NAEPC
Journal
of Estate & Tax Planning

Click here to view Issue 22

FEATURE:
ESTATE PLANNING & TAXATION

By **Todd A. Flubacher**

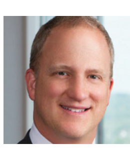
Directed Trusts: Panacea or Plague?

Proper drafting and administration can ensure that there's never a doubt who's responsible for a particular matter

Directed trusts have become commonplace over the last decade. There are only nine states that haven't enacted some form of directed trust statute,[1] and among those, several are considering such legislation. Section 808 of the Uniform Trust Code (UTC) implements the concept, and the Uniform Law Commission recently empanelled a Divided Trusteeship Committee to draft a modern uniform directed trust statute and amendments to the existing provisions of the UTC.[2] In the leading trust jurisdictions,[3] directed trust statutes are a major motivation for creating trusts and migrating existing trusts to those jurisdictions or converting them to directed trusts.

Directed trusts have become so prevalent because settlors and beneficiaries use trusts in the modern era of wealth transfer planning to implement specialized and often complex objectives that require a lack of diversification or investment in non-traditional or risky assets. Trusts frequently hold assets like concentrated positions in closely held companies (which could be on the verge of an initial public offering or buy-out from a venture capital or private equity firm), an interest in a limited liability company (LLC) (which might be the only asset of the trust), real estate or oil and gas interests. These objectives conflict with the limitations imposed by traditional fiduciary duties applicable to common law trusts, and corporate trustees are unwilling to accept the risk of liability for breaching those duties. Additionally, trust companies face an increasingly restrictive regulatory environment, and court decisions sometimes seem to treat deep-pocketed trustees as guarantors of trust performance.

Settlors can accomplish these objectives by using directed trusts that bifurcate investment responsibilities from the rest of the traditional trust administration functions, assigning them to an advisor who directs the trustee to carry out those objectives. Governing instruments are drafted with varying degrees of effectiveness to implement the directed trust concept. It's critical that a trust's governing instrument clearly and completely set forth the trust powers that are exercised only at direction, with the balance of the trustee powers exercised solely by the trustee in its own discretion. A governing instrument falling short of this standard can create ambiguities that expose the trustee to uncompensated risk. A trustee also must administer a directed trust properly to avoid risk. With attentive drafting and administration, there should never be any doubt whether the trustee or the investment advisor is responsible for a particular matter.



Todd A. Flubacher is a partner at Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Del.

Who's Responsible?

Generally, an advisor who directs the trustee with respect to investments, distributions or other duties is considered a fiduciary, unless the governing instrument provides otherwise.[4] If the governing instrument and applicable state law achieve proper bifurcation, the trustee shouldn't be liable for following directions except in cases of its own willful misconduct, and the investment advisor will be the fiduciary that's accountable for upholding fiduciary duties related to trust investments.[5]

There's very little case law addressing the authority or liability of an investment advisor. In R. Leigh Duemler v. Wilmington Trust Company,6 the Delaware Court of Chancery ordered that the trustee wasn't liable for trust investments in the absence of willful misconduct. Leigh was a sophisticated investment advisor who invested in "a nondiversified portfolio with extremely risky assets," the kind of portfolio "that requires the most diligent of monitoring."7 The court stated that 12 Del. C. Section 3313 requires the investment advisor to make investment decisions in isolation, without oversight from the trustee, because if the investment advisor doesn't make the investment decisions alone, his role wouldn't work, as the trustee would always "second guess" the investment advisor's decisions.8 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 advisor] making the decision knew what they were doing," it would "gut the statute."9 In Shelton v. Tamposi,10 a New Hampshire court recognized a directed trust structure and found that the "investment directors," and not the trustee, had full power and authority to direct the investments of the trust.

In a recent case, *Mennen v. Wilmington Trust Company, et al.*,[11] the beneficiaries of a directed trust sued the trustee and direction advisor claiming damages in excess of $100 million for breaches of fiduciary duties in connection with the trust's investments. The trustee operated under the belief that it acted solely at direction with respect to investments. The beneficiaries alleged that the investment advisor directed the trustee to invest substantially all of the trust's assets in disastrous investments in which the investment advisor was personally interested, resulting in a drop in value from over $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 Chancery Court to remove the individual trustee who served as direction advisor, for the appointment of a successor and to access certain investment information that the direction advisor was allegedly withholding. Shortly thereafter, the beneficiaries brought claims for breach of trust against both the trustee and direction advisor (who was the primary beneficiary's brother) and brought a claim against the trust that was established for the direction advisor by the same settlor, seeking a transfer of its assets to their trust on equitable grounds. The trustee also filed a cross-claim against the investment advisor for indemnification and contribution, and the direction advisor filed identical counterclaims against the trustee. The claims brought against the trustee were ultimately settled out of court. In a Draft Master's Report issued on Dec. 8, 2014, the court entered a judgment against the direction advisor in the amount of $72,448,299 plus interest, finding that he engaged in a pattern of bad faith. The parties in *Mennen* have taken exceptions and the orders are subject to appeal.

Shifting accountability from a corporate trustee to an individual investment advisor could have a significant impact on beneficiaries' ability to hold a fiduciary accountable. An individual, like a family member or friend, is often designated as the investment advisor responsible for investments that a corporate trustee may find too risky. However, an individual doesn't have the deep pockets of a corporate trustee. Thus, appointing an individual investment advisor could reduce the beneficiaries' ability to have recourse against the fiduciary if things go wrong. For example, in *Mennen*, the Chancery Court entered a separate summary judgment order holding that as creditors, the beneficiaries were prohibited from attaching the assets of the direction advisor's trust under that trust's spendthrift clause and Delaware's spendthrift statute, 12 Del. C. Section 3536.[12]

The investment advisor should accept his fiduciary obligations by signing the governing instrument. The advisor assumes certain responsibilities traditionally held by trustees, and the governing instrument sets forth the terms and conditions of the investment advisor's authority, duties and standard of liability. The governing instrument may also impose obligations on the investment advisor, such as requiring him to provide information or valuations to the trustee.

Authority to Act

A 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 trustee should act only on written direction. While the previous statement seems obvious, many governing instruments simply state that the investment advisor may direct the trustee to exercise certain powers but don't clearly state that the trustee may exercise those powers only on written direction. A provision that states the investment advisor "may direct" the trustee is insufficient. Unless the governing instrument provides that the trustee can only exercise certain powers when directed, it could be argued that in addition to exercising powers as directed, the trustee could also independently exercise those powers.

Investment advisor provision should cross-reference all investment powers. The only powers exercisable by a trustee are the powers conferred by the governing instrument, plus those powers conferred by applicable law.[13] Thus, the complete set of powers possessed by a trustee is readily identifiable, and any power beyond that is ultra vires. An investment advisor provision should cross-reference all trustee powers granted by both the governing instrument and statute. Ambiguities will arise if a governing instrument uses generic words to attempt to describe all of the investment powers subject to direction. Without actually cross-referencing all investment powers, there's a risk a beneficiary could argue that: (1) the trustee possessed independent power that could have been exercised to mitigate investment losses, or (2) the powers the trustee exercised weren't clearly covered by the investment advisor language in the governing instrument.

For example, suppose a document states the trustee shall act only on direction with respect to "the retention, purchase, sale, exchange, tender or other transaction affecting the ownership thereof or rights therein and with respect to nonpublicly traded investments, the valuation" of trust assets (or similar language).[14] During the administration of the trust, when the trustee receives a direction to execute a complicated transaction, it may be unclear whether the powers necessary to complete the transac-

tion clearly fall within the scope of this language. Assume the trustee is directed to pledge trust assets and borrow funds that the trust will then loan to an LLC owned by another trust that has the same beneficiaries. Can the trustee rely on a direction letter and be protected from liability if it's not clear that powers, such as making guarantees, pledges and loans to trusts for the same beneficiaries, fall within the scope of the investment advisor provision? Trustees are routinely directed to enter into complex transactions like stock purchase agreements, voting proxies or powers of attorney, payment of real estate taxes or life insurance premiums, leases, security agreements, formation of special purpose entities, loans, guarantees, registration statements or documents that include representations and warranties. The trustee very well may possess the requisite power among the long list of trustee powers in the governing instrument, but it might be questionable whether those powers fall within the scope of the investment advisor provision. Why would a governing instrument attempt to describe all of the trustee's investment powers with a few generic descriptive words when all of the actual powers are spelled out in great detail in the governing instrument and by statute? Beneficiaries could use such an ambiguous provision to argue that investment losses were the result of actions taken by the trustee that weren't within the scope of the investment advisor provision.

The list of directed trustee powers must be complete. Even if the investment advisor provision cross-references investment powers in the governing instrument, one could argue that the trustee also had an independent power to act if all investment powers aren't cross-referenced, including those 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 maintain 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 made in *Mennen*.[15] They argued that the trustee possessed powers granted in the trust agreement, which 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.

Was Trustee Properly Directed?

It's also critical that the trustee acts solely on the written direction of an investment advisor memorialized in a properly drafted direction letter. The direction letter should leave no room for ambiguity, expressly directing the trustee to take an explicit action. To the extent that the trustee is being directed to execute a document, the final form of that document should be attached to the letter with a direction to execute it. The direction letter shouldn't leave any discretion to the trustee as to how to take a specific action. For example, a direction letter shouldn't instruct the trustee to simply create an LLC, enter into a note for a certain amount or enter into a purchase agreement on terms and conditions as the trustee determines. It's also hazardous for the direction letter to include a catch-all provision that directs the trustee to "take any other actions that are necessary or appropriate." If something goes wrong with the investments, the beneficiaries could argue that such language directed and authorized the trustee to take appropriate actions to prevent the harm.

Other Trustee Fiduciary Duties

There's limited case law suggesting that even if a trustee is exonerated from liability with respect to decisions made by an investment advisor, the trustee may have an overriding duty to warn beneficiaries. A Virginia trial court in *Rollins v. Branch Banking & Trust Company of Virginia*[16] 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. The *Rollins* court found that even though "[t]he beneficiaries, alone, had the power to make investment decisions" and the trustee wasn't liable for failure to diversify the trust in accordance with the investment decisions made by the beneficiaries, nevertheless, the trustee had an overriding duty to warn the beneficiaries about the impending decline in the value of the concentrated position of stock. 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."[17]

The bifurcation of responsibilities can produce a conflict between the duties of the trustee and its limited access to areas of administration under the advisor's control. For example, when a directed trust is structured to hold an interest in an LLC, the trustee has no control over the LLC, and the LLC manager may not provide

the trustee with information about the LLC's operations or value (or even provide the trust with liquidity to fund expenses, trustee compensation or litigation costs). Yet, the trustee has a fiduciary duty to value the trust's assets and provide the beneficiaries with accurate account statements.[18] To address this situation, it's advisable to include provisions in the LLC operating agreement that grant the LLC members the right to obtain necessary information the trustee needs to fulfill its fiduciary duties. In addition, the directed trust provisions of the governing instrument should impose an obligation on the investment advisor to provide information to the trustee. Some states, like Illinois and Delaware, have statutes that impose a duty on the advisor to provide information to the trustee that's reasonably necessary for the trustee to perform its duties.[19]

A beneficiary could, theoretically, argue that a trustee has a duty to exercise its rights under applicable law to bring a books and records action to obtain information necessary to value the trust's interest and fulfill its duty to account if the LLC manager refused to provide the information voluntarily. There's little guidance under LLC law whether a trustee has a right, in the absence of a provision in the LLC operating agreement, to obtain information necessary to value the trust's interest so the trustee can provide proper account statements to the beneficiaries. However, books and records issues have been litigated numerous times in corporate, LLC and limited partnership cases, and it's generally clear that even in the absence of a right granted in the LLC agreement, a member of an LLC is entitled to obtain information for a proper purpose reasonably related to the member's interest.[20] The valuation of one's ownership interest has consistently been held to be a proper purpose for seeking books and records.[21] For example, assume that a directed trust holds an interest in an LLC once worth $50 million and the trustee has included that value on the beneficiaries' statements. However, the value of the LLC dropped to $30 million and, for years, the manager of the LLC has refused to provide updated information to the trustee for it to properly value the trust's interest. When the beneficiaries discover the harm to the trust's value, they could blame the trustee for failing to properly value the LLC interest and misinforming them on the account statements. They might argue the trustee should have pursued all available rights as a member of the LLC to obtain necessary information to properly value its interest. From the trustee's perspective, it's obviously better to have a provision in the trust's governing instrument that states that the trustee shall only report values on non-marketable assets as directed by the investment advisor or a provision in the governing agreement or LLC agreement that requires information to be provided to the trustee.

Larger Role for Trustee?

A trustee should perform as much due diligence as it deems appropriate prior to accepting a directed trust, and such due diligence shouldn't undermine the protections available to a trustee. Trust companies typically use their new business intake process to inquire into the identity of the investment advisor and the nature of the assets to be held by the trust. It's advisable for a trust company to perform such due diligence before entering into the fiduciary role to avoid reputation, litigation or other business risk.

The governing instrument should be drafted to permit the trustee to conduct any desired due diligence during the administration of the trust and to require the investment advisor to provide the trustee with sufficient information. Many directed trust statutes waive the trustee's duty to monitor, inform or remedy breaches of trust by the advisor. Some states, like Delaware and South Dakota, go one step further and provide that certain activities performed by the trustee that might arguably creep into the authority of the investment advisor are presumed to be administrative actions solely to allow the trustee to perform its duties and shall not be deemed to constitute an undertaking by the trustee to monitor the investment advisor or otherwise participate in actions within the scope of the investment advisor's authority.[22]

A trustee could, theoretically, expose itself to liability based on the trustee's course of conduct. For example, it's possible that regularly providing the investment advisor with advice or making requests for information could give rise to equitable theories of liability, such as equitable estoppel, or expose the trustee to liability if the trustee discovers egregious facts that might require the trustee to seek some sort of remedy. The investment advisor could theoretically argue that notwithstanding the terms of the governing instrument, the trustee's regular advice or requests for information led the investment advisor to believe that the trustee had assumed responsibility or was independently monitoring the assets, and the investment advisor relied on such advice and monitoring. Although it's not at all clear whether such an argument would be successful, it's theoretically possible that the more involved the trustee is with investment decisions, the more likely an aggrieved beneficiary (or even an investment advisor) could argue that the investment advisor was somehow relying on the trustee's independent judgment.

These risks underscore the importance of drafting a governing instrument to clearly delineate responsibilities and eliminate liability in connection with such activities. To avoid any improper expectations by the beneficiaries or investment advisor, the trustee should make requests for information and documentation from an investment advisor, or any advice or consultation with the investment advisor, in a writing that states that: (1) the trustee is only acting in a limited role as a trustee, (2) the trustee doesn't waive any protection available under the governing instrument or applicable law, and (3) the communication may not be relied on by the investment advisor or any beneficiary and shall be deemed to merely constitute administrative steps taken for the trustee to carry out its limited role as a directed trustee.

Improper Directions to Trustee

Trustees will occasionally receive directions they believe to be improper. When this happens, the trustee must first ascertain whether it has the power to follow the direction. For example, if a trustee is directed to distribute trust assets to an individual who's not a beneficiary or make an investment that the trustee doesn't have the power to make, then the trustee should refuse to follow the direction on the basis that it's been directed to do something it doesn't have the power to do. However, it's a much tougher question if the trustee has the power (and is required) to follow a direction, but the decision by the advisor is clearly wrong. For example, consider the following scenarios I've seen in my practice: (1) the trustee is directed to enter into transactions that clearly constitute self-dealing or bad faith on the part of the investment advisor; (2) the trustee received numerous directions to lend money to the investment advisor personally with interest-only notes at the applicable federal rate, and the trustee knows the advisor has no intention of ever making a payment on the loan; (3) the trustee is directed to sign an agreement that contains representations and warranties the trustee doesn't know to be true or believes to be false; or (4) the trustee is directed to invest in an asset that requires the trust to be an accredited investor, and the trustee knows that it doesn't qualify. In some of these cases, such as the accredited investor scenario, the trustee could deem the direction to exceed the trustee's power, but in others, the trustee is arguably compelled to follow the direction according to the terms of the governing instrument. Should the trustee refuse the direction, notify the beneficiaries or file a petition with the court? What if the governing instrument limits the trustee's ability to inform beneficiaries, like a so-called "silent trust?"

Putting It All Together

To mitigate risk, a trustee should follow certain procedures every time it's directed to take an action. The trustee should review the direction letter to ensure that it's specific and leaves no discretion to the trustee. The trustee should also review the governing instrument and the transaction documents it's being asked to sign to determine that: (1) the trustee possesses the requisite power to execute the direction, (2) the direction isn't in violation of the governing instrument, (3) the investment advisor has the authority under the governing instrument to direct it with respect to the exercise of the investment powers necessary to take the action, and (4) the direction doesn't involve an action that's illegal or against public policy or that would otherwise preclude the trustee from being able to execute it. If the investment advisor has the authority to direct the trustee to take the action, the direction letter is sufficiently specific and the trustee's power can be properly exercised, the trustee must follow the directions, notwithstanding any reservations the trustee may have as to the propriety of such directions.

Difficult issues may arise if the trustee is directed to take an action that may cause a problem. While directed trusts are a powerful tool relied on by settlors, beneficiaries and trustees, there are pitfalls to avoid by careful drafting and trust administration. For most existing directed trusts, the settlor actually intended to completely allocate investment responsibility to an advisor and didn't anticipate the risk resulting from ambiguities like those described in this article. In such cases, it should be possible to correct these issues using techniques such as a non-judicial settlement agreement that construes the trust to clarify the direction language to effectuate the settlor's intent and achieve complete bifurcation.

Endnotes

1. Those states are: California, Connecticut, Hawaii, Louisiana, Minnesota, New Jersey, New York, Rhode Island and Washington.
2. Depending on the effectiveness of a state's statute, the trustee could remain ultimately responsible for the investment decisions of the advisor like, for example, the approach taken under Uniform Trust Code (UTC) Section 808, which provides that the trustee may be liable if the directed actions constitute a breach of fiduciary duty by the advisor.
3. Those jurisdictions include: Alaska, Delaware, New Hampshire, Nevada, South Dakota and a growing list of other jurisdictions entering the competition. *See* Daniel G. Worthington and Mark Merric, "Which Trust Situs Is Best in 2014?" *Trusts & Estates* (January 2014) at p. 53.
4. *See* UTC Section 808; 12 Del. C. Section 3313.
5. Except as may be varied by the governing instrument, the advisor possesses traditional fiduciary duties of care, loyalty and impartiality and will be subject to the traditional standard of liability.
6. *R. Leigh Duemler v. Wilmington Trust Company*, C.A. 20033, V.C. Strine (Del. Ch. Oct. 28, 2004) (Trans).
7. *Ibid.*, at pp. 11-12.
8. *Ibid.*, at p. 11.
9. *Ibid.*, at p. 16.
10. *Shelton v. Tamposi*, 164 N.H. 499 (Jan. 11, 2013).
11. *See Mennen v. Wilmington Trust Company, George Jeffrey Mennen and Owen J. Roberts as Trustees*, C.A. No. 8432-ML, and *Mennen v. Wilmington Trust Company, George Jeffrey Mennen and Owen J. Roberts as Trustees*, C.A. No. 8432-ML, Master LeGrow (Del. Ch. Dec. 8, 2014) (Master's Final Report).
12. *Mennen,* Master LeGrow (Del. Ch. Jan. 17, 2014) (Master's Draft Report).
13. *See Restatement (Second) of Trusts* Section 186.
14. This language comes directly from the definition of "investment decisions" found in 12 Del. C. Section 3313(d).
15. *Mennen, supra* note 11.
16. *Rollins v. Branch Banking & Trust Company of Virginia*, 2001 WL 34037931 (Va. Cir. Ct. April 30, 2001).
17. *Ibid.*, at p. 3.
18. The governing instrument may provide that the trustee shall value assets only as directed, but in the absence of such language, the trustee has a fiduciary duty to value the assets.
19. *See* 760 Ill. Comp. Stat. 5/16.3(h), 12 Del. C. Section 3317.
20. *See, e.g.,* 6 Del. C. Section 18-305.
21. *See State ex rel. Rogers v. Sherman Oil Co*, Del. Super., 117 A. 122, 125 (1922) (holding "valuation of one's shares is a proper purpose for the inspection of corporate books and records"); *CM & M Grp., Inc. v. Carroll*, 453 A.2d 788, 792 (Del. 1982); *Somerville S Trust v. USV Partners*, LLC, 2002 WL 1832830, at *5 (Del. Ch. Aug. 2, 2002) (holding "It is undisputed that both of Somerville's stated purposes are proper as a matter of Delaware law").
22. *See* 12 Del. C. Section 3313(e); S.D. Codified Laws Section 55-1B-2(3).