Fixer Upper

Using an NJSA to Fix a Broken Directed Trust

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Over the last decade, directed trusts have become commonplace in Delaware. More and more, settlors and beneficiaries are using trusts to implement complex investment, tax and wealth transfer objectives that come in conflict with the limitations of traditional fiduciary duties and pose potential risks on fiduciaries. Settlors often accomplish these objectives by employing directed trusts that bifurcate responsibilities (such as investments) from the rest of the traditional trust administration functions, assigning them to a separate adviser who will direct the trustee to carry out those specific objectives.

Many governing instruments use different approaches with varying degrees of effectiveness to implement the directed trustee concept. A Delaware directed trustee that exercises its trustee power in accordance with a direction from an investment adviser as provided for in a properly drafted governing instrument should not be liable for any loss resulting directly or indirectly from taking such action, except in the case of the directed trustee's own wilful misconduct pursuant to 12 Del. C. § 3313. This limitation of liability applicable to a directed trustee under 12 Del. C. § 3313 is referred to in this article as the "Statutory Defense". However, not all directed trustee provisions are created equal. It is critical that a governing instrument describe, in clear and complete terms, the specific trustee powers that are exercised only at direction, with the balance of the trustee powers exercised solely by the trustee in its own discretion, so that there can be no doubt whether the directed trustee or the investment adviser is responsible for a particular matter. A provision in a governing instrument that falls short of this standard may create ambiguities that pose risks to the fiduciary that were not likely intended by the settlor nor the trustee. The focus of this article is how to identify problematic directed trust provisions, and how to use an NJSA to fix them by interpreting ambiguous or vague provisions that may cause risk.

How To Effectively Bifurcate Investment Responsibility

In order for a directed trustee to be able to rely upon the Statutory Defense, it is critical that the trust's governing instrument properly and unambiguously state which trustee powers, duties, and responsibilities are exercisable by the directed trustee only upon the written direction of the investment adviser and which are not. We begin with the principle that a trustee has all of the powers conferred upon it by a governing instrument as well as those conferred by applicable law, and that those are all of the powers exercisable by the trustee. See Restatement (Second) of Trusts, Section 186. Almost every governing instrument includes a somewhat lengthy list of powers granted to the trustee, including investment powers. In addition, Subsection 3324(a) of Title 12 of the Delaware Code provides that a trustee may exercise any powers conferred under the governing instrument and, except as limited by the governing instrument, under Chapter 33 of Title 12 of the Delaware Code, including 12 Del. C. § 3325. Section 3325 provides a discrete list of trustee powers conferred upon Delaware trustees. Thus, the complete list of investment powers possessed by a trustee is readily identifiable in the governing instrument and Section 3325 of Title 12 of the Delaware Code.

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The investment adviser provisions in some governing instruments do not cross-reference the actual trustee powers, rather they give a generic description of investment powers. For example, some investment adviser provisions merely state that the trustee shall act upon direction of an investment adviser with respect to the "investment and management of the trust assets," or perhaps it includes some form of short, generic description of investment activities, like "retention, purchase, sale, lending and voting" of trust assets. Some investment adviser provisions merely refer to the definition of "investment decisions" under Section 3313(d), which 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 non-publicly traded investments, the valuation thereof". The problem with these provisions is that during the real-world administration of a trust, when the trustee receives a direction letter to execute complicated, nuanced transactions, it often becomes ambiguous whether such directions are clearly within the scope of trustee powers exercised only upon the direction of an investment adviser. When it comes time for the directed trustee to enter into a transaction involving complicated contractual arrangements like a stock purchase agreement, security agreement, a special purpose entity, loan, guarantee, documents that include representations and warranties or grant proxies or powers of attorney, or to manage investment paying real estate taxes or life insurance premiums, there are ambiguities relating to the scope of the direction provision in the governing instrument that immediately become apparent. Can the trustee safely rely on the direction letter and be protected by the Statutory Defense if it is not clear whether the trust powers that it exercises in order to carry out certain investment activities fall within the scope of the investment adviser provision?

Ambiguities Create Fiduciary Risk

The powers that a directed trustee can exercise exclusively at direction should be described in the governing instrument by express cross-reference to the investment powers granted under the governing instrument and under Section 3325. The risk associated with an improperly drafted governing instrument is that if the investment adviser provision in the governing instrument does not specifically reference all such powers, there could be an argument that the trustee independently possesses any powers that are not specifically referenced, and that those powers could (or should) be exercised by the directed trustee without direction from the adviser. Furthermore, if a governing instrument uses a generic description of investment activities, there could be an argument that certain actions taken by the trustee fall outside of the direction language because there is ambiguity as to whether a specific trustee power or investment transaction is covered by that language. In other words, if a governing instrument was drafted in an arguably ambiguous manner, the beneficiaries could make an argument that investment losses or poor investment decisions are the result of actions taken by the trustee that were not within the scope of an ambiguous directed trustee provision, or that the trustee possessed independent powers that could have been exercised to mitigate such losses. If such arguments prevail, the directed trustee might not be entitled to the Statutory defense.

Another issue arises when a document provides that the investment adviser may direct the trustee with respect to the exercise of certain powers, but does not clearly state that the trustee shall exercise those powers "only" upon direction. Without providing that the trustee only has the ability to exercise those powers as and when directed, it could be argued that not only may the investment adviser direct the trustee to exercise the powers, but the trustee also has the power to exercise those powers independently.

Others issues relate to the due diligence and reporting that might be performed by a directed trustee. Subsection 3313(e)(3) of Title 12 creates a default rule that, absent clear and convincing evidence or a contrary provision in a governing instrument, any action of the directed trustee with respect to "matters within the scope of the investment adviser's authority" are presumed to be administrative actions of the directed trustee solely to allow the directed trustee to perform its duties and shall not be deemed to constitute an undertaking by the directed trustee to monitor the investment adviser or otherwise participate in actions within the scope of the investment adviser's authority. However, if the language of the governing instrument creates an ambiguity as to whether certain powers are within the scope of the investment adviser's authority, the directed trustee may not be entitled to the protection under Subsection 3313(e)(3).

A directed trustee may, and often does, consult with or request information from an investment adviser. Without the protection afforded by Subsection 3313(e), a directed trustee could theoretically expose itself to a risk of liability based on the directed trustee's course of conduct. For example, it may be possible that consultation with an investment adviser or requests for information could, in certain circumstances, expose the directed trustee to an argument that the directed trustee, by requesting or receiving such documentation on a frequent basis, has undertaken the duty of monitoring whether such asset remains a proper investment for the trust. Additionally, the investment adviser could theoretically argue that notwithstanding the terms of the governing instrument, the directed trustee's conduct led the investment adviser to believe that the directed trustee was independently monitoring such assets and the investment adviser relied on such monitoring and assumed the directed trustee would provide advice as and when it was necessary to act with respect to such asset. This risk could be compounded if there is an argument that certain investment activities do not fall within the directed trustee provision, or that the trustee possesses independent investment powers that could be exercised without direction.

Clearly, none of these risks and potential arguments were intended or even anticipated by a settlor who included an investment adviser provision in the governing instrument with the intent to separate investment responsibility from other trustee functions and allocate that responsibility to an investment adviser. However, issues could potentially stem from the potential ambiguity in the governing instrument.

Ambiguities Can Be Fixed With An NJSA

In 2013, Delaware enacted a Non-Judicial Settlement Agreement ("NJSA") statute as new Section 3338 of Title 12 of the Delaware Code. Subsection 3338(b) provides that "interested persons" may enter into a binding NJSA with respect to any matter involving a trust. Subsection 3338(c) provides that a nonjudicial settlement agreement is valid only to the extent that it does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the Court of Chancery. The term "material purpose" is not defined in new Section 3338. Subsection 3338(d) provides a list of six matters that may be resolved by an NJSA, including: "(1) interpreting or construing the terms of a trust" and "(6) determining the liability of a trustee for an action relating to the trust". Although there is some question as to whether an NJSA can be used to modify irrevocable trusts under Delaware law to add new investment adviser

provisions or modify an investment adviser provision, an NJSA under Section 3338 clearly can be used to interpret or construe an existing investment adviser provision to eliminate any ambiguities. Consequently, an NJSA can be used to resolve the types of ambiguities described in this article and minimize or even eliminate the related risks.

For example, if an investment adviser provision includes only a vague, generic description of investment activities that are to be exercised at the direction of an investment adviser, an NJSA could interpret and construe that provision to clarify that all investment powers are to be exercised only upon direction (by specific reference to each of them) and to limit trustee duties and liability in connection with such matters under the authority of the investment adviser. Also, an investment adviser provision that cross-references the investment powers in the governing instrument but fails to cross-reference the investment powers granted to the trustee under Section 3325 of Title 12 of the Delaware Code could be construed to include the investment powers found in Section 3325. An investment adviser provision that does not clearly provide that the trustee shall exercise certain powers only upon the direction, could clarify that the trustee shall not exercise those powers except upon written direction. An NJSA can also reinforce the willful misconduct standard of liability and clarify that the directed trustee shall have no duty to monitor the investment adviser or notify beneficiaries if the trustee does not agree with the investment adviser's decisions. An NJSA can also make it clear that the trustee shall value assets subject to the direction of an investment adviser shall only as directed.

Generally, existing governing instruments that include directed trustee provisions clearly manifest the settlor's intent that the investment responsibility should rest exclusively with the investment adviser and not the trustee. The inclusion of such a provision demonstrates it was the intent of the settlor and the trustee at the time they entered into the trust agreement that the trustee should not take part in investment decisions and should have limited liability and charge lower compensation for the reduced role. In other words, fully bifurcating the investment function is clearly consistent with the settlor's intent, and is indeed a material purpose of the trust. Nevertheless, there may be potential risks associated with some directed trusts to the extent that an ambiguous investment adviser provision provides a beneficiary with an argument, after investment losses occur, that the trustee could have taken some action, or that actions taken by the trustee were not within the scope of powers exercisable only at the direction of the investment adviser. For such trusts, an NJSA can be used to minimize or even eliminate that risk and effectuate the settlor's intent.

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