CALIFORNIA DIRECTED TRUSTS:

A BIG STEP FORWARD FOR CALIFORNIA TRUST LAW, BUT WHAT HAPPENS NOW?

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TRENDS IN CALIFORNIA TRUST LAW

- California's Place in the Trust Marketplace
  - Historical Vanguard
  - Current Laggard

- What Changed after GST tax enacted in 1986?

MODERN TRUST LAW CANON

- Extended/Repealed Rule Against Perpetuities
- Self-Settled Asset Protection Trusts
- Silent Trusts
- Virtual Representation
- Purpose Trusts
- Non-Judicial Settlements
- Trust Protectors
- Decanting
- **Directed Trusts**

HOW CALIFORNIA STACKS UP

Rules and Features	California	States Who Shall Not be Named
RAP Repeal/Extension	No	Of Course
Self-Settled Asset Protection Trusts	Never Ever	Of Course
Silent Trusts	Seems Unlikely	Of Course
Virtual Representation	Maybe	Of Course
Non-Judicial Settlements	If you had VR…	Of Course
Purpose Trusts	Might Happen	Of Course
Trust Protectors	Probably OK	Of Course
Decanting	Kind of	Of Course
Directed Trusts	Finally!	Of Course

WHAT IS A DIRECTED TRUST?

- A trust where fiduciary powers and duties are split between the trustee and other non-trustee fiduciaries (commonly known as trust directors or advisers).
  - Beware the wishful mislabeling of the trust director as a non-fiduciary
  - Terminology is not controlling

- This is different from a traditional trust where the trustee holds all fiduciary powers and duties.
  - AKA the traditional “unitary model”
  - The OCC and many academics stand by the unitary model: Directed trusts represent a *fundamental assault on the “irreducible core” of the trust*

WHAT DOES A TRUST DIRECTOR DO?

- A Trust Director is a **non-trustee** who has a “**power of direction**” by which the Trust Director can direct the trustee to act
- For example, the Trust Director may have the power to direct the trustee how to invest trust assets, vote shares of stock, make distributions, or amend trust terms
- In most states, the Trust Director’s powers are defined in the **trust instrument**
  - Some states provide a laundry list of powers in the statute

WHAT'S LEFT FOR THE DIRECTED TRUSTEE TO DO?

- The Trustee has a duty to take **reasonable action to carry out the Trust Director's directions** (with limits we will discuss), and exercise all powers not granted to the Trust Director.

- E.g., Trust Director may direct the Trustee as to investments, but the Trustee is in charge of distributions, as well as custody, tax compliance, record keeping, statements, reports, accountings, etc.

EVOLUTION OF DIRECTED TRUST STATUTES

- Pre-1935: Common Law, mainly Delaware (DuPont trusts)
- 1935 - Rest. 1st of Trusts
- **1986 - Delaware Statute (and the 1986 Tax Act)**
- 1992 - Rest. 3rd of Trusts
- **2000 - UTC §808**
- Post UTC §808 Rush
  - Hodge-podge of ever more corporate trustee-friendly statutes
  - Rational or cynical?
- 2017 – Uniform Directed Trust Act

NOW 47 STATES HAVE ENACTED DIRECTED TRUST LEGISLATION

Statutes Primarily Diverge on Two Issues:

Approach to Directed Trustee Liability

- UTC 808 – Distasteful to Corporate Fiduciaries: Too Risky?
- No Duty/Excluded Fiduciary/Neo-Trusts: Too Radical?
- Scintilla of Duty/Willful Misconduct States (Del. Since 1986) – Just Right!

Approach to Trust Director's Standard of Conduct

- Trust Director is a Fiduciary
  - Of Course! Agents can look out for themselves
- Meretricious "Not a Fiduciary" Option
  - Wishful Thinking
  - Empty Chair: Agency, not a Trust
- Distinguish the Traditional Trust Protector

WEALTH MANAGEMENT

PROBATE CODE §16600 ET SEQ.

CALIFORNIA UNIFORM DIRECTED TRUST ACT

NEED FOR A STATUTE

- California attorneys have long drafted trusts giving certain powers and duties to non-trustees
    - o “My brother Frank will have the duty to manage the strip mall and his decisions are final and binding”

- This was a practical solution, but it exposes the Trustee to liability for Frank’s breach of duty.
    - o Under *Crocker-Citizens National Bank vs. Younger* (4 Cal.3d 202), the parties were treated as co-trustees, imposing a duty on the Trustee to prevent the power holder from breaching the trust

- No corporate trustee with trust powers in a state with an enabling statute would accept that risk of liability – nor would the regulators bless this arrangement

CALIFORNIA UNIFORM DIRECTED TRUST ACT (CALIFORNIA UDTA)

- From the ashes of the failed 2011 effort…
- Adds Sections 16600 et seq. to Probate Code (and certain other conforming provisions)
- Effective January 1, 2024
- Applies to any decision or action occurring after January 1, 2024 (doesn't matter when trust was created)
- Applies to a trust, wherever created, that has its principal place of administration in California

CALIFORNIA UDTA - DEFINITIONS

- ***Section 16608(a)*** *~ the terms of a trust may grant a* ***power of direction*** *to a* ***trust director***

- **Power of Direction** means a power over a trust granted to a person by the terms of the trust to the extent the power is exercisable while the person is not serving as a trustee. Power of direction includes a power over the investment, management, or distribution of trust property or other matters of trust administration.

- **Trust director** means a person that is granted a power of direction by the terms of a trust, to the extent the power is exercisable while the person is **not serving as a trustee**. The person is a trust director whether or not the terms of the trust refer to the person as a trust director and whether or not the person is a beneficiary or settlor of the trust.

CALIFORNIA UDTA - DUTY AND LIABILITY OF DIRECTED TRUSTEE

- ***Section 16614***

(a) Subject to subdivision (b), a directed trustee shall take **reasonable action** to comply with a trust director's exercise or nonexercise of a power of direction […] and the trustee is not liable for the action.

(b) A directed trustee shall not comply with a trust director's exercise or nonexercise of a power of direction […] ***to the extent that, by complying, the trustee would engage in willful misconduct***.

[…]

(d) A directed trustee that has reasonable doubt about their duty under this section **may petition the court for instructions**.

DIRECTED TRUSTEE LIABILITY: ULC CHOSE THE "SCINTILLA OF DUTY"/WILLFUL MISCONDUCT (DELAWARE?) APPROACH

- Policy reasons: Trustee must bear **some** duty even if under direction
- Practical reasons: Would courts embrace "no liability" in unsympathetic circumstances
- Political reasons: States would balk at enacting an aggressive UDTA
- Up to States to Define Willful Misconduct
  - Delaware: "intentional wrongdoing, **not** mere negligence, gross negligence or recklessness;" and "wrongdoing" is "malicious conduct or conduct designed to defraud or seek an unconscionable advantage"
  - California: "[u]nlike negligence, which implies a failure to use ordinary care, and even gross negligence, which connotes such a lack of care as may be presumed to indicate a passive and indifferent attitude toward results, willful misconduct is not marked by a mere absence of care. Rather, it involves a more positive intent ***actually to harm another*** or to do an act with a positive, active and absolute disregard of its consequences." *Calvillo-Silva v. Home Grocery*, 19 Cal. 4th 714, 729 (1998).

ACADEMIC DEBATE PERSISTS

- Does UDTA Create UTC 808-Like Duty to Monitor the Director?
  - What is Implied by: Directed Trustee must not comply with direction “to the extent that **by complying** the trustee would engage in willful misconduct”
    - Commentators claim this creates a duty to monitor actions of trust director; i.e., associative liability
  - **Contrast Delaware**: Directed Trustee not liable “except in cases of willful misconduct **on the part of the fiduciary** so directed”
    - Do you see a subtle difference?
  - Regardless, Directed Trustees Are Not Liable Unless Their Behavior (Whether Associative or Their Own Initiative) Descends to Willful Misconduct
    - Ergo, the UDTA is still more protective of a directed trustee than UTC 808, which has no prescribed standard of conduct

DIRECTED TRUSTEE’S IMPLIED THRESHOLD DUTY?

Elephant in the Room: Has the Threshold Duty to Determine Whether Trust Director is Acting Within its Authority Been Negated?

- Some States, e.g. Iowa, South Dakota Have Caught On
  - Statute explicitly provides that the directed trustee is NOT liable for following a direction that is outside the scope of the trust director’s authority
- Add Language Negating This Duty in Trust Document

Another Additional Duty: Duty in Prob. Code §16614(a) to Take “Reasonable Action” to Comply With the Direction

- **Not the same as ensuring that the direction is reasonable**

STATUS OF TRUST DIRECTOR: THE UDTA TO THE RESCUE

The Other Contentious Issue - Status of Trust Director?: Fiduciary! (Duh)

- Absorbs Local Law of Trusteeship Regarding Standard of Duty, Exculpation of Trustee
  - Director Bears Same Fiduciary Duties as a Trustee “In a Like Position Under Similar Circumstances” in that state
  - **California and NY Trust Directors**: Sorry!
- Exception: Certain Flavors of Trust Protector May be Non-Fiduciaries
  - Swap Power – IRC §675
  - Should states expand this category?
- California: Door Shuts on Labeling a California Trust Director a “non-fiduciary” for State FIT Reasons
- Contrast with radical “Neo-Trust” States (e.g., Tennessee)

CALIFORNIA UDTA – STATUS OF TRUST DIRECTOR: TREATED AS *TRUSTEE*

- Trust Directors are treated the *same as Trustees* under California law: California law regarding trustees is absorbed and applied to Trust Directors

  - ***Section 16612*** ~ Trust Director is subject to the same rules as a trustee in a ***like position and under similar circumstances*** in the exercise or nonexercise of a power of direction

  - ***Section 16612(a)(1)*** ~ Trust Director **has the same fiduciary duty and liability** in the exercise or nonexercise of the power, if the power is held individually, as a sole trustee in a like position and under similar circumstances or, if the power is held jointly with a trustee or another trust director, as a cotrustee in a like position and under similar circumstances.

CALIFORNIA UDTA – STATUS OF TRUST DIRECTOR (CONT.)

- Trust Directors are treated the same as Trustees under California law

  - ***Section 16622*** ~ An action against a trust director for breach of trust shall be commenced within the same limitation period (and a report or accounting has the same effect on the limitation period for an action) as […] for an action for breach of trust against a trustee in a like position and under similar circumstances

  - ***Section 16624*** ~ In an action against a trust director for breach of trust, the director may assert the same defenses a trustee in a like position and under similar circumstances could assert in an action for breach of trust against the trustee.

CALIFORNIA UDTA – STATUS OF TRUST DIRECTOR (CONT.)

- Trust Directors are treated the same as Trustees under California law

- ***Section 16628*** ~ Unless the terms of a trust provide otherwise, the rules applicable to a trustee apply to a trust director regarding all of the following matters:
  (a) Acceptance, (b) Giving of a bond to secure performance,
  (c) Reasonable compensation, (d) Resignation or removal,
  (e) Vacancy and appointment of a successor

- ***Section 300*** ~ A trust company may be appointed to act as a personal representative, guardian or conservator of an estate, trust director, or trustee, in the same manner as an individual[…]

CALIFORNIA UDTA – EXCLUSIONS FROM POWERS TO DIRECT

- ***Section 16606*** *~ the statute does not apply to:*

  - A power of appointment
  - The power to appoint/remove trustee or trust director
  - The power of a settlor over a revocable trust
  - The power over a trust if (a) the trust terms provide that the power is held in a nonfiduciary capacity **and** (b) the power is required to be held as a nonfiduciary to achieve the settlor's FEDERAL tax objectives (IRC §675)

- What about other reactive, trust-protector-ish powers? Change situs, amend the document, etc.

CALIFORNIA UDTA – DUTY TO INFORM

- ***Section 16616*** ~ A trustee shall provide information to a trust director (and vice versa) to the extent the information is reasonably related both to the powers or duties of the trustee and the powers or duties of the trust director. A trustee that acts in reliance on information provided by a trust director (and vice versa) is not liable for a breach of trust to the extent the breach resulted from the reliance, unless by so acting the trustee engages in willful misconduct.

- ***BUT…***

CALIFORNIA UDTA - NO DUTY TO MONITOR

- ***Section 16618*** ~ Neither a trustee nor a trust director is obligated to monitor each other, or inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which they might have acted differently.
    - This provision is standard in all state directed trust statutes – a response to the infamous *Rollins* decision

CALIFORNIA UDTA - OTHER FEATURES

- **Section 16608(b)** ~ Trust Director Powers: Trust Director May Exercise “Any Further Power Appropriate” to the Exercise of a Direction
  - E.g.: Incur costs; make reports; employ professionals to advise; prosecute, defend, join an action; delegate

- **Section 16620** ~ **Cotrustees**: The terms of a trust may relieve a cotrustee from duty and liability with respect to another cotrustee’s exercise or nonexercise of a power of the other cotrustee to the same extent that, in a directed trust, a directed trustee is relieved from duty and liability with respect to a trust director’s power of direction […].

WHAT'S NOT IN THE CALIFORNIA UDTA

- **Off-the-Rack Laundry List of Duties** or Segregated Categories of Directors
  - But see comments to UDTA with a non-exclusive list
  - Some state statutes provide

- Burden is on the Drafter to Precisely Define the Respective Powers and Duties of the Trust Director and Directed Trustee

- Guidance Regarding Discrete Boundaries Between the Trustee and Trust Director Responsibilities
  - Are Beneficiary Loans Investments?
  - Who Can Encumber Trust Assets?
  - Who Enforces Investment Contracts?
  - Who Settles Litigation?

WEALTH MANAGEMENT

DIRECTED TRUSTS IN PRACTICE

DIRECTED TRUSTS RULE: WHY?

- Settlors can assign responsibilities to different fiduciaries (e.g., Uncle Larry directs the trustee to make distributions, Aunt Lucy directs the trustee as to investments, the Bank acts as trustee)
- Reduced (Eliminated?) Risk for Corporate Fiduciary
- Easier for Corporate Fiduciaries to hold illiquid assets if directed
- Reduced trustee fees for professional trustees
- Freedom of Investment (“Hold the ENRON”)
- While Retaining Professional Administration (and liability?)
- Despite: the Legal Immaturity/Uncertainty of the Concept

DIRECTED TRUSTEE VS. DELEGATION

- How is giving a trust director a power of direction over investment decisions different from delegation?

- **Delegation**: A trustee may delegate investment and management functions as prudent under the circumstances. The trustee shall exercise prudence in the following: (1) Selecting an agent; (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; (3) Periodically reviewing the agent's overall performance and compliance with the terms of the delegation. [*Section 16052*]

- **Directed Trustee**: a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction […] **and the trustee is not liable for the action**. [*Section 16614*]

DIRECTED TRUSTEE VS. DELEGATION

- **Delegation**: The **Trustee** chooses to delegate an investment power, but still retains a duty to select the agent, establish the scope and terms, and review the agent's performance

- **Directed Trust**: The Settlor grants the power of direction over investments to the **Trust Director**, and the Trustee is not liable for following the Trust Director's direction.*

*Except willful misconduct…

DO WE NEED DELAWARE, NEVADA, ET AL. ANY MORE?

A settlor may still want to establish a trust outside of California for a number of reasons, including:

- No state income tax
- Longer (unlimited) duration under perpetuities rule
- Silent/Quiet Trust (trustee can provide information to designated representative instead of beneficiaries)
- Availability of estate-remote and creditor protected self-settled irrevocable trusts
- Virtual representation statute
- Broader decanting powers / availability of nonjudicial settlements / sealed court proceedings
- Stronger no-contest clauses
- Limitation on claims period against trustees for disclosed actions
- Statutory authority for trust protectors
- Different principal and income act provisions
- And many more …

CASE LAW

A Pattern of Confusion and End-Runs (Except in Delaware – Duemler)

- **Duemler** (Delaware)
  - Directed trustee not liable for director’s lousy investment
  - Delaware so proud of this case
- **Rollins** (Virginia)
  - Directed Trustee not liable for following direction, BUT…
  - Infamous back-door directed trustee liability for ***failure to warn***
- **McLean** (Missouri)
  - Court **infers,** from the (fiduciary) power to remove trustee, a ***duty to act*** to protect the trust
  - What about a (fiduciary) power to change situs?
- **Shelton** (New Hampshire)
  - Conflict over Sub-trust funding between trustee and investment directors. Illiquid investments prevented trustee from making distribution to a beneficiary

PRACTICAL CONSIDERATIONS

- Forum is **Critical**
  - o Advantage Delaware
- Precise Drafting a Must
  - Who sues the beneficiary on note delinquency?
  - Who has authority to encumber trust assets?
  - Friendly Trust Co's have forms
- Is There Really Much Practical Difference Between UTC 808 and "Modern Statutes"?
  - o Or is this all marketing
    - o Modern Statutes do add necessary bells & whistles (standard of care, no duty to monitor, etc.)
  - o What will a California court do? Willful Misconduct is a new standard – and a *very* high bar – at least in Delaware

PRACTICAL CONSIDERATIONS

- Who Wants to be a Trust Director?
  - Who Represents the Hapless, Patsy Trust Director
  - I.e., to ensure that the duty to diversify is nullified, that concentrations may be retained, etc.
- Will This Really Help in California, Given
  - Our State Fiduciary Income Tax Regime
    - Cf. Grantor Trusts, CA Source Income
  - Our Courts of Equity?
    - "Equity will not suffer a wrong to be without remedy"
- Future Amendments to Our Statute: Defining Willful Misconduct to Include Recklessness? Raise Minimum Floor to Recklessness? Excluding Other Powers to Allow them to be Non-Fiduciary?

NORTHERN TRUST