WHITE PAPER NO. 48

BEST PRACTICES
TRUSTS

GREYCOURT

White Paper No. 48 – *Best Practices Trusts*

The basic problem with the trust business is that it is operated almost entirely for the benefit of the banks, rather than for the benefit of the beneficiaries. In 1928, a few years before being appointed to the United States Supreme Court, Benjamin Cardozo articulated the standard that governed fiduciary conduct: "A trustee is held to something stricter than the morals of the market place. *Not honesty alone, but the punctilio of an honor the most sensitive*, is then the standard of behavior [emphasis supplied]."[1]

But the "morals of the marketplace" dominate the trust business today. According to the Center for Fiduciary Analysis, litigation against trustees is rising at the astonishing rate of 22% per year compounded.[2] Just to mention a random example, virtually every institutional trustee invests assets for which it serves as trustee in its own mediocre investment products, rather than in the many superior, less expensive, best-in-class products readily available everywhere.[3] What should be an obvious, actionable and surchargeable breach of fiduciary duty is in fact the everyday reality. Doesn't it seem obvious that a trustee who engages in self-dealing by using only it's own investment products should become a guarantor of performance? Dream on.

To understand how what should have been an enterprise entirely devoted to the interests of trust beneficiaries should have deteriorated into such a hopeless, swampy morass, it will be necessary to revisit the history of the common law trust, which is not as musty as it might sound.

A Brief, Unconventional (But Wickedly Accurate) History of the Common Law Trust From the Client's Perspective

The common law trust as we know it arose in the late Middle Ages as a blatant tax avoidance scheme,[4] but it proved to be so flexible and valuable that it has persisted to this day. Frederick W. Maitland, perhaps the greatest of the legal historians, went so far as to claim that:

> "Of all the exploits of equity the largest and the most important is the invention and development of the trust. * * * This perhaps forms the most distinctive achievement of English lawyers."[5]

Maybe so, but roughly three centuries before English lawyers had ever heard of the trust, Islamic law had developed the *waqf*, a device that is uncannily similar to the trust. Indeed,

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in the 9th century an Islamic legal scholar (and lawyer), Abu Bakr Ahmad b. Amr b. Muhayr al-Shaybani al-Khassaf (known, not surprisingly, as al-Khassaf) wrote an entire treatise on the *waqf*, recently translated,[6] in which he cited more than two centuries of Islamic trust law and addressed such contemporary-sounding issues as, "Will a trust over which the grantor retains powers be treated as part of his estate when he dies?"[7]

For several hundred years after the trust was either invented or reinvented in England, the business of managing trusts was pretty straightforward and largely a family matter. Trust assets were mainly land (or, later, gilt securities), and the income therefrom was passed along to the beneficiaries. Trustees were family members or friends or maybe the family solicitor. Life was simple. Life was good.

But as the world became more complicated, trust assets became more complex to manage, exceeding the capacity of family members to deal with them, and as a result the potential liabilities of trustees expanded. Moreover, family members had a nasty habit of dying off, causing unwanted turnover in the trustee ranks. Enter the institutional trust company, which promised to bring professional management to complicated trust assets, to deflect liability away from the family, and to stay alive indefinitely. In addition, since the early trust companies were local institutions, they tended to know the settlor and the beneficiaries and were in an ideal position to make informed, yet impartial, exercises of discretion as necessary.

At first, these developments were all to the good – professional management of the trust assets, a corporate deep pocket to sue if anything went wrong, and a trustee blessed with perpetual life no doubt seemed like godsends. But somewhere along the way a wrong turn was made. We would describe this wrong turn as having been navigated somewhat as follows, using the main selling points of the institutional trustee to make our arguments.

Professional Management

Since an important selling point of the institutional trustee was its ability to bring professional management to trust assets, early corporate trustees managed the assets themselves. Naturally, then, when most trust assets came to be in the form of marketable securities, corporate trustees held themselves out as experts in the management of those securities.

That may have been all well and good for awhile – certainly the trust institutions managed assets better than the families or their lawyers would likely have done. But around 1970 there occurred a sea-change in the way investment portfolios were managed. We've gone into great lengths about this elsewhere,[8] so suffice it to say here that by at least 1980 the management of securities portfolios had become a well-established and highly competitive business, and institutions that called themselves corporate trustees simply weren't among

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the competitive players.[9] At this point, corporate trustees that managed trust assets in-house were no longer acting in the interests of beneficiaries, but in their own interests. They should simply have gotten out of the investment management business – or gotten out of the trust business – since persisting in both was inimical to the interests of the trust beneficiaries they were supposedly serving.

But there was a slight problem – over the years, fees from investment management activities had come to dwarf fees from more traditional fiduciary duties. To say that this constituted a gigantic conflict of interest is merely to state the obvious. "Open architecture" was, and largely remains, a swear word among corporate trustees, except for the very largest trusts. The morals of the marketplace, indeed!

Deep Pockets

The notion that if something went wrong beneficiaries could sue the institutional trustee and expect a significant recovery was a nice one in theory, and indeed so many trusts are so abysmally mismanaged that corporate trustees lose lawsuits with great regularity. But the reality today is that institutional trustees go to extraordinary lengths to protect themselves – and in the process to disadvantage beneficiaries – from liability. Most of this occurs behind the scenes, as it were, buried in the fine print of state trust laws, over which the banks have enormous influence. The rest of it occurs in the remarkable acrobatics corporate trustees go through to avoid anything remotely smacking of an exercise of discretion (see below), or anything remotely smacking of incurring any risk in order to carry out settlor or beneficiary interests.[10]

Perpetual Life

Here, at least, we might expect the institutional trustee to live up to its billing – corporate entities do indeed have indefinite lifetimes. But, again, the real world has intervened with a vengeance, as the local banks that historically handled most trust business have been gobbled up by larger and larger banks until, today, the trust industry is very highly concentrated in a few hands. Even beneficiaries of relatively large trusts find that they are relegated to calling a toll-free number whenever they need a trustee's attention. On top of this, turnover among corporate trust employees is notoriously high, and it is the individual turnover – and the destruction of family privacy that goes out the door with it – that is as infuriating as the institutional turnover.

Sound Exercise of Discretion

When most corporate trustees were local institutions, they were generally able to exercise discretion as necessary in an impartial and informed manner, as mentioned above. But today, on the rare occasions when a corporate trustee can be arm-wrestled into making a

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decision, that decision is made by an anonymous group known as the “trust committee,” whose main role seems to be to protect the institution at all costs, especially including sacrificing the interests of the beneficiaries.

Down With the Bundled Trust!
Up With the Best Practices Trust!

Given the hopeless and infuriating state of the trust business these days, families could be forgiven for taking to the barricades and demanding that the entire 1,000-year edifice of the common law trust[11] be pulled down so that we can start over. Of course, we are aware, with Anatole France,[12] that it is rarely the wealthy families who are manning the barricades. And yet families are in effect dismantling the bundled trust as we speak, replacing it with what we have called the “Best Practices Trust.” At its core, the BPT asks the simple question: for each activity that has historically fallen under the heretofore bundled umbrella of the trust, what is the best practice today? Let’s ask – and answer! – those questions for ourselves.

Activities Required to Operate a Trust

The operation of a trust requires that the assets be held in safekeeping, that the assets be capably managed, that tax issues be addressed and tax returns be filed, that administration and bookkeeping be handled, and that there be in existence a fiduciary capable of making decisions that cannot legally be made by settlors, beneficiaries, or other disqualified persons. These activities can be bundled together and carried out by one institution, or they can be unbundled and evaluated separately, determining what the best practice might be in each case and pursuing that practice unless the cost is prohibitive. Let’s examine each of these activities separately.

Safekeeping of assets. Trust assets must be safeguarded, and in the usual case that means holding securities in a custody account that is segregated from the bank’s own assets and therefore not reachable by the bank’s creditors in the event – relatively common these days – that the bank should fail. If this were, say, 1970, keeping the assets “safe” might be all that was required of a trust/custodian bank (most trustees bundle custody with all the other activities). But these days custody is a highly competitive, vastly complex business in which perhaps ten or twelve institutions globally are even in the running. This is because the custody business is capital-intensive (banks must be willing to invest huge sums of money in their technology platforms just to stay even) and low margin – even world-class custodians typically charge only a few basis points for custody. Yet modern custodians must be capable of handling a dizzying variety of securities traded on a global basis and must also offer such complex services as partnership accounting,[13] securities lending,[14] transition management,[15] and so on.

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For these reasons, most trust banks' custody platforms are not just not "best in class," they are often "worst in class," based on technology that is decades old. An interesting observation is that when professionals of large trustee banks leave to launch their own boutique trust companies, they almost never use their former employers' custody platforms – they know far too much about them.

Thus, the best practice for custody of trust assets is straightforward: unbundle this activity and engage the best independent custodian at the best price available. For most trusts, there will be no more than a small handful of institutions that are appropriate candidates for the job.

Management of trust assets. These days the overwhelming bulk of trust assets consists of cash and securities. And as we noted above, most institutional trustees bundle asset management with other trust services. But as with the issue of custody, corporate trustees are not merely not "best in class" money managers, they are mostly "worst in class." Open architecture firms evaluate thousands of managers before selecting the best to add to their recommended list, and we do this on a straight-up, objective basis. Yet trustee-based investment managers are unrepresented to the point of invisibility on most open architecture platforms.

Thus, the best practice for management of trust assets is to unbundle this activity and to select the asset managers independently of whoever the fiduciary might be. Typically, this is done by establishing an "investment committee" made up of trustees, but often not even including the corporate fiduciary. (See *The Nitty-Gritty of Establishing Best Practices Trusts*, below.) The investment committee then selects the actual managers, usually with the advice of an investment consulting or similar firm.[16]

Tax issues. For simple and smaller trusts, the institutional trustee may be perfectly capable of advising on tax issues and of preparing and filing the tax returns. But for more complex trusts, tax issues should be unbundled and handled by competent tax counsel. In any case, tax returns can be prepared by outside tax advisors and then reviewed and filed by the trustee, or prepared and filed by the trustee on its own. The complexity of the trust's needs, including the need for partnership accounting,[17] should determine whether tax issues are bundled or unbundled.

Trust administration. Trust administration is a relatively straightforward proposition. It encompasses such tasks as ownership of the assets, bookkeeping, preparing trust statements, making distributions to beneficiaries, paying bills, maintaining bank accounts, and so on. The fiduciary normally bundles these activities ("ownership" must be bundled), but there is no reason why most of them couldn't be outsourced in appropriate circumstances.

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Fiduciary matters. The fiduciary sits at the core of the trust relationship and should obviously be selected with great care. Therefore, the selection of the fiduciary should be based on a trustee's direct fiduciary skills, almost without reference to any other services the trustee might offer. While occasions requiring the exercise of serious fiduciary discretion are typically rare, when they do arise they are likely to be sensitive and important.[18] Typical candidates for the role of fiduciary are trusted individuals (albeit raising the succession issue), distribution committees (see *The Concept of the Directed Trustee*, below), boutique trust companies,[19] traditional institutional trustees who are willing to unbundle trust services, and private trust companies.

The Nitty-Gritty of Establishing BPTs

The Concept of the Directed Trustee

A key to the successful use of the Best Practices Trust is the ability – under the language of the trust instrument or under the trust law of the state in which the trust is domiciled – to "direct" the trustee.[20] For example, management of the trust's assets might be vouchsafed to an "investment committee," and the trust institution will be "directed" to follow the instructions of the committee as to investment matters.[21] (Note that the trustee can be "directed" for some purposes – asset management, e.g. – but not for other purposes – making discretionary distributions, for example.) The investment committee might engage an advisor, such as an investment consulting firm, to assist it in designing the portfolio, selecting and monitoring money managers, reporting on investment performance, etc.

Similarly, discretionary decisions over distributions to beneficiaries might be lodged in a "distribution committee," which itself might be sub-divided into a family distribution committee that handles normal distribution issues and an independent distribution committee (with no disqualified members) to handle more sensitive, legally restricted decisions about distributions.

When a trust operates with an investment committee and a distribution committee, the corporate trustee becomes an administrative trustee, whose responsibilities are largely limited to owning the trust assets, physically making distributions to beneficiaries, preparing trust statements, signing the tax return and similar administrative and ministerial activities. In a sense, the administrative trustee's most important role is to take direction from the trust committees.

Large institutional trustees who normally bundle asset management with other trust services will often agree to serve in an unbundled, Best Practices Trust structure, so long as (a) the trust is a very large one, *or* (b) they can be directed to accept the decisions of

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investment committees and distribution committees. Many boutique trust companies are organized to do business mainly as directed trustees.

Isn’t the BPT Complicated?

Not really. Keep in mind that even if you take your trust business to a traditional, bundled provider, you will be dealing with completely different individuals for every key activity. The trust officer assigned to your account will be different from your investment officer, who will be different from the tax guy, who will be different from the folks in the custody group, and so on. With the BPT, instead of dealing with several different individuals selected for you by the bank, you will be dealing with several different individuals selected by you because they are competent and cost-efficient.

What About Costs?

A carefully designed BPT will almost certainly be *less* expensive than the usual bundled trust structure. The main reason is that the client negotiates fees across the board in a BPT structure, rather than waking up years down the road to find that embedded fees in the bundled trust (for asset management, for example) have eaten up all the returns. In addition, under a BPT structure, each provider has no conflict of interest, and hence they will be watching each other. If the investment advisor’s fees are too high, the outsourced tax advisor will happily point this out, and vice versa. If custody and reporting services are deteriorating, the investment advisor will cheerfully bring this matter to your attention – and vice versa. None of this happens in a bundled environment.

Deductibility Issues

Families sometimes express reluctance to unbundle their trust relationships because, historically, trustees’ bundled fees have been deductible as ordinary and necessary business expenses, while some unbundled expenses (such as asset management fees) are subject to the “2% floor.” This is pennywise and pound-foolish, but in any event even if it was once an advantage of bundled trusts it won’t be for long. Following the United States Supreme Court decision in *Knight v. Commissioner of Internal Revenue*,[22] it is expected that the Treasury department will issue regulations requiring bundled trustees to unbundle their fees, even if they don’t (or won’t) unbundle their services.

The Rise of Beneficiary Rights

Suppose you are the beneficiary of an existing trust that you wish were a BPT but unfortunately isn’t. Under common law you were basically up the creek without a paddle: there was little a beneficiary – or even a grantor – could do to remove or replace a trustee. Once a trustee was appointed it became the legal owner of the trust property with full

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authority over it. Only a gross breach of the trustee's duties could be grounds for its removal.

But the times they are a changing! Many states are adopting (in whole or in part) the Uniform Trust Code, which acknowledges, to a far greater degree than common law, the rights of beneficiaries and grantors. Often, for example, a beneficiary's rights can be protected only by removal of the existing trustee or by requiring the trustee to unbundle an activity that it is able to carry out only in mediocre fashion. For example, the Uniform Trust Code permits a trustee to be removed for "unfitness, unwillingness or persistent failure…to administer the trust effectively."[23] Commentary by the drafters of the Code suggests that a "persistent failure" may "include a pattern of mediocre performance, such as consistently poor investment results."[24]

We believe that the natural evolution of court decisions in Code states (and, by analogy, in non-Code states) will be to require trustees to unbundle activities they are not very good at: custody and asset management especially.

If We Were a Big Trust Institution

If we were a big trust institution we would be very nervous about the increasing use of Best Practices Trusts, directed trusts, private trust companies, the rise of the beneficiary rights movement, etc. It would seem to us that the world was ganging up on us.

But, actually, trust families are simply mounting an "intervention:" trying to get the trust institutions' attention before it's too late. The BPT is one of those "disruptive" business models that seem to come out of nowhere and then one day it owns the business.[25] There are, after all, lots of reasons a family would want to work with a large institution as trustee, so long as it could pick and choose the activities it wanted and could go elsewhere for the others.

We don't blame the big banks for wanting all the business, but we actually believe that they would be better off in the long run by playing the BPT game: their liability would be significantly reduced as a directed trustee; they wouldn't have to mess around with the complex business of custody unless they were good at it; they would likely get some of the asset management business; their relationships with their trust clients would be far happier; and the trust relationships would be much "stickier" than they are now, which is very good for profitability.

At the end of the day, if the big trust institutions don't become more flexible the bundled trust business will go the way of the closed architecture business, i.e., it will evolve from the dominant business model to a besieged backwater. But if they do become more

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flexible, both they and the families they work with will be a lot happier and more productive.

A Note about Private Trust Companies

In many ways, the private trust company (PTC) is the archetype of the Best Practices Trust. Families that establish PTCs are engaged in the ultimate trust-unbundling activity, creating their very own trust company from scratch: selecting the form of organization (C corporation, S corporation, LLC); selecting the best jurisdiction based on cost, regulation, “family-friendly” laws and court decisions; deciding how the PTC will be owned (direct ownership by family members, ownership by family trusts or GSTs, etc.); deciding whether the PTC will administer itself or will outsource administration to an administrative trustee; selecting a custodian; selecting investment advisors; selecting tax advisors, and so on. For families with liquid assets of $100 million and up, the PTC may well be the way to go. For everyone, else, there is the BPT.

Summary

There will probably always be a role for the traditional bundled trust structure, but we believe that if the BPT and bundled structures were analyzed on a straight-up basis, very few clients would opt for the latter. The fact that a family has decided to establish a trust is no reason why the family should have to give up control over how those assets will be held, managed, custodied, or tax-advised. The Best Practices Trust keeps control where it belongs – with the family whose capital it is.

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[1] Meinhard v. Salmon, 164 N.E. 545 (NY 1928).

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[2] Thrupthi Reddy, *How Not to Get Sued*, available at registeredrep.com/mag/finance_not_sued/, April 1, 2005. Ms. Reddy was a Senior Editor at Trusts & Estates magazine.

[3] At least one trust company, which manages almost all trust assets in its own mediocre products, was recently quoted as bragging that its clients trusted it because "we have no conflicts of interest." Such is the sad, deluded state to which corporate trustees have fallen. (We can't give the cite for this quote without divulging the identity of the hapless miscreant.)

[4] Following the Norman conquest of England in 1066, all land on the island was confiscated in the name of the Crown. The king then parceled it out to his lords, who passed it on to their own vassals and so on, via the process of subinfuedation. Obligations, including heavy taxation and severe restrictions on the sale and use of the land, flowed from the bottom up: from the serfs to the higher vassals to the lower and higher lords and so on up to the king. Since these obligations applied to the holder of legal title, the common law trust – which divided legal title from beneficial use – was a kind of trick to avoid most of these obligations, especially taxes. In 1535 Henry VIII convinced Parliament to enact the Statute of Uses (a "use" is a trust), which collapsed legal title and equitable use back into each other. Henry's purpose was to destroy the monasteries, which, to avoid the Statutes of Mortmain (1279 and 1290), were all held in trust. (We know, it's complicated, but it gets better.) Henry dissolved the monasteries, all right, but most other trusts persisted via a nice bit of sleight of hand: trusts were now created by making a grant in fee simple "unto and to the use of A in trust for [i.e., for the use of] B." Since a use upon a use had not been contemplated by the Statute of Uses, the Statute was held not to apply to these clever trusts. If this is hard to follow, it's because you slept through your first year of law school.

[5] F. W .Maitland, "Uses and Trusts in Equity: A Course of Lectures," revised by J. Brunyate (1936).

[6] Gilbert Paul Verbit, *A Ninth Century Treatise on the Law of Trusts* (2008). It is a matter of considerable dispute whether the trust was independently invented by English common law or whether Crusaders returning from Arab lands brought the idea back with them. See, e.g., Monica M. Gaudiosi, "The Influence of the Islamic Law of Waqf on the Development of the Trust in England: The Case of Merton College", University of Pennsylvania Law Review 136 (4): 1231-1261 (April 1988).

[7] Verbit, op. cit., p. 16.

[8] See Greycourt White Paper No. 24 – *A Modest Proposal: Let's End Conflicts of Interest in the Wealth Advisory Business* (February 2003).

[9] There were many reasons for this, but the main one was that bank and trust company cultures were inherently incompatible with superior securities management.

[10] One of the most common issues involves holding concentrated securities positions. We aren't fans of concentrated positions, but when the enterprise is a family company there can be very important reasons to be flexible about such holdings. Institutional trustees, on the whole, aren't.

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[11] When we were reading the law, shortly after the *waqf* was invented, the leading compiler of trust law was a busy fellow named Austin Wakeman Scott, Jr., whose monumental *Scott on Trusts,* first published in 1939, then ran to some 12 volumes – 6,837 pages! – of small print. Vast tracts of Canadian pulpwood forests, to say nothing of our GPA, disappeared in this effort.

[12] "The law, in its majestic equality, forbids the rich as well as the poor to sleep under the bridges."

[13] In situations where a family has many trusts to manage, investment partnerships are often established so that the assets of the individual trusts can be aggregated for more efficient and less expensive management. Accounting for these partnerships can be a very complex undertaking, and only a few institutional trustees are good at it. Of course, partnership accounting can also be outsourced to an accounting firm.

[14] Large custodial institutions lend out securities to people who want to sell them short, rebating a portion of the profit back to the owner of the securities. A well-managed securities lending business can add a few basis points of return to a portfolio, but at the cost of additional risk (in the form of potential investment losses, counterparty exposures, fraud, etc.) In general, our opinion is that the game isn't worth the candle.

[15] When smallish sums of money are being moved from one managed account to another, the sale of the securities is usually handled by the manager being terminated and the buying of the new securities is usually handled by the newly engaged manager. But when very large sums are involved, the agency issues inherent in this practice begin to loom large. (The terminated manager has already been fired and doesn't much care how efficiently the stocks are sold. The engaged manager will be paying more attention, but may have little experience at selling the stocks owned by the terminated manager.) Instead, the trustees might engage a "transition manager," that is, an independent party who will oversee the trading from start to finish, ensuring best execution and pricing and, of course, sharing in the value added.

[16] Not to blow our own horn, but increasingly trust investment committees are engaging open architecture advisory firms to design appropriate strategies for the trust assets, to select the best managers, and to provide performance reporting and monitoring.

[17] There are a (very) few institutional trustees that handle tax accounting for partnerships competently. For all others, partnership accounting should be unbundled and outsourced.

[18] A common example would be a request by an income beneficiary for a principal distribution. Principal distributions are often permitted by the trust instrument, but are usually surrounded with qualifications. Only a completely independent fiduciary can make such decisions.

[19] The rise of the boutique trust company is an important phenomenon. Typically launched by trust professionals who are refugees from the large institutional firms, these boutiques are usually located in and associated with a specific jurisdiction (Delaware, Nevada, South Dakota) that has abolished the Rule Against Perpetuities and has adopted other family-friendly laws and regulations.

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Other boutiques are regional firms not attempting to take advantage of a particular trust situs but simply designed to be much more user-friendly

[20] If your trust doesn't contemplate the use of a directed trustee, it is usually possible to have the trust language reformed (in court). If the state of your trust's domicile doesn't acknowledge directed trustees, it is usually possible to move the domicile to a more modern state.

[21] E.g., the South Dakota provision covering directed trustees: "Any excluded fiduciary [i.e., a directed administrative trustee] is also relieved from any obligation to perform investment reviews and make recommendations with respect to any investments to the extent the trust advisor has the authority to direct the acquisition, disposition or retention of any such investment." SDCL Sec. 55-1B2.

[22] 552 US 1 (2008). Following Knight, and in light of proposed regulations issued by the Treasury department, most fees paid by trusts (bundled or unbundled) will be subject to the 2% floor; in particular, custody fees and investment advisory fees. For trustees who bundle services under a single fee, the trustee must unbundled the fees and use a reasonable method to allocate the single fee between the costs subject to the 2% floor and those that are not (trust accountings, filing of tax returns, etc.)

[23] Uniform Trust Code §706(b)(3).

[24] Uniform Trust Code §706 (Comment); Restatement (Third) of Trusts Section 37, comment e (Tentative Draft No. 2, approved 1999).

[25] See, e.g., Gregory Curtis, "Open Architecture As a Disruptive Business Model," a chapter in *Disruptive Technologies: Concepts and Applications*, edited by A. Srikant and C. Anand, Icfai University Press (India, 2007), p. 99 ff.

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