TI TRUST
TRUE INTEGRITY FIDUCIARY SERVICES
estate planning studies®
www.ti-trust.com
July 2021

Directed Trusts

By Todd A. Flubacher*

Over the last decade, trust law has undergone a transformative evolution. Trust settlors are now commonly creating directed trusts and existing trusts are frequently being transferred to new jurisdictions to be modified so they can become directed trusts. 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, and the trustee continues to possess the trust power and authority that the direction covers, executing those powers only at the direction of an adviser.

Today, there are only four states that haven't enacted some form of directed trust statute (California, 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 as well as migrating existing trusts to those jurisdictions to convert them to directed trusts. With a directed trust, a settlor can choose to utilize different fiduciaries for investment functions or distribution decisions and remove and replace the person or entity that performs those roles without actually changing the trustee that performs administrative functions.

Divided responsibilities

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 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. Trusts can be complicated wealth transfer vehicles with specific objectives that can 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, a set of prudent investor or prudent person rules can come in direct conflict with holding such specialized assets. The settlor might even live in a jurisdiction in which such duties are not waivable. Trust settlors often seek to achieve unique investment, tax, and dispositive objectives that can conflict with traditional fiduciary limitations and pose unacceptable risks, particularly for corporate fiduciaries. Settlors can accomplish these same goals by bifurcating the responsibilities from the rest of the traditional trust administration functions and giving them to a separate adviser.

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 leaves any ambiguity about which trustee powers are (and are not) exercised only upon direction, a trustee could be exposed to unnecessary liability, and the trust may not be administered as intended. The governing instrument and the applicable statute should make it clear that the trustee has no duty to monitor or supervise the direction adviser, nor should they have the 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.

Purposes

Why would anyone want a directed trust? Isn't this just used to protect the trustee? The general answer is simple: the settlor, beneficiaries, 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 decisions made by the advisor. 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.

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 subset of investment decisions. Often, trusts hold 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.

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. Here, the settlor can retain the power to manage the trust investments by serving as the investment adviser and directing the trustee.

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.

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.

Distributions

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. 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. Other possible areas for trustee direction include limiting a trustee's duty to inform beneficiaries, tax return preparation and reporting, amendments to the trust agreement, change of situs, and change of governing law.

State statutes

Currently there are 47 states (including the District of Columbia) with a directed trust statute, offering varying levels of effective bifurcation. There are 12 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 4 states without any directed trustee statute. The Uniform Laws Commission finalized the Uniform Directed Trust Act ("UDTA") in 2017, and 14 states (Arkansas, Colorado, Connecticut, Georgia, Indiana, Maine, Michigan, Montana, Nebraska, New Mexico, Utah, Virginia, Washington, and West Virginia) have already adopted the UDTA.

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 that are rather weak and should generally not be relied upon to implement a direct trust strategy. Some statutes provide 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. The directed trust statutes present many different approaches, and settlors should be attuned to which jurisdiction's laws will produce the desired result.

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. The UTC approach under § 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.

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 no liability for the trustee, no trustee duty to warn or monitor, a duty to keep other fiduciaries informed and provide information, and methods of dealing with the so-called coordination gap.

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 others 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. 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.

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 § 808 of the UTC don't effectively bifurcate the investment function and remove it from the trustee's responsibilities because the trustee will have a duty to monitor the decisions of the advisor.

Practical issues

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.

Some of the best directed trust statutes include sections 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." 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. 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 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.

What can be directed?

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 § 6 of the UDTA describe the breadth of the trust director's powers to direct the trustee under § 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.

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. However, a directed trustee should not comply with a trust director's exercise or nonexercise of a power of direction if by complying the trustee would engage in "willful misconduct." The UDTA does not define "willful misconduct," and application of the standard is 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.

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)."

In practice, whenever the directed trustee is to follow the directions of a trust director, he or she has no duty to monitor or consult with the trust director, communicate with or warn a beneficiary, or commence proceeding against the trust director unless the terms of the governing instrument provide otherwise. This includes providing advice to or consulting with the trust director, including any duty to perform investment or suitability reviews, inquiries, or investigations, or to make recommendations or evaluations with respect to any such investment. In addition, the directed trustee has no duty to 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 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.

Converting an existing trust

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, a 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 who don't agree with the change, then the trustee should exercise caution in deciding whether to modify the trust to be directed.

Decanting: 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. Decanting 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, and those statutes might prevent the trustee from decanting to convert a trust to a directed trust.

Merger: 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.

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.

Consent modification

UTC § 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.

NJSA

More than half of all United States jurisdictions have adopted some form of the UTC, which includes provisions for a Non-Judicial Settlement Agreement ("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.

**Attorney Todd A. Flubacher is a partner in the firm of Morris, Nichols, Arsht & Tunnel. Todd is a Fellow of the American College of Trust and Estate Counsel (ACTEC) and he is also a member of the Society of Trust and Estate Practitioners. He is a recognized speaker, frequently appearing before professional and business audiences across the country, including ACTEC, the Heckerling Institute, Notre Dame Tax & Estate Planning Institute, Estate Planning Councils, the Delaware Tax Institute, and the Delaware Trust Conference.*