquisition, disposition, retention, exchange, change in character, lending, borrowing, pledging, mortgaging, managing, voting, leasing, granting of options with respect to, insuring, abandoning, or in any other way relating to the investment or management of the trust estate, only upon the written direction of the investment adviser (the "Investment Adviser"); provided, however, that the Grantor, when acting as an Investment Adviser hereunder, shall have no power to direct the Trustee with respect to life insurance on the life of the Grantor or any incidents of ownership within the meaning of Code Section 2042 of the Code

associated therewith and no power to vote any interest in a controlled corporation within the meaning of Code Section 2036(b) of the Code.

F. **The list of directed trustee powers must be complete.** Even if the investment advisor provision cross-references investment powers in the governing instrument, it could be argued that the trustee also had an independent power to act if all investment powers aren't cross-referenced, including powers granted by statute. It may actually not be enough for the investment advisor provision to cross-reference the powers in the governing instrument if a statute also grants investment powers to the trustee. A beneficiary could argue that even though the trustee acted at direction, the trustee also possessed independent trust power and authority found in the governing instrument or applicable law that wasn't referenced in the investment advisor provision that the trustee could have (and should have) exercised to mitigate losses. Or the beneficiary could argue that the powers the trustee exercised weren't the ones cross-referenced in the investment advisor provision. This risk wouldn't exist if all of the trust investment powers had been properly cross-referenced. These are some of the arguments the beneficiaries actually made in Mennen. The beneficiaries argued that the trustee possessed powers granted in the trust agreement that weren't cross-referenced by the investment advisor provision and were outside of the scope of powers exercised at direction. They claimed that the trustee could have independently exercised those powers to mitigate the losses. The beneficiaries also argued that the trust agreement was written in a sufficiently ambiguous manner, so that a portion of the trust losses were the result of actions the trustee took that weren't within the scope of powers exercisable by the trustee only at the direction of the investment advisor.

G. **The document must only provide for the trustee to act at direction.** If the trustee is not acting at direction, but rather 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 be responsible and liable for a portfolio that does not necessarily reflect its own decisions unless the consent adviser always agrees with the trustee. Additionally, the investment adviser provision should not enable the adviser to toggle between consent or direction as this could unilaterally shift unwanted responsibility onto the Trustee.

H. **The trustee should have no duty to monitor or supervise the investment adviser.** A well-drafted directed trust governing instrument will not empower a trustee to monitor or supervise an adviser due to the possibility that a trustee could be liable for ineffective oversight. Most Strong Form directed trust statutes address this concern. For example, Subsection 3313(e) of Title 12 of the Delaware Code clarifies the protections afforded to a directed trustee with respect to certain actions that may be taken by a directed trustee when acting at the direction of an investment adviser. Under Subsection 3313(e), unless the

governing instrument provides otherwise, a directed trustee has no duty to (1) monitor the conduct of the investment adviser, (2) provide advice to or consult with the investment adviser, or (3) communicate with, warn, or apprise any beneficiary or third party in instances where the directed trustee would or might have exercised its own discretion in a manner different than the manner directed by the investment adviser. The purpose of Subsection 3313(e) is to enable the investment adviser to exercise its authority without any monitoring or second-guessing by the directed trustee and to clarify that the directed trustee should not be deemed to possess the duties described in Subsection 3313(e) when it is acting solely at the direction of an investment adviser. In addition, the plain language in Subsection 3313(e) creates a default rule that, absent clear and convincing evidence to the contrary, any actions of the directed trustee with respect to matters within the scope of the investment adviser's authority are presumed to be administrative actions of the directed trustee solely to allow the directed trustee to perform its duties and shall not be deemed to constitute an undertaking by the directed trustee to monitor the investment adviser or otherwise participate in actions within the scope of the investment adviser's authority. Subsection 3313(e) provides two examples of such actions, namely confirming that the investment adviser's directions have been carried out and recording and reporting actions. The purpose of these provisions of Subsection 3313(e) is to clarify that a trustee shall not have assumed any additional duties or liability in connection with actions taken by the trustee that fall within the scope of the investment adviser's authority. Additionally, it is advisable for the trust's governing instrument to expressly include a provision providing that the directed trustee has the protections provided in Section 3313(e) or can provide additional clarification or protection by its express terms.

i. **Sample Language.** The Trustee shall have no responsibility to undertake any review of, or to provide advice regarding, any part of the trust estate subject to the direction of the Investment Adviser. The Trustee shall have no duty or obligation to (a) communicate with or warn any beneficiary or any third party concerning instances in which the Trustee would or might have exercised the Trustee's discretion in a manner different than the manner exercised by the Investment Adviser (b) to inquire into or monitor the directions of the Investment Adviser notwithstanding any appearance of or actual conflict of interest of the Investment Adviser, or (c) inquire into, monitor or question the prudence of or inform any beneficiary with respect to the investment of the trust estate subject to the direction of the Investment Adviser, and any and all review of the investments by the Trustee shall be presumed to be solely for statement, tax reporting and/or other administrative purposes. The Trustee shall have no duty to seek the direction of the Investment Adviser in the absence of any direction. The Trustee shall be entitled to the full protection of Section 3313(e) of Title 12 of the Delaware Code without limitation. The Grantor has included the provisions of this Article in order to effectively bifurcate the investment function from other functions of the Trustee in order for investment

decisions to be made by the Investment Adviser without the interference of the Trustee.

I. **<u>Specifically address unique issues pertaining to "Special Holdings".</u>** The directed trustee provision should give special attention to the responsibilities related to Special Holdings like closely-held companies, limited liability companies, restricted stock, real estate, life insurance, and private equity, such as valuations and entity management. Special Holdings present unique issues for the trustee concerning management, valuation, risk, tax reporting and liquidity. The governing instrument should include specific language addressing these unique issues.

i. **<u>Sample Language.</u>** For purposes of this Agreement, the term "Special Holdings" shall include (i) shares of common capital stock (voting or non-voting), preferred stock, membership interests in limited liability companies, interests in limited partnerships and other interests in closely held businesses not actively traded on an established public market; (ii) real estate; (iii) any property received with respect to, or in exchange for, property described in clause (i) above; and (iv) property identified in writing as Special Holdings by the Investment Adviser. The Trustee shall value Special Holdings and any other assets of the trust not actively traded on a public exchange only as directed by the Investment Adviser. Additionally, the Trustee shall manage or participate in the management of Special Holdings, to the extent the governing instruments or applicable law require the trust to manage the same, only as directed by the Investment Adviser. Finally, the Trustee will not be responsible for the investment performance of any Special Holdings, and shall not take Special Holdings into consideration in the investment management of the other trust assets.

J. **<u>Specifically Address Execution of Documents and Reps and Warranties.</u>** Complications can arise with directed trusts when the trustee is directed to execute transaction documents that contain reps and warranties made by the trustee on behalf of the trust, and the trustee does not know the underlying facts and has not performed any investigation necessary to make the assertions. It is cleaner and more effective to specifically address the execution of documents, and reps and warranties, specifically in the directed trust provision.

i. **<u>Sample Language.</u>** The Trustee shall execute all documents necessary or appropriate in connection with any matter that is the subject of directions from the Investment Adviser, including, without limitation, making any representation, warranty or covenant required in order to make or maintain any investment of the trust and any future action with respect to any such representation, warranty or covenant, only as directed by the Investment Adviser. The Trustee shall have no duty to conduct an independent review of documents presented to it by the Investment Adviser in

furtherance of the Investment Adviser's written instruction to the Trustee and shall sign the same as presented.

K. **The direction letter must be written, specific, and detailed.** The advisor should give all directions to the trustee in writing. The direction letter should direct the directed trustee to take a specific action without leaving any room for the trustee to exercise discretion. To the extent that the directed trustee is being directed to execute a document, such as a promissory note or a limited liability company agreement, the direction letter should direct the directed trustee to execute the precise form of document attached to the letter. The direction letter should not leave any discretion to the directed trustee as to whether and how to take a specific action. The 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. Directions should be delivered to the trustee in writing, and should recite relevant statutory provisions so the adviser clearly understands the bifurcation of the roles for each direction. It's also advisable to include the language of the given statute that provides for the ability for the trustee to be directed, as well as language that states that the trustee does not have the duty to monitor the actions of the trust advisor.

L. **No ability to remove/appoint advisor.** In addition, the trustee shouldn't be able to remove or appoint the advisor. If the trustee has appointed the investment advisor, or has the power to remove or appoint the investment advisor, the trustee may be vicariously liable for the advisor's conduct for negligently hiring or failing to fire the investment advisor. The applicable state statute and the language drafted in the trust instrument must adequately address these issues. Otherwise the structure will be tantamount to a delegation and there will be no bifurcation.

7. **Trustee Procedures for Following Direction.** Upon receipt of a direction letter, the directed trustee should not blindly execute the directions contained therein. A directed trustee must take reasonable action to comply with a power of direction, which imputes certain duties and obligations on the trustee in carrying out the direction. The duty to comply with a direction is limited by the scope of the powers – both the power of the investment adviser to direct the trustee with respect to the particular matter as well as the trustee's trust power and authority and any applicable limitations under the trust instrument and applicable law.

A directed trust structure generally requires the directed trustee to act reasonably as it carries out the acts necessary to comply with and execute a director's exercise of its powers. The directed trustee should, at a minimum, verify the investment adviser's authority under the governing instrument to direct it with respect to the exercise of the necessary trust powers and ensure that the direction is specific and leaves no discretion to the directed trustee as to how to execute the direction. The trustee must also verify that the trustee has the requisite trust power and authority under the trust instrument and/or applicable law to carry out the direction. For example, if the trustee is directed to make a

loan, the trustee must verify that the trustee has the trust power and authority to make that loan and it must verify that the directed trustee provision makes it clear that the trustee shall exercise that power at the direction of the investment adviser. Lastly, the trustee should confirm that it is permitted to exercise the trust power and authority. A trustee is not permitted to follow a direction that violates the terms of the trust instrument.[14] Likewise, a trustee should not carry out a direction that is illegal or impermissible.

If the trustee has the requisite trust power and authority, the investment adviser has the authority to direct the directed trustee with respect to the trust power and authority necessary to carry out the direction, the direction letter is sufficiently specific, and the trustee's power can be properly exercised (i.e. the exercise of the power is permitted), then the directed trustee must follow the directions, notwithstanding any reservations the directed trustee may have as to the advisability of such directions. When being directed to execute documents, the directed trustee should engage in the following procedure:

A. **Review the transaction documents.** Review the transaction documents to (1) understand the nature of the transaction for the purpose of determining whether the directed trustee has the requisite trust power and authority that must be exercised to execute its obligations under the transaction documents, and (2) ensure that the transaction does not violate the terms of the trust's governing instrument.

B. **Review the governing instrument.** Next, the directed trustee should review the directed trust's governing instrument (1) to ensure that the directed trustee has been granted the trust power and authority to execute the transaction and that it does not violate the terms of the governing instrument, and (2) to ensure that the trust power and authority that must be exercised by the directed trustee to affect the transaction is clearly exercised only upon the written direction of the investment adviser.

C. **Review the direction letter.** Finally, the directed trustee should review the direction letter to ensure that it is a clear, complete, and specific executory direction which leaves no room for discretion on the part of the directed trustee.

8. **Vacant Office.** The trust instrument should expressly provide that at any time that there is no 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 adviser. If the trustee assumes investment responsibility from an 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,

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[14] See, e.g., UTC § 105(b)(2) (making mandatory "the duty of a trustee to act … in accordance with terms … of the trust"); Restatement (Third) of Trusts § 76 (2007) ("The trustee has a duty to administer the trust … in accordance with the terms of the trust.").

investigate or remedy any decisions of the adviser that served previously. The trustee should have no liability for retention of assets selected by the previous 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.

i. **Sample Language.** At all times during which no successor Investment Adviser has been appointed and is serving for a trust hereunder, the Trustee acting alone shall exercise all of the powers theretofore exercised upon the written direction of the Investment Adviser. At any time or times when the Trustee is exercising the powers theretofore exercised upon the direction of the Investment Adviser, the Trustee shall be under no duty to examine the actions of any Investment Adviser that served theretofore or to inquire into the acts or omissions of any such Investment Adviser and shall not be liable for any act or omission of any such Investment Adviser and shall not be liable for any failure to seek redress for any act or omission of any such Investment Adviser. At any time or times when the Trustee is exercising the powers theretofore exercised upon the direction of the Investment Adviser, the Trustee may sell, transfer, exchange, convert or otherwise dispose of, any property held as part of the trust estate, at public or private sale, with or without security, and without regard to tax implications, in such manner, at such time or times, for such purposes, for such prices and upon such terms, credits and conditions as the Trustee, in its sole and absolute discretion, may deem advisable. The Trustee may also, in its sole and absolute discretion, retain any such property for any period, whether or not the same be speculative or be of the character or proportion permissible for investments by fiduciaries under any applicable law, without regard to any effect the retention may have upon the diversification of the investments, and without regard to liquidity of, or any change in the value of any particular investment. The Trustee shall be under no duty to sell or otherwise dispose of any particular investment merely because of the amount or value of such investment or type of investment in relation to the total amount or value of the trust estate. It is the Grantor's intent that if the Trustee becomes responsible for the investment of the trust estate following a vacancy in the position of Investment Adviser, that the Trustee shall have a reasonable opportunity to modify the investment composition of the trust estate in accordance with its own discretion, and accordingly, notwithstanding any other provision of this Agreement, the Trustee shall not be liable hereunder for any investment decision made for a reasonable period of time following a vacancy in the position of Investment Adviser absent such Trustee's own willful misconduct.

9. **Due Diligence.** A directed trustee should be able to perform as much due diligence as it deems appropriate regarding a directed trust prior to accepting the trust without jeopardizing the protections available to it under the relevant statute. The extent of the due diligence is, of course, a business judgment, but the subject and scope of such due diligence should not undermine the protections available to a directed trustee because it

occurs before acceptance of the trusteeship. Thus, for example, a trust company could use its new business intake due diligence to inquire into the identity of a proposed investment adviser, the nature of the assets expected to be held by the trust (and the nature of any underlying assets to be held by an entity owned by the trust), and other details about a potential directed trust opportunity to the extent the trust company deems necessary. Indeed, it would be advisable for a trust company to perform such due diligence before entering in to the fiduciary role to avoid reputation, litigation, or other business risks. States that have strong directed trust statutes allow the governing instrument to be drafted to permit the trustee to conduct any desired due diligence during the administration of the trust and to require the investment adviser to provide the directed trustee with sufficient information, all while protecting the directed trustee from liability absent willful misconduct. Under such statutes, a directed trustee should be able to request documentation providing proof of ownership of entities that the investment adviser directs the directed trustee to hold, including stock certificates, subscription agreements, and certificates of good standing, especially to the extent that such documentation assists the directed trustee in following the investment adviser's directions. Additionally, a directed trustee should be able to confirm with the investment adviser that property taxes, insurance, and other carrying costs have been paid with respect to real property owned by a directed trust.

10. **<u>How to Get a Directed Trust?</u>** A settlor can draft a trust agreement to create a directed trust if the trust is governed by the laws of a jurisdiction that provides for directed trusts. If a new trust is being created, it's important to successfully satisfy the conflicts of law rules applicable in the desired jurisdiction. It's more complicated when the beneficiaries and the trustee of an existing trust wish to modify the terms of the trust to make it a directed trust. In those cases, several alternatives may exist. If the governing instrument permits the amendment of the trust for administrative purposes, then the trust document can be changed to include a directed trustee provision. If no amendment power exists, it will be necessary to perform a judicial modification of the trust or use one of the other many tools available to modify an existing irrevocable trust, such as decanting, merger, consent modification, or non-judicial settlement agreement (or virtual representation agreement) to modify the trust or to create a new trust that includes a directed trustee provision. Of course, the trust with the directed trustee provisions will need to have its situs in a jurisdiction that permits directed trusts. If the trust isn't already located in such a jurisdiction, then the situs and law governing the administration of the trust will need to be changed. In the case of amendment, decanting or judicial modification, the trustee will likely participate in the changes. The trustee will not want to be responsible for selecting the advisor that will direct it, due to the liability issues of negligently selecting the advisor. Furthermore, there will be potential liability associated with the discretionary act of changing the structure of the trust, and a trustee will likely seek releases or consents from all interested beneficiaries. If there are beneficiaries that don't agree with the change, then the trustee should exercise caution in deciding whether to modify the trust to be directed.

A. **<u>Decanting.</u>** Under a decanting statute, a trustee empowered to make distributions to or among trust beneficiaries may instead distribute the principal of the first trust (and in some cases, the income) to a second trust for the benefit of one or

more beneficiaries to whom such trustee could have made an outright distribution. If the trustee may invade the trust only pursuant to an enforceable distribution standard, many decanting statutes require that the distribution replicate or otherwise comply with any such standard. Although decanting generally cannot be used to expand beneficial interests, it is a useful tool for modifying a trust's administrative provisions, such as making a trust a directed trust. However, some states restrict the ability to modify certain administrative provisions, such as trustee compensation, reducing trustee liability in the second trust, or changing certain provisions pertaining to trustee succession.

B. **Merger.** A trustee's power to merge two or more trusts, often by statute but occasionally under a governing instrument, may allow parties to change administrative provisions by merging a first trust into a second trust drafted to have the desired provisions. Because the scope of the merger power is often limited to trusts with substantially identical beneficial provisions, merger may be an attractive option for making administrative changes but is usually not a viable option for making changes to beneficial interests.

C. **Administrative Power of Amendment.** Many trust instruments will reserve to the trustee, trust protector or other fiduciary a limited power to amend the provisions of the trust. Ordinarily, the scope of this power will prohibit changes to beneficial interests or provisions specifically included to trigger a certain tax treatment; however, the grant of power may be further limited to solely administrative changes, or changes necessary to preserve certain tax results or otherwise fulfill the settlor's intent with respect to the trust. If some power holder other than the trustee, such as a trust protector, possesses the power to make administrative amendments to the governing instrument, then this strategy is clearly the best approach for the trustee, because the discretionary action and all the risk are taken by another party. Consequently, when analyzing strategies, one of the first steps should be a careful review of the governing instrument to determine whether some trust protector or other power holder possesses the power to make amendments to the governing instrument. If this turns out to be a viable option, then an amendment can be the quickest, easiest and lowest risk option.

D. **Consent Modification.** Uniform Trust Code Section 411 and the statutes in many states (including Delaware) allow any trust, even an irrevocable trust, to be modified to include any provision that can be included in the governing instrument of a trust that is created upon the date of the modification upon the written consent or written non-objection of the trustor, all then living fiduciaries, and all beneficiaries.

E. **Non-judicial Settlement Agreement.** More than half of all United States jurisdictions have adopted some form of the Uniform Trust Code (UTC), which includes provisions for an NJSA. Under such provisions, the trustees and beneficiaries of a trust may settle matters relating to a trust by private agreement, without the need for court involvement. In some states, an NJSA may expressly be used to modify a trust. In others, modification is not specifically listed as one

of the matters that can be addressed by an NJSA, but there are other broad areas of relief that can be effective to accomplish beneficiary and trustee objectives.

F. **Appointment of "Excluded Trustee".** In June, Delaware enacted its latest installment of annual trust legislation. "Trust Act 2019" included a new statute, Sections 3343 of Title 12 of the Delaware Code. Section 3343 provides that when the terms of a trust instrument gives someone the power to appoint a successor trustee, they are now deemed to have the power to appoint multiple successor and additional trustees, and to allocate specific trustee powers to one or more of the trustees exclusively and exclude other trustees from having that responsibility. Absent a contrary provision in the governing instrument, Section 3343 deems any power to appoint a successor trustee to include the power to appoint multiple successor trustees and new additional trustees to serve together. Moreover, the power to appoint multiple successors and additional trustees is deemed to include the power to allocate various trustee powers exclusively to one or more of the trustees to the exclusion of other trustees. Importantly for the effective bifurcation of responsibilities, when allocating specific powers to a trustee, it shall be a fiduciary *only* with respect to those powers, and a trustee who is excluded from exercising powers shall be an "excluded trustee" within the meaning of Section 3313A of Title 12, thus having no liability for the actions of the other trustee and no duty to monitor or advise the other trustee or notify the beneficiaries. Section 3343 allows the person responsible for changing fiduciaries of a trust administered under Delaware law to divide responsibilities and allocate duties and fiduciary risk across multiple trustees.

G. **Fiduciary Risk Concerns.** When making an existing trust into a directed trust, there are two areas of particular concern that can negatively affect the beneficiaries. As described above, often a directed trust is desirable so that the trust can hold a special asset, such as an LLC, or to carry out a particular transaction. To facilitate this investment objective, the beneficiaries may look to a family member or friend to serve as the investment advisor, who is willing to go along with the objective. The very reason for the directed trust may be that the desired objective isn't one that any professional fiduciary is willing to carry out, or may not be permissible under traditional fiduciary duties. To accommodate the advisor and facilitate the objective, the standard of liability for the investment advisor may need to be limited to willful misconduct so that the advisor is willing to be responsible for directing the trustee to hold the interest in an LLC or sell the stock pursuant to the objectives. This raises two issues. First, prior to bifurcating the investment responsibility, the large corporate fiduciary with deep pockets was on the hook for the investment decisions. Now, the family member or friend is the fiduciary responsible for the multi-million dollar investment decision. He probably doesn't have the deep pockets or institutional expertise, or experience as a fiduciary, that the trustee had when it possessed the investment responsibility prior to the modification. Second, the trustee was subject to a standard of liability for negligence or gross negligence or prudence under the document or applicable law, but now the fiduciary solely responsible for investment decisions may only be liable for willful misconduct. In both cases, the beneficiaries have given up

some of their recourse against the investment fiduciary. The beneficiaries need to be properly advised and attuned to the relative adverse change to their rights as beneficiaries and the accountability of the investment fiduciary. That isn't to say that the structure described in this section is bad per se. Directed trustee arrangements are structured this way all the time to facilitate objectives that would have been inhibited by a skittish trustee and fiduciary law that applies to the trust. If the beneficiaries go into the structure fully informed and still intend to put in place an investment adviser who will direct the trustee to carry out a desired outcome, then they should be entitled to take on that risk and consent to the consequences.