The Rise of Impact Investing in Trust Administration

Private Family Trust Company Research
Welcome

In the coming years, it is likely that Trustees will be asked increasingly by beneficiaries to invest trust assets with an objective of advancing social or charitable causes, as opposed to achieving economic gains, as the trend of impact investing is expected to continue to grow. While incorporating an impact investing philosophy is not per se a violation of a Trustee’s fiduciary duties, there are a couple steps a Trustee should take before acquiescing to the beneficiaries’ goals of using trust assets to “do good.”

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Traditionally, investment decisions have focused primarily on increasing economic value. Over the past few decades, however, an investment philosophy focused on creating non-economic value by advancing social or charitable causes has become increasingly commonplace. This investment philosophy, traditionally referred to as socially responsible investing, has historically been assumed to involve the sacrifice of economic gains in furtherance of non-economic objectives. Recently, a new investment trend has emerged in which investors seek to create non-economic value (e.g., make an impact) without sacrificing economic returns. While this trend has many names, it is generally referred to as “impact investing.”

With respect to trusts, beneficiaries are beginning to have a desire to see trust assets used, in some degree, to advance the greater good rather than purely for wealth accumulation. It is believed this trend will continue as younger generations tend to believe that companies have a responsibility to “do good.” With respect to investing trust assets, however, a Trustee must balance the beneficiaries’ desire to use trust assets to make an impact with the Trustee’s fiduciary duties in administering the trust.

Broadly speaking, a Trustee is under a duty to administer a trust in the best interests of the beneficiaries (commonly known as the duty of loyalty). Therefore, when investing trust assets, the Trustee may only take into consideration the interests of the beneficiaries, and not the interests of any non-beneficiaries. As such, a Trustee’s duty of loyalty has been seen as in conflict with the traditional notion of socially responsible investing because of the perceived acceptance of the sacrifice of economic gains. However, a form of impact investment, known as ESG investing, has been shown to not require any economic sacrifice. ESG investing is a type of impact investing wherein the investor seeks to identify, and thus reward, companies that advance one or more “e”nvironmental, “s”ocial or “g”overnance causes (hence “ESG”), such as the use of renewable energy sources or a focus on minority-run businesses. Recent studies have shown that the incorporation of these ESG factors as part of an investing approach can actually lead to greater or, at a minimum, similar investment returns and, in fact, greater risk-adjusted returns. Therefore, the incorporation of ESG factors in investment decisions should not be a per se violation of a Trustee’s duty of loyalty because it does not require sacrificing economic gains.

Another fiduciary duty to which a Trustee is subject is a duty of prudent administration which includes prudent investing, and requires a Trustee to administer a trust in the same manner as a “prudent person.” When it comes to investing, a standard for governing prudence is to compare the Trustee’s actions to those of other investment professionals. Consequently, the fact that financial analysts are starting to incorporate ESG factors into their investment decisions supports the notion that, because these “prudent” investors are taking such factors into consideration, it is likewise prudent for a Trustee to do so.

While the trend of socially responsible investing, in general, and, more recently, impact investing has been growing, most trusts do not contemplate such an investment focus. With respect to drafting new legal documents, an individual who wishes to require or, at least, permit a Trustee to engage in impact investing can specifically authorize a Trustee to take into consideration both economic and non-economic benefits of an investment, and relieve the Trustee from any liability for doing so. Better yet, from the Trustee’s perspective, would be the incorporation of a Directed Trustee structure, whereby the Trustee is relieved of all investment authority which is vested in a third party, who may or may not be subject to its own fiduciary duties. In this structure, since the Trustee is to follow the directions of the third party with respect to investments, state law typically relieves the Trustee of all liability regarding such investment decisions.

As for trusts that are already in existence, some states permit a the Trustee and beneficiaries to enter into a nonjudicial settlement agreement, which may address any matter involving the trust. Therefore, a nonjudicial settlement agreement could be entered into permitting the Trustee to take non-economic factors into consideration when making investment decisions; however, it is possible in these instances, that the Trustee could remain liable for its investment decisions. Consequently, where permitted, a preferred alternative would be to implement a Directed Trustee structure, either by nonjudicial settlement agreement or pursuant to judicial action, which would protect the Trustee from any liability pertaining to investment decisions.

Over the next several years, it is likely that Trustees will encounter beneficiaries who wish to see trust assets invested in a manner that may stress non-economic benefits as much, if not more, than financial gain. Unfortunately, this desire of the beneficiaries could inherently conflict with the Trustee’s fiduciary duties in administering the trust. While the incorporation of non-economic factors in investment decisions should not, in and of itself, cause a Trustee to breach such fiduciary duties, the Trustee is nonetheless required to balance this desire with achieving economic growth. To assist the Trustee in this balancing act, as well as to better enable the Trustee to accommodate the beneficiaries’ desire, it is helpful for either the underlying trust to authorize the Trustee to engage in impact investing or for an agreement with the beneficiaries to be in place authorizing such action. Moreover, in certain situations, the use of a Directed Trustee structure could further enable the trust assets to be used in a manner that more closely aligns with the beneficiaries’ desire to see their trust assets make an impact, even at the potential sacrifice of economic gains.
Our Team

For nearly 30 years, large, family-owned and closely held businesses, high net worth individuals, family offices including their private family trust companies, and tax-exempt organizations around the world have sought out our team to provide practical tax, business, and estate and trust planning solutions.

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