PRIVATE TRUST COMPANIES

A Practical Introduction to a Bespoke Solution

By Miles C. Padgett, JD, CIMA®

Private trust companies are not a new phenomenon. The Bessemer, Rockefeller, Glenmede, and Pitcairn trust companies have been operating as fiduciaries for those respective families for many years. Over the past 25 years, however, private trust companies have increased dramatically in number. Rather than a handful of private trust companies, there are now hundreds of major, family-controlled trust institutions in the United States. This article addresses why the number of private trust companies has been growing; describes a typical private trust company (PTC) organizational structure; and discusses certain legal and practical considerations that a family exploring a PTC should address.

Why the Proliferation of Private Trust Companies?

Trust practice and governance have evolved as a byproduct of fundamental changes in business, economics, and wealth management in the United States and globally. This evolution is primarily attributable to banking consolidation, modernization of family governance, democratization of technology, and the great wave of economic success that has swept certain segments of the U.S. marketplace. Those who were in wealth management during the late 1980s and the 1990s will remember that time period as one of dramatic consolidation in the banking industry. That consolidation displaced large numbers of trust officers and other staff in corporate trust departments. The resulting displacement and turnover, and the accompanying deterioration of service levels in many institutions, led wealthy families to consider whether their desired level of service could be better met by, in effect, creating their own institutions, using business plans tailored to their needs and desires.

In addition, during the 1980s and particularly the 1990s, the writings and speeches of Jay Hughes[1] attracted the attention of wealthy families who then began to ask themselves questions such as "What is the purpose of the family's wealth?" and "How can we use it to improve fundamentally the lives of family members?" That line of questioning led, in some cases, to the conclusion that by creating their own trust institution, a family could best implement its own processes, particularly related to trust distributions, to assist family-member trust-beneficiaries in living better, more fulfilling lives and to mentor family members, either explicitly or implicitly.

The 1990s and 2000s were a time of rapid technological advancement and its democratization. Before the 1990s, sophisticated data analytics were reserved to the province of those with large main-frame computers, either universities or large financial institutions. Now exceptionally sophisticated financial and statistical analytics can be done in Excel, either through the standard program included on almost all business and personal computers or through inexpensive plug-ins designed for certain specific functions. What is more, in contrast with the 1980s and early 1990s, the sharing of large volumes of data across long distances is virtually instantaneous. Once received, data can be manipulated to produce whatever output is desired. This technology advancement and democratization has enabled family offices and private trust institutions of even modest wealth to gain transparency into holdings and investments (and indeed markets themselves) that was previously either unachievable or prohibitively expensive and to share knowledge with almost no barriers, thus replicating the decision-making and execution processes for trusts, and their beneficiaries and investments, that was the historic preserve of large financial institutions. In other words, family trust institutions and family offices really can do it all by themselves now, particularly with the assistance of similarly situated institutions with which they readily share knowledge.

Finally, PTCs have proliferated over the past 30 years because of the significant increase in wealth in the United States over that time period. The S&P 500 has increased, in price alone, eleven-fold since 1985, and net wealth in the United States has increased by several multiples since 1985.[2] This has caused wealth owners to be concerned more with "where will it all go" and "how can I ensure that it will help, rather than hinder, my family," compared with concerns in previous decades over how to make it and keep it. In other words, this increase in wealth has increased the stakes for proper family and trust governance, and in conjunction with other societal changes has led many families to create their own private trust institutions.

What is a Private Trust Company?

A private trust company or PTC is an entity owned by one family and created specifically to serve as the trustee for that family's own trusts. A PTC also acts as the family's fiduciary in certain other roles, such as executor of a family member's probate estate or guardian for an incompetent family member. A PTC typically is structured to look like, and function as, a state law corporation, even though in most cases a PTC is legally a limited liability company. See figure 1 for an organizational chart of a typical PTC.

A PTC is normally organized to function as if it were a commercial trust institution, governed by a board of directors and managed by them through the use of board committees such as a trust committee, audit committee, and investment committee, and through delegation to officers, such as a president, vice president, senior trust officer, compliance officer, etc. Where a PTC differs from the typical commercial trust institution is the use of a discretionary decisions committee, which is a specifically designated committee designed to insulate family members from adverse transfer tax results described in guidance from the Internal Revenue Service.[3] Such a committee usually is populated by individuals who are independent of the family and is tasked with making tax-sensitive, discretionary decisions related to the family's trusts. Other than the discretionary decisions committee, the typical PTC functions similarly to a commercial trust institution, with annual audits of its financials and its fiduciary processes, methodical vetting of investment strategy for trusts, routine distribution decisions executed by trust officers, vetting of clients and client transactions for anti-money laundering compliance, and periodic review by the board of directors of the PTC's operations.

Often a PTC is used in conjunction with a family office. In that arrangement, the PTC is responsible for making top-level fiduciary decisions and most back-office functions of the PTC are delegated by contract to the family office. More importantly, the PTC makes strategic-level investment decisions for the family's trusts, primarily long-term asset allocation, and the family office is tasked with execution of that investment strategy, either itself or as a manager of managers, again pursuant to an agreement with the PTC or with a trust client itself. This arrangement allows a family office that is already in existence to avoid disruption of staff, location, and function, and permits the PTC to conduct its business at the appropriate level, i.e., making important fiduciary decisions related to distributions, investment strategy, etc.

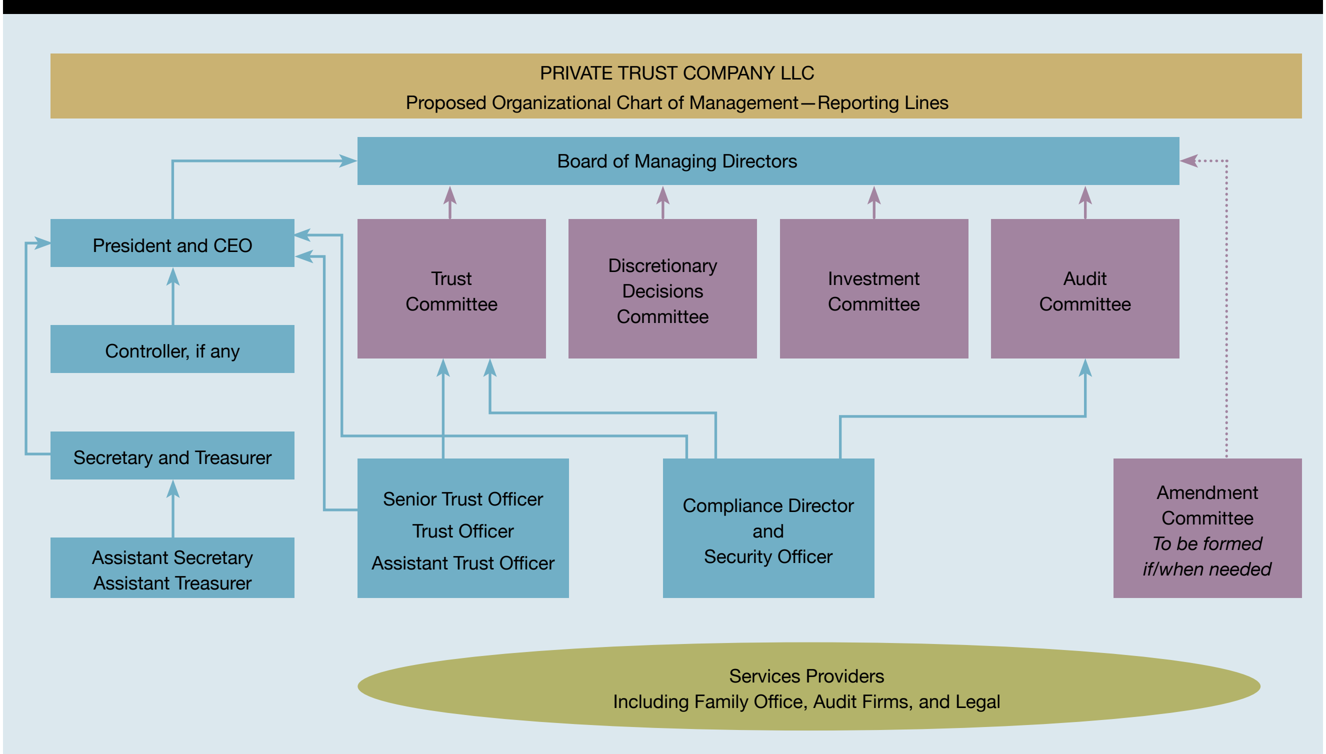
Factors to Consider

In considering whether to create a PTC, a family usually is driven by, and typically addresses, the following factors (among others):

- Need for legal control of strategic assets and decisions
- Permanent fiduciary status and protection against personal liability
- How to effect decisions made within the family's agreed upon governance system and beneficiary mentoring
- Cost and required asset base
- Choice of regulatory regime
- Choice of situs of entity and operations

Ultimately, whether or not to pursue a PTC is determined by a combination of several of these factors, as well as others. Each of

Figure 1: Organizational Chart of a Typical Private Trust Company



the above factors is addressed briefly below; certain of them favor, while others discourage, the creation of a PTC. An in-depth discussion of each, and the discussion of all relevant factors, is beyond the scope of this article.

> *"The process of selecting and replacing the individuals who will serve the family within the PTC is clear, well-defined, and based on a corporate-law model that has been tested and refined over decades."*

Legal Control of Strategic Assets and Decisions

Ultimate decision making rests with the legal owner of assets. For the typical successful family, that legal owner is the trustee of the family's trusts, not the family's family office. We all have observed many instances in which the family office has the responsibility of causing decisions of the asset owner to be effected, but does not have the legal authority to demand that effectuation. That is an uncomfortable position to find oneself. This is true even if the family office utilizes family investment funds in which a family investor's assets are locked up for long periods of time. Ultimately, the family's trustees, as the legal owners of the assets, determine whether to remain invested in those vehicles, and more generally have the legal authority and responsibility to make decisions regarding what happens to those assets, both as a spending and an investing matter. Accordingly, certain families are attracted to the PTC structure because it allows the family, or its elected proxies, to exercise ultimate decision-making authority over the family's assets and their use.

Permanent Fiduciary and Protection against Personal Liability

Senior family members who control the family's enterprises and who are reaching the end of their working lives and entering retirement generally intend to devote much of their time and attention to matters other than managing the family's wealth and related enterprises. So, too, an entire generation of trusted advisors to successful families is retiring from their professional lives. At the same time, most individuals who are informed, regardless of the strength of their relationship with a family, will not serve as fiduciaries for a family without strong liability protection. This is true even of family members serving as fiduciaries for their relatives. These phenomena have not escaped the attention of senior family leaders, and many are reaching the conclusion that, for the family's fiduciary transition to occur successfully, at least two things will be required: a long-term solution to the family's fiduciary needs, and liability protection for those individuals who will be involved in the future with the family's affairs.

Many families view the PTC as a potential solution to both of those requirements. A PTC provides a permanent, undying fiduciary for a family's fiduciary needs. The process of selecting and replacing the individuals who will serve the family within the PTC is clear, well-defined, and based on a corporate-law model that has been tested and refined over decades. Moreover, the individuals who manage a PTC are protected from personal liability if they make decisions (whether investment, distribution, or otherwise) properly in their capacities as PTC directors and officers, again under a legal model that has been tested and refined over decades. All that is required to achieve that protection is that those individuals make unconflicted, informed decisions in a timely manner and in the interests of those for whom the PTC is acting, and that the PTC have sufficient assets and insurance to make meaningful any indemnity and hold harmless commitment.

Family Governance and Beneficiary Mentoring

Many families struggle to decide how they will make decisions as family units. Once they have determined the best system for making family decisions, those families that employ commercial trust companies or independent, individual trustees for the family's trusts further struggle with legally integrating the family's decision-making system into the commercial or individual trustee's decision-making and management processes. Because of this, many families are attracted to a PTC because it provides a family, once the family has designed and implemented its own internal governance system, with the legal authority to implement decisions generated by that system through the PTC structure's mechanisms.

Most of our clients determine that a representative form of family governance is best suited to making family decisions, particularly difficult ones. Usually the criteria for voting and holding leadership roles (i.e., the elected offices) are established in the family governance procedure, and decisions are communicated to the trust company as shareholder directives. This form of family governance, combined with PTC structure, allows a client family to ensure that its governance decisions are executed as intended, and the client family, in its entirety in most cases, has a voice in the management and uses of its wealth.

Furthermore, many families proactively and consciously focus resources on mentoring beneficiaries and assisting them in becoming the human beings they aspire to be. Those families with a PTC are finding that the discretionary decisions committee (which sometimes is called a "distribution and mentoring committee") is an ideal mechanism to connect with beneficiaries and assist them in growing their intellectual, spiritual, and emotional skills (sometimes referred to as "human capital"). The members of such a committee, as the PTC's gatekeepers of trust distributions, are best-positioned to build relationships with beneficiaries and have the opportunity to involve themselves in a beneficiary's decision-making process. Indeed, the law governing trustees, including PTCs, requires those making distribution decisions for a beneficiary to know the beneficiary and understand a beneficiary's personal circumstances. It is in knowing the beneficiary and understanding the beneficiary's personal circumstances that the opportunity to mentor a beneficiary presents itself. The PTC structure allows a family to staff a distribution and mentoring committee with the individuals the family believes are best-suited to mentor beneficiaries and make distribution decisions for them, and to make such activities a true priority for such a committee.

Cost and Required Asset Base

In truth, the incremental cost and burden of a PTC cannot be described in the abstract because much depends upon the circumstances of the family and the trusts in question. However, most people need some rules of thumb to help them orient the thought process, and so, the following are our such rules.

Regarding ongoing costs, after having properly created and structured a PTC, the additional (i.e., marginal) costs of running the PTC business properly is between $75,000 and $125,000 per year for most families. This figure consists primarily of insurance, space, travel, regulatory fees, proper audits, and a required local, part-time trust officer, but it excludes other personnel costs and the costs of investing. The excluded costs are of course present regardless of whether a PTC (or a family office, commercial trust, or investment advisory institution) is used, and these costs depend on the family's exact situation and needs. Certain families spend much more than $125,000 per year because of idiosyncratic reasons, including costs of staff, some slightly less, but in our experience none materially less, if the PTC is to be operated properly.

As far as asset base is concerned, we organize the necessary wealth as follows:

- $250 million of collective family assets is enough for an exceptionally motivated and unified family that sees a PTC as the only possible way to achieve adequate control over management of trust assets or to obtain one or more other primary benefits of a PTC;
- $500 million is more typical and generally sufficient to justify a PTC's expense for a family seeking to obtain the benefits of a PTC with a more customary level of commitment to family-wide goals; and
- $1 billion makes the costs of properly maintaining a PTC "like rolling off a log" (as one of my colleagues says) for a family committed to pursuing multi-generational goals effectively.

The costs of creating the PTC vary widely—between $100,000 and $500,000 for the entire process—depending among other things upon:

- whether the PTC will be licensed and regulated by a state, or will be an unlicensed PTC;
- the efficiency with which the family and its close advisors participate in the creation process;
- whether any problematic disclosures to regulators are required of the family or its advisors and how much legal effort is required to address those issues;
- how complex is the family's current trust and investment situation; and
- most importantly, whether the family's governance system will be designed and implemented at the same time as the PTC.

Choice of Regulatory Regime

Most PTCs provide investment advice as defined by the Securities and Exchange Commission (SEC), whether in the basic form of making recommendations to the PTC's clients regarding where to park cash temporarily or in the form of full-blown investment advisory services to trusts and family members, such as asset allocation, stock selection, and manager due diligence. Therefore, most families must determine whether they want their investment advisory activities to be regulated directly by the SEC (or state securities regulator) or by a state banking regulator.[4] If the family pursues an unlicensed PTC,[5] or a licensed PTC in a state where the regulator chooses not to engage in substantive examinations of the licensed entity,[6] then the family must ensure that its PTC conforms to the requirements of the SEC's so-called "single family office rule."[7] Otherwise, the family will need to register its PTC as an investment advisor with the SEC (or appropriate state agency). After analysis, most clients determine to avoid registration with the SEC (or applicable state agency), and rely either on the "single family office rule" or on substantive regulation by the banking agency of the state where the family has procured a state trust company license for its PTC.

Situs of Entity and Geographical Concerns

Related to the choice of regulatory regime is the choice of situs of the fiduciary entity. If a family pursues an unlicensed PTC, the choice for situs is limited because only four states allow such an entity, and each has different requirements for a private trust company, including variations in those to whom a PTC may provide fiduciary services, in capital requirements, in necessary insurance, and other differences. Similarly, even if a family pursues a licensed PTC, only certain states provide charters to private family trust companies, and each of those states has similar variations regarding those to whom a PTC may provide fiduciary services, regulatory capital requirements, etc. Each state's requirements must be carefully compared and weighed in making the determination of which regulatory regime to pursue and the resulting situs/location decision.

Also involved in the situs decision is an investigation of which state's laws are best-suited to the family, specifically substantive trust laws and substantive banking and trust company laws. Similarly, the issue of the robustness of the local court system and its judges is a factor to be weighed in the analysis. For example, New Hampshire recently has begun a process of consolidating its probate and trust cases in a specifically designed "probate and trust court" with specialized judges, much like Delaware with regard to issues involving corporate law issues. Furthermore, the choice of situs is also impacted by how friendly or open a state's regulator is to private trust companies; it is not advisable to procure or even seek a trust company charter in a jurisdiction where the regulator is hostile to private trust companies.

Inherent in the choice of situs is the practical consideration regarding the jurisdiction to which the family and its advisors are willing to travel multiple times per year to conduct the business of managing a PTC. We advise our clients that all true fiduciary actions (i.e., board and committee meetings in which decisions about trust distributions, investment policy, etc. are made) must occur in the jurisdiction of charter. Also permitted from our perspective are such activities if conducted from a trust office not in the charter jurisdiction but in a jurisdiction that has approved specifically the opening of a trust office by the PTC at issue. For a variety of reasons, the explanation of which is beyond the scope of this article, we advise our clients not to conduct material fiduciary activities outside of those two locations. Suffice it to say that willingness to travel is a real, practical issue to be considered by a family.

Required Commitment

As the reader likely has surmised, creating a private trust company requires material effort and resources of a family, both in hard- and soft-dollar costs. More important, however, is the ongoing commitment required to conduct operations properly and to prioritize equally the process of decision making along with the decisions themselves. Ultimately, both of these challenges are quite manageable with an appropriate level of commitment from a family and its trusted advisors. However, the greatest challenge for PTC management and the family is maintaining the commitment to do the hard work and to allocate the resources (financial, emotional, intellectual, and otherwise) needed to sustain the personal journey with beneficiaries undertaken by the discretionary decisions committee members. Indeed, from our perspective, there lies the potential for the greatest reward. If those personal journeys develop successfully, then the promise of the PTC itself will be achieved and by extension, so too will the purpose of a family's wealth be achieved—that is, increasing the likelihood that family members will have, and capitalize upon, opportunities to make their lives better and more meaningful.

Miles C. Padgett, JD, CIMA®, is a partner with Kozusko Harris Duncan, where his practice focuses on affluent families, family offices, and trust companies (private or commercial) serving such clients. He earned a BA with distinction from Cornell University and a JD from Vanderbilt University. Contact him at mpadgett@kozlaw.com.

Endnotes

1. Jay Hughes is the author of *Family Wealth: Keeping It in the Family*, and *Family—The Compact Among Generations*, and is the co-author with Susan Messenzio and Keith Whitaker of *The Cycle of the Gift: Family Wealth and Wisdom* as well as numerous articles on family governance and wealth preservation. See http://www.jamesehughes.com/about.php.
2. See Federal Reserve, Financial Accounts of the United States, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Historical Annual Tables 1985–1994, http://www.federalreserve.gov/Releases/Z1/Current/annuals/a1985-1994.pdf; and Financial Accounts of the United States, Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Second Quarter 2015, http://www.federalreserve.gov/releases/z1/20150918/z1.pdf.
3. See IRS Notice 2008-63, 2008-2 CB 261.
4. Federal banking regulators are specifically not mentioned as an alternative regulator because, currently, procuring a national banking association license with related trust powers is very difficult and extremely expensive (e.g., in terms of required regulatory capital, etc.). Accordingly, a national charter is not a practical option for even the most affluent families in the United States and will continue not to be an option until major change occurs at the respective federal agencies.
5. Permitted at this time only in Nevada, Wyoming, Pennsylvania, and Florida.
6. Such as Florida.
7. See 17 CFR Section 275.202(a)(11)(G)-1 (2015).

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