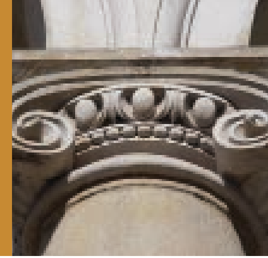

COMMITTEE REPORT:
FIDUCIARY PROFESSIONS

By **Daniel F. Lindley**

# Shielding PTC Directors From Fiduciary Risk

Best practices to consider

Increasingly, families of substantial wealth, particularly families with a minimum of $500 million in assets, are contemplating or actually setting up a private trust company (PTC) to serve as the trustee of their family trusts. By one recent estimate, "hundreds" of families have created PTCs in the U.S. jurisdictions that authorize formation of a PTC as a distinct entity.[1] Clearly, there's a demand for PTCs, and states are responding to the demand. From less than a handful of states 10 years ago, there are at least a dozen states that now have some form of PTC legislation in place.[2]

The demand for PTCs is motivated by a number of factors, including: (1) exercising greater control over the family investments, especially concentrated positions and closely held interests; (2) protecting from fiduciary liability those family members who would otherwise serve as a co-trustee or as an advisor to a directed trust; (3) engaging younger generations in the stewardship of family wealth through their participation on the PTC board or its committees; (4) achieving an exemption from registration under the Investment Advisers Act of 1940 as a "bank," whose definition includes a state-regulated trust company and is more certain than the Securities and Exchange Commission's exemption for a "family office;"[3] and (5) using a private family entity to provide a more personalized approach to distribution decisions.

Let's consider the interplay of the first and second listed factors—a family's strong interest in controlling the investments within their trusts, without the correlative risk of fiduciary liability for the family members who manage trust assets.[4] Families have been understandably eager to take on investment authority for their family trusts, which often serve as a long-term engine of their collective wealth. This is particularly the case when family trusts contain a concentration in an asset (such as an equity position in a public company that's the source of the family wealth) or a closely held asset (such as an operating business). Over the past 30 years, since 1986 when Delaware codified the practice of allowing trust duties to be bifurcated between a trustee and an advisor without creating cross-liability for the trustee, the domestic trust market has witnessed an explosion of so-called "directed trusts" in which an investment advisor has exclusive responsibility for the investment management of the trust assets. While a directed trust solves the problem of giving a family investment control over its trust assets, it doesn't address the second factor that's led to the rapid development of the PTC market—the concern of family members about their personal liability for managing trust assets in their capacity as investment advisors. Under the law of most states with a directed trust statute, an advisor serves as a fiduciary and has a corresponding risk of personal liability to trust beneficiaries.[5] Although some states allow a trust instrument to excuse an advisor from serving in a fiduciary capacity, no reasonable court is going to condone a trust with an "empty seat," one in which no party has potential culpability for investment performance because the directed trustee is relieved of investment responsibility, and the investment advisor isn't a fiduciary. If a trust's investments perform badly in that scenario, rest assured that a court of equity will find someone other than the beneficiaries to bear the loss.[6]

A PTC structure offers an alternative to this apparent risk-shifting quandary. As the analysis below demonstrates, a PTC largely shields family directors from fiduciary risk—with the strong caveat that bad conduct can undo their seeming immunity.

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## Business Judgment Rule

Given their legitimate concern about fiduciary liability arising from a directed trust, it isn't surprising that the wealthiest families are turning instead to a PTC structure to address their desire to maintain investment control in a more personal environment. There's a salient difference between a family member acting as a member of an investment committee for a directed trust and the same family member acting as a director or committee member of a PTC. The difference is that a PTC structure offers its directors the protection of the business judgment rule (BJR), the common law principle that a corporation's directors or committee members are presumed to have exercised their discretion in the best interests of the corporation.[7] Absent a showing of gross negligence, disloyalty or bad faith disregard of a corporation's interests, a court shouldn't review the soundness of the actions of its directors or committee members. Put another way, courts are reluctant to second-guess the decisions of corporate directors unless there are compelling reasons to shift the business judgment presumption and undertake a substantive review of the decision or transaction in question. The rationale for the BJR is that it permits the directors of a corporation to manage its business without constant fear of liability for their decisions.[8]

Family participants in the management of a PTC would be well advised to put aside any family differences lest they lose the shield of the BJR.

Since a PTC isn't likely to be highly capitalized, at least to the extent of satisfying a beneficiary's claim for substantial damages, the pertinent inquiry is whether the individual directors remain vulnerable to personal liability for their acts or omissions as members of the PTC board, notwithstanding the BJR. While the rule has been subject to a variety of formulations over the decades, it's essentially procedural in nature. A beneficiary who's disappointed by the performance of a trust's investments may well have a simple claim of lack of due care against the trustee—the PTC—for its poor investment choices. Likewise, a beneficiary may have an abuse of discretion claim against the PTC for its action on a requested discretionary distribution. Nevertheless, to impose personal liability on any of the directors or committee members of the PTC, the unhappy beneficiary would have to demonstrate one or more compelling factors to penetrate the shield that the BJR imposes.

## A Procedural Duty of Care

Directors and their committees must exercise care in their deliberations if they seek to avail themselves of the BJR. Their decisions can't be uninformed; they have a "procedural duty of care" to apprise themselves of all relevant facts and circumstances.

The notion that directors owe a procedural duty of care first arose in what's now known as the *Trans Union* case, in which the management of Trans Union Corporation proposed to sell the company in a leveraged buyout transaction, at a price that the company's CFO developed at the CEO's direction.[9] When the directors met to vote on the deal, they didn't have the benefit of expert analysis of the price and didn't seriously inquire about management's methodology for structuring the deal. The court found that the directors had breached their duty of care because they failed to fully inform themselves in any meaningful way prior to approving the sale. Having lost the protection of the BJR, the Delaware Supreme Court held the directors personally liable for the resulting damage to the company's shareholders.

The outcome in the *Trans Union* case led the Delaware General Assembly to adopt a provision in the Delaware General Corporation Law (DGCL) that allows corporations to adopt charter provisions exculpating its directors from liability for a breach of the duty of care.[10] Notwithstanding the enactment of that exculpatory provision, directors of a corporation should continue to keep themselves fully informed before making decisions. An egregious set of facts that's immunized from liability under DGCL Section 102(b)(7) for a lack of due care can still pose a risk of liability for breach of the directors' duty of good faith.

A family member who serves on a PTC board or investment committee should understand whether the investment policy for each trust is appropriate for

the trust's objectives, time horizon and current and remainder beneficiaries, how the asset mix of each trust is meeting the trust's investment policy, how the investment managers are tracking in comparison to their benchmarks, whether it remains appropriate to hold a concentrated position, whether a closely held operating business is meeting its performance plan and the like. If the directors don't have this sort of data or the experience to put such data in context, they should demand it from their family office or an appropriate investment professional. Blind, uninformed assent to a trust's investment strategy can strip the directors of their protection under the BJR and, in turn, result in personal liability for poor investment performance.

## Self-Dealing or a Conflict of Interest

A director can also lose the protection of the BJR through self-dealing or a conflict of interest. In the corporate context, this issue typically arises when the director is also a significant shareholder or has a financial stake in the outcome of a particular transaction. Voting to approve a corporate action that would enhance the director's personal financial interests would be enough to forfeit the BJR, resulting in "heightened scrutiny" of the transaction.[11] As explained in *Aronson v. Lewis*, a disinterested director is one who "can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[12] A lack of disinterestedness would most likely arise if a PTC board were considering for the family trusts the selection of a family member's own business, say, a registered investment firm, for a particular service or investment product. Family members who serve in the PTC's management must fully disclose any conflicts and recuse themselves from any vote on, and avoid participating in any deliberations of, the merits of any transaction involving their personal financial interests. They should carefully memorialize protective steps such as disclosure and recusal. Failing to distance themselves from a self-dealing transaction will impose on the directors the burden of proving the entire fairness of the deal.

## Lack of Good Faith

Directors can sabotage their ability to rely on the BJR if they fail to exercise good faith in fulfilling their duties. The duty of good faith had an exhaustive discussion in *In re Walt Disney Co. Derivative Litigation*, a case in which Disney's directors were alleged to have breached their fiduciary duties for approving Michael Ovitz's employment agreement under which he was paid $140 million when he was terminated the following year.[13] As the Delaware Supreme Court explained in *Disney*, a failure to act in good faith may be shown when a director: (1) intentionally acts with a purpose other than that of advancing the best interests of the corporation; (2) acts with the intent to violate applicable positive law; or (3) intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.[14] The first two categories represent forms of subjective bad faith—an actual intent to harm the corporation or its stockholders. The final category of bad faith involves conduct that's qualitatively worse than gross negligence, akin to an intentional dereliction of duty.

While it's difficult to imagine a court stripping an independent, disinterested and fully engaged director of a PTC participating in a questionable decision of his protection under the BJR, the same degree of confidence doesn't apply in the case of a family member qua director. Intra-family disputes could well cause a family director to allow malice to influence his decision with respect to a beneficiary or a class of beneficiaries, especially in the context of discretionary distributions. Allowing family dynamics to lead to an investment or discretionary action that knowingly puts the PTC at risk of fiduciary liability might well amount to evidence of a director's bad faith.[15] Family participants in the management of a PTC would be well advised to put aside any family differences lest they lose the shield of the BJR.

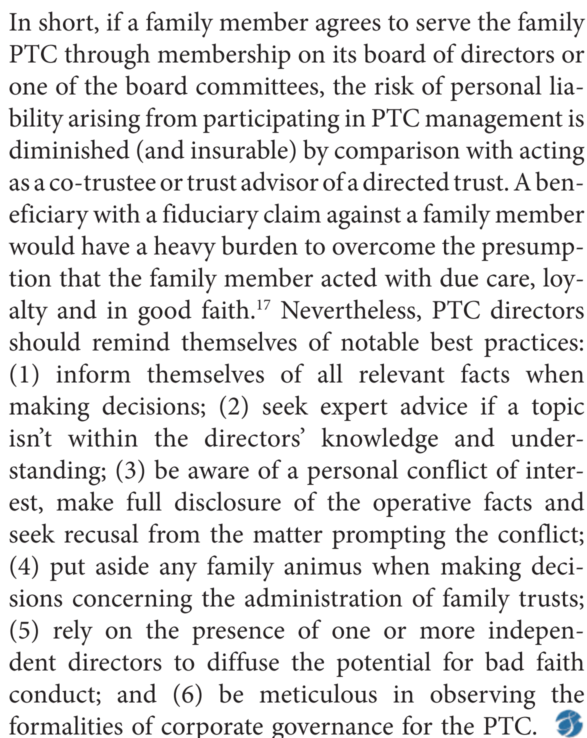
## Piercing the Corporate Veil

No discussion of potential liability would be complete without a brief foray into the theory of piercing the corporate veil. In its traditional context, piercing the corporate veil enables a plaintiff to impose personal liability on a controlling stockholder for whom the corporate entity is a mere alter ego. Veil piercing requires a fact-intensive analysis into multiple factors, including whether: (1) the company was adequately capitalized for the undertaking, (2) the company was solvent, (3) corporate formalities were observed, (4) the controlling shareholder siphoned company funds, or (5) in general, the company simply functioned as a façade for the

controlling shareholder.[16] That traditional formulation is problematic to apply to a PTC because its owner is typically a purpose trust with no active involvement in the management of the PTC other than the appointment of the PTC board. However, given a proper set of facts, a court of equity could readily look through the purpose trust to find the family members who truly exercise control over the PTC—such as the appointer of the trustee of the purpose trust and the protector (or enforcer) who has the power to remove and replace the appointer. If family members have multiple roles in, and vast authority over, the family's PTC, they must be sensitive to the factors enumerated in the traditional veil piercing case. If there's a pattern of the directors disregarding corporate formalities, together with an undercapitalized PTC and clear dominance of the family founder throughout the entity's decision-making process, the dominant family members could be setting themselves up to have the Court of Chancery disregard the PTC altogether and impose personal fiduciary liability.

## Notable Best Practices

In short, if a family member agrees to serve the family PTC through membership on its board of directors or one of the board committees, the risk of personal liability arising from participating in PTC management is diminished (and insurable) by comparison with acting as a co-trustee or trust advisor of a directed trust. A beneficiary with a fiduciary claim against a family member would have a heavy burden to overcome the presumption that the family member acted with due care, loyalty and in good faith.[17] Nevertheless, PTC directors should remind themselves of notable best practices: (1) inform themselves of all relevant facts when making decisions; (2) seek expert advice if a topic isn't within the directors' knowledge and understanding; (3) be aware of a personal conflict of interest, make full disclosure of the operative facts and seek recusal from the matter prompting the conflict; (4) put aside any family animus when making decisions concerning the administration of family trusts; (5) rely on the presence of one or more independent directors to diffuse the potential for bad faith conduct; and (6) be meticulous in observing the formalities of corporate governance for the PTC.



## Endnotes

1. Miles C. Padgett, "Private Trust Companies: A Practical Introduction to a Bespoke Solution," *Investments & Wealth Monitor* (January/February 2016), at p. 37.
2. Private trust company (PTC) enabling states include: Alaska, Delaware, Florida, Illinois, Nevada, New Hampshire, New York, Ohio, South Dakota, Tennessee, Texas and Wyoming.
3. *Compare* 15 U.S.C. Section 80b-2(a)(2)(C) *with* 17 C.F.R. Section 275.202(a)(11)(G)-1(b).
4. Given the signal importance of Delaware law in the field of corporate governance, my analysis of the potential liability of PTC directors is based on the Delaware General Corporation Law, 8 Del.C. Section 101 et seq., and relevant case law of the Delaware Court of Chancery and the Delaware Supreme Court.
5. *See, e.g.*, 12 Del.C. Section 3313(a) (by default, an investment advisor of a directed trust is considered a fiduciary); *see also* Uniform Trust Code, Section 808(d) (2010) (a person with a power to direct is presumptively a fiduciary).
6. There's a liability mitigating option for a family with directed trusts. The family can establish a limited liability company (LLC) to serve as the investment advisor to its directed trusts. The family members who serve as managers of the LLC can rely on the LLC operating agreement to minimize their potential liability (*see infra* note 7) and obtain errors and omissions insurance to minimize their residual risk exposure. The LLC itself will remain liable for its fiduciary responsibility related to the trusts' investments.
7. This analysis assumes that a family PTC is a corporation, not an LLC. In the case of an LLC, the laws of most states are more protective of members and managers in terms of their potential liability to the entity. For example, Section 18-1101(c) of the Delaware Limited Liability Company Act, 6 Del.C. Section 18-1101(c), provides that "the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." In short, apart from a duty to act in good faith, a family member serving as a manager of a PTC formed as an LLC may be exculpated from all liability attributable to his performance in that role. The LLC must be sufficiently capitalized to support the exculpation.
8. *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (setting out rationale for the rule).
9. *Smith v. Van Gorkum*, 488 A.2d 858 (Del. 1985).
10. 8 Del.C. Section 102(b)(7).
11. *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).
12. *Ibid.*, at p. 812.
13. *In Re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006).
14. *Ibid.*, at pp. 62-68.
15. *Cf., Mennen v. Wilmington Trust Co.*, C.A. No. 8432-ML, at pp. 55-56 (Del.Ch. 2015) (the objective portion of good faith requires a court to determine whether a family trustee acted "beyond the bounds of a reasonable judgment").
16. *See, e.g., Winner Acceptance Corp. v. Return on Capital Corp.*, 2008 WL 5352063 at *3 (Del. Ch. 2008).
17. In contrast to the limited availability of affordable insurance for individual co-trustees, there's a healthy insurance market for directors and officers liability insurance for individuals who serve as directors of family PTCs.