CONCORD TRUST
COMPANY

3 Executive Park Drive, Suite 302
Bedford, NH 03110
603-219-0264
www.concordtrustcompany.com

Directed Trusts

Enabling More Control & Flexibility through Multi-Participant Trust Structures

February 2012

Overview:

Trust law is evolving in the United States, and New Hampshire and South Dakota have enacted some of the most progressive trust laws in the country. Part of this progression includes the development of open architecture techniques for trust governance. Careful and thoughtful use of directed trust structures will provide new opportunities that will empower families and provide comfort to fiduciaries.

Evolution of the Laws Applicable to Multi-Participant Trusts

The use of trusts with more than one trustee or non-trustee participants was not widespread in this country until the last decade or so. The movement away from the traditional fully empowered unitary trustee model began with the increased use of co-trustees. Co-trusteeships first became popular to overcome the inability of a single trustee to administer property in multiple jurisdictions (i.e., where the primary trustee was not legally competent to act outside of the state of its residence or charter). Later, co-trustees provided specific competence not possessed by the primary trustee – for example, the use of “special trustees” to administer closely held business assets, or to participate in distribution decisions that an “interested” primary trustee could not make without risking adverse wealth transfer tax consequences. The increased use of multiple trustees forced changes in the law concerning the duties and responsibilities of co-trustees among themselves and with respect to the beneficiaries in several noteworthy respects that were instrumental in the development of the current laws relative to multi-participant trusts.

Allocation of Responsibilities

Generally, if the terms of a trust with more than one trustee provide that one or more of the trustees will possess exclusive authority with respect to trust administration, the other trustee ordinarily has no duty to participate in the matters exclusively delegated to the empowered trustee. If, however, a non-participating trustee believes that the empowered trustee may be committing a breach of trust, the non-participating trustee has a duty to take reasonable steps to investigate and prevent a breach, if possible.

Trustee Action

The common law “default” rule initially required unanimous decision-making among co-trustees. The law evolved over time and replaced the unanimity requirement with a majority rule standard. A deadlock among trustees could only be resolved by court intervention. These were default rules that could be modified by specific provision in a trust agreement. For example, even if a document empowered one of many co-trustees to decide specified questions or take actions as “controlling trustee” in the event of deadlock, the courts required that all trustees participate in decision making with respect to those matters and to be an informed fiduciary participant in all trustee deliberations (including those exclusively delegated to another co-trustee). This is sometimes referred to as a “duty to consult”. The duty of each trustee to use reasonable care to prevent a breach by the controlling trustee was considered to be non-waiveable by a contrary instruction in the trust agreement.

Co-Trustee Liability

Co-trustee liability is generally joint and several. A co-trustee is not liable to a beneficiary for a breach of trust committed by another trustee unless such co-trustee: (i) participated in the breach; (ii) improperly delegated the administration of the trust to the acting trustee; (iii) approved, acquiesced in or concealed the breach; (iv) through failure to exercise reasonable care in the trust's administration, enabled the co-trustee to commit the breach, or (v) neglected to take proper steps to compel the acting co-trustee to redress the breach. Thus, by common law, most jurisdictions did not allow a trustee to avoid liability merely by remaining inactive in the administration of the trust. When a co-trustee dissents, however, the dissenting trustee is often able to avoid liability.

- **The Influence of Prudent Investor Legislation**.

  The death knell finally sounded for the rules prohibiting delegation of trustee functions with the states' adoption of legislation modeled after the Uniform Prudent Investor Act ("UPIA") first promulgated in 1992. The UPIA reflects "modern portfolio theory" and a total return approach to the exercise of trustee investment powers and discretions. Most states have enacted some form of the UPIA that allows the trustee to acquire most types of investments, as opposed to the "traditional" trustee investment laws, such as the "prudent person standard", which limited choices among conservative alternatives said to be of "trust quality". The UPIA measures investment performance by assessing the entire portfolio, replacing the asset-by-asset analysis required by the predecessor prudent person standards. UPIA's "prudent investor" standard may require trustees to delegate investment authority to co-trustees or agents if the trustee does not have sufficient expertise to perform that function for a particular trust. Even a trustee with investment skill may delegate certain investment functions.

<u>The Emergence of "Directed" and "Delegated" Trust Arrangements</u>

Perhaps more than any other development, the wholesale adoption of prudent investor standards has fueled the popularity of what have come to be known as "directed" and "delegated" trusts. These terms are sometimes incorrectly used interchangeably. Each type of trust has, however, important characteristics that distinguish one arrangement from the other.

Delegated Trusts

Generally, a "delegated trust" is one in which the trustee hires a third party to perform some or all of the trustee's discretionary investment management functions. The relationship of the delegating trustee and the third party is generally one of principal and agent. The trustee of a delegated trust has a duty to select the investment manager with care, and to exercise prudence in monitoring the manager's activities.

Directed Trusts

A directed trust, by contrast, strips from the trustee all discretionary duties – whether related to investment management, discretion over distributions to beneficiaries, or both. A directed trustee, also often referred to as an "administrative trustee", generally has no duty other than to follow the directions of the empowered party. The empowered party's powers to direct are expressed in the trust agreement. Unlike the delegated trustee, the directed trustee does not have any selection or monitoring responsibilities. The directed trustee's only obligation is to insure the accomplishment of the settlor's intent as expressed in the trust agreement.

Recognition of Multi-Participant Structures in the Uniform Trust Code

As indicated above, before the enactment of directed trustee statutes, the few courts that had occasion to address the issue generally found that a trustee would not be held liable for following the instructions of a person empowered by the trust instrument. They had trouble, however, defining the extent, if any, of a directed trustee's affirmative duties to the beneficiaries. A consensus emerged from the few decided cases: the trustee must insure that following those instructions does not violate the trust agreement or fiduciary duties owed to the beneficiaries, and must intervene to prevent a breach (or at least warn the beneficiaries so that they themselves can take timely action).

Although the legislatures have been slow to codify and improve on this narrow and sometimes conflicted body of common law, from the beginning the Model UTC recognized that a regime imposing duties to investigate and intervene does not always make sense in light of the increased use directed and delegated trust arrangements.

The Anatomy of a Modern, Open Architecture "Directed" Trust Design

The Perils of Relying Exclusively on Statutory Default Rules

New Hampshire, South Dakota and a few other "progressive" trust jurisdictions have taken the lead in going beyond the UTC's limited recognition of directed trusts with comprehensive statutory default rules that answer several questions concerning a directed trustee's residual responsibilities that the UTC failed to address. Still, the estate planning attorney charged with drafting a modern directed trust under NH or S. Dakota legislation (or the laws of any other states, whether or not the governing law expressly sanctions directed trusts) will be careful to craft the trust's provisions to remove the passive trustee's duties and discretions as to distributions and/or investments and give them to an investment committee/trustee, distribution committee/ trustee, and/or trust advisor or trust protector. Generally, it is best not to leave these issues to the default rules.

Defining the Participants and Their Respective Roles

The directed trustee's duties should specifically be defined -- for example, to include taking title and ownership of the trust assets, establishing and maintaining a trust bank account, preparing or signing the trust tax returns, preparing and sending trust accountings and other statements, making distributions and receiving contributions, as directed by the empowered party. The directed trustee also will orchestrate things among the multiple participants so that the provisions of the trust agreement are strictly followed. What follows is a sampler of the usual participants in a modern directed-trust structure.

- **Investment Committees and Advisors**

  The participants possessing specifically allocated investment powers are typically the settlor's family members, investment advisors, consultants and investment management professionals. Often they work together and comprise an "investment committee" that provides directions to the directed trustee. The investment committee often will manage insurance, closely held stock, partnerships, LLCs, real estate, art, commodities, vacation homes and other illiquid "special assets" that may be held in the trust.

- **Distribution Committees and Advisors**

  Discretionary distribution decisions often are handled in a similar fashion. The trust agreement will establish a distribution committee composed of both family and independent members. The independent members are important for avoiding the imputation of wealth transfer tax-sensitive discretionary actions to committee members who are beneficiaries. Such tax sensitive distributions generally require a non-related or subordinate person to make discretionary distributions to keep the trust assets out of the trust settlor's and the beneficiaries' gross estates under the federal estate tax laws

- **Trust Protectors**

  Trust protectors are often used in tandem with directed trusts' investment and distribution committees. Estate planning attorneys in states without trust protector statutes are drafting the trust protector function into trust agreements governed by the laws of those states (although such structures may be riskier for the directed trustee and the trust protector in states that do not specifically recognize the office of trust protector).

  A trust protector typically is given one or more of several duties:

  - Amend or modify the trust agreement to achieve favorable tax consequences or respond to changes in the tax laws;

- Amend or modify the trust agreement to take advantage of laws relating to the administration of the trust, restraints on alienation, and the distribution of trust property;
- Increase or decrease the interests of trust beneficiaries;
- Grant, revoke and modify the terms of beneficiary-held powers of appointment;
- Remove and appoint trustees, trust advisors and investment and distribution committee members;
- Terminate the trust;
- Veto or direct trust distributions;
- Change the situs or governing law of the trust, or both;
- Appoint their own successors as trust protectors;
- Interpret ambiguous terms of the trust agreement as may be requested by the trustees; and
- Advise the trustee on matters concerning one or more trust beneficiaries.

Illustration – Concord Trust Company Serving as Directed Trustee in a Multi-Participant Trust