Trust Protectors - A Pandora's Box?

Carla S. Ranum
Elizabeth L. Mathieu
Mathieu & Ranum, PLLC

The concept of trust protectors was first introduced to practitioners in the U.S. in connection with offshore asset protection trusts.[2] However, in the last two decades, practitioners have also slowly begun to add them to domestic trusts' governance structures for reasons other than creditor protection.

A large body of legal commentary now exists that addresses the myriad of issues associated with the use of trust protectors.[3] Additionally, a number of states,[4] including Idaho, have enacted specific trust protector legislation. Nevertheless, it still appears that the trust protector function is often misunderstood, and therefore oftentimes not used, even if a trust protector could be a useful addition to a trust's administration.

The Idaho trust protector statute "the "Statute"[5] sets forth a framework for using trust protectors in trusts governed by Idaho law. Referencing the Statute, this article discusses what a trust protector is, when a trust protector can be useful, and key issues that should be addressed in a trust document when a trust protector is included.

What is a trust protector and when can one be useful?

A trust protector is an individual or institution named in a trust document with decision-making powers that are in addition to or replace specific powers normally held by a trustee. Idaho's Statute does not provide an exclusive list of permissible powers, but does list examples.[6] A drafter may incorporate some or all of the powers listed in the Statute into a will or trust instrument by making specific reference to the Statute.[7] Usually trust protectors act as the final decision maker when specific issues defined in the trust document arise, creating a sort of "springing protector."[8] Common powers include:

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- **Removing and/or replacing trustees**. For example, a beneficiary with the power to remove a trustee may shop the market for one more likely to distribute income as the beneficiary desires - potentially disregarding a grantor's wishes. Giving the power to remove and replace trustees to a disinterested trust protector may make it more likely that the grantor's intent is respected and trust assets are not wasted.
- **Making decisions where a trustee has a conflict of interest**. Giving authority to a third party regarding matters where a trustee may have a conflict of interest can protect the trustee from litigation and enable the trust to take advantage of beneficial investments.
- **Directing a trustee-beneficiary regarding matters that could adversely affect him or her.** For example, if a beneficiary is also a trustee of a trust, and has the power to distribute principal or income to himself or herself, there can be adverse estate tax consequences, and probable loss of any protection of the trust assets from the beneficiary's creditors. There could also be adverse gift tax consequences if he or she makes distributions to other beneficiaries. Giving a trust protector the authority to make trust distribution decisions can prevent these problems.[9]
- **Directing a trustee regarding moving a trust's situs or appointing assets from one trust to another**. Such changes may result in the original trustee either being replaced or losing income so that a trustee might be reluctant to make such a decision. Therefore, a grantor may not want to rely on the trustee to make such a change, but rather rely on a disinterested third party trust protector to make these decisions.
- **Amending a trust to correct drafting mistakes or respond to unanticipated needs of beneficiaries in long-term trusts**. In the absence of a power to amend an irrevocable trust, a trustee would be required to petition a court to make such a change. Aside from the cost and delay that can arise from this, a court could deny the petition. If a present or future trustee could also be a beneficiary, or be swayed by beneficiary pressure, a trust protector may be a better choice than the trustee to address these issues.
- **Terminating a trust**. A trustee may have a financial interest in continuing the trust. Vesting the power to terminate a trust in a disinterested third party could avoid this conflict of interest.

Who can be appointed as a trust protector?

While most clients prefer that their trust protector be their attorney or accountant, some clients wish to name a beneficiary, often a financially successful child, instead. The Statute, however, clearly states that a trust protector is a "disinterested third party"- thereby excluding the grantor, beneficiaries, and all of their related and subordinate parties, from being trust protectors in the State of Idaho.

The Idaho Trust Institutions Act further limits who can serve as a trust protector. Idaho Code §26-3204(1) states that "no person shall act as a fiduciary in this state except "certain qualifying state or national banks or trust companies" and "such other person as may be authorized by the director, in his discretion, and upon such conditions as he may require." Idaho Code §26-3205 states that a person is "not engaged in the trust business or in any other business in a manner requiring a charter under this act, or in an unauthorized trust activity... [if they obtain] trust business as a result of an existing attorney-client relationship or certified public

accountant-client relationship[10]... [or if they are] "acting as a fiduciary for relatives"[11].

Because of the existence of both the Idaho trust protector statute, and the Idaho Trust Institutions Act, the trust drafter should be aware of the implications of appointing anyone as a trust protector other than:

- A chartered bank or trust institution,
- An attorney or accountant with a pre-existing attorney-client or accountant-client relationship who is also a "disinterested third party,"
- A person authorized by the director of the Idaho department of finance, or
- Relatives of the grantors or beneficiaries — subject to the caveat that a "relative" today may not be a "relative" tomorrow due to divorce or other changed circumstances.

State the applicable standard of care in the trust instrument

The default standard of care for a trust protector under the Idaho Statute is clearly a fiduciary one. The Statute states the "powers and discretions of a trust protector shall be as provided in the governing instrument and may, in the best interests of the trust, be exercised or not exercised".[12] The Statute further defines a "fiduciary" to include a "trust protector, who is acting in a fiduciary capacity for any person, trust or estate."[13] If the trust protector is a fiduciary, beneficiaries have standing to hold the trust protector accountable.

In contrast, several states including Alaska and Arizona do not subject trust protectors to a fiduciary standard of care[14]. If a trust protector's conduct is subject to a personal standard of liability, rather than a fiduciary standard, then, short of fraud or violation of the trust's terms, the trust protector can make decisions on a whim, with no reasonable basis, benefiting him/herself, disadvantaging beneficiaries, and violating the grantor's intent. Thus, when a fiduciary standard does not apply, the beneficiaries may have very limited or no recourse against the protector.[15]

Because the Idaho Statute's provisions could be changed, and because the situs of an Idaho trust may be moved to another state with other liability default provisions (to take advantage of more favorable tax and/or trust laws), it is important to ***state the standard of care that is applicable to a trust protector in the trust instrument***. It is also important to inform a client that the beneficiary may have very limited ability to hold a trust protector legally accountable if he or she is subject to a personal standard of care.

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Specify the trust protector's duties and responsibilities

Merely stating that a trust protector has a power to do something may be insufficient to provide guidance to the trust protector as to what he/she is required to do - and, in a worst case, may result in litigation as to the scope of his/her obligations. The trust instrument should ***not only list the powers of a trust protector, but also address whether the power constitutes a duty to act or just the right to act, and the scope of, and limitations on, the duty***.

The importance of being very specific in the trust agreement regarding these questions was highlighted in the one case in the US addressing, although not resolving, trust protector duties and liability. *Robert T. McLean Irrevocable Trust v. Davis* (2009)[16] was a case in Missouri that had no trust protector statute at that time[17]. The trust at issue involved special needs trust funded by a legal settlement awarded because of an automobile accident that left a young man a quadriplegic. The trustees depleted the trust assets in a short period of time through wasteful spending.

The case involved the allegation that the trust protector knew about the trustees' wasteful spending of the trust assets and had a duty to remove them. The trust agreement was clear that the trust protector was held to a fiduciary standard, but the court stated that it was not clear to whom the duty was owed and whether not removing the trustees was an act of bad faith thus subjecting the trust protector to liability. The district court dismissed the case on summary judgment and the appellate court reversed for outstanding questions of material facts. The case is instructive on a number of fronts, not the least of which is the increased risk of litigation when the trust instrument does not clearly set forth the duties and responsibilities of the trust protector and when a court is confronted with a new issue in trust law.

State whether the trustee is an "excluded fiduciary"

Not all trust protector statutes address the priority of decision-making between trust protectors and trustees, but the Idaho Statute does so by: (i) making the exercise by a trust protector of powers and decisions "binding on all other persons"[18] and (ii) relieving an "excluded fiduciary" from liability for "any loss resulting from any action taken upon such trust protector's direction."[19]

The Statute defines an "excluded fiduciary" as:

> "any fiduciary excluded from exercising certain powers under the instrument, which powers may be exercised by the grantor or a trust advisor or trust protector."[20]

The Statute, however, is silent on whether the trust agreement must use the term "excluded fiduciary" for the trustee to actually be relieved of liability.[21] Because failure to include such language might result in a trustee refusing to follow a trust protector's direction (due to a perception of continued exposure to liability), it is advisable to use that specific term when defining the role and responsibility of a trustee. In addition, if the trustee is stated *not* to be an "excluded fiduciary", then the drafter should address potential overlap in duties and address the applicability of section (6) of the Statute, which renders a trust protector's exercise of authority binding on "all other parties".

Additionally, the Statute relieves an "excluded fiduciary" from liability for any "loss resulting from any action taken upon such trust protector's direction."[22] This language does not expressly relieve a trustee from failing to take action regarding decisions within the scope of the authority of a trust protector[23] if the

trustee "sought but failed to obtain authorization" [24] from the trust protector. For example, if a trust protector has authority to terminate a trust once assets fall below a certain level and the trustee sought, but did not obtain, a direction to terminate the trust, is the trustee liable if he/she exhausts the remaining assets through continued deduction of trust fees and expenses?

Obviously, if the grantor insists on a personal standard of liability for a trust protector, the trust instrument should not name the trustee as an "excluded fiduciary." If the instrument names the trustee as an "excluded fiduciary," the beneficiaries may be without recourse to anyone in the event of run-away trust administration. Similarly, section (6) of the Statute (that states that the powers and discretions of a trust protector are binding on all other persons) should not be used as a default provision in the trust instrument if the standard of care is lowered.

In summary, given the above, the drafter should consider: ***(1) expressly stating in the trust instrument whether the trustee is an "excluded fiduciary" or not, (2) broadening liability relief to include a failure to act after seeking, but failing to receive, direction from a trust protector and, (3) providing the beneficiaries specific recourse if the trust protector is subject to a personal standard of care.***

Clarify decision making priority

Unlike trust protector statutes in some other states, the Idaho Statute distinguishes "Trust Advisors" from "Trust Protectors." While an "advisor" is commonly understood to refer to someone who merely provides recommendations, the Idaho Statute provides that, unless the trust document states otherwise:

- An "Investment Trust Advisor" has the power to: "(a) direct the trustee with respect to the retention, purchase, sale or encumbrance of trust property and the investment and reinvestment of principal and income of the trust, (b) vote proxies for securities held in trust; and (c) select one (1) or more investment advisors, managers or counselors, including the trustee, and delegate to them any of its powers;"[25] and
- A "Distribution Trust Advisor" "shall direct the trustee with regard to all discretionary distributions of beneficiaries"[26].

Due to the specificity of the default powers listed above, it appears the intent of the Statute is for trust advisors to focus on investment and distribution decisions. However the Statute does not expressly limit trust advisors' decision-making authority to those areas. The Statute also does not exclude distribution and investment decisions from the possible powers of trust protectors. Even if a trust advisor is appointed, grantors often want the trustee or trust protector to oversee the trust advisor's activities and to have priority with respect to certain investment decisions or deviations from an investment plan. Because the Statute provides that the powers and discretions exercised or not exercised by both trust protectors and trust advisors are "binding on all other persons"[27] (including each other), ***whenever there is an overlap in decision making authority between or among fiduciaries, the priority of decision making should be clarified.***

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State the rights of the trust protector

The drafter should also determine what rights the trust protector should have to effectively exercise his/her duties. Depending on the trust protector's duties, useful rights might include:

- Periodic reports from the trustees regarding the administration of the trust,
- Access to accounting and other records in the possession of the trustees such as notices from regulators, taxing authorities and beneficiaries,
- Ability to hire other advisors at the expense of the trust, and
- Ability to petition a court for instructions.

Address all administrative matters

Additional factors that should be addressed with both trust protectors and trust advisors are compensation, resignation, removal, replacement, indemnification, and tax implications. This is particularly important if powers are held in a fiduciary capacity and can be exercised for the trust protector's benefit, or in favor of someone to whom the trust protector owes a legal obligation of support.[28] In summary, ***any issue that should be addressed in relation to a trustee should also be addressed for a trust protector or trust advisor.***

Summary

Use of trust protectors may provide grantors hope that their intent will be followed and unforeseen difficulties addressed - even in very long-term trusts. However, the Idaho trust protector statute does not, and indeed could not, address all of the issues that can arise in each client's situation. Therefore, it is important to address the applicable standard of care, the trust protector's powers, duties, and rights, and the priority of each fiduciary's decision-making authority relative to other fiduciaries.

About the Authors

Carla S. Ranum *and* **Elizabeth L. Mathieu** *are founding members of Mathieu & Ranum, PLLC, focusing on estate planning, probate and trust administration, asset protection, and tax-exempt organization law in Idaho, New York and Illinois. Ms. Ranum holds a JD from DePaul College of Law and a MBA from the University of Texas-Austin. Ms. Mathieu holds a JD from Suffolk University Law School, and a Masters in International Affairs from Columbia University.*

Endnotes

[1] *The authors wish to gratefully acknowledge the very valuable comments provided by Robert L. Aldridge, Esq. about the Idaho trust protector statute.*

[2] Under US law, if a grantor retains control over the administration of a trust, depending on the level and type of control, such a trust can be subject to creditor claims. Using a trust protector to control a foreign trust's administration (e.g. distributions to the grantor and his or her family) was long thought to be an effective way for a grantor to keep control, but only indirectly, thus protecting trust assets from creditor claims. This strategy has been thoroughly debunked by a solid line of cases decided on a range of principles the most important of which is that the assets of foreign trusts over which the grantor retains control, even if indirectly through a trust protector, are not insulated from the claims of creditors. See Jay D. Adkisson and Christopher M. Riser, Asset Pro-

tection Concepts & Strategies for Protecting Your Wealth (McGraw-Hill 2004).

[3] See, e.g., Gideon Rothchild and Alexander A. Bove, Jr., *Trust Protector Trust(y) Watchdog or Expensive Exotic Pet,* 46 Heckerling Institute Special Session IVA materials (2012), *Richard* C. Ausness, *The Role of Trust Protectors in American Trust Law*, 45 Real Prop. Est. & Tru. J. 319 (2010); Philip J. Ruce, *The Trustee and Trust Protector A Question of Fiduciary Power,* 59 Drake Law Rev. 67 (2010); Gregory S. Alexander, *Trust Protectors: Who Will Watch the Watchmen?*, 27 Cardozo L. Rev. 2807 (2006); Austin Scott & William Fratcher, *The Law of Trusts* (4th ed. Little Brown 1987); Alexander A. Bove, Jr., *The Trust Protector: Friend or Fiduciary?*, Asset Protection Strategies-Wealth Preservation Planning with Domestic and Offshore Entities, Vol. 2 (American Bar Association 2005); Alexander A. Bove, Jr., *The Trust Protector, Trust(y) Watchdog or Expensive Exotic Pet,* Estate Planning, Vol. 30, No. 8 (August, 2003) (hereinafter "Bove. A. (2003)"); Joseph A. McDonald III, *Bibliography of Articles on Directed Trusts, Trust Protectors and Open Architecture Trust Designs,* McDonald & Kanyuk, PLLC (2003). For a discussion of trust protectors and offshore trusts, see Jan Dash and Herman Liburd, *The Role of Protectors in Offshore Trusts,* LiburdDash.com (2003).

[4] See for example, Alaska Stat. §13.36.370; Arizona Rev. Stat. §14-10818; Del. Code. §3313 and §3570; Idaho Code Ann.§15-7-501; Rhode Island Code §18-9.2-2 and §18-9.2-4; Tenn. Code Ann. § 35-15-808; S.D. Codified Laws 55-1B-6; Wyo. Stat. Ann. §4-10-710. Additionally, on May 18, 2012 the Missouri Legislature passed a trust protector statute by approving S.B. 628 revising R.S. Mo. 456.8-808 to be effective August 28, 2012 unless vetoed by the Governor.

[5] Idaho Code §15-7-501 (hereinafter, the "Statute"). For an interesting discussion of the codification of trust law in the US, see John H. Langbein, *Why Did Trust Law Become Statute Law in the United States?*, 58 Ala. L. Rev. 1069, 1080 (2007).

[6] Idaho Code Ann §15-7-501 (6) states that the powers and discretions of a trust protector may include the following: "(a) To modify or amend the trust instrument to achieve favorable tax status or because of changes in the Internal Revenue Code, state law, or the rulings and regulations thereunder; (b) To increase or decrease the interests of any beneficiaries to the trust; (c) To modify the terms of any power of appointment granted by the trust…(d) To terminate the trust; (e) To veto or direct trust distributions; (f) To change situs or governing law of the trust, or both; (g) To appoint a successor trust protector; (h) To interpret terms of the trust instrument at the request of the trustee; (i) To advise the trustee on matters concerning a beneficiary; and (j) To amend or modify the trust instrument to take advantage of laws governing restraints on alienation, distribution of trust property, or the administration of the trust."

[7] Statute, note 5 at §(8).

[8] Bove, A. (2003), note 3.

[9] Under the Idaho Statute, drafters can also address these issues by incorporating a "Distribution Trust Advisor". See discussion below.

[10] Idaho Code §26-3205(2).

[11] Id., at §(11). What is a "relative" for purposes of this statute remains unclear. For example, if a relative of a husband is named as a trustee of a trust for the benefit of the wife and then the husband and wife divorce, is the trustee still a "relative" for purposes of this statute?

[12] Statute, note 5 at §(6).

[13] Id., at §(1)(b).

[14] See e.g., Alaska Stat. §13.36.370; Arizona Rev. Stat. §14-10818.

[15] This statement may beg the question: When would a "personal" as opposed to "fiduciary" power be preferable? One answer could be, although not recommended, when a trust protector has the power to remove a litigious beneficiary for "misbehaving". For a discussion of the dangers of not holding a trust protector to a fiduciary standard, see Alexander A. Bove, Jr., *The Case Against the Trust Protector,* ACTEC Journal 37, p. 77 (2011).

[16] *Robert T. McLean Irrevocable Trust v. Davis*, 283 S.W. 3d 786 (MO. Ct. App 2009).

[17] Although Missouri had enacted section 808 of the Uniform Trust Code that provides that "A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries."

[18] Statute, note 2, at § (6).

[19] Id, at §(5).

[20] Id, at §(1)(b). Note that if the trust instrument states that the trust protector is not a fiduciary and that the trustee is an excluded fiduciary with respect to the trust protector's decisions, and further if the powers of the trust protector are broad, covering for example trustee replacement, distributions, and investments, the trust might not actually exist as there would be no fiduciary administering the trust! Notwithstanding this observation, under Idaho law, all the functions of a trustee cannot be delegated to another. See Idaho Statute 68-107. For an interesting discussion of this issue, see Alexander A. Bove, Jr., *The Trust Protector Mighty Mouse or Just a Cat in a Bag,* 46 Heckerling Institute Special Session IVA materials (2012).

[21] During a conversation with the authors, Mr. Robert L. Aldridge stated that he recalled the intent of the Statute's drafters was for the trust instrument to specify whether the trustee is an "excluded fiduciary".

[22] Statute, note 2 at § (5).

[23] In contrast to the Statutory provisions applicable to trust protectors, section (2)(b) of the Statute does exempt an "excluded fiduciary" from loss that results from a failure to take action, if prior authorization is sought, but not obtained from a trust advisor.

[24] Id, at §(2)(b).

[25] Statute, note 5 at §(10)(a).

[26] Statute, note 5 at §(11).

[27] Statute, note 5, see §(6) (regarding trust protectors), §(10) (regarding investment trust advisors), and §(11) (regarding distribution trust advisors).

[28] See, e.g., Bove (2003), note 3.

[21] During a conversation with the authors, Mr. Robert L. Aldridge stated that he recalled the intent of the Statute's drafters was for the trust instrument to specify whether the trustee is an "excluded fiduciary".