

WHO'S IN CHARGE—USING DIRECTED TRUSTS

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2015 STANLEY M. JOHANSON
Estate Planning Workshop
December 4, 2015
Austin, Texas

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State Bar of Texas Charitable Giving Program (2004)
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Texas Bankers Association Trust School II (2003-2007)
State Bar of Texas - State Bar College Summer School (2006)
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WHO'S IN CHARGE—USING DIRECTED TRUSTS

I. BASICS OF DIRECTED TRUSTS

A. Definition

A directed trust is a trust in which the settlor retains or gives a third party the power to direct, consent to or refuse an action that is traditionally performed at the discretion of the trustee. The power to direct, consent to or refuse an action may relate to investment decisions, management decisions, distribution decisions or any other decision affecting the administration of the trust.

B. History

Traditionally, the settlor of a trust names a trustee to administer a trust for the benefit of the beneficiaries pursuant to the terms of the trust agreement. The trustee is responsible for decisions involving trust investments, asset management, distributions to beneficiaries, tax strategy and compliance, and recordkeeping. Over time, as the value of family owned entities have increased, and the portfolios of wealthy families have become increasingly diversified, the role of trustee has evolved to address new challenges and opportunities in trust administration.

Wealthy families have utilized directed trust concepts for nearly a century to allow settlors to maintain control of family owned entities while sharing the economic benefits of ownership with beneficiaries. Twenty-nine years ago Delaware, the first state to do so, recognized by statute a settlor's ability to appoint trust advisors who may participate in trust administration and thereby restrict a trustee's authority to dispose of or otherwise deal with specified trust assets.¹ Today all but nine states have enacted some form of directed trust statute.²

In recent years, corporate trustees have experienced increased regulation and consolidation in the financial services industry, leading to restrictive internal policies which make it increasingly difficult for corporate trust departments to manage unique family assets—e.g., golf courses, ranches or other legacy assets that may be unprofitable during certain economic cycles. In light of these challenges, and in order to remain competitive in the businesses of trust drafting and service as corporate trustees, state bar and bankers associations have successfully lobbied for legislation to ratify directed trust concepts. As a result, the starting point for the creation of directed trusts is the statutory framework that ratifies their use combined with a carefully drafted trust agreement.

II. STATUTORY FRAMEWORK

A. Model Law

State legislatures tend to follow one of three approaches when drafting directed trust statutes: (1) Restatement (Second) of Trusts; (2) the Uniform Trust Code; or (3) the Delaware approach. Each approach is described in detail below.

¹ See 12 DEL. C. § 3313 (65 Laws 1986, ch. 422, § 5).

² Todd A. Flubacher, *Directed Trusts: Panacea or Plague?*, Trusts & Estates Magazine, Feb. 2015.

1. RESTATEMENT (SECOND) OF TRUSTS § 185 (1959). DUTY WITH RESPECT TO PERSON HOLDING POWER OF CONTROL

Restatement (Second) of Trusts, § 185 provides,

If under the terms of the trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of such power, unless the attempted exercise of the power violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power.

a. Role of Trust Advisor.³ Restatement (Second) of Trusts (referred to herein as “Restatement 2d”) § 185 ratifies the trust advisor role where the trust terms provide that a person or class of persons have the power to control the action of the trustee as to some aspect of trust administration. The trust advisor may be a co-trustee, the settlor, a beneficiary, or an unrelated third party.

b. Trustees Duty to Act; Trustee Liability.⁴ Under the terms of the trust, the trust advisor may have control over trustee action by either a power to direct or a requirement of advisor consent. Upon the trust advisor’s exercise of a power to direct, the trustee has a duty to act and is ordinarily liable for losses resulting from a breach of that duty to act. Similarly, in the absence of the trust advisor’s consent, the trustee has a duty to abstain from action and is ordinarily liable for losses resulting from a breach of that duty. But see “Trustee Duty to Monitor Advisor and Advise,” below.

Example:

- If the trust terms provide that a trust advisor shall direct trustee in investments or sales of securities, the trustee shall not invest in or sell any securities without the advisor’s direction or consent, as applicable. Ordinarily, the trustee is under a duty to comply with these terms, and is not liable if he complies, but the trustee is liable for a loss resulting from his failure to comply, by either refusing to invest or sell securities when a trust advisor so directs or investing or selling securities without the requisite consent.

c. Trustee Duty to Monitor Advisor and Advise.⁵ Whether subject to trust advisor direction or consent, the trustee’s duty to comply is contingent upon whether the “exercise of the [trust advisor’s] power violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power.”

³ Restatement 2d § 185, comment a.

⁴ Restatement 2d § 185, comment b.

⁵ Restatement 2d § 185, comments e, f and g.

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First appeared as part of the conference materials for the
2015 Stanley M. Johanson Estate Planning Workshop session
"Who's in Charge—Using Directed Trusts"