Open-Architecture Trusts: The Wiser Choice

There are scenarios that call for a private trust company. But usually open-architecture trusts are best

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The trust we use today first took shape in a quite different time and place six centuries ago. Since then, its form has evolved; its uses have proliferated. In fact, the trust is widely used today precisely because it has adapted so well to changing needs and wants. (See, "A Brief History of Trusts," page 46.) Now U.S. laws are beginning to evolve in ways that permit still more flexibility. An important part of the next stage will be the use of what might be called "open-architecture" techniques for trust governance. For most wealthy families, open architecture works better than the more cumbersome structure of a private trust company.

POWER TO FAMILIES

What exactly is an open-architecture trust? It is nothing less than a new breed that will change the way we think about trusts. Open-architecture trusts allow willing family members to hold individually tailored fiduciary roles. The governance in such a trust is not designed for the convenience of the trustee, but to empower the family. Through open-architecture trusts, the true owners of estates can integrate their family members into the trustee decision-making process, thereby encouraging informed participation by beneficiaries and fostering responsibility rather than dependency.

The new Uniform Trust Code facilitates this process. Beneficiaries are granted specific rights to be kept informed about trust affairs. More importantly, they also are given an active voice in decisions such as trustee removal and succession, trust migration, trust amendments

and trust terminations.

But the UTC does not dictate a form of beneficiary populism. It accommodates trust creators who see things differently. Except for certain obligations to inform beneficiaries, the exact form of trust governance can be shaped by the creator and protected from ready amendment by the beneficiaries, if the creator so chooses. Still, the direction of the open-architecture trust tilts decidedly in favor of beneficiary participation, viewing the trust almost as a partnership between the family and the trustee.

Because of the UTC, families can use open-architecture trusts to craft meaningful, appropriate fiduciary roles for family members and advisors. This provides a clear alternative to the traditional one-size-fits-all trustee structure used by most private trust companies or institutional trustees.

Now co-trustees (by whatever name called) can specialize officially, avoiding the traditional makeshift efforts to divide responsibilities. Under UTC sections 105 and 808, a trust creator may specify that different trustees each have sole, exclusive authority for different jobs, without exception or qualification. By carefully dividing tasks among professional trustees and individual trustees (including family members), the families and their advisors can take responsibility for decisions that suit their experience, time, knowledge and capabilities. Aspects of trusteeship such as investing, custody, safekeeping, tax compliance and bookkeeping can be assigned to professionals, and even divided among different kinds of professionals. This matching of roles also reduces the liability exposure of trustees, allowing families and their close advisors to stay involved as decision-makers, without undue risk or disproportionate commitment.

More choices bring more complexity. Unbundling trustee duties creates a need for greater coordination among responsible parties. Open-architecture trusts not only permit family participation, but also require it. The family and its advisors must be willing to actively supervise this coordination, making the education of beneficiaries a key ingredient for successful open-architecture trusts. Thoughtful families recognize that better trust governance requires informed beneficiaries. Thus, the open-architecture trust marks a return to the best aspects of the English trust heritage—family members connected to the trustee and knowledgeable in their own collective way.

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WHEN PTCS ARE GOOD

How does this new choice compare with a private trust company? By creating its own trust company to act as trustee of its trusts, a family can limit the liability of the shareholders, evaluate directors under a business-judgment standard, and benefit from a familiar, well-established hierarchy of relationships among shareholders, directors, officers and employees. Given that such an integrated structure provides many fundamental advantages, why doesn't every wealthy family use it? History supplies the answer.

Because of the long-standing association between banks and the legal authority of companies to serve as trustee, almost all states now regulate any entity serving as a trustee as if it were a bank. In contrast, almost no state applies similar regulation to individuals serving solely as trustees. Private trust companies must be licensed, meet capital requirements, and endure regulation and periodic audits under the same general framework imposed on commercial trust institutions. No wonder few families find such a prospect appealing, and most stay away.

Still—assuming that a family's assets are large enough, its dedication to excellence strong enough, and its proclivity to "build and not buy" financial services is great enough to permit it to build either an open-architecture trust or its own PTC, or both—two scenarios strongly suggest the use of a PTC:

• A family has a significant in-house funds management operation that supports large numbers of trusts for extended family branches.

• A family is burdened with old-style, wooden trusts organized in old-law states.

In the first scenario, the size and scope of the in-house activities implicates the Investment Company Act of 1940, the Investment Advisors Act of 1940, the Securities Act of 1933 and their increasingly

burdensome regulatory schemes. The goal shifts from avoiding regulation entirely to making it, like modern surgery, minimally invasive. In this setting, a family using individual trustees must determine the status of the family's trusts and pooled funds under these intricate rules, as well as determine the need for family members, employees and related companies to qualify as registered investment advisors. The burden of becoming a PTC must be evaluated in light of how other regulatory schemes will apply if a PTC is not used. Often the regulated PTC will be the winning option.[2]

In the second scenario, the change to an open-architecture arrangement may be impossible at the trust level, because it may not be feasible to amend the trusts so completely. Substituting a PTC for the existing trustees of such a frozen trust is a good solution, if permitted under the trust and the applicable law. Because the PTC becomes an old-style trustee exercising all trustee powers, the family can organize and divide functions within the trust company, and in effect, within each trust for which their "captive" company serves as trustee. The PTC thus becomes a reasonably flexible, back-door way to match advisors to specialized trustee roles, notwithstanding trust-law limitations. Trusted individual advisors can be appointed to investment committees or distribution committees, or elected to voting or non-voting memberships on the board of directors

A BRIEF HISTORY OF TRUSTS

In the beginning, there was the country squire trustee. Then tax policy and the industrial revolution pushed institutional trustees into family affairs. Now things are changing again

Trusts were originally developed as a means of conveyance, not a means of management, at a time when the primary store of wealth was real estate. The lord of the castle and his family knew how to manage the estate. The trustee was needed solely to pass title to the land by trust, avoiding the vestigial feudal restrictions on inheritance still imposed by English land law. Yet to serve this purpose, trustees had to hold full legal title to the land, so the law protected the family by severely limiting the authority of trustees. Accordingly, early trustees worked for free and did not do much. They were close friends, advisors and relatives. Serving as a "country squire" trustee became widespread among the English privileged class. The roles of the family and trustee of that day were in harmony.[1]

But the industrial revolution ushered in a commercial age. New stores of wealth emerged, taking the form of stocks, bonds and other complex financial promises. As a result, businessmen adapted the trust form to all manner of commercial purposes beyond the world of family wealth, forming monopolies (engendering anti-trust laws), pooling and pledging assets, and still later, sheltering pensions and even protecting a rabbi's retirement fund.

Traditional family trusts also adapted, yet labored under the constraints of their heritage as simple devices for conveying land. The inherent powers of trustees remained limited even as the foundations of wealth were changing. In addition, the law continued to mandate that a single trustee (or multiple trustees acting unanimously) had to make all important trust decisions. With limited exceptions, one function (such as investing) could not be assigned to one of several trustees without the others retaining responsibility for errors and omissions. Even the creator of the trust could not override this notion of a single, integrated office of the trustee.

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American and English law gradually replaced the concept of protecting beneficiaries by limiting trustee powers with a new system that granted broader trustee powers, but coupled them with a strict duty of fiduciary care and loyalty. Only recently has trust law relaxed the single-trustee rule—by allowing the trustee function to be divided among different trustees and by protecting the trustees who do not have primary responsibility for particular tasks. Far from lowering the standard of performance, trustee specialization allows modern trusts a new means for managing what has become a bewildering array of assets throughout multiple lifetimes and under demanding standards enforced by aggressive U.S. tort lawyers.

Because the single-trustee notion persisted for so long, another evolutionary step taken during the 19th century paradoxically led to a profound shift away from the

(which acts like a trust oversight and policy-making committee). Also, rotating younger family members into nonvoting positions can provide for beneficiary education and training for future participation in trust management. The flexibility of this alternative is not as great as an open-architecture trust in many important respects (particularly when different trustees are needed or desired for different trusts within one family), but it does resolve the old-trust, old-law dilemma.

FOR MOST FAMILIES

Apart from those cases in which the PTC is a competing or superior choice, the open-architecture alternative better suits most families. Families can participate in their open-architecture trusts from one or more of three basic platforms: as informed beneficiaries with rights to influence independent trustees, as holders of trustee investment powers, and as holders of trustee distribution powers. These rights come in many shapes and sizes, such as veto powers, swing votes, super-majority vote requirements, and powers to make certain kinds of distributions but not others. An open-architecture trust can shape these three core relationships with surgical precision and in almost limitless combinations that can change over time.

By comparison, the PTC is a blunt instrument. As the family grows in number and younger generations mature, it is natural and often desirable for the roles of family members to change. Adding and subtracting

heritage of the country squire trustee. At the request of an insurance company, a U.S. court permitted an inert entity, not a human but a corporation, to act as the trustee of a trust. Armed with this new authority and supported by the single-trustee concept, banks captured the market for trust asset management services by becoming professional trustees-for-hire. By the end of the 20th century, global financial institutions and asset managers of every stripe served as trustees of family trusts, loading up on marketable securities and avoiding holdings of real estate and other illiquid family assets.

The movement toward the institutional trustee was reinforced by the introduction of new federal taxes. In 1913 the U.S. Constitution was amended to permit taxation of personal income; wealth transfer taxes were assessed on inheritances in 1916 and on lifetime gifts in 1932. As the rates of these taxes at times topped 70 percent, tax planning played a compelling role in the development of trusts. U.S. tax policy conspired against the heritage of individuals serving as trustees, because many trustee powers triggered adverse tax results if held by trust creators, beneficiaries or family members. While this result seems as natural to us today as fiduciary law, it was not inevitable. The U.S. tax law did not have to assume that related-party trustees would act differently simply because of their relationships. It did not have to create a taxable difference between a support and maintenance standard vs. one of complete discretion.

Tax policy, together with the single-trustee rule, invited institutional strangers into the homes of wealthy Americans and crowded out the human trustees who were familiar to them. By the end of the 20th Century, harmony between the family and its country squire trustee had ended. The family's control of its own destiny diminished.

Fortunately, new trends in the law and the marketplace for trust services will allow families to harmonize the intimate trustee tasks best suited for family and friends with the complex commercial tasks more ably performed by professional trustees.

A few financial institutions are offering comprehensive "family-office services" and decoupling trustee service from trust-asset management—at least in part. The Uniform Trust Code (UTC) was first published in 2000, and already five states have adopted it (Arizona, Kansas, Nebraska, New Mexico and Wyoming). The UTC is significant not because it is revolutionary (though some aspects are), but because it allows trust creators and even beneficiaries to shape their trusts in new and creative ways.

Importantly, the UTC allows the amendment of existing trusts, even for old trusts with no powers of amendment or appointment. Under UTC sections 411 and 412, for example, both administrative and dispositive trust terms can be modified if the change does not conflict with the creator's "material purposes" or "probable intention." Today's forward-thinking families can now look across the nation to find laws and trustees that fit their needs, then move their trusts to jurisdictions with this new rule of law, in effect extending its geographic reach. When land was wealth, there was little need to consider where a trust should be administered. Today, if families do not like the trust law or trustees where they live, they often can move their trusts to greener, pastures where those trusts can be modernized. The UTC is the gateway to open-architecture trusts.

-John Lahey

Endnote

1. For an analysis of this history, see John Langebein's "The Contractarian Basis of the Law of Trusts," 105 Yale L. J. 625.

individual trustees or committee members in an open-architecture system at the level of individual trusts is relatively easy; but forming more than one PTC, or using multiple combinations of players within a single entity, is burdensome.

Similarly, moving the trust to a new jurisdiction to seek a better local trust or tax law, or dealing with family migration, can be more expensive and difficult when the PTC is the seat of trust governance. Of more immediate importance, the process of trying to divide family rights within one corporate structure can create awkward confidentiality issues within family groups that are not easy to solve. For example, a family member who serves on the board of directors of a PTC has access to all of the information regarding the trust company and its trustee activities. Aunt Millie may not want Cousin Opie to know how many times she visits her psychiatrist (paid for by the trust).

Finally, federal tax law may affect the choice of structure due to the risk of an estate tax being imposed when family members and related parties are treated as holding trustee distribution powers.[3] For wealthy families, this is a game of high-stakes poker. The combination of a huge tax bill for an error in judgment and the relative uncertainty surrounding current IRS positions makes this issue particularly vexing. Building Chinese walls around family members serving as directors of a PTC can shield the trusts from undue tax risk. Nonetheless, this risk can usually be addressed with greater precision and certainty at the trust level in the open-architecture alternative.

CHANGING TIMES

Trust law is now increasing the options available to wealthy families, and forward-thinking financial institutions are offering unbundled trustee and family office services. Families can begin shifting some of the regulatory burdens and tedium of being a modern trustee (and the attendant liability exposure), while at the same time retaining for family members and their most trusted advisors more intimate and sensitive trustee functions. Private trust companies are flourishing in the offshore trust centers with less of a regulatory burden, and perhaps global competition in trust services will someday expand the opportunities for U.S. families to employ this technique either at home or abroad. Hopefully, the U.S. regulatory environment will permit the widespread use of family-controlled trust companies with less regulation.

Until then, however, the U.S. version of the private trust company will remain a useful vehicle for only a limited number of very wealthy families with either an in-house funds management business or an inability to get an old-law trust amended in court. ❚

Endnotes

1. James Hughes, *Family Wealth: Keeping it in the Family* (1997).
2. For a treatment of the RIA aspects of this topic, see: John Duncan, "Family Offices and the Investment Advisors Act," *Family Office Exchange Newsletter*, 4th Quarter 2002.
3. For a thorough analysis of these issues, see Don Kozusko and Miles Padgett, "Private Trust and Protector Companies: How Much Family Control," 2002 *Tax Management Memorandum* 443 (September 2002). For example, note that fail-safe state laws protecting individual holders of "hot" trustee tax powers may not apply in the PTC context, and the existence of employees within the PTC tends to create "related or subordinate" persons who become tax-sensitive holders of power, thus adding further complexity. Virginia recently addressed this issue with special provision in its new private trust company act. VA Code Ann. at 6.5-32.30:7 (2003). However, on a quite different tax issue, PTCs currently enjoy an advantage; it is easier to deal with the application of the 2 percent floor on miscellaneous deductions to trust administration costs because the PTC can more readily charge a bundled trustee fee.

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