

**New Hampshire Legislation Recognizes "Open Architecture" Trust Designs
Through the Use of Multiple Non-Trustee Participants -- Protectors, Directors,
Advisors, Committees and Other Strange Bedfellows**

By: Joseph F. McDonald, III
McDonald & Kanyuk, PLLC
7 Hills Avenue
Concord, New Hampshire, 03301
603-228-9900
February, 2008 (a work in progress)

A. Introduction. An article recently appeared in the Wall Street Journal¹ in which the author observed that ". . . as trusts become more complex and investing strategies become more sophisticated, more well-off families are using teams of multiple trustees and advisors, each with very specific rules and responsibilities. . . . Families are 'slicing and dicing' trustee duties, and allocating them among these multiple trustee and non-trustee participants. . . .", including co-trustees, agents, trust "protectors", distribution and investment committees and trust "advisors".²

You know that an estate planning concept has achieved some currency when it moves beyond the arcane world of the professional journals and into the popular press. In recent years, many commentators have addressed the nuanced legal issues implicated by such multiple participant "open architecture trust" ("OAT") structures -- a modern development unknown to the common law.³ New Hampshire is one of a growing number of states which have responded by enacting an extensive set of default rules governing the interrelationship and legal responsibilities of these new players to each other, to trustees and to beneficiaries.

OAT structures offer both promise and peril for New Hampshire estate planning attorneys, trustees and clients alike; while they can be crafted to allow families more meaningful roles in the administration of their large trusts and address many of the constraints and liability risks trustees faced under prior law (particularly those relating to investments and the duty of diversification), there remains the potential for unintended tax and other consequences as the law and drafting practices continue to evolve. This paper will attempt to explain the origins of these new models for trust governance and some of their implications for New Hampshire attorneys, clients and trustees.

¹ Rachel Silverman, *How Many Trustees Do You Need?*, Wall Street Journal (July 12, 2007) at B5.

² *Id.*

³ See, e.g., King and McDowell, *Delegated vs. Directed Trusts*, July, 2006 Trusts & Estates at 26; Bove, *Trust Protectors*, November, 2005 Trusts & Estates at 28; Minnigh, *Using Trust Protectors in Domestic Estate Planning*, Tax Management Memorandum (2007); Lahey, *Open-Architecture Trusts: The Wiser Choice*, August, 2003 Trusts & Estates at 44.

B. Origins.

1. The "Unitary Trustee".

a. In Feudal England. Trusts were originally developed in England as a means of conveyance of feudal lands, not as a vehicle for the management of fungible investment assets. The trust structure evolved as a title holding intermediary to avoid the vestigial feudal assessments and restrictions on inheritance which existed under the ancient English law of real estate, particularly primogeniture. Achieving these purposes required that trustee hold full legal title to the land. Accordingly, English common law protected the family by severely limiting the authority of the trustees. The chosen trustees were typically individuals: friends, advisors and members of the family. These early trustees served without compensation and did very little. There was no need for elaborate trust laws to define the powers of trustees and the interrelationship between the family and trustee because they peacefully co-existed within their limited spheres.

b. Post Industrial England. The need for a deeper body of trust law became more apparent after the industrial revolution. Financial instruments -- stocks, bonds and other complex financial promises -- replaced real estate as the stores of wealth for the privileged classes. Traditional family trusts in England suffered from the shackles of their heritage as simple devices for holding and conveying real estate. Still, the trustee's inherent powers remained limited despite dramatic changes in the foundations of wealth. The law continued to require that a single trustee, or multiple trustees acting unanimously, took all important trustee actions and participated in all significant trust decisions. Generally, important trustee functions such as investing or distributing assets among beneficiaries could not be delegated one of several trustees without the others retaining some responsibility for the acting trustee's misdeeds and breaches of fiduciary duties. The "unitary trustee" with limited powers, and the subsidiary principle prohibiting delegation, were generally immutable; they could not be overridden by the trust creator by a contrary instruction in the trust agreement. The common law, therefore, recognized only a single, integrated office of trustee.

c. In the United States. The unitary trustee principle was carried-over from English-law to the crown colonies, including the United States. It initially proved resistant to reform despite a rapid evolution in financial and investment management practices which cried out for change. American courts and some legislatures gradually responded first by replacing the concept of protecting beneficiaries by limiting trustee powers with a new system that granted broader powers, but restricted their exercise by imposing strict duties of fiduciary care and loyalty.

Another watershed development in the evolution of the law of trusts and trustees: the rise of the institutional trustee-for-hire, which began to supplant the uncompensated "philosopher-king" lay trustee by the end of the 20th century. U.S. tax

law helped accelerate this trend because many trustee powers triggered adverse estate and tax consequences if they were held by settlors and related beneficiaries. Corporate trustees found comfort in the unitary trustee rule because it tended to protect their near monopoly position and give them disproportionate powers over substantial family trusts. Dissatisfaction with this attitude and a desire on the part of many family members to assert more control over their own destiny began to erode the unitary trustee principle and the dominant position of the corporate trustee. Other more recent developments have also contributed to this trend, including a growing sophistication and complexity in the investment world, the decline of the rule against perpetuities and the resulting growth in dynasty trusts, vigorous competition among states for trust business, rapid consolidation and merger among financial institutions (including banks with trust departments) and dramatic recent changes in trust laws.

d. The Influence of the Principles Applicable to Co-Trustees.

The use of non-trustee participants was not widespread in this country until the last decade or so. Before then, dissatisfaction with the traditional fully-empowered unitary trustee model was manifested in a movement toward the use of co-trustees. Co-trusteeships first became popular to overcome the inability of a single trustee to administer property in multiple jurisdictions (i.e., where the primary trustee was not legally competent to act outside of the state of its residence or charter). Later, co-trustees were used to provide special asset class competence not possessed by the primary trustee -- for example, the use of "special trustees" to administer closely held business assets, or to participate in distribution decisions an "interested" primary trustee could not make without risking adverse wealth transfer tax consequences. The increased use of multiple trustees forced some changes in the law concerning the duties and responsibilities of co-trustees among themselves and with respect to the beneficiaries in several noteworthy respects which have relevance to the development of the laws relative to non-trustee OAT participants.

(1) Allocation of Responsibilities. Generally, if the terms of a trust with more than one trustee provides that one or more of the trustees will possess exclusive authority with respect to trust administration, the other trustee or trustees ordinarily have no duty to participate in the matters exclusively delegated to the empowered trustee(s).⁴ If, however, a non-participating trustee has reason to believe that the empowered trustee or trustees may be committing a breach of trust, the non-participating trustee or trustees have a duty to take reasonable steps to investigate and prevent a breach if possible.⁵

(2) Trustee Action. The common law "default" rule initially required unanimous decision-making among co-trustees.⁶ The law evolved over

⁴ Restatement (Second) of Trusts §185, Comment c (the "Restatement (Second)").

⁵ *Id.*

⁶ *See, e.g.*, Restatement (Second) §184, Comment c.

time and replaced the unanimity requirement with a majority rule standard.⁷ A deadlock among trustees could only be resolved by court intervention.⁸ These were generally default rules which could be modified by specific provision in a trust agreement. For example, a document might specify that one of many co-trustees is entitled to decide specified questions or take actions as "controlling trustee" in the event of deadlock. Even where such provision was made, however, the courts required that all trustees participate in decision making with respect to those matters and to be an informed fiduciary participant in all trustee deliberations (including those exclusively delegated to another co-trustee).⁹ This is sometimes expressed as a "duty to consult".¹⁰ The duty of each trustee to use reasonable care to prevent a breach by the controlling trustee was considered to be non-waiveable by a contrary instruction in the trust agreement.¹¹

(3) Co-Trustee Liability. Co-trustee liability is generally joint and several.¹² A co-trustee is not liable to a beneficiary for a breach of trust committed by another trustee unless such co-trustee: (i) participated in the breach; (ii) improperly delegated the administration of the trust to the acting trustee; (iii) approved, acquiesced in or concealed the breach; (iv) through failure to exercise reasonable care in the trust's administration, enabled the co-trustee to commit the breach, or (v) neglected to take proper steps to compel the acting to redress the breach.¹³

Thus, by common law, most jurisdictions did not allow a trustee to avoid liability merely by remaining inactive in the administration of the trust. When a co-trustee dissents, however, the dissenting trustee is often able to avoid liability.¹⁴

e. The Influence of Prudent Investor Legislation. The death knell finally sounded for the rules prohibiting delegation of trustee functions with the states' adoption of legislation modeled after the Prudent Investor Act ("PIA") first promulgated in 1994. The PIA reflects "modern portfolio theory" and total return approach to the exercise of trustee investment powers and discretions. Most states have enacted some form of the PIA which allows the trustee to acquire most types of investments, as opposed to the "traditional" trustee investment laws, such as the "prudent person standard", which limited choices among conservative alternatives said to be of

⁷ Restatement (Third) of Trusts §39 (2003) (the "Restatement (Third)").

⁸ See, e.g., *Stuart v. Continental Illinois National Bank Trust Co. of Chicago*, 369 N.E. 2d. 1262 (1977).

⁹ Restatement (Second) §184 (1992) Comment c.

¹⁰ See *Klein v. Reed*, 479 N.E. 2d. 714 (Mass. App. Ct. 1985).

¹¹ Restatement (Second) §184 (1992) Comment c.

¹² Bogert, *The Law of Trusts and Trustees*, §701 (2d Rev. ed. 1984) (hereinafter cited as "Bogert").

¹³ Restatement (Second) §224 (1992).

¹⁴ Comments to the Restatement (Third) state that the rule of majority trustee action which now prevails in most states ordinarily protects a dissenting trustee from liability for an act authorized by the majority, while preserving the dissenting trustee's duty normally to participate in deliberations and decision making and to act reasonably to prevent a breach.

"trust quality".¹⁵ The PIA measures investment performance by assessing the entire portfolio, replacing the asset-by-asset analysis required by the predecessor prudent person standards.¹⁶ PIA's "prudent investor" standard may *require* trustees to delegate investment authority to co-trustees or agents if the trustee does not have sufficient expertise to perform that function for a particular trust. Even a trustee with investment skill may delegate certain investment functions.¹⁷

f. The Rise of "Directed" and "Delegated" Trusts. Perhaps more than any other development, the wholesale adoption of prudent investor standards has fueled the popularity of what have come to be known as "directed" and "delegated" trusts. These terms are sometimes incorrectly used interchangeably. Each of type trust has, however, important distinguishing characteristics.

(1) Delegated Trusts. Generally, a "delegated trust" is one in which the trustee has contractually delegated to a third party agent the performance of some or all of the trustee's discretionary investment management functions. The trustee of a delegated trust may have some duties regarding selection of the investment manager as well as some ongoing monitoring obligations.¹⁸

(2) Directed Trusts. A directed trust, by contrast, strips from the trustee all discretionary duties -- whether related to investment management, or discretion over distributions to beneficiaries, or both. A directed trustee, also often referred to as an "administrative trustee", generally has no duty other than to follow the directions of the empowered party. The empowered party's powers to direct are expressed in the trust agreement. Unlike the delegated trustee, the directed trustee does not have any selection or monitoring functions. The directed trustee's sole responsibility is to insure the accomplishment of the grantor's intent as expressed in the trust agreement.

C. The Anatomy of a Modern OAT Design. As indicated above, the common law generally requires that a trustee may not be held liable for following the instructions of a person empowered by the trust instrument, but the trustee must insure that following such instructions does not violate the trust agreement or fiduciary duty owed to the beneficiaries, and intervene somehow to prevent a breach (or at least warn the beneficiaries so that they can take timely action for themselves). Although the law has been slow to respond to the new OAT governance structures, when it was first promulgated in 2000 the UTC recognized that a duty to investigate and intervene

¹⁵ Trust quality investments traditionally included a diversified portfolio of large capitalization growth stocks, laddered portfolio of intermediate term treasury bonds and/or investment-grade municipal bonds, and cash held in an insured money market account.

¹⁶ Bogert, *supra*, §612 n. 20.

¹⁷ For example, a corporate trustee lacking expertise in a certain investment area such as venture capital or foreign investing may delegate that particular responsibility. *Id.*

¹⁸ See Adams, *Delegating*, June, 2003 *Trusts & Estates* at 80.

standard does not always make sense in light of the increased use directed and delegated trust arrangements.¹⁹

New Hampshire and a few other "progressive" trust jurisdictions have taken the lead in going beyond the UTC's limited recognition of directed trusts by designing in comprehensive "default rules" which recognize multi-participant directed trusts and specifically address other important issues, such as a directed trustee's residual responsibilities. The estate planning attorney charged with drafting a modern directed trust will be careful to craft the trust's provisions to remove the passive trustee's duties and discretions as to distributions and/or investments and give them to an investment committee/trustee, distribution committee/trustee, and/or trust advisor or trust protector. Generally, it is best not to leave these issues to the default rules of even the most comprehensive and well-drafted statute.

The directed trustee's duties may specifically be defined, for example, to include taking title and ownership of the trust assets, establishing and maintaining a trust bank account, preparing or signing the trust tax returns, preparing and sending trust accountings and other statements, and making distributions and receiving contributions, as directed by the empowered party. The directed trustee will also orchestrate things among the multiple participants so that the provisions of the trust agreement are strictly followed. For example, if a specified trust advisor is investing in hedge funds that are specifically prohibited by the trust agreement, the administrative trustee must call the advisor on the carpet and may have an obligation to resign if nothing is done to correct the problem. What follows is a sampler of the typical participants in a substantial modern directed trust structure.

1. Investment Committees and Advisors. The participants possessing specifically allocated investment powers are typically drawn from the settlor's family members, investment advisors, consultants and investment management professionals. Often these persons work together and comprise an "investment committee" which provides directions to the directed trustee. The settlor often designates a family member or members to serve on the investment committee. They in turn, hire the appropriate investment professionals. Alternatively, the trust agreement may designate an investment professional to serve on the investment committee. The investment committee well often manage insurance, closely held stock, partnerships, LLCs, real estate, art, commodities, vacation homes and other illiquid "special assets" which may be held in the trust.

2. Distribution Committees and Advisors. Discretionary distribution decisions are often handled in a similar fashion. The trust agreement will establish a

¹⁹ See UTC §808 cmt. (2005) (indicating that §808(b) relating to directed trustees "imposed only minimal oversight responsibility on the [directed] trustee. A trustee must generally act in accordance with the direction . . . refusing only if the attempted exercise would be manifestly contrary with the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty owed by the holder of the power to the beneficiaries of the trust.")

distribution committee composed of both family and independent members. The independent member participants are important for avoiding the imputation of wealth transfer tax-sensitive distributions to committee members who may also be beneficiaries, or have spouses or children who are beneficiaries who the committee member may have legal obligation to support. Such tax sensitive distributions generally require a non-related or subordinate person to make the independent decision over discretionary distributions so that the trust assets remain out of the trust settlor's and the beneficiaries' gross estates.

3. Trust Protectors²⁰. Trust protectors are often used in tandem with directed trusts' investment and distribution committees. Estate planning attorneys in states without trust protector statutes are drafting the trust protector function into trust agreements governed by the laws of those states (although such structures may be riskier for the directed trustee and the trust protector in states which do not specifically recognize the office of trust protector).

A trust protector is typically given one or more of several duties:

- Modify or amend the trust agreement to achieve favorable tax consequences or respond to changes in the tax laws;
- Increase or decrease the interest of trust beneficiaries;
- Grant, revoke and modify the terms of beneficiary-held powers of appointment;
- Remove and appoint trustees, trust advisors and investment and distribution committee members;
- Terminate the trust;
- Veto or direct trust distributions;
- Change the situs or governing law of the trust, or both;
- Appoint their own successors as trust protectors;
- Interpret ambiguous terms of the trust agreement as may be requested by the trustees;

²⁰ The comments to §8 of the UTC differentiate a trust protector from conventional advisors, stating that: "Advisors" have long been used for certain trustee functions, such as the power to direct investments or manage a closely-held business. "Trust protector", a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust. UTC §808 cmt. (2005).

- Advise the trustee on matters concerning one or more trust beneficiaries, and
- Amend or modify the trust agreement to take advantage of laws relating to the administration of the trust, restraints on alienation, and the distribution of trust property.

D. New Hampshire's OAT Legislation. New Hampshire's OAT statutory provisions refine many of the UTC provisions and represent perhaps the most comprehensive effort nationwide to codify "default rules" relating to directed and delegated trusts, particularly addressing uncertainties concerning responsibilities and liabilities of directed trustees in the context of the duty of diversification of investments. Some background is helpful in understanding our new laws.

1. The Thorny Problem of Reconciling the Investment Diversification Requirement With the Modern Directed Trust. Under most states' common law and statutory standards for trustee investments, diversification is essential to prudent investing. "Modern portfolio theory" ("MPT") is an amalgam of concepts gleaned from various articles and studies published in the financial press. One of the time-honored principles of MPT is that portfolio risk can be reduced by diversification which is often referred to as "the only free lunch". There is general agreement that a portfolio is truly diversified only when it is made up of distinctly separate and broadly different asset classes – generally cash, stock, bonds, and perhaps real estate and "alternative investments" for larger trust portfolios. Within the equity asset class, it takes at least 15 stocks, spread among five or six non-correlated sectors and issuers (domestic and international) to achieve adequate diversification and thereby reduce non-systemic risk (also referred to as "uncompensated risk"). At the atomic level within a domestic equity portfolio, this refers to firm and industry specific risks – the risks of one company or economic sector causing a significant move, either up or down, in a portfolio.

Modern fiduciary investment standards, including those incorporated in New Hampshire's pre-TMCA statutes, adopted diversification as a bedrock principle for the prudent management of trust portfolios. Under these standards, it was clear that a trustee must diversify unless it is prudent under the circumstances not to. A New

Hampshire trustee must have had a compelling reason not to diversify. These prudent investor rules were a default rules and could be expanded, restricted, eliminated or otherwise altered by provisions of a trust. Such provisions are commonly referred to as exoneration, exculpatory, or authorization provisions.

Under New Hampshire's pre-TMCA law, trustees could confront many thorny issues when dealing with provisions of a trust agreement which authorized or directed the retention of a concentrated stock position or an illiquid asset such as real estate or closely held business interest. The trustee and his or her counsel was forced to read and analyze these provisions carefully. In the context of the settlor's intent, the trustee was well advised to understand whether the trust instrument alters the trustee's authority, or standard of care, or both.

For example, did the trust document (i) authorize the trustee to refrain from diversifying the trust assets, thereby eliminating or diluting the normal diversification requirement, but (ii) remain silent on the standard of care by which the trustee's decision not to diversify may be reviewed?

As a general proposition, under the old rules in New Hampshire, an exculpatory, exoneration, or authorization provision could change the normal prudence standard by which the trustee's investment conduct was to be reviewed. But a trust document that simply authorized the trustee to depart from the normal standards of prudent investing might not change that standard at all. In any given case involving a trustee's investment conduct and a failure to diversify, under pre-TMCA law, the same set of facts could lead to two very different results when the trust instruments vary even slightly. Although the New Hampshire Supreme Court has not had specific occasion to address the diversification issue in the context of an undiversified trust portfolio, courts in several other states have, often resulting in surprisingly harsh surcharges against trustees.

As a general rule, courts will strictly construe an exculpatory, exoneration or authorization provision before relaxing the normal diversification requirement. Standing alone, a permissive provision in a trust agreement would not relieve a trustee from scrutiny under the prudent investor standard. *Indeed, to the shock and dismay of*

many in the fiduciary professions, trustees have been held liable for failure to diversify even in cases involving a **direction** in the trust document to retain a concentrated position or an illiquid asset such as real estate or a closely held business interest. Courts have found that such a direction does not excuse the trustee from a duty to monitor the investment and petition the local probate court for modification of the trust agreement if the asset in question substantially declines in value. This has made it quite difficult for settlors and their drafting attorneys to negate or dilute the normal diversification requirements of prudent investing, or find corporate trustees to manage undiversified trust portfolios or retain real estate or closely held business interests which might comprise a disproportionate portion of a trust's value, irrespective of the extent of the authority, direction, or exoneration language contained in the governing document.

2. New Hampshire's Solutions. TMCA has removed many of these obstacles and provided cover for trustees holding undiversified trust investments by enacting changing several provisions of the UTC.

a. New §9-901(b): Protecting from Surcharge Exposure A Trustee Who Relies In Good Faith on a Court's or Settlor's Direction or Authority to Retain an Investment. In 2004, the UTC repealed the prudent investor rule contained in RSA 564-A:3-b. The new investment standard was recodified as Article 9 of the UTC, which did not differ substantially from the former rule or the general standards of prudence and diversification described earlier in this section. Pre-TMCA UTC §9-901(b) purported to protect the trustee from surcharge liability "to the extent that the trustee acted in *reasonable reliance* on the provisions of the trust" (italics supplied) which altered or eliminated the duty to diversify. §9-903 provided that the trustee need not diversify if "the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying" – language taken verbatim from NCCUSL's corresponding §903. NCCUSL's Comments offered as examples of such special circumstances a trustee's consideration of the tax consequences of selling a large block of stock with a low cost basis, or a trust that was clearly designed to hold a family business or vacation home.

While the interest of the NCCUSL drafters was to provide more cover from surcharge exposure, trustees and their counsel took cold comfort in these two exceptions to the normal diversification requirement. The “reasonable reliance” exception is an objective, “reasonable person” standard. It does not focus on any given trustee’s subjective good faith reliance on a retention direction or authorization. Trustees operating under the reasonable reliance exception were still wary of the cases from other jurisdictions which surcharged trustees for failure to diversify despite a contrary direction or authority. A New Hampshire trustee operating under former §§9-901(b) and 9-903 would have no certainty concerning the reasonableness of the trustee’s reliance on the retention provision until after the beneficiaries’ lawyers took their best shots and the surcharge litigation concluded with the presiding judge’s application of 20:20 hindsight to the trustee’s actions. It remained uncertain the extent to which a trustee could justify a decision based on special circumstances, if even if they fell within the examples (low cost basis, etc.) given in the Comments.

TMCA addressed these issues in part by amending §9-901(b) by adding the following italicized language: “A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust or court order *or determined not to diversify the investments of a trust in good faith in reliance on the express terms of the trust or a court order or pursuant to [§9-903]*” (italics supplied). This new language *both* specifically addresses the issue of a trustee’s liability for failure to diversify and provides a *subjective* “good faith” standard for judging the trustee’s conduct. A beneficiary and his or her lawyers seeking to surcharge a trustee for relying on a authority to retain under a governing instrument or court order have a formidable evidentiary burden: they must now show that the trustee acted in bad faith in following a direction or authorization not to diversify for a court to surcharge the trustee for any losses which resulted. Importantly, a court may find that a trustee’s determination not to diversify was inappropriate and therefore may force the

sale of a concentrated position, but the good faith standard will take the surcharge remedy out of play in all but the most egregious cases (I can't imagine any).²¹

b. New §8-808 and Several Companion Provisions Recognized Directed Trusts and Give Greater Cover to Directed Trustees. TMCA also attacks the diversification problem by improving the former UTC provisions relating to directed trusts. Pre-TMCA UTC §8-808 recognized their use and validity by allowing settlors to confer trust functions on third parties, and ratifying the use of such third parties. §8-808(b) provided that if the trust agreement confers upon a third party the power to direct the trustee, “. . .the trustee shall act in accordance with the exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of fiduciary duty that the person holding the power owes to the trust beneficiaries.” Former §8-808(d) provided that a third party with a power to direct is “presumptively . . . a fiduciary”, with a duty to “act in good faith in regard to the purposes of the trust and the interests of the beneficiaries”, and subjected that party to the corresponding liability for breaching a fiduciary duty.

While these provisions authorized generally the use of directed trusts, they were in many respects vague and uncertain in their application. TMCA addresses this in several respects: first, by providing some new definitions to the UTC's definition section, §1-103; and second, by enacting a comprehensive, bullet-proof new UTC Article 12 devoted exclusively to trust protectors and trust advisors.

²¹ Of course, a trustee who fails to diversify and who cannot rely on a provision on the governing instrument or a court order is likely to be surcharged for any resulting losses if the trustees' failure to diversify is deemed to be unreasonable under the general prudent investor standards of §9-901 and the specific "special circumstances" exception of §9-903, with all of their resulting uncertainty. Anyone considering a trusteeship which will require the retention of concentrated positions or special assets will be well advised to insist that specific authority or direction be given in the trust agreement, or, if the trust agreement is irrevocable and does not provide it, seek a modification through an NJSA, where available, or court-order to include such a direction or authorization.

(1) Some highlights:

(A) Definitions.

i. “Directed Trust”. §103(23) defines a “directed trust” as a trust with respect to which one or more persons is given the authority to direct or consent to a trustee’s actual or proposed decision, including investment decisions and decisions concerning distributions.

ii. “Excluded Fiduciary”. §1-103(24) defines an “excluded fiduciary” as a fiduciary who is excluded from exercising a power or who is relieved of a duty because such power or duty is vested in another person. This will enable a settlor, for example, to confer investment authority, but no other authority, solely upon a trust advisor, to the exclusion of the trustee. With respect to investment decisions the trustee is an “excluded fiduciary”, and with respect to all other trust functions the trust advisor is an excluded fiduciary.

iii. “Trust Advisor”. §1-103(27) defines “trust advisor”, and §12-1203 provides a non-exclusive list of functions (including investment management) which can be delegated to trust advisors. §1204 confirms that any trust advisor is a fiduciary, subject to fiduciary liability for breaches of duties vested in the trust advisor.

(B) Exoneration of Directed Trustees. §1206 provides that a trustee, as an “excluded fiduciary”, does not have a duty to review the actions of a trust advisor, and §12-1207 insulates the trustee from liability for losses relating to duties vested solely in a trust advisor.

Taken together, these new provisions in UTC Article 12 will provide tremendous comfort to directed trustees and eliminate the needless expense of trustee oversight. Trustees who wish to modify existing trusts to allocate to trust advisors or protectors responsibilities over investments and/or distributions may seek modifications to irrevocable trust agreements which delegate those responsibilities (to designated trust advisors or even to "investment trustees" or committees and "distributions trustees" or committees), and state specifically that the directed trustee will

be an excluded fiduciary under §1-103(24). Such modifications are clearly administrative in nature and in most cases should be the proper subject of a NJSA, unless unbundling the trustee duties in this fashion can be said to violate an apparent material purpose (such as evidence that the settlor reposed particular confidence in the chosen trustee -- presumably a rare circumstance).

c. Allowing Private "Purpose Trusts" of Open Ended

Duration. Finally, amended UTC §4-409, concerning so-called “purpose trusts”, removes the time limit on such trusts, which were formerly limited to 21 years in duration. This enables a settlor to create a purpose trust to hold a family business, or a “use” asset such as a family compound, in perpetuity without concerns about trustee liability for failure to diversify, or beneficiary lawsuits seeking to terminate or modify the trust. Only a named “trust enforcer” can enforce the purposes of the trust. By definition, a “purpose trust” is established for a purpose, not for the benefit of named beneficiaries, thereby denying any person might be entitled to benefit for the purpose trust standing to surcharge the trustee.

3. How Will the New Hampshire Courts Respond to the Excluded

Fiduciary Concept? The obvious intention of this legislation is to allow: (i) settlors to write their own scripts, directing retention of concentrated publicly-traded stock positions, family businesses, family lands or other assets without fear that their purposes will be disregarded by surcharge-loathing corporate trustees, results-oriented judges or beneficiaries with clever and persistent lawyers; (ii) trustees comfortably to administer modern OAT governance structures such as directed trusts, non-directed trusts with provisions which dilute or negate normal diversification principles, and “purpose trusts” - - whether those trusts are drafted after TMCA incorporates their modern design features or modified in some user-friendly fashion to adopt them -- without fear of surcharge or vexatious beneficiary litigation, and (iii) probate judges to expect less frivolous fiduciary surcharge litigation clogging their dockets based on alleged failures to diversify where the settlor or a proactive trustee, through informed counsel, has availed him or herself of any one or more of these new techniques.

But can we be sure that the reality will live up to the promise? This newly-minted legislation has not been battle-tested in the courts. The directed trust concept has, however, been litigated in other contexts which might provide some clues as to how a New Hampshire court might respond to any attempt to expand a directed trustee's responsibility and liability beyond that contemplated in the excluded fiduciary definition.

a. ERISA Directed Trust Litigation. There have been some high profile cases decided under the Employment Retirement Income Security Act of 1974 ("ERISA") which address the duties of directed trustees of qualified plan assets to supervise, investigate and warn.

In *Tittle v. Enron Corp.*,²² a Texas district court judge expanded the Second Restatement's "reason to suspect" standard, holding the Enron retirement plan's directed trustee to a "knew or should have known" standard. Northern Trust Company ("Northern") was the directed trustee of three Enron ERISA plans. A day after Enron announced a huge charge to its third quarter earnings, Northern imposed a "blackout period" on the purchase or sale of Enron's stock in its 401(k) plan pursuant to previous directions from Enron as plan sponsor to allow for a change in plan trustees from Northern to a successor. The inability to sell the Enron stock during the blackout period exacerbated the plan's participants' loss as Enron stock continued its freefall. The participants sued Northern (among others) for breach of fiduciary duty related to the blackout and for failure to diversify, alleging that the directed trustee Northern knew or should have known that the investment in Enron was imprudent.

Northern defended on the basis that it was a directed trustee and not a discretionary trustee. ERISA incorporates a directed trustee concept in its statute.²³ Relying heavily on the Restatement (Second), the court held that the directed trustee's duties survived despite the severe restrictions on the directed trustee's authority. The court concluded that it was a factual question whether the evidence presented was sufficient to give rise to a fiduciary duty for Northern's part to investigate the advisability

²² 284 F. Supp. 2d. 511 (S.D. Tex. 2003).

²³ See §403(a)(2) of ERISA.

of purchasing and retaining company stock.²⁴ Northern still retained a degree of discretion, authority and responsibility which might expose Northern to liability. A district court judge from the Southern District of New York found a similar obligation and potential liability exposure for a corporate directed trustee in WorldCom's ERISA litigation.²⁵

b. Other States.

(1) *Rollins*. Virginia has a statute explicitly relieving a directed trustee of fiduciary liability for following a direction.²⁶ A Virginia Circuit Court had the opportunity to interpret and apply that directed trustee statute in *Rollins v. Branch Banking and Trust Company of Virginia*.²⁷

The trust in question contained an asset concentration in a publicly traded stock. The trust agreement provided that the settlor's children had full authority over "investment decisions as to the retention, sale or purchase of any asset of the Trust Fund."²⁸ The trustee obtained written authority from the beneficiaries to over-concentrate the trust. The trustee sold the stock 20 years later at the children's direction. The children sued for \$25 million, claiming, *inter alia*, failure to diversify and failure to actively secure approval for the sale of the declining stock.

The Virginia court was apparently non-plussed by the statutory language purporting explicitly to relieve a directed trustee of fiduciary liability for following the direction. While the finding the trustee not liable for failure to diversify, the court stated that:

[t]o insure the trust's conservation, a trustee also has a duty to keep informed as to the condition of the trust. Additionally, the trustee has a duty to impart to the beneficiaries any knowledge he may

²⁴ *Id.* at 601.

²⁵ *In re WorldCom, Inc. ERISA Litigation*, 263 F. Supp. 2d. 745(S.D. N.Y. 2003).

²⁶ Va. Code §26-52 ("whenever the instrument under which a fiduciary or fiduciaries are acting reserves unto the trustee, testator or creator or vests in an advisory or investment committee or any other person or persons, including a co-fiduciary to the exclusion of one or more of the fiduciaries, authority to direct the making or retention of investments, or any investment, the excluded fiduciary or co-fiduciary shall be liable, if at all, only as a ministerial agent and shall not be liable as a fiduciary or co-fiduciary for any loss resulting from the making or retention of any investment pursuant to such authorized direction.")

²⁷ 56 Va. Cir. 147 (Virginia Circuit Court 2002).

²⁸ *Id.*

have affecting the beneficiary's interest and he cannot rid himself of this single "duty to warn".²⁹

The court stated further that the "trustee has a duty to fully inform the beneficiaries of all facts relevant to the subject matter of the trust which come into the trustee's knowledge and which are material for the beneficiary to know for the protection of his interests."³⁰ In examining the statute, the court held that "the prohibition on recovery does not excuse a trustee from liability for failing to participate in the administration of the trust or failing to attempt a breach of trust. . . Thus, a trustee may be held liable for loss caused by his conduct for actions he was entrusted to take. The demurrer is overruled as to . . . the allegations of breach of fiduciary duty, except as they relate to failure to diversify".³¹

In Virginia, therefore, a directed trustee must remember what has been called the "duty to warn" -- the fiduciary duty to keep the beneficiaries informed based on the trustee's knowledge even if the trustee does not have authority to act on that knowledge.

(2) *Duemler. Rollins* and the ERISA cases will most assuredly be cited by any plaintiff's attorney attempting to hold a New Hampshire directed trustee liable for investment losses despite the apparent clear intent of our legislature in creating the "excluded fiduciary" safe harbor. Trustees can take comfort, however, that a Delaware Chancery Court Judge has ruled in a directed trustee's favor in an unpublished ruling involving a Delaware statute which is strikingly similar New Hampshire's.³²

In *Duemler*, the individual co-trustee and sole investment advisor of a trust sued the corporate trustee, alleging that the corporate trustee breached its fiduciary duty for failing to provide the investment advisor with appropriate

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² C.A. No. 20033 V.C. Strine (Del. Ch. 2004), cited in Gordon, *Directed Trusts: The Use of Trust Advisors and Protectors: Can Fiduciaries Limit Liability Through Directed Trusts? Empowering Trust Protectors While Minimizing Their Liability, or Can A House Divided Long Stand?*, §18-8, 2006 Notre Dame Tax Estate Planning Institute.

financial information necessary for him to take actions on a bond that had defaulted and lost significant value. In his unpublished bench ruling, presiding Vice Chancellor Strine ruled in favor of the corporate trustee, finding that the Delaware directed trustee statute³³ required the investment advisor to make investment decisions without oversight from the trustee. The Vice Chancellor saw no reason not to apply the Delaware statute because there was "absolutely no evidence of willful misconduct" on the part of the corporate trustee, and to rule otherwise would undermine the statute.³⁴ (The court did find that the investment advisor had breached his fiduciary duties.)

c. Clues from the New Hampshire Supreme Court. It is impossible, of course, to determine the extent to which the courts in the ERISA and *Rollins* cases might have been influenced by the deep pocket theory, having been presented with aggrieved beneficiaries/plan participants with no recourse other than a corporate directed trustees' substantial coffers (or, more likely, their bonding company or liability insurer). Perhaps the courts found it difficult to swim upstream against the time-honored notion that being a "fiduciary" must mean that there is some duty to beneficiaries other than taking instructions without further inquiry. Any self-respecting litigator representing a beneficiary in a surcharge action for trust investment losses will be certain to join all trust participants as defendants -- the investment director(s) and the directed trustee alike. It is impossible to predict whether any given probate judge will accept plaintiffs' counsels' arguments that in the absence of any New Hampshire Supreme Court precedent interpreting our new directed trust statute, *Rollins* and the ERISA cases should be followed, rather than trust counsel's assertion that *Duemler* is a superior analysis.

There are two New Hampshire cases, however, which directed trust counsel can cite to defend his client's cause.

(1) The Legislature has Spoken: *Scheffel v. Krueger*.³⁵ The New Hampshire Supreme Court is known for its judicial restraint and its sensitivity to the judiciary's limited role under the separation of powers doctrine. When

³³ 12 Del. C. §3313(d).

³⁴ Gordon, *supra*. at 18-9.

³⁵ 146 N.H. 669, 782 A.2d 410 (2001).

confronted with a statute which is clear on its face, and a party's invitation to place a judicial "gloss" on unambiguous statutory language in order to achieve an avidly broader public policy, our Court will often demur on the basis that "[it] is axiomatic that courts do not question the wisdom or expediency of a statute".³⁶ The Court refused such invitation in the *Scheffel* case by rejecting the plaintiff's assertion that a "tort creditor" exemption should be engrafted on the two enumerated exemptions from spendthrift trust protection under RSA 564:23, II and III.³⁷ The Court restrained itself despite being confronted with an extremely sympathetic plaintiff (the mother of a minor victim of egregious sexual assaults at the hands of defendant who was the spendthrift trust's beneficiary), and the plaintiff's counsel's citation of precedent from other states in which more activist courts "judicially created spendthrift law".³⁸ Because the legislature had ". . . enacted a statute repudiating the public policy exemption sought by the plaintiff", the legislature's will can not be ignored. In so holding, the Court cited both the clear language of the statutory spendthrift trust provision and the common law doctrine it overruled.³⁹

(2) *Bartlett v. Dumaine*⁴⁰ is Direct Precedent for Sanctioning OATs and Respecting a Settlor's Choice to Limit Traditional Trustee Responsibilities and Liabilities. This famous case was decided in 1986 prior to New Hampshire's enactment of the Uniform Trustees' Powers Act at a time when the rigid and conservative "prudent conservator" default rule governed trustee investment decisions.⁴¹ It involved an unusual trust structure which is perhaps an early example of the modern OAT.

The plaintiffs were beneficiaries of one of the Frederic Dumaine trusts. They were well funded and fully "lawyered-up", represented by a well-known Boston law firm. They challenged various trustee investments in closely-held corporations; the trustees' purported conflicts of interests in serving on boards of

³⁶ *Brahmey v. Rollins*, 179 A. 186 (N.H. 1935).

³⁷ *Scheffel v. Krueger*, 146 N.H. at 671.

³⁸ *Id.*, citing *Sligh v. First Nat. Bank of Holmes County*, 704 S.o. 2d. 1020, 1024 (Miss. 1997); *Elec. Workers v. IBEW-NACA Holiday Trust*, 583 S.W. 2d 154, 162 (Mo. 1979).

³⁹ *Id.*

⁴⁰ 128 N.H. 497, 523 A.2d 1 (1986).

⁴¹ See generally DeGrandpre, *Wills, Gifts & Trusts*, 7 New Hampshire Practice § 63-8 at 204.

some of those corporations with which the trustees transacted unsecured loans of trust assets, upon terms and conditions that were not commercially reasonable, and the trustees' alleged "double dipping" by being compensated as both trustees and board members and executives of the affiliated corporations.⁴² Through counsel the plaintiffs forcefully argued that such actions violated the trustees' core and non-waiveable duties of prudence and loyalty because the investments were speculative and the trustees were engaged in several acts of self-dealing strictly prohibited under traditional trust principles.⁴³

In rejecting all of the plaintiffs' claims, the Court found that it was the settlor's intent, although not explicitly stated, that the prudent conservator rule and the normal prohibition of self-dealing should not be applied to this particular form of "business trust". The opinion emphasizes that the trust was ". . . unique. . . , having features of both a trust and a corporation", and that it was the "settlor's general intent to give the trustees" absolute control over the trust property and the trust business. Instead of their prevailing strict investment standard, the Court applied a very forgiving "business judgment rule" to the challenged investment decisions and excused the self-dealing based on a finding that the settlor authorized the trustees "to take business risks with the trust funds."⁴⁴ Imagine the righteous indignation of the scorned Boston barristers as they retreated to the home of Austin Wakeman Scott and *Trustees of Harvard College v. Amory*, tails firmly fixed between quivering legs.⁴⁵ *Bartlett* arguably stands for the proposition that the New Hampshire courts should be receptive to OAT structures which substantially alter traditional trustee responsibilities and potential surcharge liabilities -- whether accomplished by statute or governing instrument -- despite forceful arguments which can be expected from the beneficiaries' counsel that doing so runs contrary to time-honored fiduciary principles which courts in other jurisdictions might consider sacred and inviolate.

⁴² *Id.*, at 507.

⁴³ *Id.*

⁴⁴ *Id.*, at 507-08.

⁴⁵ Sorry, I couldn't resist it.

E. Opportunities.

1. For OAT Settlers.

- Can now fine-tune trust structures to "unbundle" traditional trust duties, allocating them to the parties (whether possessed of "trust powers" are not) who are most capable of handling them.

- Where appropriate, enable beneficiaries to participate in trust investment and distribution decisions, creating the opportunity for financial literacy and economic stewardship training, with maximum "buy-in".

- For large financial families, can fully integrate trust management with administration and control of non-trust assets (whether under auspices of family office or otherwise).

- Assurances that traditional non-trust quality special assets, including concentrated public equity positions, closely-held business interests and "heirloom" real estate, can be held in perpetuity in trust without threat of sale to avoid surcharge liability.

2. For OAT Beneficiaries.

- Offers potential for taking active and more meaningful role in trust administration, creating opportunity for stewardship and financial literacy training, and better understanding of the purposes and benefits of the trust structure as part of family's strategic plan for dynamic wealth preservation.

- No longer indentured to unitary corporate trustees which might be unresponsive, expensive and lack special asset class management capabilities.

3. For Corporate Trustees.

- Can use excluded fiduciary concept as layer of insulation against risk of surcharge, particularly relating to investment diversification requirement.

- Retain responsibility for trustee functions with respect to which it possesses core competencies (trust administration and "core stock" and fixed income management), while other participants handle more exotic, non-traditional trustee

functions (special assets, alternative investments, trust distributions, etc.) where the potential for fiduciary liabilities has historically been greatest.

- Opportunity to build alternative "business model" for OATs, involving "directed trustee services" priced fairly to create reasonable profit margin and reflect lower levels of risk and responsibility.

4. For Estate Planning Attorneys.

- Craft OATs to meet financial families' often idiosyncratic objectives concerning investment management, beneficiary participation, etc.

- Serve as local counsel for migrating "inbound" trusts which must be retrofitted through judicial or non-judicial trust modification to become New Hampshire resident trusts to achieve family's objectives, be they refuge from other states' income taxes and/or adoption of OAT features that might not be available under the laws of the former situs state.

- Opportunity to serve as directed trustee, protector or advisor with risks and responsibilities tailored to fit the desires and objectives of both family and the attorney.