DIRECTED TRUSTS: EVERYTHING YOU NEED TO KNOW

A PRESENTATION FOR THE DELAWARE BANKERS ASSOCIATION
2011 DELAWARE TRUST CONFERENCE

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Delaware
Original Delaware Directed Trustee Statute Enacted in 1985

- Delaware’s original directed trustee statute provided:

  “Where one or more persons are given the authority by the terms of a governing instrument to direct, consent to, or disapprove a fiduciary’s investment decisions, or proposed investment decisions, such persons shall be considered to be fiduciaries when exercising such authority unless the governing instrument provides otherwise. Any fiduciary acting in compliance with such an authorized direction or disapproval shall not be liable individually or as a fiduciary for any loss resulting from an action taken or omitted by reason of such compliance.” 65 Del. Laws, C. 422.
Delaware’s Current Directed Trustee’s Statute: Section 3313

Delaware’s current directed trustee statute provides:

§ 3313. Advisers.

(a) Where 1 or more persons are given authority by the terms of a governing instrument to direct, consent to or disapprove a fiduciary's actual or proposed investment decisions, distribution decisions or other decision of the fiduciary, such persons shall be considered to be advisers and fiduciaries when exercising such authority unless the governing instrument otherwise provides.

(b) If a governing instrument provides that a fiduciary is to follow the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act.

(c) If a governing instrument provides that a fiduciary is to make decisions with the consent of an adviser, then except in cases of willful misconduct or gross negligence on the part of the fiduciary, the fiduciary shall not be liable for any loss resulting directly or indirectly from any act taken or omitted as a result of such adviser's failure to provide such consent after having been requested to do so by the fiduciary.

(d) For purposes of this section, "investment decision" means with respect to any investment, 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 thereof, and an adviser with authority with respect to such decisions is an investment adviser.

(e) Whenever a governing instrument provides that a fiduciary is to follow the direction of an adviser with respect to investment decisions, distribution decisions, or other decisions of the fiduciary, then, except to the extent that the governing instrument provides otherwise, the fiduciary 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.

Absent clear and convincing evidence to the contrary, the actions of the fiduciary pertaining to matters within the scope of the adviser's authority (such as confirming that the adviser's directions have been carried out and recording and reporting actions taken at the adviser's direction), shall be presumed to be administrative actions taken by the fiduciary solely to allow the fiduciary to perform those duties assigned to the fiduciary under the governing instrument and such administrative actions shall not be deemed to constitute an undertaking by the fiduciary to monitor the adviser or otherwise participate in actions within the scope of the adviser's authority.

(f) For purposes of this section, the term "adviser" shall include a "protector" who shall have all of the power and authority granted to the protector by the terms of the governing instrument, which may include but shall not be limited to:

1. The power to remove and appoint trustees, advisers, trust committee members, and other protectors; and
2. The power to modify or amend the governing instrument to achieve favorable tax status or to facilitate the efficient administration of the trust; and
3. The power to modify, expand, or restrict the terms of a power of appointment granted to a beneficiary by the governing instrument.
Observations About Section 3313

- 3313(a) provides:
  - An adviser may direct, consent or disapprove.
  - The adviser may direct, consent or disapprove investment decisions, distribution decisions or any other decision of the fiduciary.
  - Such a person shall be a “adviser”.
  - Such person shall be a “fiduciary” unless the governing instrument provides otherwise.
Section 3313 (cont.)

- Section 3313(b) provides that if the governing instrument requires a fiduciary to follow the direction of an adviser then the fiduciary shall not be liable when so directed except in cases of willful misconduct.

- Section 3313(c) provides that if a fiduciary is to make decisions with the consent of an adviser, then the fiduciary shall not be liable for any loss except in cases of willful misconduct or gross negligence.
Willful Misconduct Definition

- Section 3301(g) defines the term “willful misconduct” as “intentional wrong doing, not mere negligence, gross negligence or recklessness” and “wrong doing” means malicious conduct or conduct designed to defraud or seek an unconscionable advantage.”
Section 3313 (cont.)

- Section 3313(d) defines the term “investment decision”.
- An investment decision means “with respect to any investment, the retention, purchase, sale, exchange, tender or other transaction effecting the ownership thereof or rights therein and with respect to non publicly traded investments, the valuation thereof, and an adviser with authority with respect to such decisions is an investment adviser.”
Section 3313 (cont.)

- Section 3313(e) clarifies that a fiduciary that follows the direction of an adviser with respect to any decision shall have no duty to monitor, advise with respect to, warn or otherwise interfere with the decisions of the adviser and that any such actions taken by the fiduciary shall be presumed to be administrative actions taken solely to allow the fiduciary to perform the duties assigned to the fiduciary acting at direction.

- This subsection is intended to clarify the bifurcation of the investment function from the trustees duties.
Section 3313 (cont.)

- Section 3313(f) provides that the term “adviser” shall include a “protector” who shall have any powers and authorities granted under the terms of the governing instrument and which may include but shall not be limited to the power to remove and appoint trustees or other fiduciaries, the power to modify or amend the governing instrument, and the power to modify, expand, or restrict the terms of the power of appointment granted to a beneficiary.
The Duemler Case

- Delaware has a common law opinion that upholds the willful misconduct statutory defense under Section 3313(b).


- In this case, Vice Chancellor Strine explained that if the trustee were liable for the failure to provide information or to make sure that the investment adviser knew what it is doing, it would “gut the statute”. If the investment adviser does not make the investment decisions alone, the investment advisers role would not work, as the trustee would always “second guess” the investment adviser’s decisions.

ADDITIONAL RELEVANT CASE LAW

- Paradee v. Paradee, C.A. No 4988-VCL, October 5, 2010 (memorandum opinion) which cited §3313 even though there was not a trust adviser.

- Rollins v. Branch Banking, Trust Company of Virginia, 2001 Va.Cir.Lexis 146 (Va. Cir. Ct. 2001) which upheld the statute but held that the trustee was liable and could not “rid himself of this duty to warn”.

Uses for Directed Trusts

- Investments
- Distributions
- Beneficiary Notification
- Valuations
- Tax Reporting
- Change of Situs and Governing Law
- Amendment of Trust Instrument
- Other
Investment Direction Adviser

- Direction as to all investments or certain special holdings.
- Valuation of non publicly traded securities.
- Execution of documents.
- Reps and warranties.
Distribution Adviser

- Distribution adviser or committee to provide someone other than an institutional fiduciary with knowledge of the family needs to make distribution decisions.
- Distribution committee of adverse persons to achieve nongrantor trust treatment.
- Frequently advisable for special needs trusts.
Other Uses of Direction Advisers

- Direction to trustee with regard to notification of beneficial interests and information provided to beneficiaries.
- Tax reporting.
- Amendments to the trust agreement.
- Change of situs.
- Change of governing law.
The Adviser Does Not Take on The Trust Power and Authority

- Often, drafters take the approach that all of the investment power and authority is to be held by the adviser, and the trustee shall have no trust power and authority over investments. This is not how a directed trust is structured.

- The trustee holds the trust power and authority to take actions and the direction adviser directs the trustee to exercise those powers.
Requirements for Effective Bifurcation

- A directed trust is NOT like a delegation.
- Trustee should only be liable for willful misconduct, not gross negligence or any other standard.
  - It is the willful misconduct standard that enables the trustee to follow direction without monitoring or second guessing the decisions of the investment adviser.
- Trustee must act solely at direction.
  - A provision in the trust instrument that merely provides that the adviser may direct the trustee, without expressly providing that the trustee shall only act upon direction, arguably sets up a simultaneous duty for the trustee to take directions and also to act in its own discretion.
- The investment adviser provision in the trust instrument should be detailed and all-inclusive.
  - The investment adviser provision in the trust instrument should not merely include a short generic description of investment decisions or simply limit the scope of the direction power to “investment decisions” under Section 3313(d) – it should be as specific and inclusive as possible and should ideally cross reference all investment trustee powers in the instrument.
- The adviser provision should not enable the adviser to toggle between consent or direction. This could shift unwanted responsibility onto the trustee.
Requirements for Effective Bifurcation (Cont.)

- Trustee should have no duty to monitor or supervise the adviser.
- The direction letter must be specific and detailed.
  - The letter should basically say “buy this asset” or “signed the attached document”.
- Trustee should have no ability to exercise discretion with respect to the directions under the instrument or pursuant to the direction letter.
  - For example, the direction letter should not just say that the trustee shall enter into a note upon such terms as the trustee may determine.
- Trustee should not have the power to remove or appoint the adviser. This may effectively create a delegation arrangement and make the trustee responsible for the decisions to hire and fire the adviser and the advisability of maintaining the adviser.
Other Statutory Approaches

- If the statute follows the approach in Section 808(b) of the Uniform Trust Code, providing that 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”, then the trustee continues to possess the fiduciary responsibility and liability for deciding whether to follow the direction. This does not effectively bifurcate the responsibilities.

- If the trustee is not required to follow the direction, like the Alaska statute, then the trustee continues to possess the fiduciary responsibility and liability for deciding whether to follow the direction. This does not effectively bifurcate the responsibilities.
Why Consent under Sec. 3313(c) Does Not Work

- The Trustee should always act solely at direction or in its sole and absolute discretion. The trustee should not act with the consent of an adviser, as provided in Section 3313(c).

- If the Trustee must act with the consent of an adviser, then the Trustee possesses all of the fiduciary responsibility and liability for the trust investments, yet the trustee can only implement its strategies and decisions after obtaining the consent of some third-party adviser who may or may not grant its consent. The result is that the Trustee must go through the administrative task of seeking, obtaining and documenting consents, and the Trustee will responsible and liable for a portfolio that does not necessarily reflect it’s own decisions unless the consent adviser always agrees with the trustee.

- The consent adviser structure is fraught with a high degree of administrative hassle and risk. It is an untenable arrangement.
What Happens If There Is No Longer An Investment Adviser

- The trust instrument should expressly provide that at any time that there is no investment adviser serving, the trustee shall exercise all powers theretofore exercised at direction in its own discretion.

- In this case the trustee will be left holding and managing a portfolio of investments that it did not select and with which it may not agree. The trust instrument should provide exculpation for the trustee when it assumes investment responsibility.
  - The trustee should have no duty to review, investigate or remedy any decisions of the investment adviser that served previously.
  - The trustee should have no liability for retention of assets selected by the previous investment adviser and should have the power and discretion to retain, sell and invest and reinvest assets as it deems appropriate in its sole discretion and without liability.
Direction In The Governing Instrument – Section 3304

- Section 3304 now provides that a direction to retain property in the governing instrument shall be deemed to waive any duty of diversification and shall exonerate the fiduciary from liability for retaining the property except in the case of willful misconduct.

- Thus, a settlor who creates a trust with a specific investment strategy in mind may effectively carry out that strategy like a directed trust using Section 3304.
The Direction Letter

- Directions should be delivered to the trustee in writing.
- The direction letter should be specific and should leave no discretion to the trustee.
- The direction letter should recite the provisions of § 3313 so the Trust Advisor clearly understands the bifurcation of the roles for each direction.
- If there are documents to be signed, the direction letter should have those documents attached to it, essentially stating “sign here”.
- Consider having annual letter signed by advisor confirming
  - he or she is still in that role
  - still directs the trustee to perform the given act, and
  - the current value of the asset (where applicable).
Structuring the Ownership of the Assets

- Becoming common to see assets held in a single member LLC, where the trustee is directed to hold that LLC. Administrative activity is done by the LLC manager, not the trustee. Settlors often want as much control as possible.

- Be mindful of minimum requirements for Delaware nexus. The list of factors often considered is in Lewis v. Hansen, 128 A.2d 819 (Del. Supr. 1957), aff’d sub nom. Hanson v Denckla, 357 U.S. 235, reh’g denied , 358 U.S. 858 (1958).

- Also be mindful of the possibility that the state of Trust Advisor asserting jurisdiction – conflicts of laws issues possible.

- Also consider logistics for preparation of any tax returns needed at the LLC level.
Holding Real Estate in a Directed Trust

- Make sure the trust instrument or letter of direction clearly outlines duties such as payment of real estate taxes and insurance.
- Real estate should be held in LLC or similar entity
  - Isolates liability to that asset
  - Permits real estate to be held in perpetuity 25 Del. C.§503 (e).
  - Should limit other state’s jurisdiction over the trust, preventing in rem jurisdiction over the entire trust.
Longer Term Considerations for the Role of the Trust Advisor

- What is the long term succession plan for the role of the Trust Advisor?
  - Will this role be needed after death of Settlor?
  - Will the trustee be asked to choose the Trust Advisor?

- What if the trustee has questions about the Trust Advisor’s mental capacity at a later date?
  - Same considerations for acting with a co-trustee
  - However, the need to act quickly is important as the trustee’s role is to timely execute the directions of the Trust Advisor.
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