

# PERSPECTIVE



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## TO WHOM SHOULD I DIRECT YOUR REQUEST?

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The answer depends on who has the responsibility for the decision: the trustee or an advisor. And the better choice? This article attempts to answer this question.

When the conversation turns to trust law in Alaska and Delaware, asset protection trusts (APTs) come first to mind, and with good reason. The ability of an individual to create an irrevocable trust from which he or she retains powers of enjoyment (albeit limited) while at the same time protect his assets from creditors is significant. But actually, from a grantor's point of view, so-called "directed trusts" in which some fiduciary responsibilities are handled by advisors are far more useful. And despite the attention given directed trusts, in fact, many trust creators still find corporate trustees attractive because of their recordkeeping capabilities, communication systems, impartiality, and perpetual life. Grantors ask if only there were a way to combine the advantages of a corporate trustee without having it manage investments. A directed trust is a way for grantors to combine the advantages of administrative expertise while preserving their choice of advisors.

That there are today directed trust statutes shows how far the fiduciary world has progressed over the years. Common law has long held that trustees are personally responsible for every aspect of a trust's administration. Furthermore, even though trustees are authorized to hire agents to assist them in the performance of their duties, they cannot delegate their fiduciary responsibility to such agents. Increasingly complex investment instruments, tax code changes, and even new types of trusts like generation-skipping transfer trusts (GSTs) have challenged traditional trustees to administer trusts without the benefit of outside specialists.

Directed trusts are ones in which one or more fiduciary duties have been given by the governing instrument to a third party authorized to direct the actions of the trustee in these matters. "Advisors" may be the grantor himself, family members, long-time family advisors, and investment companies individually or as "committees" appointed in the trust document. Their role may be that of a co-trustee, an advisor, or trust protector. Initially an investment management option, the concept can be applied to all aspects of a trustee's duties, including discretionary distributions.

Directed trusts are useful because they greatly expand the types of assets that can be held comfortably by a corporate trustee. Corporate trustees traditionally prefer income-producing financial assets that are easily marketable or readily turned to cash, and have shied away from holding "special assets," such as real estate, especially out-of-state real estate; closely-held corporations; limited partnerships, or any other asset that does not meet the corporate trustee's marketability or liquidity standards. Without a directed trust provision that protects the corporate trustee, these assets represent a minefield through which the corporate trustee must tread very carefully to avoid fiduciary liability and attendant costs in legal fees.

Liability arises from many factors, including the retention of non-income producing assets, investments managed by third parties, and the unreasonable expectation that a trustee has experience and expertise in running all types of businesses from a widget factory, a mom-and-pop grocery store, or a commercial real estate development company.

In a directed trust these concerns are avoided when a bank holds limited liability companies, corporations or partnership interests because management decisions are made internally or by the investment advisor, not the trustee.

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Any decisions pertaining to the retention, management or sale of the asset are left to professionals, and the corporate trustee is protected from liability by both the terms of the instrument and statutory law.

Directed trusts work when there is the issue of a single-stock and/or over-concentrated portfolio that violate sound fiduciary practice. Regulatory guidelines require diversification as a risk control measure. When times are good, the direction advisor directing the retention of the stock is a hero, but what happens when times change and the family business is no longer a good investment?

When previously indivisible assets like real estate or investment accounts are contributed to limited liability companies and partnership interests, they become divisible into smaller pieces. The older generation can, in turn, give these portions to the younger generation as part of a value-shifting plan.

Directed trusts raise many issues for the corporate trustee. The primary issue is liability and its close relation, accountability. Another is the degree to which the corporate trustee must review or communicate the decisions of the advisor and what obligations, if any, does the trustee owe the advisor or the beneficiaries. The decisions in the following two cases are illustrative.

In a Delaware case the corporate trustee was sued by the individual co-trustee who was the trust's sole investment advisor because the corporate trustee did not inform the advisor that a bond had defaulted. The court ruled in favor of the corporate trustee, saying "it was absolutely clear that this was on [the advisor's] side of the ledger," and there was clearly no evidence of the corporate trustee's willful misconduct. A Virginia case reinforced the fact that the "court cannot hold a trustee, or anyone else, liable for decisions that it did not and could not have made."

#### Liability of the Corporate Trustee

As the possessor of "deep pockets," corporate trustees consider the liability attached to a breach of trust to be a major concern. Two of the most venerable and authoritative sources, Scott's Restatement of Trust Second and Third and the Uniform Trust Code (UTC), offer scant comfort to a concerned trustee. Scott holds that a trustee must obey an advisor's direction except when the advisor's attempted exercise is "contrary to the terms of the trust or power or that the trustee knows ... that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries." In other words, the corporate trustee must obey the advisor's direction or be guilty of a breach of trust, while at the same time the corporate trustee must review the direction to see if it is contrary to the terms of the trust!

Under the Restatements, the trustee not only loses protection from liability but also assumes a continuing, potentially limitless responsibility to monitor the actions of the third-party advisor. These responsibilities include the duty to provide the advisor with information upon which the advisor can make a decision. The fiduciary's workload is not lessened and arguably increases, at the same time that the trustee has no authority over the advisor. Furthermore, the Restatements put the burden on the trustee, not the advisor, to decide whether a direction is "manifestly contrary" or just contrary to the terms of the trust. Meanwhile, beneficiaries clamor for discounted trustee fees because in their mind, the trustee has less to do!

Trustees fare no better under the Uniform Trust Code. Like the Restatement, the UTC directs the trustee to "act in accordance with an exercise of the power [of the advisor] unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows that the attempted exercise would constitute a serious breach of a fiduciary duty."

While the UTC acknowledges that the power to direct is "most effective when the trustee is not deterred ... by fear of potential liability," it reiterates that "the trustee does have overall responsibility for seeing that the terms of the trust are honored" and considers this oversight to be "only minimal." If the governing instrument so states, however, the trustee can accept the advisor's decision without question. To balance these competing concerns responsibly, the directed trustee may well seek clarification or approval of the instructions provided by the selected advisors. With communication among the interested parties, the trust creator and the trustee are assured that the intent of the trust can be implemented.

Where does the authority for directed trusts come from? State law is the answer. At least 28 states have adopted UTC standards, while as of late 2010 at least eleven states permit some form of directed trusts. The differences among three states, Alaska, Delaware, and Nevada, are the subject of this article.

## Accountability

Closely related to liability concerns is the accountability issue. Fiduciaries are accountable to trust creators, beneficiaries, and the court. Fiduciaries must behave according to a code that goes back to English common law that puts the interest of beneficiaries first. Violations of the code are subject to surcharge, a penalty incurred as a result of being sued by beneficiaries or the state. If statutory law exempts advisers from being considered fiduciaries, there is no basis for holding them to fiduciary standards and their concomitant responsibilities.

## Alaska

Although Alaska passed the first asset protection statute in 1997, it added a directed trust statute, known as a "Trustee advisor" section, much later. Although the Alaskan statute states that the governing instrument may provide for the "appointment of a person to act as an advisor to the trustee with regard to all or some of the matters relating to the property of the trust," the statute does not expand upon its authorization and seems to create situations where accountability is vague.

Unless the governing instrument states that the advisor has been given the authority to direct the trustee, "the property and management of the trust and the exercise of all powers and discretionary acts exercisable by the trustee remain vested in the trustee as fully and effectively as if the advisor were not appointed." Furthermore, unless the governing instrument specifies to the contrary, "the advisor is not liable as or considered to be a trustee ... or a fiduciary when acting as an advisor to the trust." Thus, the advisor appears to have no fiduciary duties to beneficiaries. As one commentator said, if the governing instrument absolves the advisor of any fiduciary responsibility while requiring the trustee to follow the advisor's directions, an interesting situation occurs in which "neither the trustee nor the advisor has any fiduciary liability to the beneficiaries" other than the "standard of good faith."

## Nevada

In 2009 Nevada passed a directed trust statute that covers "trust advisers," "investment trust advisers," and "trust protectors," and limits the liability of the "excluded fiduciary," a/k/a, the corporate trustee. Nevada defines trust advisers as fiduciaries given authority by the instrument to exercise "any and all powers and discretion" listed in the specific section of the Nevada code pertaining to advisers.

"An excluded fiduciary is not liable, individually or as a fiduciary, for any loss" resulting from complying with the directions of the trust adviser or trust protector. The corporate trustee has no "obligation to perform an investment or suitability review" of the adviser's actions or evaluate or recommend actions to the adviser. Any trust adviser or trust protector is subject to the laws of Nevada, regardless of what the governing instrument says. Nevada, then, addresses the issues of liability, accountability, and the responsibility to review the actions of an adviser or trust protector.

## Delaware

Delaware designed its laws so as "to give maximum effect to the principle of freedom of disposition and to the enforceability of governing instruments." Its directed trust statutes are an excellent example of this philosophy.

Delaware is clear that if an advisor is given the authority to direct, consent to, or approves another fiduciary's actual or proposed actions, that person is considered to be a fiduciary. Unless the fiduciary is guilty of "willful misconduct" or "gross negligence," the fiduciary is not liable for any loss stemming from its acceptance in taking direction from an advisor.

The term "fiduciary" is all encompassing and includes both trust protectors as well as advisers, unless the governing instrument states otherwise. All are accountable for their separate actions by the fiduciary code but are not accountable for the actions of other fiduciaries unless specified in the governing instrument.

A fiduciary has no duty to "monitor the conduct of the adviser; provide advice to the adviser or consult with the adviser; or communicate with or warn or apprise any beneficiary or third party concerning instances in which the fiduciary would or might have exercised ... its own discretion in a manner different from the manner directed by the adviser." The Delaware statute establishes a clear criterion for trustees acting under the direction of other fiduciaries; confirms the potential liability of all parties, and states definitively the obligation of one fiduciary to another.

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The statutes create the possibility that a Delaware trustee may act solely as an administrative trustee at a reduced fee, a boon to grantors establishing directed trusts in Delaware.

The premise of this article is that directed trusts are a good, positive, and constructive step forward on the path to well-administered irrevocable trusts that frequently beat their investment boogies. Flexibility is always good, and the ability of corporate trustees to hold assets that they could not hold before has to be positive. But what if something goes wrong? What if the investment advisor picks poorly and the trust dramatically decreases in value? What if a distribution advisor favors one beneficiary over another? What is the obligation of the trustee to the beneficiaries when problems arise from the actions of the advisor?

Here you have a conflict between legal issues and the fiduciary code. Delaware law is clear: the corporate trustee has no duty to review or monitor the actions of an advisor and is held harmless unless the trustee is guilty of willful misconduct or gross negligence. Yet does the trustee have a duty somehow to raise a flag to the advisor or beneficiaries when, for example, the advisor hires his own investment firm or invests in assets that create a conflict of interest? It would seem that if the advisor is considered to be a fiduciary, he or she is bound by the same rules of conduct that govern the actions of all fiduciaries. Is this enough?

Directed trusts permit a grantor to make his own inspired investment choices, as well as his own investment mistakes, either personally or by his choice of investment counsel. While Alaska, Nevada, and Delaware authorize irrevocable trusts in which a particular fiduciary responsibility is given to a third party, the states are also alike in reiterating the primacy of the governing instrument over all else. In any event the combination of a corporate trustee with grantor-appointed advisors that direct the trustee on certain issues may offer the best of both worlds.

**If you or your clients would like to learn more about the personal trust services of Christiana Trust, we invite you to contact Amy Brown at 302.888.7740 or [abrown@christianatrust.com](mailto:abrown@christianatrust.com), or contact Deborah Markwood at 302.571.5276 or [dmarkwood@christianatrust.com](mailto:dmarkwood@christianatrust.com) For information on our corporate trust services, please speak with Lou Geibel at 302.888.7424 or [lgeibel@christianatrust.com](mailto:lgeibel@christianatrust.com).**

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