



MEMORANDUM

From: Robert H. Sitkoff, Chair
Turney Berry, Vice-Chair
John D. Morley, Reporter

To: Uniform Law Commission

Re: Directed Trust Act (First Reading)

Date: May 23, 2016

This memo provides an overview of the Directed Trust Act, which is slated for first reading at the upcoming 2016 Annual Meeting in Stowe, Vermont.

Background. The Directed Trust Act addresses an increasingly common arrangement in contemporary estate planning and asset management known as a directed trust. A directed trust involves the naming of a trustee to hold custody of the trust property and another person who is not a trustee to perform one or more of the investment, distribution, and administration functions that would otherwise have belonged to the trustee. There is no consistent vocabulary for the nontrustee powerholder in a directed trust. Several terms are common in practice, including “trust protector,” “trust adviser,” and “trust director.” There is much uncertainty about the fiduciary status of a nontrustee who has control or potential control over a function of trusteeship and about the fiduciary responsibility of a trustee with regard to actions taken or directed by such a nontrustee. Existing uniform trusts and estates statutes address the issue inadequately. Existing nonuniform state laws are in disarray.

The Directed Trust Act. Under the draft Directed Trust Act, a nontrustee who holds a fiduciary power over the administration or management of a trust is called a “trust director.” A trustee that is subject to a fiduciary power of a trust director is called a “directed trustee.” The core contribution of the act is to address the many complications created by giving a fiduciary power over the administration or management of a trust to a person who is not a trustee. These complications include the fiduciary duty of a trust director (Section 7) and the fiduciary duty of a directed trustee (Section 8).

Structure of the Act. The heart of the act appears in Sections 5 through 10, which address, in turn, the powers and duties of trust directors and directed trustees. Sections

5 through 7 address the kinds of powers that the terms of a trust can grant to a trust director and the fiduciary duty of the director. Sections 8 through 10 prescribe the fiduciary duty of a directed trustee, addressing the ways in which the existence of a trust director changes the normal fiduciary duty of a trustee. Section 11 addresses the relationship between a directed trust and cotrusteeship. The remaining sections address a variety of important technical issues in the administration of a directed trust and in this act's relationship to existing law.

Key Policy Issues. The key policy questions on which the drafting committee has focused are (i) the scope of the powers that may be granted to a trust director (Sections 5 and 6); (ii) the fiduciary duties of a trust director (Section 7) and (iii) a directed trustee (Sections 8 and 10); and (iv) the extension of the fiduciary rules of a directed trust to a cotrustee (Section 11). With respect to the fiduciary duties of a directed trustee (point iii), it bears emphasis that of the viable options, the drafting committee preferred the more beneficiary-protective option.

i. Scope of powers that may be given to a trust director. Section 6 validates terms of a trust that grant a trust director a fiduciary power over a trust. Section 6 divides a trust director's possible powers into three categories: a "power of direction," a "power of consent," and a "power of protection." Section 6 specifies which kinds of powers fall within each of these categories. The categories are organized for the practical purpose of simplifying the act. The categories facilitate provision of different fiduciary duties for different kinds of powers.

The list of powers in Section 6 is exclusive. A power not listed in Section 6 is not covered by this act, and the holder of such a power is not a trust director. Similarly, Section 5 prescribes five categories of exclusions for circumstances that might otherwise fall within Section 6, but that are excluded on policy grounds. Matters that are not included by Section 6 or are excluded by Section 5 are governed by other law.

ii. The fiduciary duties of a trust director. Section 7 prescribes two possible fiduciary regimes for a trust director. The first applies to a power that is categorized as a power of direction or a power of consent. With respect to such a power, a trust director is subject to the same fiduciary duty as a trustee, and the settlor may vary that duty in the terms of the trust to the same extent that the settlor could vary the duty of a trustee. The drafting committee reasoned that within the scope of a power of direction or consent, the trust director functions much like a trustee in a conventional trust that is not directed.

The second fiduciary regime applies to a power categorized as a power of protection. With respect to such a power, a trust director must act in accord with the terms and purposes of the trust, and the director is not liable for breach of trust unless the director's exercise or nonexercise of the power was done in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries. This limitation on liability is consistent with the maximum exoneration of a trustee allowed by Uniform Trust Code § 1008(a)(1) (2000) and prevailing law.

Because the duty and liability of a trust director turns on the classification of the director's power, the agenda for the next meeting of the drafting committee includes attention to whether the matters classified as powers of protection are clearly differentiable – and whether on policy grounds they should be differentiated – from those classified as powers of direction.

iii. The fiduciary duties of a directed trustee. Roughly speaking, on the question of the duty and liability of a directed trustee, the existing specialized directed trust legislation fall into two groups. In one group, which constitutes a majority of the specialized legislation, are the statutes that fully relieve a directed trustee from duty or liability for complying with an action of a trust director. The policy rationale for these statutes, such as in Alaska, New Hampshire, Nevada, and South Dakota, is that the settlor could have made the trust director the sole trustee. Thus, on greater-includes-the-lesser reasoning, the settlor should be able to eliminate a directed trustee's duty and liability for complying with an action of a trust director. Because the trustee will not second guess the director, the settlor's intent that the director be the decisionmaker will not be frustrated. Under these statutes a beneficiary's only recourse for bad conduct by the trust director is an action against the director for breach of the director's fiduciary duty to the beneficiary.

In the other group, which includes Delaware, Colorado, North Carolina, and Virginia, are the statutes that say a directed trustee is not liable for complying with a direction of a trust director, except in cases of "willful" or "intentional" misconduct on the part of the directed trustee. The policy rationale for these statutes is that a trustee must bear at least some duty even if the trustee is directed. Although the settlor could have made the trust director the sole trustee, the settlor did not actually do so. And under traditional understandings of trust law, a trustee must always be accountable to a beneficiary in some way. These statutes also recognize, however, that to facilitate the settlor's intent that the trust director rather than the directed trustee be the primary decisionmaker, it is appropriate to reduce the trustee's duty and liability below the usual level. Accordingly, under these statutes a beneficiary's main recourse for bad conduct by the trust director is an action against the director for breach of the director's fiduciary duty to the beneficiary. But the beneficiary also has recourse against the trustee if the trustee's compliance with the actions of the trust director amounted to "willful misconduct."

After extensive deliberation and debate, the drafting committee opted in Section 8 to follow the second group of statutes, which includes the Delaware act, on the grounds that this model does more to protect a beneficiary and is more consistent with traditional fiduciary policy, even while remaining viable and popular, as evidenced by the large number of directed trusts in Delaware. To put the point otherwise, the popularity of directed trusts in Delaware establishes that a directed trust regime that preserves a "willful misconduct" safeguard is workable, and that a total elimination of duty in a directed trustee is thus unnecessary.

The "willful misconduct" standard prescribed by Section 8 of the Directed Trust Act changes the policy of Uniform Trust Code § 808(2000), which provides the current

uniform law treatment of directed trusts. Section 808(b) of says: “If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise 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 that the person holding the power owes to the beneficiaries of the trust.” In deciding to change this standard, the drafting committee was deeply influenced by the fact that this provision increasingly has been subject to nonuniform modification to follow one of the two other models discussed above. The drafting committee was also deeply influenced by the fact that a review of every existing specialized state statute on directed trusts showed that no state that has considered this issue specifically has chosen to follow this provision of the Uniform Trust Code.

iv. The extension of the fiduciary rules of a directed trust to a cotrustee. Under traditional law governing cotrustees, each cotrustee “has a duty to use reasonable care to prevent a co-trustee from committing a breach of trust and, if a breach of trust occurs, to obtain redress.” Restatement (Third) of Trusts § 81(2) (2007). This rule applies even if the settlor limits the role or function of one of the cotrustees so that the trustee does not share responsibilities over the same areas as another trustee. “Even in matters for which a trustee is relieved of responsibility, ... if the trustee knows that a co-trustee is committing or attempting to commit a breach of trust, the trustee has a duty to take reasonable steps to prevent the fiduciary misconduct.” *Id.* cmt. b.

In contrast to the law of cotrusteeship, this act allows a trustee to be subject to a less demanding fiduciary standard if the trustee is not directly responsible for a particular area of trust management or administration. Given that a settlor could have opted into this more permissive rule by naming a trust director and a directed trustee under this act rather than naming cotrustees, there seems little reason to prevent the settlor from also directing the application of the rules of this act to an arrangement that uses the labeling of cotrustees. Accordingly, Section 11 allows a settlor to choose either fiduciary regime for a cotrusteeship – the traditional rules of cotrusteeship or the more permissive rules of a directed trusteeship. Under Section 11 the default rule is that the traditional law of cotrusteeship will apply to parties named as cotrustees, but this default rule may be changed by a contrary indication in the terms of a trust.