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Be Positive About Trusts

'Open architecture' design permits more flexible management tomorrow.

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The typical personal trust used in the United States today for wealth transfers is designed to protect against two risks: a loss of value due to estate and gift taxes, and the shortcomings of heirs who lack the desire, experience, aptitude, or legal capacity to manage assets properly. Though valuable, this defensive posture fosters the impression that personal trusts lack any positive function and serve simply to prevent harm.

The governance plan of most trusts reflects this narrow orientation—build in what's needed to satisfy the tax law and control young children and spendthrifts, and stop there. Such limited objectives naturally lead to a limited decision-making process, and such a limited process naturally neglects the possibility of change over time. This myopic attitude may have been fostered by early court cases that turned aside requests to alter a trust document and granted overriding deference to the settlor's original intentions. The trust form became a defense against change.

But this is not what the future holds for trusts. Increasingly, the law is granting settlors wider choices in writing the trust document, and providing courts and beneficiaries with broader latitude to change the trust's terms after the settlor's death.

As a result, the early decades of this new century will see more trusts created with an "open architecture." The design of these trusts will encourage more openness in decision making and greater acceptance of change. The collaborative relationship among the beneficiaries and the trustee will take on the aspects of a partnership. Multiple trustees or managers will assume the duties once assigned to a single trustee. And changes in the trust document will be considered through a specific approval process rather than categorically resisted as against the settlor's wishes.

As Trusts Developed

When the English common law developed the trust vehicle at the close of the Middle Ages, its intended use was largely passive: The trustee functioned as a convenient titleholder to allow the settlor to pass land free of certain restrictions on inheritance. The settlor's confidant was chosen to serve as trustee and had no inherent legal right to resign or collect compensation, nor any authority to delegate responsibility or actively manage the property.

Centuries later, as the tie between land and wealth was swept away by the Industrial Revolution, the trustee became a more active steward. As this trend continued into the 20th century, the position of trustee became overtly commercialized. U.S. banks secured the legal right to serve as trustees and developed this into a fully specialized line of business. When the desire arose to solidify this source of fees by providing active management of assets, the law obliged: Whether by permission of the settlor, the courts, or the legislature, trustees were authorized to invest in something more than a list of approved investments.

This process of modernizing the trustee's role seemed to proceed slowly when viewed against the broader transformation of financial services in the 20th century, as investing grew from an art of quiet judgment into an elaborately promoted discipline grounded in higher mathematics and practiced by companies with a scale and reach previously seen only in manufacturing enterprises. Modernization of the trustee function appeared complete, however, by the close of the century. Almost all large financial institutions, as well as many boutique investment houses and regional brokerages, were actively managing assets held in personal trusts. "Prudent investor" legislation was enacted across the United States to allow, and indeed require, trustees to consider the full range of asset classes in making investments. It was quite simply no longer unusual for a trust to invest in real property, private equity, and other "alternative investments." And some states, such as Delaware and South Dakota, took steps early on to let investment responsibility be separated from the trustee's other duties.

Yet the evolution of the trust form is, in many important ways, just beginning. Many more states are considering or have recently adopted new statutes that open up choices in trust design. Four states have enacted the Uniform Trust Code since 2000, when the model act was promulgated by the National Conference of Commissioners on Uniform State Laws (www.nccusl.org).

Sharing the Future

Trusts are still viewed too narrowly, as instruments of protection against improvidence and youth and taxes. Even if the original motivation for a trust is narrow, the trust design should include more positive characteristics and more fundamental flexibility. But most trusts written today continue to follow the old model. What is missing?

• *The trustee's control of the trust can be shared with the beneficiaries, including more than one generation.*

Trusts need not shackle their "owners," but can include the beneficiaries (by name or by class) in all or any part of the decision-making process. This connects the trust with those who have the clearest stake in its results and fosters responsibility rather than dependency. Even experienced families and advisers tend to forget that a trust is a form of shared ownership where enjoyment is divided over time and future beneficiaries are affected by how the trust is being managed today.

Moreover, beneficiaries are being given a greater voice under the new trust laws—most notably, the Uniform Trust Code. Under the UTC, beneficiaries can initiate or approve key steps involving a number of issues, including trustee removal and succession, trust migration to a new jurisdiction, trust document amendment, and trust termination. Furthermore, beneficiaries have specific rights to be kept informed about trust affairs.

Settlors (and their advisers) should either respect the wisdom of what the UTC drafters have suggested, or consciously set forth in the trust agreement other rules to govern the role of the beneficiaries. In the absence of contrary instructions from the settlor, the UTC approach, or something like it, is likely to become the governing legal norm. At the same time, beneficiaries must realize that their greater participation will not be meaningful unless and until they become knowledgeable about how trusts should function.

• *The control inherent in the trustee's role can be divided among several trustees who are given exclusive responsibility for distinctly different functions.*

In most parts of our national economy, we have long endorsed specialization of function. Now, finally, under the UTC, it is possible for the trust settlor to specify that several fiduciaries each have sole responsibility for a different activity, whether it be investments, distributions, or accounting and custody. Even in states where the law does not yet invite such a clear division, trustees who specialize solely in administrative functions and take no active responsibility for investments or distributions have been successful in attracting trust business.

This trend will open up a whole new range of choices for settlors if, for example, specialists can be brought in to select investments, and close personal advisers can deal exclusively with distribution decisions. The approach does demand active coordination among the different fiduciaries and the family, but this is a benefit, not a burden, when broader participation by the beneficiaries is considered desirable.

Flexible New World

• *Trust documents should manage change by identifying the objectives of paramount importance and specifying a decision-making process to govern how everything else can be altered.*

Thirty years ago, financial products and financial calculators were a novelty; hedge funds were virtually unknown; the life span of trusts was restricted by the rule against perpetuities; the effective estate tax was higher and the generation-skipping tax was zero; trust services were provided by individuals and a highly fragmented banking industry; stock brokers were stock brokers; life insurance was life insurance; octogenarians were rare birds; and few people had ever heard of a "family office," a "private trust company," or an "offshore trust." And virtually no one placed a trust in a jurisdiction where he didn't live. Against that record of change, the very idea of drafting a document today for a trust that could last forever, or just a mere 200 years, is daunting.

Fortunately, under the UTC and similar state statutes, a trust can be amended in a number of ways, both as to administrative and dispositive terms, subject generally to the condition that the change not conflict with the settlor's "material purposes" or "probable intention." Under such laws, a settlor is well-advised to distinguish between intentions that should be scrupulously honored and everything else, and to consider how changes will be approved or rejected. The cost of not doing so is the risk of having important intentions misunderstood and ignored, and leaving everyone guessing in the future as to what kinds of alterations can be made.

Trusts would be used more often and more effectively if they were better understood by families and better designed by lawyers. Too often, the trust is simply tolerated as a necessary evil for saving taxes or preventing mismanagement. It should be respected as a more flexible means for improving collective family decision-making and individual responsibility. As open-architecture trusts become more common, we will begin to see more trusts that acknowledge the past but focus on the future. ■

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