In Defense of Quiet Trusts

A call to rewrite the Uniform Trust Code so that it still prevents fraud and abuse—but protects confidentiality, privacy and discretion

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Despite its scope, the Uniform Trust Code (UTC) has provoked surprisingly little debate since it was first proposed by the National Conference of Commissioners on Uniform State Laws. The UTC redraws almost the entire territory of trust law—a body of law that has historically evolved at a pace measured in decades and centuries, not mere years. In its 100-plus sections, the UTC restates and revises many long-standing rules and propounds subtle solutions to puzzling old questions. Yet only a few items in this shiny catalogue have been difficult to sell to the scores of trustees, legislative staffers and advisors in as many as 30 states that have scrutinized it.

Probably the most confusing of the UTC provisions concerns how much trust information must be disclosed to beneficiaries and a settlor's right to control the answer to that question. Trust professionals and legal advisors have protested that the UTC requires too much disclosure. In fact, opposition to the disclosure rules and a short list of other items grew so strong in Arizona that the legislature, having recently enacted the UTC, voted on the eve of its effective date of Jan. 1 to delay the law for two more years to allow time for controversial provisions to be addressed.

Opposition to broad disclosure rules just helped derail adoption of the UTC in Arizona.

Supporters claim the UTC simply codifies existing law.[1] Clearly, a gap has been exposed between the rule of law and actual practice, or at least preferences, as to how much information should be available to whom and when, especially when disclosure conflicts with a settlor's intentions.[2]

The issue comes into focus if a settlor wants what I call a "quiet trust."

In a quiet trust, a settlor expressly intends to prevent certain (or all) beneficiaries from learning about a trust, or at least the details of its terms and holdings, believing that the trustee will make the best decisions without the beneficiary's intervention or knowledge. Sometimes disclosure is permitted, but its timing and degree are left to the trustee's judgment.

Should the law prohibit settlors from creating quiet trusts? UTC supporters justify the ban on the ground that a trustee's duty to account to beneficiaries is essential. Supporters say the ban promotes trustee responsibility, responsiveness, and a healthy relationship with the beneficiary.[3]

But by barring this choice, the UTC has effectively declared the quiet trust violates public policy—an official contempt usually reserved for transfers in fraud of a settlor's creditors, or gifts tied to racial or religious overtones.

If accountability can be managed by other means, does it still make sense to thwart a settlor's desire to minimize disclosure to beneficiaries? In its recently adopted version of the UTC, the District of Columbia devised a relatively simple solution. The nation's capital now allows settlors to name a representative to receive UTC disclosure on behalf of beneficiaries. This change creates opportunities to design quiet trusts to satisfy a spectrum of legitimate objectives—without tolerating mismanagement.

LET THE SUN SHINE

The UTC rests on the premise that forcing fiduciaries to keep beneficiaries informed—and to answer beneficiaries' inquiries for almost any information—is the immutable line of defense against fraud, waste and abuse in trust administration.

Certainly in the legal and political culture of the United States, we have an abiding faith that the sunshine of disclosure empowers the everyman to ward off all manner of demons. We prevent abuse by disclosure, posting the tax returns of private foundations on the Internet. We punish accused wrongdoers by publicity staging perp walks of Fortune 500 executives that would make Elliot Ness proud. We consumers are kept informed about things that most of us cannot understand (snack packages warning of trans-whatever fat content) or about things that we hopefully already know (signs alerting us not to stand on the top step of tall ladders).

It may be that our faith in disclosure is suited to personal trusts. Out of respect for tradition, private property and family values, the law allows settlors to name family members and friends as trustees. We allow this selection without imposing licensing requirements or other minimal quality standards—unlike the rules we apply to trust companies or many other types of financial service providers. Given this freedom to choose a trustee, a duty to disclose could be justified as a necessary safeguard. People who are intended to benefit from the management efforts of amateur trustees should be kept informed about how things are going, as an alternative to more intrusive regulation.

AGAINST THE GRAIN

On the other hand, the opposition to the UTC's rules of full disclosure has sent a different message: It's time for a fresh look at disclosure mandates.

The trust law requiring reporting to beneficiaries was developed before the industrial revolution, much less the information age. Compliance with disclosure rules was more easily accomplished and less threatening when investment choices were simpler than today, families more homogeneous, and disputes over rights and remedies had not yet become a profit center for lawyers. In earlier times, we lived in closer-knit communities and the typical stores of wealth were more visible, making confidentiality hard to achieve in any event.

By restating and amplifying old disclosure standards, the UTC overlooks the need to adapt the trust form so that it offers a choice that respects our contemporary concerns

Why thwart a settlor's desire to minimize disclosure if accountability can be managed by some other means?

about confidentiality and management of wealth transfers. Indeed, today's prevailing public policy calls for fewer trust rules, not more detailed rights that increase compliance costs and invite legal challenges. Modern trust laws have liberalized the restrictions on perpetual trusts and the procedures for changing irrevocable trusts and settling trust controversies, as well as the customary prohibitions against delegation and allocation of fiduciary responsibilities. Still other changes have opened the trust investment process and reduced the cost of regulation surrounding wealth transfers, by liberalizing probate laws and embracing the Prudent Investor Rule.

Most importantly, we have seen in the last 20 years a substantial growth in lifetime giving, pushed largely by the opportunity to reduce estate and gift tax costs. Settlors today are more likely to be surrendering wealth while they are still living, and are more conscious of the outcome and effect their early gifts have on young or immature beneficiaries. All of these developments have increased the importance of giving choices to settlors, and suggest that the desire for quiet trusts will intensify.

U.S. trust and inheritance law generally has been kind to settlors' intentions. Settlors are allowed to disinherit their children, grant unchecked powers of appointment over a trust to anyone they choose, give fiduciary powers to inexperienced trustees, and provide standards for trust distributions that are so discretionary, and investment powers that are so broad, as to put the trustee's decision virtually beyond challenge. These laws rest on a common foundation: a belief that people who use these tools do so knowingly and that, absent some overriding public policy, those choices should be respected.

It is inconsistent with a respect for private property to prohibit quiet trusts by specifying what trustees must disclose, even if it contradicts a settlor's best judgment.[4] The UTC paradoxically favors a beneficiary's right to information over a settlor's right to shape those rights in the first place. It seems incongruous that a settlor can control a beneficiary's economic enjoyment, but not his information rights.[5]

While the UTC represents a blend of codified existing law and compromises on new rules of law on many topics, the sweeping strokes of logic relied upon by UTC supporters do not justify the scope and detail of the code's disclosure rules. These rules apply to every trustee, regardless of qualifications, and every settlor, regardless of family circumstances. They call for disclosure of everything sought in what the code calls a "reasonable" request made by any person who might receive a distribution from the trust at any time, however unlikely that distribution may be. The rules encourage such requests by requiring formal notice to most beneficiaries of these rights. Is this system the only way to avoid mismanagement by trustees lacking in fiduciary experience or expertise?

Trust law could be rewritten to allow settlors to substitute a watchman to whom disclosure is made in lieu of beneficiaries.

A SIMPLE SOLUTION

Settlors' desires for quiet trusts demand more attention than the UTC drafters anticipated. How, then, to balance the need for quiet trusts with the need to protect against mismanagement? In fact, the UTC and other modern trust laws suggest a simple solution. Trust law, both in UTC Section 808 and elsewhere, lets settlors provide for specialized fiduciaries and varying standards of personal liability for such fiduciaries. Using these concepts, trust law could be rewritten to allow settlors to substitute for beneficiaries, a watchman to whom disclosure is made. Washington, D.C. adopted this approach in its version of the UTC, which became effective early in 2004. The D.C. statute allows settlors to name one or more people who will receive disclosure otherwise due to one or more of the beneficiaries. These watchmen are required by the statute to act "in good faith" to protect the interests of those beneficiaries.[6]

Who watches the watchman? Possibly no one,[7] depending on the rules in each trust governing the number of fiduciaries and the process for removal and appointment. Still the D.C. solution is a good one. The settlor who wants to make a gift, but in a quiet trust, needs a more reliable alternative than the only other option available under the UTC: granting someone else a power of appointment over the trust that is exercisable in favor of the reckless or untested beneficiary. As this power holder is not constrained by any fiduciary duty to honor the settlor's intention, this alternative is certainly less reliable than a quiet trust that shifts disclosure to a substitute watchman, and less favorable to the intended beneficiary.

TRUST DESIGN

What if, like Kansas, a state passes the UTC but amends it to allow settlors to unconditionally waive a trustee's duty to disclose? In those

states, settlors could select the Washington innovation by writing the watchman's role into the trust document as a condition of the waiver of the duty.

The Washington structure could be further adjusted to fit each trust's individual circumstances. For example, management of substantial funds in a quiet trust during a long period may warrant a stronger trust governance structure. So a trust document could call for a periodic review by a third party such as a peer review by an independent professional trustee every five years or an accounting review or both. The purpose of such a review would be prophylactic, to discourage neglect or collusion.[8] The review process also would help assure trustees that their stewardship of the trusts is less likely to be successfully challenged.[9]

How would this structure work if a trust ended up in court? An uninformed beneficiary could be given whatever information the substitute

AGE-OLD PROBLEM

The need to keep information from beneficiaries is not new

The phrase "quiet trust" is my name for a trust that restricts disclosure to beneficiaries. The idea behind it grows out of the conflict between the right of a beneficiary to know about a trust and a settlor's desire to control that information.

Why is a quiet trust needed? Anyone with experience with personal trusts has come across a settlor who'd prefer that one or more of the beneficiaries of his irrevocable trust not be told about the wealth it holds, or even that the trust exists. The settlor wants distributions to be made if and when needed, but only as a trustee decides, not as the beneficiary expects or demands. He wants information about the trust terms and assets rationed out in the same way.[1]

These constraints on access to information may be a settlor's solution for dealing with a particularly immature or even reckless beneficiary. More often, the concern for confidentiality is a response to a persistent fear that easy money corrupts untested character.[2] A settlor believes that if the trust is fully disclosed early on, young family members are more likely to grow up feeling dependent and conflicted, fail to develop their natural ambition and desire for independence, and may seek to challenge the trustee's authority. A settlor wants a quiet trust, one that speaks to the beneficiary only if and when needed, in order to safeguard against the dangers created by knowledge of wealth close at hand.[3]

Anyone who sets out to construct such a trust must first confront the mysteries of human motivation and discipline. It is clear that intellectual accomplishment is not synonymous with financial prudence. History provides examples of extraordinary talents, such as Thomas Jefferson and Mark Twain, who were poor stewards of wealth. Moreover, the connection between inherited wealth and personal ambition is not well understood. Anecdotal evidence and academic studies point in many directions; those who are seriously wealthy or advise others in that class have differing views on whether it is useful or counterproductive to try to manage the motivation of younger family members by minimizing their knowledge of the family fortune, or by minimizing their inheritance.[4]

—Donald D. Kozusko

Endnotes

1. The focus here is on the law and practice in the United States, but British trust law has also faced the issue with some frequency. See Ingrid Pierce, "Do Beneficiaries Have 'Rights' to Information and at What Cost to Trustees?" Vol. 9, Issue 9, *Trusts and Trustees* (Sept. 2003); Dietmar Loretz, "Beneficiaries' Rights to Information in Liechtenstein: Can the Trust Deed Exclude This?" Vol. 9, Issue 10, *Trusts and Trustees* (Oct. 2003); *Rosewood Trust Ltd v Vadim Schmidt* [2001] 3 ITELR 734.
2. The personal fallout from inherited wealth has recently been addressed in "Born Rich," an HBO documentary directed by heir Jamie Johnson and in *Worth* magazine ("The Inheritance Issue," Vol. 12., no. 2, March 2003). Professional estate planning articles on drafting incentive trusts also address this issue. See Ellen Whiting, "Controlling Behavior by Controlling the Inheritance," Vol. 15, no. 5 *Probate and Property* p. 6 (Sept/Oct 2001); and family constitutions (William Doyle, "Creating a Framework for Family Governance," *Trusts & Estates*, Nov. 1999, pg. 42.
3. Such a confidential trust is "quiet," but not secret, because information reporting is due to any beneficiary, if and when he receives a distribution. Also, the Schedule K-1 used for federal income tax purposes will supply enough data to encourage educated guesses about the size of the trust. Using more than one trust tends to minimize, but not eliminate, this disclosure risk.
4. See the extensive materials on this topic collected at *www.kozlaw.com* (click on: how we think, our views, controlling wealth, inheriting values). Successful entrepreneurs tend to worry about this issue more than most people. Dinesh D'Souza, *The Virtue of Prosperity: Finding Values in an Age of Techno-Affluence* 59 (The Free Press 2000). Charles Schwab, in a CSPAN interview on Jan. 25, 2003, stated emphatically that children should not inherit an "outrageous" amount of assets. In Schwab's opinion, the right size of inheritance is enough to obtain an education and start a business, but not to finance a "life full of lollipops." Schwab suggested that "most responsible people feel that way." On the other hand, advisors to wealthy families believe that an inheritance can be an opportunity, rather than a handicap, if inheritors are offered guidance, knowledge and encouragement needed to participate actively in wealth management and still pursue their own dreams. James E. Hughes, Jr., *Family Wealth: Keeping it in the Family* (NetWrx, Inc. 1997).

watchman saw fit; a guardian ad litem acting for the beneficiary could make any necessary decisions. Ideally, local law or court procedures should provide for sealing of the court record on personal trust and estate matters upon request of any interested party.[10] This would not only allow the substitute watchman to maintain confidentiality, but also would protect against gratuitous public curiosity in the event of a contentious court dispute.[11]

If the option of a quiet trust was readily available, we also would see the development of more creative uses of confidential gifts in trust. Suppose, for example, that the founder of a privately owned business wanted to make some large gifts of stock for tax purposes, but didn't want to encourage a debate over the direction of the business with his younger family members, who are also his intended beneficiaries.[12] Using nonvoting stock for the gift would likely not provide enough reassurance. A quiet trust of nonvoting stock would be far more reliable.

In a different context, settlors also would be free to create trusts for their siblings that were intended as safety nets, used only if needed. Settlors also would be freer to use shifting and discretionary trust interests that applied different terms at different times, depending on the circumstances for friends and family members. A quiet trust arrangement would eliminate the potential embarrassment of having to tell almost every beneficiary about those parts of the document that once were operative but became obsolete for personal reasons.

In short, if quiet trusts were more flexible and available, there would be less sunshine but more options to

CONFIDENTIALITY DESTROYED

The proposed law forces too much disclosure to too many

The Uniform Trust Code (UTC) requires detailed disclosure under Section 813 to all "qualified beneficiaries" under UTC section 113(12). Qualified beneficiaries are roughly classified into:

- *first-in-line*—those who must or could, in the trustee's discretion, receive a current distribution; and
- *next-in-line*—those who would join the first group if the interest of someone in the first group was to terminate (such as by death, passage of time, or termination of the entire trust).

A 30-year-old who receives trust income until he's 35, at which time he receives the entire trust fund outright, is a qualified beneficiary. But so are his children, who would receive distributions if the 30-year-old died prematurely.

The list of required disclosures is comprehensive. It includes:

- a copy of the entire trust document whenever requested, not just the part the trustee considers relevant to the particular beneficiary's interest;
- complete financial accounts, at least annually;
- notice of interim events that are "material" so that all affected beneficiaries can act to protect their interests, such as to prevent the sale of a major asset; and
- information on how to contact the trustee and how much the trustee is or will be paid.

A trustee must notify each qualified beneficiary of his rights to information, such as his right to the entire trust document and complete financial accounts.

Under Section 813, a trustee also must satisfy any request for information made by any beneficiary unless the request is "unreasonable."[1] This duty to respond applies even to remote beneficiaries who are not among the qualified beneficiaries. So every trust beneficiary likely will be able to acquire all or most of the required disclosure listed above, if he knows enough to ask. Any individual who knows about a trust (or bears some relationship to the settlor) might inquire whether he is a beneficiary. Even if he is a remote beneficiary, he could make a standing request to be supplied with all of the information that must be provided to qualified beneficiaries. A trustee would think twice before rejecting that request as "unreasonable."

UTC Section 105(b)(8) and (9) limits a settlor's freedom to waive these required disclosures. A trust document can remove the affirmative duty to provide accounts and interim material information to beneficiaries. But the duty to notify qualified beneficiaries about a trust and their right to request certain information cannot be restricted for beneficiaries who are at least 25 years old. The duty to respond to requests cannot be restricted, including requests made by more remote beneficiaries who are not in the two qualified groups.[2] So, while a waiver may be occasionally useful, the fine distinctions between what duties can and cannot be waived do not provide any practical assurance of confidentiality. The UTC rule, in effect, has declared that each beneficiary, or certainly each qualified beneficiary, needs and deserves substantial information rights regardless of a settlor's intent.

—Donald D. Kozusko

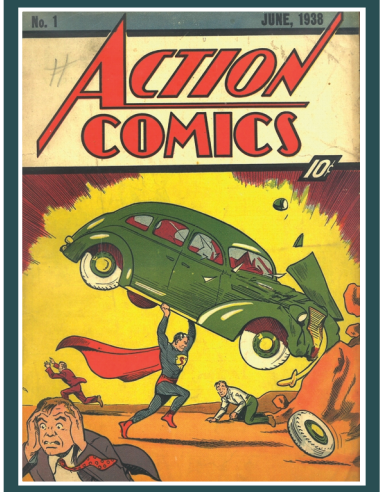
Endnotes
1. UTC Section 813.
2. UTC Section 105 (b)(8) and (9).

manage wealth transfers across a spectrum of different needs and family circumstances. Such innovations help keep the trust model adaptive and alive, encouraging improvements in trust governance, and avoiding the confining logic that declares more disclosure is better simply because some disclosure is good. ▮

Endnotes

1. David English, "The Controversy over UTC Section 105(b)(8)," *UTC Notes*, p. 2 NCCUSL Spring 2003, available at *http://www.utcproject.org*.
2. The gap between theory and practice also reveals the serious policy disagreement as to the disclosure needed. District of Columbia, *Judiciary Comm. Report on Bill* 15-234, p. 8 (2003).
3. English, p. 4; Joseph Kartiganer and Raymond Young, "The UTC: Help for Beneficiaries and Their Attorneys," *UTC Notes*, p.4-5 (NCCUSL Fall 2002), available at *http://www.utcproject.org*.
4. Similarly, someone can choose to have his assets managed in the event of incapacity under a power of attorney, or can leave them in a joint account, without the law imposing mandatory standards of disclosure on the person granted the access to the funds.
5. For example, Delaware recently amended Section 3303 of Title 12 of the Delaware Code to make it clear that the "terms of the governing instrument may vary the rights and interests of the beneficiaries" including information.
6. Note also that the decisions and other actions of a guardian ad litem, or similar legal representative, usually are subject to only minimal oversight by the court process in trust matters. Extensive regulation is not the universal norm in trust law.
7. District of Columbia Uniform Trust Act of 2003, Bill 15-234, section 19-1301.05 (c).
8. James E. Hughes, Jr., *Family Wealth: Keeping it in the Family* (NetWrx, Inc. 1997) p. 129.
9. The statute of limitations on claims against a trustee is usually tied to a beneficiary's knowledge and disclosure to a surrogate may not be sufficient for this purpose. UTC Section 1005(a).
10. S. Dakota Codified Laws Section 21-22-28 (court record sealed upon request of settlor, trustee, or any beneficiary); *Shenandoah Publishing House, Inc. v. Virginia K. Fanning, Ex.*, 368 S.E.2d 253 (S.C. Va. 1988) (successful challenge to lower court's order to seal records of civil trial). The trust document could be written to require beneficiaries to support a petition for such a request for privacy, even if the law did not grant it as a matter of right.
11. For example, the trust dispute among members of the family that founded the Hyatt hotel chain was described in detail in Susan Fitch, "*Pritzker v. Pritzker*," p. 142, Vol. 172, no. 11 *Forbes* (Nov. 24, 2003).
12. Richard S. Tedlow, *The Watson Dynasty: The Fiery Reign and Troubled Legacy of IBM's Founding Father and Son* (Harper Business, 2003), describes a very contentious relationship between the Watsons when they were running IBM.

Collectors' Spotlight



Action Comics No. 1 introduced Superman to the world in 1938. This copy fetched $57,500 at a Heritage Comics auction Feb. 6.