A Practical Orientation to Directed Trusts

By Miriam Abrams Goodman*

A directed trust is an estate planning tool that allows a settlor to divide responsibilities and liabilities traditionally held by a single trustee. On March 28, 2019, Governor Polis signed Senate Bill 19-105, the Colorado Uniform Directed Trust Act ("CUDTA"), scheduled to become effective August 2, 2019, which will replace current law governing directed trusts, CRS §15-16-801 et seq.[i]

The primary purpose of this article is not to familiarize attorneys with Colorado's directed trust statutes, but to introduce practical considerations when working with a client who desires a directed trust arrangement. This article will focus on the most common use of a directed trust, where a settlor appoints a "trust director" (known as a "trust advisor" in the current statute), empowering the director/advisor to manage trust investments, and directing the trustee to comply with the director/advisor. Where the settlor has excluded the trustee from investment management in the trust document, both current law and the proposed act protect the trustee from duties and liabilities connected with trust investments, absent willful misconduct on the part of the trustee.[ii] Both also place fiduciary liability on the trust director/advisor,[iii] and subject the director/advisor to jurisdiction of the Colorado courts.[iv]

In practice, two common situations may lead a client to inquire about a directed trust. In both situations the client/settlor has a longstanding, successful relationship with an investment advisor, and desires his or her beneficiaries to continue to profit from that relationship. In one situation the settlor appoints an individual trustee with little or no expertise in investment management. In the other situation the settlor desires that a corporate trustee handle administrative duties such as exercising discretion over distributions, fiduciary accounting and tax preparation, but prefers placing control over investment management with the trusted advisor.

A few guidelines will help the attorney use the directed trust tool properly in these situations, to help ensure the estate plan is effective in implementing the client's wishes. This may be tricky for the attorney where the investment advisor has referred the client to the attorney for estate planning. Nevertheless, for the tool to be effective, the attorney should understand and communicate with the client and the advisor a few relatively simple concepts at the intersection of investment management and trust law.

The attorney's first line of inquiry is to determine whether the client's trusted investment advisor (1) exercises discretion over the client's investment account, and (2) has the independence to accept full fiduciary responsibility over the account when it transfers to trust ownership. The client may be unaware that underlying his or her relationship with the advisor is an account agreement stating that the investment advisor does not exercise discretion over the account, and all trades must be approved by the client. Payment of an annual advisory fee instead of brokerage fees on transactions is not necessarily determinative on this question. The estate planning attorney does not need to be an expert in securities law to conclude that an investment advisor who is not authorized to exercise discretion over an account cannot act in a fiduciary capacity as the directed trust statutes require. In these circumstances, the alternative framework is for the settlor (or beneficiaries, if the settlor is incapacitated or deceased) to request or direct the trustee to delegate investment management to the advisor under the Colorado Uniform Prudent Investor Act.[v] That Act imposes a duty of reasonable care on the agent, and subjects the agent to jurisdiction of Colorado courts, but does not expressly state that the agent is acting in a fiduciary capacity.

A prudent delegation under the Colorado Prudent Investor Act provides the trustee some protection from liability, but it does not absolve the trustee from oversight of the investment advisor to the same extent as the directed trust statutes.[vi] This may be a common and acceptable framework for an individual trustee to continue working with a family's investment advisor. The client should be aware of the responsibility and liability he or she is placing on the individual trustee, and review with the attorney trust provisions authorizing the delegation and exonerating the trustee. Where the client desires the services of a corporate trustee, however, a trust company may decline to accept a prudent delegation arrangement where the cost of staffing oversight of the outside investment advisor prevents discounting the trustee's fees to a level which, when combined with the investment advisor's fee, is a reasonable overall fee for the beneficiaries to bear. [vii] The corporate trustee also may be likely to decline in light of its duty under the Prudent Investor Act, in investing and managing trust assets, to incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.[viii]

Where a client's investment advisor does exercise discretion over the client's account, the advisor still may be unable to act in the fiduciary capacity contemplated by the directed trust statutes, particularly if the advisor operates under a large brokerage house. A large brokerage firm will typically have corralled its trust fiduciary liabilities in its own captive trust company, and its arrangements with individual retail advisors will not authorize them to sign extraneous paperwork exposing the company to outlying liabilities. As discussed further below in the context of a corporate trustee, this relates not only to fiduciary liability, but also to regulatory oversight of the financial institutions and flexibility in executing trades.

Thus, the directed trust can be an effective arrangement where the investment advisor is not only willing and able to accept full fiduciary responsibility for trust investment management, but may act ***independently*** from its broker/trader in doing so. Under these circumstances, a settlor may effectively insulate the excluded or directed trustee from liability for investment management, and a corporate trustee may be willing to discount its fee.

If the client desires the services of a corporate trustee in a directed trust arrangement, there are further issues to discuss with the client and his or her investment advisor. A corporate trustee is regulated by state and/or federal authorities who face the task of auditing one financial institution (the trust company), only to find that responsibility for prudent investing lies with another financial institution (the investment advisor), regulated by a different agency. Corporate trustees continue to struggle with properly documenting these accounts to satisfy regulators, insurers, and the practicality of efficient business arrangements. Where a corporate trustee is involved in a directed trust arrangement, it may be advisable for the investment director/advisor to sign the trust agreement. The corporate trustee will require the director/advisor to sign an account agreement explicitly acknowledging and accepting full fiduciary responsibility for the trust's investment management. Another matter to address is the duty of each fiduciary under the trust agreement, the CUDTA, and the Colorado Uniform Trust Code to inform trust beneficiaries of the arrangement (and the costs and fees involved).[ix]

Along with a written agreement to establish the bifurcation of duties and liabilities for regulatory purposes, there are administrative practicalities to be resolved. Unless addressed by the trust agreement, the investment director/advisor must (prudently) delegate to the trustee or another director/advisor responsibility for managing any trust assets the director/advisor is not capable of managing – real estate, closely held business interests, or more unique assets for example.

Choice of a securities trading platform is another practical matter to be resolved. A corporate trustee's trading platform is integrated with its trust accounting software, which produces periodic statements and a tax worksheet efficiently satisfying the trustee's inventory, accounting and tax reporting responsibilities. Statements produced from a brokerage platform do not provide income and principal (fiduciary) accounting, nor will a Form 1099. Where the director/advisor is unwilling or lacks the independence to trade securities on the trust company's platform, the alternatives may impose additional costs on the trust beneficiaries. The trust company will either need to acquire software to electronically feed brokerage account activity to the trust platform, and assign trained staff to manually perform trust accounting and tax coding activities on those transactions, or will need to pay an accountant to straighten it all out at the end of the year.

In sum, Colorado's directed trust statutes provide a legal framework for clients to divide trustee responsibilities and liabilities for investment management among different fiduciaries. It is incumbent upon the attorney drafting such arrangements to discern circumstances where such an estate planning tool will be effective in implementing the client's desires and where it may not be effective, due to excessive costs or other barriers that the statutes themselves do not contemplate.

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[i] The signed Act can be viewed at http://leg.colorado.gov/bills/sb19-105.
[ii] CRS §15-16-807; SB 19-105: §15-16-809.
[iii] CRS §15-16-801(8)(a); SB 19-105: §15-16-808.
[iv] CRS §15-16-809; SB 19-105: §15-16-815.
[v] CRS §15-1.1-109.
[vi] *See* CRS §15-16-805-807; SB 19-105: §15-16-811.
[vii] *See* Comments to CRS §15-1.1-109 on protecting the beneficiary against unreasonable delegation.
[viii] CRS §15-1.1-107.
[ix] *See* CRS §15-16-806(3); SB 19-105: 15-16-808(1); and CRS §15-5-813.