

The Rise of Directed Trusts and Why It Matters



Trust law in Tennessee has changed more in the last 20 years than in the previous 200. New types of trusts have been invented,[1] new statutes add trust flexibility,[2] and historic trust law has been radically reconsidered.[3] "Directed trusts" are in that last category, for good reason.

Historically, a trust existed only if and when a trustee had fiduciary duties to beneficiaries, and what's more, a trustee could neither divide nor delegate its duties or liabilities. This "unitary trustee" system made one trustee (or set of co-trustees) responsible and liable for all aspects of trust management and investment.

The late 20th century saw the unbundling of trustee duties and liabilities, allowing "multi-participant" governance structures. For example, a myriad of trust companies were created whose business model is to refuse to control any asset investing at all, but rather to serve only as an administrative trustee while trustors or beneficiaries keep or select their own investment advisors. Such a trust company expects to bear little or no liability for any investment losses, in exchange for lower fiduciary fees. This became a successful market niche.

The trend went much further, however, as trustors demanded ever more flexibility. Powers could be given to individuals who were not trustees to direct specific areas of trust operations, leading to the term "directed trusts." The policy issue is how to divide the law of trusteeship between a trustee with normal fiduciary duties and a non-trustee "trust director" who may control the trustee only in certain respects but who may or may not have any fiduciary duties in the traditional sense.

State laws have varied widely in addressing this trend.[4] Tennessee, consistent with its desire to attract trust business from other states, is among the leading jurisdictions[5] in creating unique and flexible but sensible directed trust laws. In fact, Tennessee claims credit for being perhaps the second state to authorize what are now known as directed trusts.[6]

Tennessee law creates three key concepts: (1) a "trust advisor" (also known as a "trust protector") vested not only with power to direct the trustee but in many cases to take direct actions that the trustee would otherwise perform or even actions that the trustee would not normally have power to perform; (2) an "excluded fiduciary," *i.e.*, a trustee or other trust advisor immune from liability for following the direction of a trust advisor vested with a particular power of direction; and (3) a trust advisor's default fiduciary duty under *Tenn. Code Ann.* §35-15-1202 is only to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Crucially, the 2013 Restated Comments to Official Text of *Tenn. Code Ann.*

§35-15-1202 make clear that the trustor may exclude a trust advisor from being a fiduciary at all, with or without a duty of good faith, provided only that a trust advisor cannot be exculpated from reckless indifference to the purposes of the trust or the interests of the beneficiaries.

In other words, Tennessee law allows a trustor to create a designer trust, with custom tailored duties and liabilities allocated among any number of parties.

Why does this matter? Because most trustors choose family members and friends as trustees, and they want them to serve without worrying unduly about lawsuits from ungrateful beneficiaries. They may want these individuals to be subject to liability only for egregious misdeeds, such as "reckless indifference," or perhaps gross negligence or willful misconduct, while still holding paid experts, such as banks, trust companies, and investment advisors, to a more exacting and traditional fiduciary standard. Conscientious trustors can now carefully consider which individuals or professional organizations constitute the optimum combination and allocation of skills and services and design the right matrix of duties and standards of liability for each.

For example, a trustor can choose XYZ Trust Company as sole trustee, with full fiduciary duties; investment advisor Joe Blow to manage all the marketable securities, with full fiduciary duties as to that task; family members Aunt Bertha to make any decisions on distributions to the trustor's descendants, brother Steve to vote all the closely held company stock, and sister Act to manage all the real estate, all three such family members having fiduciary liability only for willful misconduct; and Uncle Joe to have the power to remove and replace any trustee and to appoint successors to any trust advisors, with no fiduciary duty at all except the statutory default of reckless indifference. All are excluded fiduciaries as to the other parties' duties. Each can have a separate fee structure.

Tennessee really wants it to be easy to make any trust a directed trust. Effective July 1, 2021, the non-judicial settlement statute for essentially administrative issues, *Tenn. Code Ann.* §35-15-111, explicitly authorizes modifying irrevocable trusts to become directed trusts. Such an action is now considered merely administrative. Perhaps directed trusts will become the default in the 21st century.

NOTES

1. E.g., Community Property Trusts (*Tenn. Code Ann.* §§35-17-101 *et seq.*) and Tenancy by the Entireties Trusts (aka "Marital Asset Protection Trusts") (*Tenn. Code Ann.* §35-15-510).

2. E.g., Non-Judicial Modifications of Irrevocable Trusts (*Tenn. Code Ann.* §35-15-111 and §35-15-411), along with a 360-year Rule Against Perpetuities (*Tenn. Code Ann.* §66-1-202(f)).

3. E.g., Purpose Trusts (*Tenn. Code Ann.* §35-15-409) and Domestic Asset Protection Trusts (aka "Tennessee Investment Services Trusts") (*Tenn. Code Ann.* §§35-16-101 *et seq*).

4. Many states rely on Section 808 of the Uniform Trust Code (UTC), also found in Tennessee in *Tenn. Code Ann.* §35-15-808, which allows a trustor to grant a non-trustee power to direct the trustee, but then in effect makes both parties fiduciaries subject to fiduciary liability, especially keeping the trustee potentially liable for deciding when to follow directions. Other states have adopted a variation of Section 185 of Restatement (2nd) of Trusts, or Section 75 of Restatement (3rd) of Trusts, similar to UTC Section 808. Other states have adopted the recently available Uniform Directed Trust Act, which purports to allocate fiduciary liability according to who actually holds fiduciary powers, regardless of title, and permits a directed trustee not to follow a direction if the action would knowingly be a breach of the trustee's fiduciary duty. Finally, a few states, notably California and New York, have no directed trust statute at all.

5. States other than Tennessee considered to have the best statutes for directed trusts are Alaska, Delaware, Nevada, New Hampshire, South Dakota and Wyoming. See https://www.wealthadvisorstrust.com/best-trust-laws-by-state.

6. The 2013 Restated Comments to the Official Text of *Tenn. Code Ann.* §35-15-1201 state that Tennessee has one of the longest histories of statutorily providing for directed trusts, enacting *Tenn. Code Ann.* §35-3-122, effective July 1, 1987 (as compared to Delaware's similar statute enacted on July 3, 1986), as well as *Tenn. Code Ann.* §35-3-123, effective in 1989, which statutes grant immunity to a trustee for following the investment directions by a person given such power to direct by the trustor.

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