Limiting Liability Exposure for a Private Family Trust Company

Private Family Trust Company Research
A Private Family Trust Company (PFTC) should be aware of its potential for liability and the ways in which liability can be limited or controlled. This article offers a broad overview of steps a PFTC should consider in assessing and controlling its liability exposure.

Provisions in Trust Instrument

Provisions in a trust instrument can expressly limit and define the scope of the PFTC’s fiduciary duties, including the Prudent Investor Rule and the duty to inform and report. Generally, the ability to limit fiduciary duties is subject to “mandatory” rules dictated by state statutes or common law. Some states have stringent mandatory rules, while other states seek to maximize the trust settlor’s freedom of disposition and freedom of contract. For example, section 105(b) of the Uniform Trust Code (UTC) provides that the terms of a trust cannot eliminate the duty of a trustee to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Prudent Investor Rule

Provisions in a trust agreement can also limit a PFTC’s potential liability from violations of the “prudent investor rule.” The prudent investor rule generally requires a trustee to use investment strategies that are objectively reasonable, which would include a duty to diversify investments, employ prudent asset allocation, and control investment costs. PFTCs should be aware of the potential issues with holding non-traditional assets, concentrated equity positions (for example, stock in a family company), and other assets that would not typically be considered “prudent” investments for a trustee under applicable state law. Other examples of investments that could violate the default prudent investor rule include family real estate such as farms, ranches, and vacation homes.

State laws vary on the degree to which a trust agreement can waive the default requirement that trust assets be invested based on modern notions of prudent investment, so PFTCs should be aware of what law applies. PFTCs may also explore the possibility of changing the applicable law or modifying the trust agreement in order to address prudent investment concerns.

Duty to Inform and Report

Provisions in a trust agreement can limit a PFTC’s statutory and common law duties to inform and report to beneficiaries, but the extent to which such provisions are effective depends on applicable state law. For example, section 105(b) of the UTC would not allow a trust agreement to eliminate the duty to inform a “qualified beneficiary” who has attained age 25 of the existence of their beneficial interest, nor would the UTC allow a trust agreement to eliminate the duty to respond to beneficiary requests for trustee’s reports and certain other information. Some states have more stringent mandatory duties to inform and report than the UTC, while other states liberally allow the provisions of the trust agreement to control these requirements. For example, Tennessee’s trust code allows a trust agreement to include “silent trust” provisions, whereby the trust agreement can eliminate any requirement to inform a beneficiary or the trust agreement can designate a third party to receive reports on a beneficiary’s behalf.

Non-Traditional Trustee Relationships

Additionally, a trust instrument, in accordance with state law, can create non-traditional trustee relationships for the PFTC, including as a “directed trustee,” a trustee of a “purpose trust,” and as a trustee of a trust where certain traditional trustee functions are subsumed by “trust protectors” or “trust advisors.”

Directed Trust, Trust Advisors, and Trust Protectors

Under a “directed trust,” the trustee is bound to follow the instructions of one or more other individuals or entities named in the trust agreement (or by agreement of trust beneficiaries in certain states). For example, “trust advisors,” “trust protectors,” “distributions directors,” or
“investment advisors” can have the power under the trust terms (whether or not in a fiduciary capacity) to direct the trustee, rendering the trustee a “directed trustee.” Where distribution and investment decisions are taken out of the trustee’s hands, the directed trustee’s duties can be limited to asset custody and administrative functions. State laws vary on the extent of the directed trustee’s potential liability where the directed trustee is simply “following orders.” In some states, the directed trustee can still be liable for a failure to monitor or advise the other decision makers, while other states provide extremely broad protections for a directed trustee where the directed trustee has no duty whatsoever with regard to functions assigned to others.

**Purpose Trust**
A “purpose trust” is a term used to describe a trust that has no beneficiary under state law during its term, but instead has a valid (not illegal) purpose described under its terms. Because the trust has no beneficiary, the trustee does not have to act in the best interests of any persons, but rather can carry out the purposes of the trust unhindered by those concerns. A purpose trust typically provides specific persons or classes of persons with the power to enforce the purposes of the trust.

By way of example, under Tennessee law, a trust lasting up to 90 years can be established without having any beneficiary. By default, the property of such a trust would revert to the settlor or settlor’s estate after the 90-year term.

A purpose trust can be an extremely flexible vehicle for owning special assets (including, for example, ownership of a PFTC itself), or accomplishing certain goals, where a traditional trust relationship would not be suitable.

**Separate Agreement between PFTC and Beneficiaries**
Fiduciary liability issues can also be affected by agreements directly between the PFTC and the trust beneficiaries, whether entered into at the time that the PFTC accepts the trusteeship or afterward. State laws vary on the potential scope of such agreements, such as the effectiveness of a prospective release by the beneficiaries where the release does not specify a particular proposed action.

**Limiting Liability through Beneficiary Notification or Approval**
A PFTC may also limit potential fiduciary liability by reporting information to beneficiaries and by seeking beneficiary approval, whether before or after an action is taken.

**Shortened Statute of Limitations through Beneficiary Notification**
Some states provide for a shortened statute of limitations (for example, one year) for a breach of trust where a trustee has satisfied certain requirements for informing beneficiaries of the conduct or inaction giving rise to the potential breach.

**Eliminating Liability Through Beneficiary Consent, Release, or Ratification**
A PFTC may also seek beneficiary consent, release, or ratification of specific trustee actions in order to foreclose liability to those beneficiaries and the persons whom those beneficiaries can represent under a virtual representation statute.

**Tort and Contract Liability to Third Parties**
A PFTC should also be aware of laws and regulations relating to its potential liability to third parties for actions taken as trustee, such as tort and contract claims from third parties. Generally, trustees are not personally liable to third parties for actions taken as trustee provided that their fiduciary capacity was disclosed. Some states have more specific and protective provisions regarding a trustee’s liability to third parties, including liabilities stemming from ownership of a general partnership interest.

A trustee may, however, be held personally liable for torts or for obligations stemming from ownership of trust property in cases where the trustee is found to be “personally at fault.” Some states raise the threshold for finding a trustee personally liable. Tennessee, for example, limits the trustee’s liability to situations in which the trustee is “personally at fault on account of the trustee's own willful misconduct proven by clear and convincing evidence.”
Our Team

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