► **Greycourt White Paper**

White Paper No. 17 – *Taming Your Trust*

When families consider the prospect of having to establish appropriate provisions in trust instruments for spouses, children or future generations, they naturally approach the matter with trepidation. There is, first of all, the problem of attempting today to design provisions that must work well many years, perhaps many decades, into the future. There is the further problem of dealing with intra-family emotions and stresses that tend to interfere with otherwise good judgment. Finally, there is a natural tendency to be intimidated by the legal and tax complexity that appears to surround the arcane world of trusts.

As a result, far too many trusts look as though they were designed by a word processor, rather than a real family. The fact of the matter is that trusts are enormously flexible instruments that can be designed to meet virtually any need, and families shouldn't be intimidated by the process of designing a trust. The purpose of this white paper is to suggest, much more by way of example than as an exhaustive list, a group of trust provisions that families may wish to consider.[1]

What is a Trust?

At its essence a trust is simply a vehicle for separating the ownership and control of an asset from its beneficial use. For example, if you establish a trust for your child, the trust actually owns the assets, not the child, and the trustee actually controls the assets, not the child. Yet the entire benefit of the assets flows to the child, not the trust or trustee. Trusts are entirely a creature of Anglo-Saxon law and are unknown in other legal systems.

Since there is a natural temptation on the part of trustees to use the assets for their own purposes, rather than those of the beneficiaries, courts and legislatures have imposed very serious responsibilities on trustees. Known as "fiduciary" duties, these responsibilities require a trustee to act always in the interests of the beneficiary, completely ignoring his own interests.

[1] I am indebted for some of the provisions described in this paper to the excellent and thorough consideration of trusts contained in *Estate Planning Documents: A Case for Much More Flexibility*, by Solomon "Sonny" Kamm, Esq., presented at the 1999 Annual Meeting of the American College of Trust and Estate Counsel.

Trust Provisions Worth Considering

Provisions regarding the trustee(s)

If the assets in a trust are modest, the trustee is usually an individual. But as the assets become more significant, the duties associated with managing those assets, reporting on the assets, and the legal exposure associated with fiduciary responsibilities toward the assets will typically overwhelm an individual and require the appointment of a corporate trustee. In some cases both an individual trustee and a corporate trustee are present, often with different allocated duties. More commonly in large trusts there are more players. A typical lineup might include the following:

- Corporate trustee (usually a bank or stand-alone trust company) – Accounts for the assets, collects dividends and interest, prepares formal court accountings as required, transfers income and/or principal to the beneficiaries, sends monthly reports to the beneficiaries, has overall fiduciary responsibility.
- Advisor or protector (usually an individual trusted by the family) – Handles discretionary issues as they arise. For example, the trust may provide that 1/3 of the principal will be distributed to the beneficiary at age 35, subject to approval by the advisor. If the beneficiary happens to be engaged in a bitter divorce at that age, the advisor may step in and prevent the distribution from being made at that time.
- Investment advisor (typically an investment advisory firm, but sometimes an individual) – Performs advisory functions considered by the corporate trustee to be too complex for it to undertake, given its fiduciary duties. Examples might include selecting best-in-class money managers, approving venture capital or private equity investments, or overseeing investments in fine art.

Provisions regarding the investment of trust assets

Broad investment powers. Most standard trust forms contain the usual list of investment powers granted to the trustee. For many trusts, these powers will be adequate, but as the investment world becomes ever more complex and challenging families may wish to consider authorizing the trustee to engage in more sophisticated investment activities, including the power to buy and sell speculative, illiquid or closely held investments, including private equity, venture capital and hedge funds; the power to buy securities on margin or otherwise to leverage the portfolio (perhaps within stated limits); the power to act as a general or limited partner in a partnership or limited liability company; the power to hedge investment exposures via derivative instruments. While some of these provisions may appear dangerous in the hands of an unscrupulous or unskilled trustee, their absence can insure that the trust will be unable to participate in many of the more sophisticated investments a family's non-trust assets will enjoy. In any event, broader investment powers will almost always be appropriate in revocable inter vivos trusts.

Open architecture trusts. These days most wealthy families seek to manage their personal investment portfolios in an open architecture manner.[2] Yet, no sooner do they set up a trust than they blithely give complete investment authority to a closed architecture[3] firm. But in fact, many trust companies will manage a trust's portfolio on an open architecture basis, and many more will offer open architecture trust management in the future. In some cases, the trustee will have established its own in-house capacity to design and manage trusts using best-in-class managers, while in other cases the trustee will employ an open architecture advisory firm (such as Greycourt or one of its competitors) to design the portfolio and select and monitor the managers.

Provisions designed for QTIP trusts

A QTIP trust[4] is typically used to protect children from a prior marriage. In other words, a spouse leaves an amount in trust for the benefit of the surviving spouse. The survivor receives the income from the trust but cannot dictate where the assets will go after his or her death. By law, the surviving spouse must receive all the income from a QTIP, and many QTIP trusts are drafted to provide exactly that and little more.[5] But this very frequently places the surviving spouse in an awkward position. Consider that the day before her spouse died the wife could pretty much spend money on whatever she wanted, within reason. But the day after her husband's death she is entitled only to the income on the family assets. If this income is insufficient, she must either do without or face the humiliating prospect of petitioning the trustee to make a discretionary distribution of what was, a few days earlier, a family asset. No doubt this is the outcome devoutly desired by some deceased spouses, but it is probably a rare desire for all that. Many settlers of QTIP trusts will want to insure that much broader discretion is given to the trustee.

Flexibility versus ease of application

Mandatory provisions in a trust have the virtue of being simple to apply, but that is frequently their only virtue. Consider a trust that requires principal to be distributed to the beneficiary as follows: one-third at age 35, one-half the balance at age 40, the entire balance at age 45. Simplicity itself. But now imagine that at age 35 the beneficiary is engaged in a bitter divorce. The apparent simplicity of the arrangement has dissolved into endless vexation.

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[2] In the unlikely event that this paper has found its way to a reader unfamiliar with open architecture investment management, the term simply means that the portfolio will be managed by best-in-class money managers in every asset class, and will pursue best investment practices throughout the investment management process.

[3] Closed architecture means a firm – in this case a corporate trustee – that seeks both to advise investors and to sell them its own (almost always undesirable) investment products.

[4] Qualified terminable interest property trust.

[5] Typically, the trustee is authorized to distribute principal if necessary for the surviving spouse's "health, support and maintenance."

On the other hand, how could the settlor of the trust possibly have foreseen that a divorce would occur at such an inopportune moment? The answer is that while no settlor can possibly anticipate every event that will occur in the future, the settlor can certainly anticipate that if something can go wrong, it will. This suggests that trusts would be better designed with as much flexibility as possible.

The difficulty with flexibility is not in the flexibility itself, but in the ability or inability of the trustee to apply the flexibility intelligently. Alas, most corporate trustees are peculiarly inept in this regard. Discretionary actions under a trust are decided, when the trustee is a corporate trustee, by a trust committee consisting of senior and intermediate trust officers, most of whom will know little or nothing about the family at issue. Worse, all the members of the committee will have the protection of the trustee uppermost in their minds, when what the settlor would want is for them to have the welfare of the family uppermost in their minds.

One solution is to name an "advisor" to the trust, the advisor being charged with no duties except to exercise discretion when called for. In the case proposed above, the advisor could step in and prevent the "age 35" distribution from being made at that time – allowing it to be made when the divorce has been settled.

Total return trusts

From the time the concept of the trust was first developed in the late Middle Ages until about the 1950s, trust assets tended to produce far more income than capital appreciation. But today the problem has reversed itself. Sensibly invested trusts – that is, those with predominantly equity-oriented portfolios – tend to appreciate handsomely over time, but they produce little in the way of current yield in our low-dividend, low-interest-rate environment.

Properly drafted trusts can deal with this problem by providing both a floor and a ceiling for payouts to current income beneficiaries, regardless of the actual amount of interest and dividends being generated. (And note that trusts that were drafted years ago can often take advantage of "total return" legislation now available in roughly half the states.)[6]

Miscellaneous provisions

Arbitration. When disputes arise between beneficiaries and trustees, between beneficiaries and beneficiaries, or (frequently) among all parties to the trust, litigation is almost always the worst possible way to resolve the disputes. Litigation is complex, endless, expensive

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[6] See the Greycourt white paper, *Total Return Trusts* (April 2002).

and – sometimes worst of all – very public. Families may wish to consider providing for simpler and less public dispute resolution mechanisms, such as arbitration.

Disposing of superceded trust documents. Many families create inter vivos trusts which can be easily amended during the lifetime of the settlor(s) but which become irrevocable and difficult to amend at death. If a settlor chooses to have one basic trust document to which numerous amendments are appended over the years, he or she should realize that children and others will see all the original provisions, as well as the provisions that finally control. If earlier provisions were more generous, the child will be rendered unhappy for no reason. Hence, while it seems a minor issue, it will usually be better to amend *and restate* a trust completely, destroying all old counterparts..

We will be happy to discuss this memo at your convenience.

GREYCOURT & CO., INC.
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(This paper was written by Gregory Curtis, Greycourt's Chairman.)