COMERICA TRUST

The 3 “Rs” of Directed and Delegated Trusts: Risks, Responsibilities, and Rewards

Families are becoming more sophisticated about wealth management, incorporating modern trust documents into their estate-planning and looking for ways to maximize the flexibility of their trust investments. Typically, a trustee's duties and flexibility regarding investment responsibilities vary depending upon whether a state has adopted the Prudent Investor Act; whether a trust is directed or delegated; the applicable state statutes; and the terms of the trust instrument itself.

For many families with complex personal situations (e.g., geographically dispersed family members, the disintegration of the family unit, multiple marriages, special needs children, etc.) naming a bank or trust company as the trustee is often beneficial. Professional fiduciaries are a natural choice to provide an unemotional, unbiased professional when you have children from various marriages or a second or third spouse, each of whom may have varying financial needs. What if you have a family business as well as marketable securities in a trust - who has control over these assets? Can or should the bank manage the business? What checks and balances do you want on the professional fiduciary?

“Directed” Versus “Delegated”

There are ways to structure a trust to secure the benefits of independent and professional trustee services without jeopardizing other important goals. For a directed or delegated trust, it comes down to who has the legal risk. The challenge for any trustee rests on knowing the overall purpose of the trust. Trustees spend significant time understanding the needs of the trust beneficiaries. The challenge occurs when trust documents provide little or no guidance around the priority of beneficiaries and their distributions. The manner in which trust assets are managed becomes paramount for the distributions to occur as intended.

A directed or delegated trust choice for investment management has evolved over the last 190 years. A landmark trust law case, Harvard College and Massachusetts General Hospital v. Francis Amory. 26 Mass. 446, 9 Pick. 446 (1830), established the concept of the Prudent Man Rule. Judge Samuel Putnam stated:

"All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

The Prudent Man Rule remained in force for 150 years. By the mid-1980s, however, it became apparent that trustee investment management needed to have a more global overview. In 1992, the Uniform Prudent Investor Act was adopted by the American Law Institute's Third Restatement of the Law of Trusts. This allowed for the implementation of modern portfolio theory or total return for trustee investment management, and allowed the trustee, whether through a directed or delegated trust, to consider the entire trust investment portfolio for balancing risk and return.

For example, if you have real estate or family business interests, your trusts should include an express mechanism to “direct” investment management by another person or entity you name in the role of “investment adviser.” It is often not merely enough to permit the trustee to “delegate” investment decisions as that will leave the trustee liable for the investments. If that language is used in the trust document, the professional trustee may not be willing to allow the trust to hold family investments. Rather, the trust should be structured as a “directed” trust so that the investment adviser directs certain investments.

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Also, the law of the state in which the trust is formed must permit this distinction. Therefore, many such directed trusts should be formed according to the laws of one of the "trust friendly" jurisdictions like Delaware, Tennessee or Nevada. Doing so will help ensure professional trust management and the proper succession of real estate or family business holdings, which may be important objectives that cannot be effectively achieved any other way.

Understanding this technique may help you develop a more sophisticated estate plan to serve your needs better than "traditional" trust planning.

Investment Management for Directed Trusts

The concept of a delegated or directed trust for investment management starts with the goal of the grantor. Often, one of the largest challenges for any trustee is ambiguity in a trust agreement. And one of the most common areas of ambiguity in a trust agreement involves the fiduciary investment responsibility. A well-drafted directed trust eliminates the ambiguity and provides clear power of investment direction from the grantor; it can clearly distinguish the discrete fiduciary duties among various parties identified in the trust agreement.

The assets of a trust can be managed by the trustee or a delegee selected by the trustee. If delegation is not mandated in the trust agreement, delegation to a third party will be at the trustee's discretion, but the trustee will remain responsible for the acts of the delegee. Alternatively, if state law permits, the trust agreement can expressly name an investment adviser to manage trust assets. The terms of a trust may expressly describe the duties, rights and responsibilities between the designated investment adviser, the trustee and any other named fiduciaries. These provisions should address compensation of the fiduciaries, the use of proprietary investment products, investment allocation matters, any restrictions on investments, reporting, and so forth. Often, the investment adviser's role is bifurcated - a professional wealth manager is appointed to manage marketable securities and either the grantor, or a relative of the grantor, manages the family business interests held by the trust. In 2017, the Uniform Law Commission created the Uniform Directed Trust Act to clarify directed-trustee liability. Delaware, Nevada, Alaska and South Dakota are the states with the strongest directed trust statutes and should be strongly considered when selecting the law that will govern a directed trust.

Investment Management for Delegated Trusts

Some trusts are structured as delegated trusts, which permits the trustee to delegate certain fiduciary duties to a third party. Such duties may include tax return preparation, valuations, or investment management. If you are uncertain whether a directed or delegated trust is preferable, the trust document can make delegation of investment management permissible by the trustee, but not mandatory.

The delegation of investment management is a fiduciary duty undertaken by the trustee. The trustee and the investment adviser share the same fiduciary investment management risk. The trustee's duty is to supervise and monitor the investment adviser. The investment adviser's duties are defined by the Prudent Investor Rule.

A trust that owns non-marketable assets, however, may provide an additional challenge. Non-marketable assets may include closely held assets, partnerships, oil and gas interests, business assets, real estate, etc. The risk to the trustee when delegating investment management of non-marketable assets increases because it is often difficult to verify whether the proposed investment adviser is truly qualified to manage such assets.

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Should a trust beneficiary sue the trustee and the investment adviser for poor investment performance, the lion’s share of the risk will likely be borne by the trustee because the trustee is responsible for the decision to delegate to the investment adviser. Because of this additional risk, trustee fees for delegated trusts are typically higher than trustee fees for directed trusts.

What is the Best Choice Between a Directed Trust and Delegated Trust?

Ultimately, the choice between a directed trust and a delegated trust may come down to a single consideration - complexity or simplicity.

If you want all the “bells and whistles” around investment management, distributions, trust protectors, decanting, and complex administration provisions, a directed trust is likely your best choice. Be prepared to pay the drafter of your trust a significant fee to incorporate complex provisions into the trust document, especially if the drafter is a prominent estate planning attorney in a trust-friendly jurisdiction. Remember that complex trust provisions often require strict adherence and can reduce flexibility in the administration of the trust.

Alternatively, if you want an estate plan with a revocable trust that leaves the door open to make changes during your lifetime, then a delegated trust may be preferable. They key advantage of a delegated trust is that it may allow a trust protector or beneficiary to remove and appoint trustees with or without cause and without court approval. Delegated trusts also give the trustee power to change the situs and governing law of the trust if circumstances change at some time in the future.

When choosing between a directed trust or a delegated trust, the primary consideration may be the philosophy of the grantor and the grantor’s family regarding wealth transfer and the level of complexity that is desired within the trust document.

Want to Know More?

Comerica welcomes the opportunity to help. If you would like to know more about Delaware Trust Administration or any other trust consideration, contact your Comerica Fiduciary Strategist or contact Comerica Trust comerica.com/trust.