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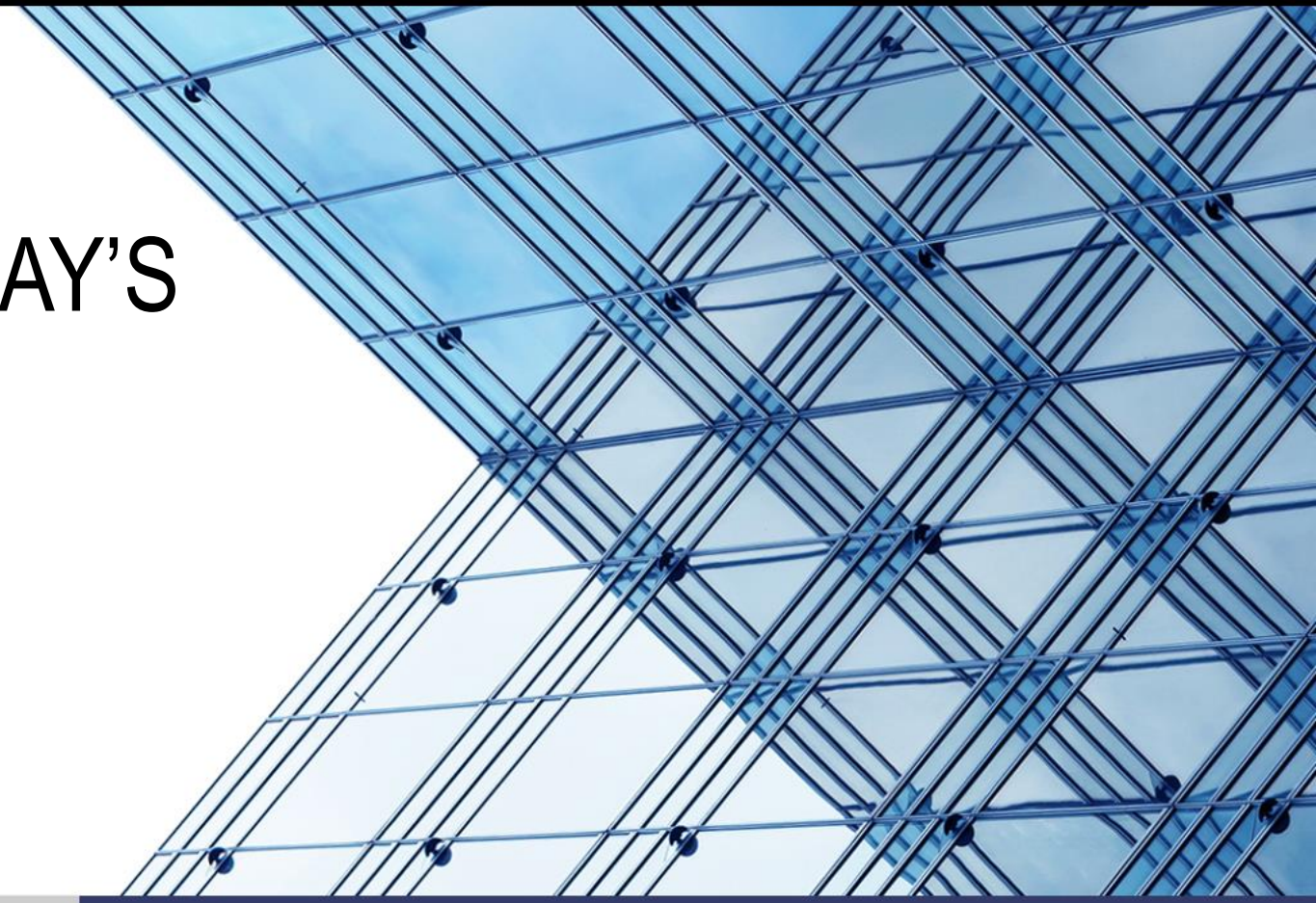

DIRECTED TRUSTS IN TODAY'S FIDUCIARY WORLD

Presented by Todd A. Flubacher

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Introduction

1. What is a directed trust?
2. Why do people use them?
3. Different statutes.
4. How to structure directed trusts.
5. How to administer directed trusts.

WHAT IS A DIRECTED TRUST?

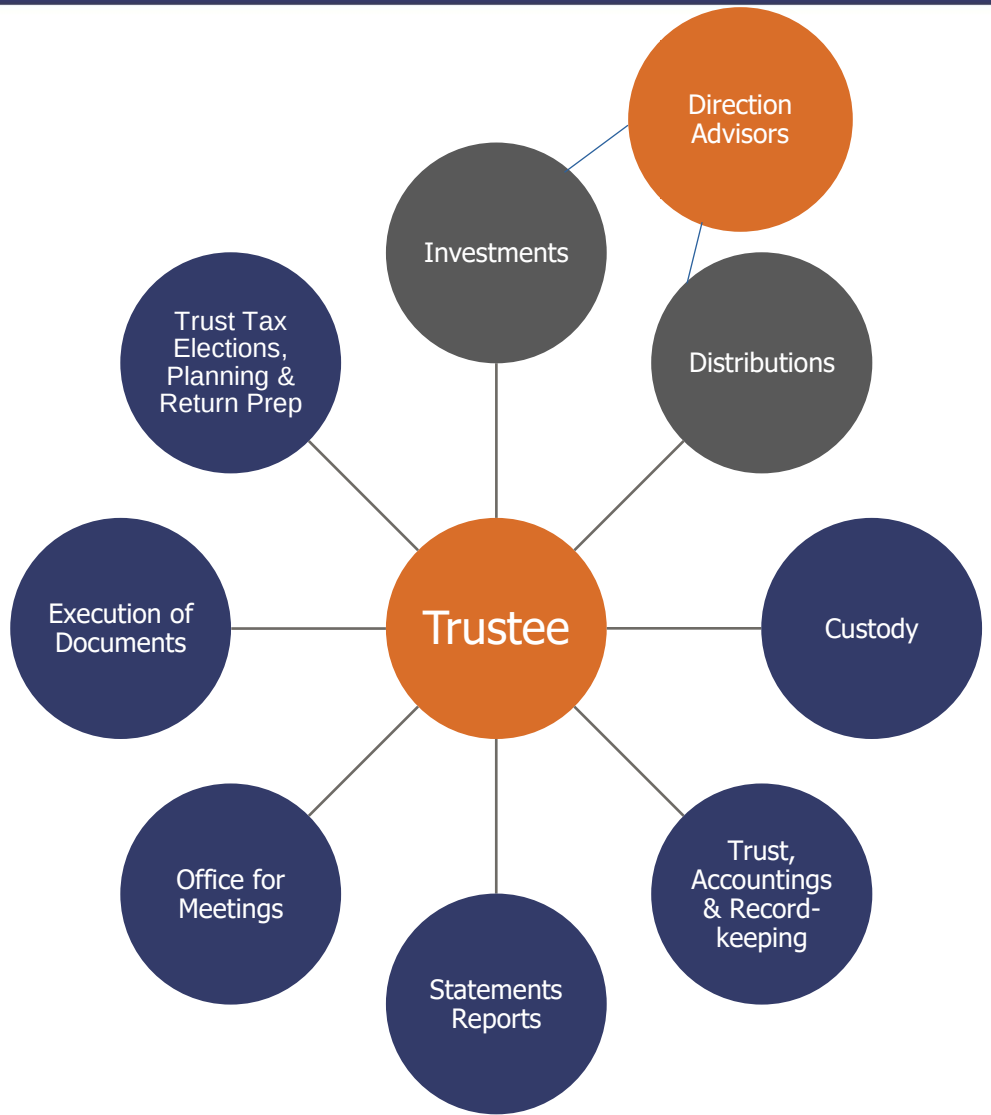
Bifurcation of Decision-making Authority

A Directed Trust is NOT a Delegation

- Trustee doesn’t have vicarious liability for the actions of the adviser.
- The Trustee should have no duty to monitor or supervise the adviser.
- Trustee should have no ability to exercise independent discretion with respect to the directions under the instrument or pursuant to the direction letter.
- Trustee should not have the power to select, remove or appoint the adviser. This may effectively create a delegation arrangement and make the trustee responsible for the decisions to hire and fire the adviser and the advisability of maintaining the adviser.
- Trustee should only be liable for willful misconduct (or no liability) when acting at direction and should not have liability for breaches of duty committed by the adviser.

What is a directed trust?

With a directed trust, duties traditionally held by a trustee are held by an adviser. The trustee still possesses the trust power and authority, but exercises it only at the direction of the adviser. The grantor is able to use different specialized advisers to make decisions on behalf of the trust.



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WHY USE A DIRECTED TRUST?

Understanding its Usefulness

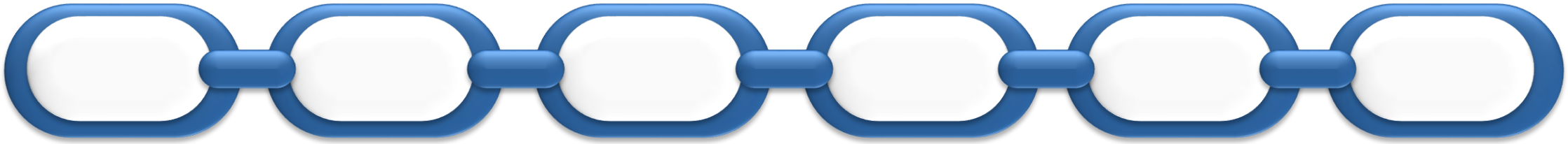
Directed Trust Powers

- Investments (all investments or certain special holdings)
- Distributions
- Beneficiary Notification
- Valuations
- Tax Reporting
- Change of Situs and Governing Law
- Amendment of Trust Instrument
- Any Other Matter (depending upon the flexibility of the statute)

Reasons for Directed Trusts

- Retain control over family company, real estate, founder's shares, or concentrated position.
- Retain family control over investment or distribution decisions.
- Ability to carryout investment objectives that are outside the scope of a typical corporate trustee's risk tolerance.
    - Avoid pressures of duty to diversify and prudent investor demands (e.g. closely held assets, concentrated positions).
- Reduce trustee fees.
- Use different fiduciaries for investments and ministerial administration (and flexibility to change investment fiduciary without changing the administrative trustee).
- Ensure flexibility and ease of administration in replacing fiduciaries.

A directed trust is only as strong as its weakest link



Statute

Directed Trust Provisions

Trustee Powers

Direction Letter

Transaction Documents

Execution

Different Approaches to Directed Trusts Vary Among Jurisdictions

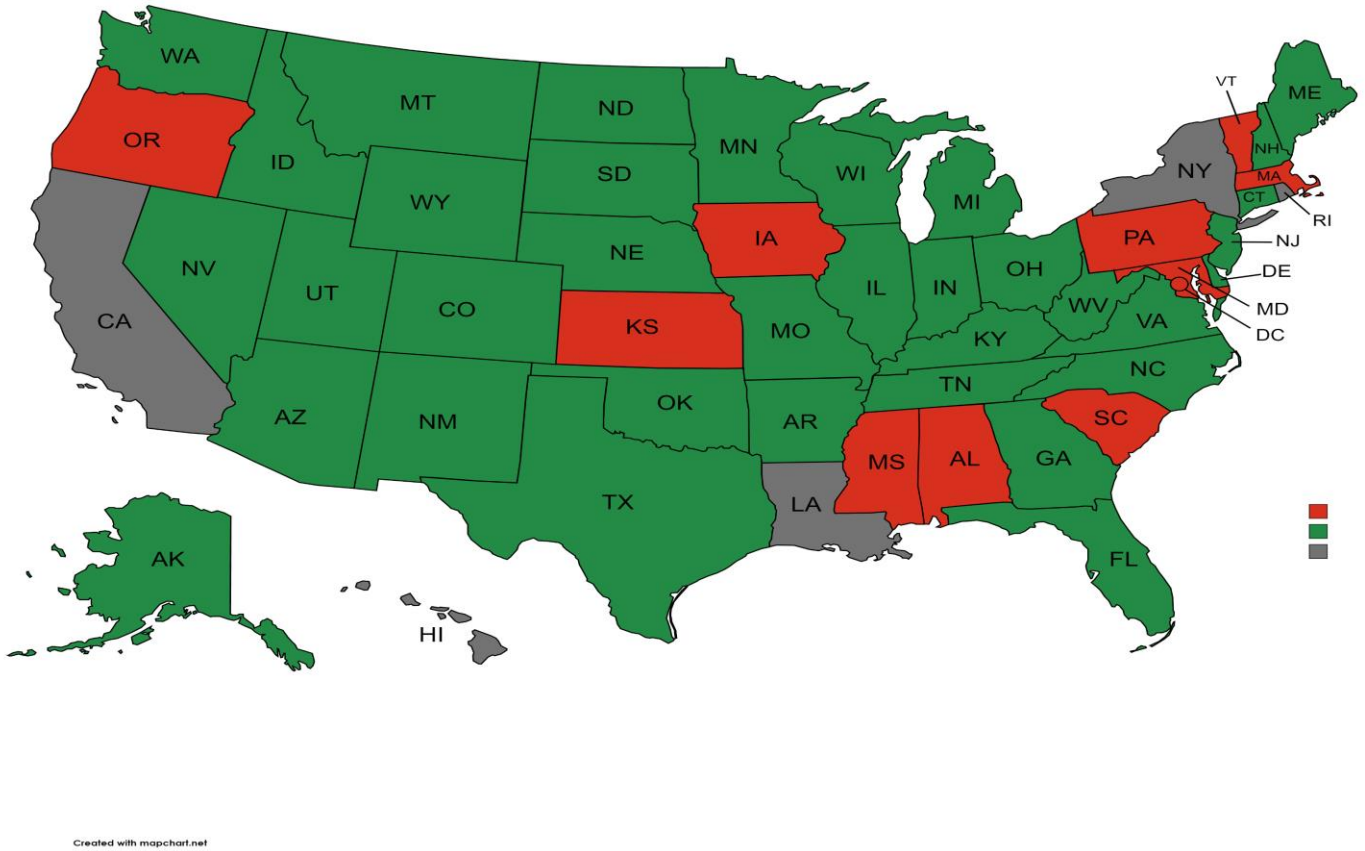
Jurisdictional Differences

- States have enacted directed trust statutes with varying degrees of effectiveness. It depends upon:
  - Different Statutes
  - Different Case Law
  - Different Drafting
  - Different Administration Practices by Trustees

Directed Trust Statutes

- Currently 46 states (including the District of Columbia) have directed trust statutes, offering varying levels of effective bifurcation.
- 10 states (including the District of Columbia) with directed trust statutes based on the UTC (some with variations).
- 1 state (Iowa) with a directed trust statutes based on the Restatement Section 185.
- 35 states with stronger forms of directed trust statutes.
    - 15 states with statutes based on the Uniform Directed Trust Act (Arkansas, Colorado, Connecticut, Florida, Georgia, Indiana, Maine, Michigan, Montana, Nebraska, New Mexico, Utah, Virginia, Washington, and West Virginia).
- There are only 5 states without any directed trust statute (California, Hawaii, Louisiana, New York, and Rhode Island).

Directed Trust Statutes Across the Country



Green = Strong-form Statutes
Red = UTC and Restatement Statues
Grey = No Statute

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The Restatement Approach

- 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.

The UTC Approach

- UTC § 808 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.

Strong Form Statutes

- Many states have enacted directed trustee statutes that clearly provide stronger bifurcation. These statutes are tailored to each state and incorporate best practices.
- These statutes often include one or more of the following:
  - Limited standard of directed trustee liability;
  - No trustee duty to warn or monitor;
  - Duty to keep other fiduciaries informed and provide information; and
  - Submission to jurisdiction in trust situs.

Enabling v. Off-the-Rack Statutes

- Strong form statutes across the country generally fall into one of two categories:
  - enabling statutes; and
  - off-the-rack statutes.
- Enabling statutes limit the liability of the directed trustee and allow the trustee to be directed with respect to any matter, but they rely very heavily on the terms of the governing instrument to set forth the terms and conditions of the directed trust arrangement.
- Off-the-rack statutes provide a detailed framework that define the directed trust arrangement, fill many of the coordination gaps, and sometimes limited the scope and usefulness of directed trusts.

Uniform Directed Trust Act (UDTA)

- The Uniform Laws Commission finalized the UDTA in October 2017 and it has been adopted by 15 states.
- UDTA is largely an enabling statute, the powers of the "trust director" can be defined by the governing instrument and can include anything, without limitation (§§ 2, 6).
- The standard of liability applied to trustees acting upon the direction of trust director is willful misconduct; however, the states are left to define that term as they determine appropriate (§9).
- As a policy, UDTA intends the default standard of liability for a trust director to match that of a trustee performing the same task (§8).
- The trust director and the trustee have a duty to share information with each other; however, the trustee does not have a duty to monitor the actions of the trust director, inform or give advice to the settlor, beneficiaries, co-trustees, or the trust director (§§ 10, 11).
- UDTA provides that by accepting appointment to serve, a trust director submits to the personal jurisdiction of the state court where the trust has its situs (§15).
- The same statute of limitations and defenses that would apply to a trustee for a breach of trust will apply to a trust director (§§ 13 14).

Implementing the Directed Trust Structure

Always Draft “Direction” Language

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

Consent Does Not Work

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

The Trustee Must Act SOLELY at Direction

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

The Adviser Doesn’t Take On the Trust Power and Authority

- Often, drafters take the approach that all of the investment power and authority is to be held by the adviser, and the trustee shall have no trust power and authority over investments. This is not how a directed trust is structured. That is an “excluded trustee”.
    - The issue is further complicated by the fact that many statute’s refer to the directed trustee as an “excluded trustee”.
- The trustee holds the trust power and authority to take actions but the direction adviser directs the trustee to exercise those powers.

Always set directed trustee liability to “Willful Misconduct” or “No Liability”

- Trustee should only be liable for willful misconduct or no liability, not gross negligence or any other standard.
- It is the willful misconduct standard that enables the trustee to follow direction without monitoring or second guessing the decisions of the adviser. This is critical for effective bifurcation.
- For example: 12 Del. C. § 3301(g) defines the term “willful misconduct” as “intentional wrong doing, not mere negligence, gross negligence or recklessness” and “wrong doing” means malicious conduct or conduct designed to defraud or seek an unconscionable advantage.”

The “Direction Letter”

- Directions should be delivered to the trustee in writing.
- The direction letter should be specific and should leave no discretion to the trustee.
  - 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.
- The direction letter should recite relevant statutory provisions so the adviser clearly understands the bifurcation of the roles for each direction.
- If there are documents to be signed, the direction letter should have those documents attached to it, essentially stating “sign here”.
- Consider issues such as reps and warranties, no duty to monitor, etc.
- NOTE: Trustee cannot control the form of the direction letter, yet the trustee would prefer a certain form and often drafts the letter for adviser signature. What are the implications?

Directed Powers: Don't just rely on a statutory definition of "investment decisions" or short generic list of investments

- Section 3313(d) defines the term "investment decision". An investment decision means "with respect to any investment, the retention, purchase, sale, exchange, tender or other transaction effecting the ownership thereof or rights therein and with respect to non publicly traded investments, the valuation thereof, and an adviser with authority with respect to such decisions is an investment adviser."
- Some off-the-rack statutes describe a specific list of investment powers of the investment adviser.
- The adviser provision in the trust instrument should be detailed and all-inclusive. It should not merely include a short generic description of investment decisions or simply limit the scope of the direction power to "investment decisions" defined under the statute. The provision should be as specific and inclusive as possible and should ideally cross reference all investment trustee powers in the instrument. The trust instrument will generally include a long list of every conceivable investment power granted to the trustee. Use that list by cross-reference.
- Without a clear, complete detailed list of powers to be exercised at direction, there will be ambiguities during the administration of the trust. Questions will arise about whether a particular action falls within the direction provisions.

Expressly limit the Trustee's duty to monitor the actions of other fiduciaries

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

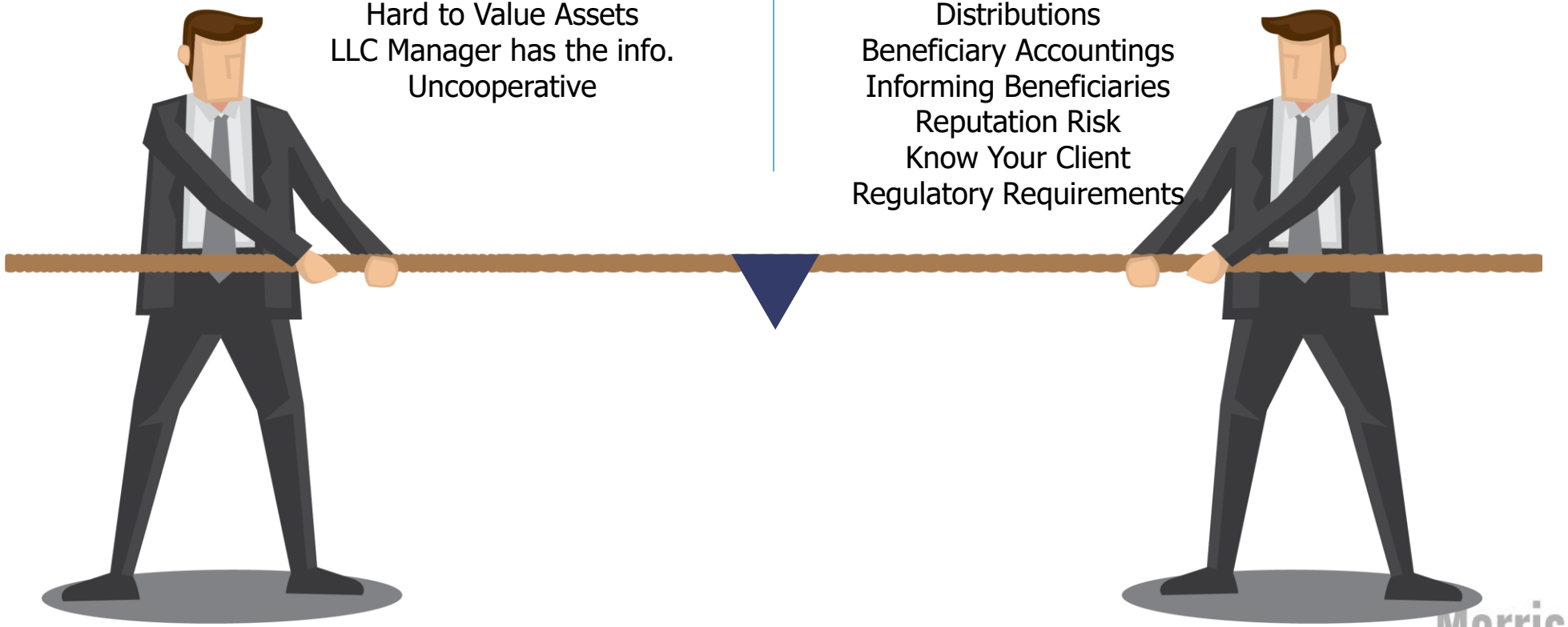
The Tension between Trustee and Adviser with Special Holdings

Investment Adviser

Exclusive Management
Hard to Value Assets
LLC Manager has the info.
Uncooperative

Trustee

Valuation of Assets
Distributions
Beneficiary Accountings
Informing Beneficiaries
Reputation Risk
Know Your Client
Regulatory Requirements



Tax Issues

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

What happens if there is no longer an Investment Adviser serving?

- Some statutes specifically provides that at any time that there is no adviser serving, the trustee shall exercise all powers theretofore exercised at direction in its own discretion. Some even go so far as to 60 days within which the directed trustee shall not be liable for the transition.
- 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.
- The trustee should have no duty to review, 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.

Other Considerations for the role of the Adviser:

- Compensation, Standard of liability and indemnification?
- Each adviser should accept the role in writing and agree to be bound by the terms of the trust instrument.
- What is the long term succession plan for the role of the adviser?
  - Is replacement mandatory or permissive?
  - Will there always be someone to appoint an adviser?
- Consider having annual letter signed by Adviser confirming
  - still in that role
  - still directs the trustee to perform the given act, and
  - the current value of the asset (where applicable).
- What if the trustee has questions about the adviser's mental capacity at a later date?

The End

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Todd represents Delaware trust companies, individuals, and law firms throughout the United States on all aspects of the creation, migration, modification, and administration of Delaware trusts.

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Todd has substantial experience with migrating trusts to Delaware, changing governing law, and modifying trusts by decanting, merger, and non-judicial settlement agreements. He drafts, reviews and comments on trust agreements and renders legal opinions. Todd routinely files trust petitions with the Delaware Court of Chancery for instructions, reformations, modifications, transfer of trust situs, construction, choice of law, and other trust-related matters.

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