# TRUST COMPANIES FOR FAMILY WEALTH: BUILD MY OWN?

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## CHOICES

Most wealthy U.S. families still choose individuals rather than trust companies to serve as trustee, even for complex trusts holding very substantial assets and even though a family who can afford it now has the option of creating its own trust company, a so-called “private trust company” that serves only for its family trusts.

Part of the reason may be custom. English law developed the concept of a “trustee” long before the “company” concept, so the use of individuals to fill the role of trustee was not only natural but necessary. The alternative of using a company as trustee was not even available in the United States until the 19th Century and did not become a successful business until the 20th Century. Another, better reason may be convenience. An individual who has the confidence of the family can serve as trustee without meeting any government-imposed qualifications, and without obtaining a license or demonstrating any special skills, aptitude or experience to anyone outside the family. In contrast, companies serving as trustee tend like banks to be part of a regulated industry.

Yet if we are not prisoners of custom and convenience, what is the best solution for a family with very substantial trusts? Does a private trust company represent a better choice than a succession of individual trustees? Or does the best choice depend on the particular family and trust circumstances, and if so, what are the relevant factors in making the most appropriate choice?

## INDIVIDUALS V. COMMERCIAL TRUST COMPANIES

Families who name individuals as trustees rather than commercial trust companies believe this arrangement provides more

- personalized service;
- flexible decision-making; and
- continuity.

This view may have been shaped by an unimpressive past experience with a commercial trust company or by negative reports from the experience of others. Certainly the continuing upheaval in the financial services industry over the past several years has led to disruptions in the continuity, culture and perceived quality and reliability of some commercial trustees.

When we talk here of wealthy families relying on an individual to serve as trustee we are not referring to a solitary individual crowded into a small office next to a dusty old filing cabinet. The trusts and their management needs can be quite complex and the individual trustee often serves with the support of a financial services company, family office, or a collection of service providers joined together in some combination to provide an administrative and investment system to assist the individual trustee. In this way, the individual can access the same kinds of technology platforms and financial and professional resources used by commercial trust companies.

Yet this reliance on an individual trustee still suffers from an inherent limitation: it depends on an unbroken line of succession from one wise trustee to the next, with little or no transition time or cushion to adjust for unexpected events. Put another way, the individual trustee model assumes, sometimes incorrectly, that it will be feasible to move from one honest, informed and experienced individual to the next with little or no “on the job” training. It assumes, sometimes incorrectly, that an individual will be available to act when needed, despite possible interruptions resulting from changes in that person’s lifestyle, career plans, geography, health, age, motivation, financial needs or wants, and competing professional or family commitments. In this way, something as subtle as an increasing loss of attention and focus by an individual trustee can become a real family-wide problem. (When numerous family trusts are involved, the process may depend less on a single individual but raise similar succession issues in a larger number of trustee positions.)

This limitation is compounded by the fact that the model is not conducive to building a line of succession. There is no natural place for a board of directors, which allows outside advisors to contribute directly to decision-making, nor is there an apparent place in the structure for younger family members to gradually gain first hand experience with a trustee’s responsibility and perspective. Junior roles with junior levels of authority can be created in an individual trustee setting using powers of attorney, asset holding companies, advisory boards and investment and distribution committees, but these require proactive planning and handcrafting. They are not indigenous to the model.

In contrast, a corporate trustee model may inherently offer a better organizational system, at least on paper. A company (whether a business corporation, LLC or non-profit) naturally provides a legal and practical environment for people of various talents and experience levels to work together to address the strategic, operational and administrative aspects of trust management. Gaps and weaknesses in expertise, availability, work habits and personality traits that may seriously limit the effectiveness of a single individual trustee can, at least in theory, be compensated for in a company structure since it can involve more people with different skills, with full or part-time responsibilities. On a more positive note, in the corporate model, strategic decisions can be separated readily from operational issues and addressed by different decision-makers, some of whom may have limited time available but can nonetheless make valuable contributions.

If the corporate model is the better theoretical solution, then the private trust company - - the family's own trust company serving its own trusts - - may be the practical tool needed to apply the corporate model to the family trust setting. A private trust company can offer an opportunity to blend the structural advantages of a corporate trustee with the personal advantages of the individual trustee.

## PRIVATE TRUST COMPANY: FACTORS TO CONSIDER

What are the factors to consider in determining whether a private trust company is worth exploring? In deciding between a fully supported individual trustee (or trustees) and a private trust company, you should take into account at least the following factors:

- <u>Duration, nature, and number of trusts, trust assets and trustee decisions</u>. No surprises here. For complex sets of long-term trusts, as already indicated, it may be much easier to find and support a succession of individuals if they are acting through a private trust company. Just because we use the word "company" does not mean that the chief executive of the trust company needs to be a full-time job. The head of a private trust company can draw on a board of directors for decisions and advice, and rely on other officers and employees for direct implementation inside the trust company, as opposed to using support systems and resources provided by the family office or independent professionals. Of course, a line of succession of individual trustees is easier to build if trusts are few in number and of relatively short duration. But even such trusts may benefit from a private trust company if the future holds the possibility of difficult decisions. How will decisions be made on distributions for a complex family setting or a special set of purposes? Should the family company be sold or reorganized? How do the family trusts proactively invest very large sums for a very large number of family members? Committees that control investment and distribution decisions may be the answer, but so may a private trust company.

- <u>Personal liability of individual trustees</u>. The risk of personal liability of individual trustees is difficult to measure, because so much depends on the particular circumstances. Yet it is generally true that an individual will face less risk of disruptive and expensive litigation and a reduced threat of personal liability if serving as an officer or director of a private trust company than as an individual trustee. When using individuals as trustees, most families and trusts provide indemnities to the individual trustees to address these risks since insurance coverage is often limited or unavailable. Open architecture trust structures, if available, can further reduce the threat by rearranging trustee functions into separate lines of responsibility. Open architecture trusts can be used to match the aptitude, resources and availability of different individuals to different categories of trustee functions. In this way the trust structure meets the need for asset custody and accounting, and distribution, family business and investment decisions, through suitable individuals and third-party providers. This specialization makes it easier to improve and maintain focus and therefore quality, hence reducing risk. Such solutions, however, bring on a complexity of their own, including the need for careful coordination, and in any event, may not be possible for the family and trusts in question due to practical or legal limitations. A private trust company can sometimes actually provide a simpler and more complete solution.

- Regulation and expense. Though the rules differ depending on the jurisdiction, most private trust companies are subject to government rules and regulations of some kind, which lead to certain needs for capital in the trust company and extra expense for legal, accounting and other compliance costs. Families try to avoid cumbersome and expensive structures and government regulation, so the tangible and intangible effects of regulation need to be carefully evaluated:

- "Regulation" means you need to do more of what most people instinctively want to avoid – adopt and follow formal procedures. If the family recreates the bureaucracy of the bank trust department inside the private trust company, what has been accomplished? Everyone is inclined to believe, intuitively or from past experience, that less "procedure" means more flexibility, speed and economy in making decisions and managing operations.

- It is also true, however, that a lack of formal procedures can lead to a lack of attention and ad hoc, inconsistent and ultimately careless or biased decision-making. This tendency is particularly evident in the management of long-term trusts by individuals. Much of what a trustee does is cautionary and routine: holding assets, making investment adjustments, voting minority interests, keeping accounts. It's frankly too easy for the watchful sentinel to fall asleep at his or her post by attending to other more pressing or interesting activities. In large part, regulation is another word for process, which is not all bad. More formality prompts organization, and organized process in trust management can foster better trustee decisions and prevent mistakes and carelessness. Trust management rarely calls for strokes of genius and entrepreneurial vision, so formal process is not distracting or counterproductive to the task at hand.

- Individual trustees also operate under "regulation" whether they know it or not. An individual trustee of a long-term trust owes a duty to the future, to beneficiaries not yet born or not able to speak for themselves, and as a practical matter trustee performance will be judged <u>with the benefit of hindsight</u>. Trust law sets the standard and the rules can be enforced, after the fact, in a court of law. Let's take an example. "Future" beneficiaries in a long-term trust actually have a stake in current trust decisions; if investments or distribution decisions are made carelessly, bad results will affect the value of their interest when it matters years from now. That those earlier decisions were accepted by other family members may not be controlling. Fortunately, a trustee is not required to guarantee results, so following a prudent process is usually a good defense to a bad result. Yet that process should be documented - - the steps written down - - since prudence that cannot be credibly proven is no defense. Thus, the burden of the process required in operating a private trust company cannot be legitimately contrasted with a complete lack of a need for any process when using a prudent individual trustee. Process is needed in any event or the trustee, and the results, are at risk.

- The incremental cost and burden of a private trust company cannot be described in the abstract; much depends upon the circumstances of the family and the trusts in question. Moreover, sometimes the use of a private trust company simplifies rather than increases the burden of legal compliance, e.g., for certain federal securities laws.

- Nonetheless, the inconvenience factor associated with a private trust company cannot be ignored. Regulation no doubt requires more procedure, more documentation and more capital and expense than families and their individual trustees find convenient, and to some extent, goes beyond what would be required of a careful individual trustee. Moreover, while the degree of trust company regulation is theoretically elective because some state jurisdictions allow unregulated trust companies, and others apply light regulation, these choices need to be thoughtfully considered because trust companies, even private trust companies, tend to be tied to geography. The choice of the trust company's location depends not only on a particular state's regulatory climate but on its trust and income tax laws, proximity to the family and its advisors, and its legislative and judicial climate. Private trust companies are not easily moved, and trusts are not always easily moved to where the trust company can be located. Trust documents may also restrict who and what can serve as trustee and these restrictions may be hard to modify.

- <u>Other organizational issues</u>. Other operational and design factors will need attention as well. Would different family branches or family members need to be served in different ways by the single private trust company? Would individual trustees still be used in some way? Would special procedures need to be developed to preserve the privacy of financial and personal information from unnecessary disclosure to family members involved in the management of the trust company? Would a private trust company lead to too much centralization, or would it, to the contrary, encourage broader family participation and communication on trust matters? Can the structure grow organically along with the growth and migration of new generations of the family?

- Taxes. The choice between individual trustees and a private trust company also raises tax issues, at both the federal and state level. Some states tax the income earned by trusts according to where the individual trustees reside, and many states apply multiple tests to determine whether it will tax a trust's income. These issues are easier to manage if a private trust company is used as trustee. At the federal income tax level, the expense of operating a trust company is much more likely to be fully deductible than the expense of support systems for an individual trustee; this is particularly relevant to the deductibility of outside investment advice, which tends to be a significant dollar cost for substantial trust assets. Finally, estate tax issues need to be considered whenever family members are involved in trust management in order to guard against the unpleasant surprise of an unexpected estate tax on trust assets. These issues can be suitably addressed whether the family uses a private trust company or an individual trustee, but the steps for dealing with individual trustees are more well established than for private trust companies.

## CONCLUSION

The private trust company is a choice that needs to be considered in many more family settings since the options available for trust management and financial services have changed significantly, even in the last few years, and continuing change is expected. Families who look at the available choices may well find that final decisions are quite different then their first reactions.