Delegated Vs. Directed Trusts

Know the differences between these two instruments

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Families are becoming more sophisticated about wealth management, incorporating modern trust documents into their estate-planning goals and looking for ways to maximize the flexibility of their trust investments. Typically, a trustee's duties and flexibility regarding investment responsibilities vary depending upon whether a state has adopted the Prudent Investor Act (PIA); whether a trust is directed or delegated, the individual state statutes, the trust instrument itself, and whether the trustee is a nationally chartered bank or trust company subject to Office of Comptroller of the Currency (OCC) regulations.

The PIA, adopted in 1994, itself reflects a modern portfolio theory and total return approach to the exercise of fiduciary investment and discretion.[1] Most states[2] have embraced some form of the PIA that allows the trustee to acquire most types of investments. The PIA also measures investment performance based upon an assessment of the entire portfolio versus the asset-by-asset analysis that was required by its predecessor "prudent man rule."[3] Because the PIA mandates that a fiduciary exercise the "care, skill and caution to make and implement investment and management decisions as a prudent investor would," a trustee may even be required to delegate investment authority, if the trustee is not sufficiently expert to perform that function for a particular trust. Even a fiduciary with investment skill may delegate certain investment functions. For example, a corporate trustee lacking expertise in a specific investment area—such as foreign securities or venture capital—may properly delegate that particular responsibility.[4]

DIRECTED VS. DELEGATED

Unsurprisingly then, the adoption of PIA has meant that both directed and delegated trusts—two very different concepts—have gained in popularity. Pursuant to Section 185 of the Restatement (Second) of Trusts, a trustee is generally not liable for following the instructions of a person empowered by the trust instrument. Nonetheless, a trustee must ensure that following such instructions doesn't violate the trust agreement or a fiduciary duty owed to the beneficiaries of the trust.[5] Section 185 provides only a superficial definition of "directed" and "delegated" trusts. A few states go further by having statutes that relieve trustees of liability *vis-a-vis* directed and delegated trusts.[6]

Generally, a delegated trust is one in which the trustee has contracted with a third party to perform some or all of the trustee's discretionary investment management functions with respect to the trust. The trustee of a delegated trust may have some duties regarding selection of the investment manager as well as some ongoing monitoring functions.[7]

In a directed trust, the trustee generally has no discretionary investment duties. A directed trustee generally has no other duty than to follow directions of the empowered person. The power to direct is initiated and within the control of a third party as expressed in the trust instrument. Unlike the delegated trustee, the directed trustee typically does not have any selection or monitoring functions, except to ensure that the grantor's intent as expressed in the trust document is being followed.[8]

DECISION MAKERS

A directed trust is generally drafted so that a trustees' duties and discretion as to distributions and/or investments are removed by a provision in the trust agreement and/or by state statute and given to an investment committee/trustee ("investment committee"), distribution committee/trustee ("distribution committee"), as well as a trust advisor and/or trust protector. Each of these individuals or entities play important roles in the functioning and administration of the modern trust in accordance with the trust instrument.[9]

The modern "directed trust" generally provides for an administrative trustee who acts in a directed capacity,[10] that is to say, is not responsible for the trust's investment management but takes direction from an investment committee. The administrative trustee's duties may 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 statements, and making distributions and receiving contributions. The administrative trustee also ensures that the trust document is followed (for example, if the investment managers are investing in hedge funds and the trust document specifically prohibits that type of investing, the administrative trustee must report this failure and if nothing is done to correct it, the administrative trustee may have no other choice but to resign). Generally, investment provisions in the trust are fairly broad.

Those individuals who make investment decisions for the trust comprise the investment committee, which typically is drawn from the grantor's family members, investment advisors, consultants and/or managers. The investment committee directs the administrative trustee regarding investment management of the trust. Generally, after a grantor designates a family member or members to be on the investment committee, they in turn hire the appropriate investment professionals. Alternatively, a grantor may appoint in the trust instrument an investment professional to directly serve on the investment committee, but flexibility is generally lost in doing so. The investment committee also may direct and manage insurance, closely held stock, partnerships, limited liability corporations (LLCs), real estate, art,

The modern "directed trust" generally has a trustee acting in a directed capacity, taking direction from an investment committee.

and other illiquid assets held by the trust. A grantor may select committee members based on their experience and expertise with a particular asset class.

DISTRIBUTION COMMITTEE

Because trustees also make distributions, a grantor may establish a distribution committee to determine when such discretionary distributions should be made. This committee can be comprised of both family and independent members. It's important, though, to be cognizant of the need for filling the committee with independents for tax-sensitive distributions.

The administrative trustee can fill this independent role and therefore is often appointed to this committee. Tax-sensitive distributions are typically discretionary distributions requiring a non-subservient person (that is to say no family employees or family members, etc.) to make the independent decision to make a distribution from the trust so that the trust remains out of the grantor's estate.

TRUST PROTECTORS

The trust protector also is being used more and more with domestic trusts to supplement many directed trusts' investment and distribution committees.[11] Several states now have trust protector statutes,[12] and advisors are drafting the trust protector function into trust documents even in states without specific statutes, which may be risky

Trust protectors typically have the duty to:[13]

• modify or amend the trust instrument to achieve favorable tax status or respond to changes in the Internal Revenue Code, state law or the rulings and regulations thereunder;

• increase or decrease the interests of any beneficiaries to the trust;

• modify the terms of any power of appointment granted by the trust (although a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument);

• remove and appoint a trustee, trust advisor, investment committee member or distribution committee member;

• terminate the trust;

• veto or direct trust distributions;

• change *situs* or governing law of the trust, or both;

• appoint a successor trust protector;

Virginia's directed trust statute was somewhat successfully challenged in *Rollins*. A court found common law imposed on trustees duties to keep informed of the trust's conditions and warn beneficiaries.

• interpret terms of the trust instrument at the request of the trustee;

• advise the trustee on matters concerning a beneficiary; and

• amend or modify the trust instrument to take advantage of laws governing restraints on alienation, distribution of trust property, or the administration of the trust.

STATUTORY CONSIDERATIONS

Not all states have statutes that authorize directed trusts for investment-management purposes. Therefore, advisors must carefully consider state law and trust *situs* before setting up such trusts. For example, Alaska,[14] Delaware,[15] South Dakota,[16] Texas,[17] Virginia,[18] and Wyoming[19] authorize directed trusts via statute.

The directed trust statute was upheld in Delaware, in *Duemler v. Wilmington Trust Co.*[20] The trust in *Duemler* was a "directed trust" invested in "a nondiversified portfolio with extremely risky assets," the kind of portfolio "that requires the most diligent of monitoring." The trustee forwarded a prospectus to Duemler, the investment advisor, so he couldmake an investment decision concerning one of the trust's investments; however, Duemler did not provide the trustee with any direction as to the investment and the investment subsequently experienced a significant drop in value. The court stated that in these circumstances, IRC Section 3313 of the Delaware directed trust statute requires the investment adviser to make investment decisions in isolation, without oversight from the directed trustee, because if the investment adviser did not, the investment adviser's role wouldn't work, as the trustee would always second guess the investment adviser's decisions. Consequently, the court found that the trustee did not breach its fiduciary duty and had not engaged in willful misconduct, thus upholding the Delaware directed trust statute.

Virginia's directed trust statute was somewhat successfully challenged in *Rollins v. Branch Banking & Trust Co. of Virginia*.[21] In *Rollins*, a court acknowledged that it was the duty of the directed trustee to follow the instruction of the trust's grantors not to sell shares of a textile company that were placed in trust in 1997 but later plummeted in value. The trust provided that "investment decisions as to the retention, sale or purchase of any asset of the trust fund shall likewise be decided by such living children or beneficiaries as the case may be." But the court did hold that common law continued to impose upon the trustee a duty to keep itself informed "as to the conditions of the trust" and an unavoidable "duty to warn" beneficiaries. *Rollins* was settled after the decision and it's unclear whether any payment was ever made by the trustee.

Several commentators have remarked that if Virginia's directed trust statute had contained this language in South Dakota's law, it would have helped the *Rollins* trustee: "Any excluded fiduciary (that is to say a directed trustee) is also relieved from any obligation to perform investment reviews and make recommendations with respect to any investments to the extent the trust advisor has the authority to direct the acquisition, disposition, or retention of any such investment." This statutory language expressly relieves a directed trustee of obligations to perform an investment review and make recommendations.[22]

States also vary in how they delineate the responsibilities and roles of directed trust committees. For example, most states that statutorily authorize directed trusts limit the direction capability to investment responsibility while a few allow an administrative trustee also to take direction on distributions. Still, some advisors are drafting directed trusts in states without directed trust statutes. This is being accomplished either through provisions in the trust document and/or by separate agreement. The intent is to exonerate the administrative trustee from investment and/or distribution responsibility. This practice is occurring in many states, including New York and Illinois. Such exoneration clauses and agreements vary and are often limited to *inter vivos* trusts. Their effectiveness, though, is not always guaranteed and depends upon whether the fiduciary breach falls within the applicable provision and if the provision was properly inserted into the document.Such exoneration provisions and agreements also are void against public policy in certain states, including.[26]

Typically, with or without state statutes, advisors draft flexible trust documents so that all committees and administrative functions can be combined into one "full trustee" function at any time, then possibly revert back to committee status at some future point. If this were to happen, the administrative trustee also would take on the roles of the investment and distribution committees as well as possibly some of the functions of the trust protector. This is important in the event of the death, disability or retirement of committee members.

PROTECTING COMMITTEES

Individuals who serve on investment or distribution committees or as trust protectors take on potentially large responsibilities and often want some sort of liability protection. It's often very difficult, if not impossible, to obtain individual liability insurance coverage for committee members or trust protectors. But some insurance companies will provide coverage to an unregulated entity established specifically for the purpose of placing a liability umbrella over the heads of the committee members or trust protector. As a result, a recent trend has developed to establish such unregulated entities (that is to say an LLC) to serve this purpose. Such an entity is beneficial because it provides legal continuity by its corporate existence by continuing without regard to any single individual's death, disability or resignation. The entity typically has bylaws that allow for additional members to be added or removed so that the entity can continue along with the trust. Note that entities such as these must be properly structured to avoid estate tax inclusion issues.[27] There are no specific state statutes that oversee these entities, but some jurisdictions Nevada, South Dakota, Wisconsin, and Wyoming, and the District of Columbia) will generally allow families to establish such unregulated companies on a case-by-case basis. These entities must be carefully created to remain exempt from regulated private trust company (PTC) status and are typically entities with specific purposes, limited, defined duties and properly capitalization to reflect their role.

MODIFYING INSTRUMENTS

It's relatively easy to draft a new trust as a directed trust. But pre-existing trusts also may be converted to directed trusts in states that have adopted modification and reformation statutes. This generally occurs if circumstances not anticipated by the trust's grantor arose and modification would substantially further the trust or its purpose, such as the desire for directed trust status regarding the trust's administration.[28] In addition to reformation and modification statutes, several states have privacy[29] and virtual representation statutes[30] to protect the families' privacy as well as to provide sign off via guardians, by the future vested and/or contingent beneficiaries including unborn descendents as part of the modification or reformation. Both Delaware and South Dakota have statutes that allow court documents to be sealed for this purpose for families who desire anonymity. Additionally, the virtual representation statutes prevent future beneficiaries from objecting to and/or relitigating an issue that was addressed by predecessor beneficiaries and/or grantors that is to say a modification or reformation.

Another strategy to convert non-directed trusts into directed trusts involves older non-directed irrevocable life insurance trusts (ILITs). An insurance policy generally can be sold from an old grantor defective ILIT to a newly drafted grantor defective ILIT with directed trust provisions. If properly structured, there should be no "transfer for value" problem or tax issues. But caution: there may be tax issues with this strategy, if the policy is being sold from a non-grantor trust to a grantor trust and the fair market value of the policy being sold is more than the cost basis of the policy.[31]

DELEGATED TRUSTS

Although very few states have a true directed trust statute, most states have some form of it, particularly in the wake of PIA.[32] The trustee of a delegated trust is generally allowed to delegate its investment responsibility to one or more qualified investment managers' consultants and/or advisors, pursuant to the trust document or outside agreement.

Delegated trusts are generally invested pursuant to the provisions of the trust document as well as an agreed-upon investment policy statement, which is periodically reviewed by the investment professionals, trustee and the family, to ensure compliance. Generally, most delegation standards no longer require the trustee to pre-approve all transactions or to analyze each trade.33

Many advisors suggest that a clause regarding trading or brokerage commissions should be inserted into the trust document to protect the trustee regarding the possible range of trading commissions.34 Such a clause might read "I recognize that pursuant to such brokerage instructions [as the investment committee may direct or as in an investment advisor delegation agreement], the trust may pay more in commissions for the purchase or sale of a particular security than the trustee might have obtained elsewhere. Neither the trustee nor the investment committee shall have any liability for such differences in brokerage commissions." The trustee of a delegated trust generally has a much greater degree of responsibility than a directed trustee. Consequently, a delegated trustee may not only want exoneration language within the trust document but also by separate agreement.35

In certain states, however, exoneration agreements are void against public policy in certain situations. For example, New York EPTL Section 11-1.7 makes such exoneration void against public policy for testamentary trusts, but not *inter vivos* trusts.[36]

The trustee is generally involved in the selection of the investment manager to delegate investment responsibility. The trustee must keep due diligence records regarding the investment manager selection—for example: the investment manager's experience, track record and Form ADV (Investment Advisor Public Disclosure). Investment advisers typically file a Form ADV to register with the Securities and Exchange Commission (SEC) and/or the states. A Form ADV contains information about an investment adviser and its business operations, as well as disclosure about any disciplinary events involving the adviser and its key personnel. Additionally, the terms of the delegation (compensation, duration, procedural safeguards) will generally be determined and negotiated by both the delegating trustee and the family.

The delegating trustee works with the investment manager and the family in formulating an investment policy statement and providing an annual review to ensure that the investment objectives are in accordance with the trust document.

Sometimes, the annual review reveals the need for more of an in-depth analysis to determine whether corrective action should be taken. The trustee may use agents or experts to assist them with this process.

For example, the following may trigger a more detailed review of the investment manager: a significant change in asset allocation; a significant drop in portfolio value; a large concentration of investments in one or a limited number of investments or in one market sector; a significant change in account activity (whether "churning" or no activity); or a significant deviation from the investment policy statement.37

None of these monitoring functions typically apply to a directed trust; also, many of the directed trust statutes further protect administrative trustees when acting in delegated trust situations.38

Typically, the meaning and terms of the trust are generally determined by the law of the jurisdiction designated in the trust. D

However, if a directed trustee is named in a jurisdiction other than the one designated in the trust, the law of the trust's principal place of administration will generally govern administrative matters and the law having the most significant relationship to the trust's creation will govern dispositive and other provisions.39

OCC REGULATION

The OCC regulates national banks, national trust companies, and their state chartered subsidiaries.40 Through its regulations, pronouncements and interpretive positions, the OCC has been a major contributor to the establishment of national trust law. The selection and monitoring requirements of delegated trusts are also subject to regulation 9 for OCC-regulated institutions.

State chartered banks and trust companies are generally not subject to OCC supervision. But to ensure that state procedures and statutes are followed, there are state audits and strict supervision, typically by the state division of banking. ▮

Endnotes

1. *Restatement (Third) of Trusts*, Section 227 (Prudent Investor Rule). The Uniform Prudent Investor Act (UPIA), as Article 9 of the Uniform Trust Code (UTC), is available online at *www.law.upenn.edu/bill/uk_frame.htm. See also* George Gleason Bogert, George T. Bogert and Amy Moriss Hess, *Bogert, Trusts and Trustees* 2d, Section 613 (West,) 2005.
2. To determine which states have enacted the UPIA, see *www.nccusl.org/nccusl/uniformact-factsheet/uniformacts-fs-upria.asp.*
3. 29 Code of Federal Regulations Sec. 2550.404(a)-1 (1974); Bogert, *supra,* note 1; Sec. 612 N.20;
4. Bogert, *supra,* note 1; Lyman W. Welch,

"How the Prudent Investor Rule May Affect Trustees" *Trusts & Estates*, December 1991 at p. 15.
5. Restatement (Second) of Trusts, Section 185; Uniform Trust Code Article 8, Section 808. For a full version of the state enactment status and commissioners' notes, see *www.utcproject.org*. See also Richard Nenno, 2006 Heckerling Outline, "Relieving Your Situs Headache: Choosing and Rechoosing the Jurisdiction for a Trust," 2006 Miami Tax Institute.
6. States with directed trust statutes are Alaska (AS 13.36.375), Delaware (Del. Code Ann. tit. 12 Sec. 3313), South Dakota (SDCL Sec.55-1B2), Texas (Tex. Prop. Code Ann. Sec.114.003), Virginia (Va. Code Ann. Sec. 26-5.2C), Washington (RCW11.98.070(27)) and Wyoming (Wy. Stat. 4-10-712). States with delegated trust statutes are Arizona (A.R.S. Sec. 17.7609), California (CA Probate Code Sec. 16052), Colorado (C.R.S. Sec. 15-1.1-109), Florida (Fla. Stat. Sec. 518.112), Illinois (760 ILCS 5/5.1), Nevada (N.R.S. 164.770), New Hampshire (N.H. New. Stat. Ann. 464-B.8. 807), New Jersey (N.J.S.A. 33:20-11.10) and New York (EPFL 11.2.3(c)).
7. Iris J. Goodwin and Pierce H. McDowell III, "Delegating Responsibility: Trustees Explore the Once Taboo," Trusts & Estates, March 1999, p. 10-14. Roy M. Adams, "Delegating," Trusts & Estates, June 2003, p.80.
8. *Ibid.*
9. Al W. King, Pierce H. McDowell, and Dr. Daniel G. Worthington, "Dynasty Trusts: What the Future Holds for Today's Technique," Trusts & Estates, April 1996, p. 38-39 Al W. King III, "The Modern Dynasty Trust: Flexibility is More Important Than Ever," Trusts & Estates, January 1998, p. 34. See also Goodwin, supra note 7.
10. *See supra,* note 6.
11. Alexander A. Bove, Jr., "Trust Protectors: Are They Friends of Fiduciaries? And Should Every Trust Have One?" *Trusts & Estates*, November 2005, p. 28; Alexander A. Bove Jr., "The Trust Protector: Trust Watchdog or Expensive Exotic Pet?" 30 *Estate Planning Journal,* 390 (August 2003).
12. Alaska (Sec. 13.36.370), Delaware (Del. Code Ann. tit. 12 Sec. 3570), Idaho (ID Stat. 15-7-501), South Dakota (SDCL 55-1B6), Wyoming (WY Stat. 4-10-710).
13. *See supra*, note 11, and South Dakota (SDCL 55-1B6).
14. *See supra*, note 6, Alaska.
15. *See supra,* note 6, Delaware.
16. *See supra*, note 6, South Dakota.
17. *See supra*, note 6, Texas.
18. *See supra*, note 6, Virginia.
19. *See supra*, note 6, Wyoming.
20. *R. Leigh Duemler v. Wilmington Trust Co.*, Del. Co., C.A. 20033, V.C. Strine (Del. Ch. Oct. 28, 2004).
21. *In Re: Martha Franck Rollins v. Branch Banking & Trust Co. of Va.trustee*, 56 Va. Cir 147;2001 Va Cir Lexis 146.
22. *See supra*, note 20. *See also* Christopher S. Armstrong, "The Private Trust Company: Can It Reconcile the Competing Imperatives of the Prudent Investor Rule and the Settlor's Direction to Retain?," *www.rmstnglaw.com*; Jo Ann Engelhardt and Philip J. Hayes, "Choice of Situs for Itinerant Trustees and Peripatetic Beneficiaries," SL003 *ALI-ABA* 395, 419 (July 2005).
23. Delaware (Del. Code Ann. Tit.12 Sec. 3313).
24. South Dakota (SDCL Section 55-1B1).
25. Texas (Tex. Prop. Code Ann. Section 114.003)
26. Ted. R. Ridlehuber, "How Effective are Exculpatory Provisions in Wills and Trusts," Cannon Financial, August Dec. 1, 2002; *www.cannonfinancial.com*; Roy M. Adams, "Use of Exculpatory Provisons," 21st Century Estate Planning Practical Applications, Cannon Financial Institute, 2005.
27. One can analogize to the private family trust company Private Letter Rulings; see PLRs 20053003, 200546055, and 200548035. *See* Internal Revenue Code Sections 2036, 2038, 2041 and 2514.29., *see also* Donald Kozusko and Mile Padgett "Private Trust Protector Companies: How Much Family Control?" , *Tax Management Memorandum* 443 (September 2002).
28. Alaska (Stat. Sec. 13.36.157, 345, 350 (1998)), Delaware (Del. Code Ann. 12 Section 3528 (2003)), New York (EPTL Section 10-6.6(b)), South Dakota (SDCL 55-3-24), Tennessee (Tenn. Pub. Acts 537 Section 74(b)27), Wyoming (Wy. Stat. 4-10-411), Uniform Trust Code Section 411.
29. Delaware Chancery Court Rule 5(8), South Dakota (SDCL 21-22-28).
30. D.C. (D.C. Code Sec. 19-1303.03), Alaska (included in trust modification statute, AS 13.36.260(c)), California (Cal. Prob. Code 1003), Delaware (Del. Code Ann. Tit. 12 Sec. 3548), Illinois (760 ILCS 5/16.1), Nevada (as to proceeding involving the estate of a decedent or testamentary trusts,NRS 155.140), New York (SCPA Art. 3 Sec. 315), South Dakota (SDCL 55-3-32), Washington (DC Code 19-1303), Wyoming (WY Stat. 4-16-304).
31. PLRs 20051806 and 200228019. Note that if a policy is being sold from a non-grantor trust to a grantor trust, it needs to be evaluated on a case-by-case basis. Generally, the fair market value of a normal policy will generally exceed cost basis around the seventh year of its existence.
32. *See supra*, note 6.
33. *See supra*, note 7.
34. Ibid.
35. *Ibid.*
36. *See supra,* note 26.
37. *See* Goodwin, *supra*, note 7; 12 C.F.R. Part 9; Charles E. Rounds Jr. and Eric P. Hayes,Loring: A Trustee Handbook, by Ed. 2006 Section 3.2.6.
38. *See supra*, notes 5 and 6.
39. *Supra* note 37, Loring Section 8.5 pages 540-541 and Scetion. 8.39, UTC Article 8 Sections 107, 108, 12 C.F.R.Section 9.14(b), *Seizer V. Sessions*, 132 Wis 2d 642, 940 p.2d 261 (1997).
40. 12 C.F.R. Part 9.