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Navigating the Perilous Waters of Trusteeship

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Whom do you trust? It's a sensitive question for most everyone. But in the family office world, well, it's ten-fold. Scottish author George MacDonald summed it best: "To be trusted is a greater compliment than being loved."

The topic, Trustee Obligations and Pitfalls, was addressed at a panel discussion at the Fourth Annual Family Office Conference, sponsored by the New York State Society of CPAs on February 5, 2014 at the Citi Executive Center in midtown Manhattan.

New York's Susan Schoenfeld, founder and CEO of Wealth Legacy Advisors LLC and chairwoman of the NYSSCPA Family Office Committee, opened up the talk with the issue of control. "In real estate, we all know what the three rules are: location, location, location," she quipped. "In estate planning and the trust world, the three rules are control, control, control."

Schoenfeld noted that many clients choose trusts because they like to impose control. But is this always a good idea?

Barbara Hauser, founder of Barbara R. Hauser LLC in Minneapolis, Minn., recalled one of her first law firm clients, a 65-year-old man whose money was held in a trust with payments that began at age 60. He was fed up; he wanted to manage his own money. From there, Hauser developed an expertise in breaking rigid trusts while helping beneficiaries add a bit more flexibility to their lives.

Bent on Control

"So, if you have a client who is bent on control, as many of them are, keep in mind it may not last," said Hauser. "They may run into someone [like Hauser in her former life] and find a way to go to court and break whatever that trust was."

Hauser proffered another example, fast-forwarding 20 years in her career as a lawyer, recalling when she was recruited to give advice full-time to a famous billionaire. His charge to her was to find a way to control his family for the next 300 years using trusts. "Trusts are filled with a desire on the part of the settlor to impose control for all kinds of reasons," Hauser underscored.

Other examples trickled out. Schoenfeld noted that when she previously chaired the Trust Committee for a well-known national trust company, she had a client whose trust distribution began at age 70. The client, a 60+-year-old grandmother told Schoenfeld her parents never trusted her.

Hauser added another from her line of trust horror stories: a client asked her to set up a trust for her 50-year-old daughter. When Hauser mildly protested, saying the daughter seemed old enough, the client made it clear it was the husband he didn't trust.

Laura Twomey, partner at Simpson Thacher and Bartlett

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LLP in New York, said she has witnessed this play out both ways. There's the classic scenario where the amount of control that's imposed by a trust is "just overkill" for a particular beneficiary. It could be for someone who is successful in his/her own right, who is fiscally responsible, yet having to deal with the onerous restrictions of a trust. Twomey is presently dealing with a trust that pays out all of the income to the patriarch. The issue? "That's plenty of money for him," she said. "But it doesn't allow for any distribution to his children." She added that, throughout her career, she has worked periodically to find ways to enable the children to benefit from the property of the trust while remaining within the terms of the trust agreement. That way, the trust can be directed in a much more flexible way. Referring to the patriarch, Twomey highlighted that this would have enabled him to run his life and his family the way that he wanted to.

At the other end of the spectrum, Twomey's seen situations where beneficiaries really could have used a bit more control, benefitting from a more limited stream of income or limits in the types of investments that can be requested of the trustee. "One of the difficulties with trusts is you really do have to plan so far in the future," she said. "You don't know exactly what your family is going to look like 20, 30, 40 years down the line."

The stance her firm takes is to build a lot of flexibility into its trusts. She works with clients to develop a philosophy about trusts, Twomey said. Things put on the table are: How important is this level of control? Do they really like the trust because it provides tax efficiency, asset protection, protection from spouses or assurances that their children will get on board with the trust? "For example, maybe we will build in a power for the child to serve as a trustee at a particular age, maybe even control the investments or, at least, be able to remove the trustee in certain circumstances," Twomey illustrated. She finds more and more that the children are very interested in the trust because of that asset protection and the protection from domestic issues, such as divorce. Even if there is a happy marriage, stipulations have been made. "It's an excuse for clients to deal with their spouse in a way that's not hurtful to the relationship," she said. "That kind of alleviates some of the pressure they may otherwise feel for spending on a particular categories.... So I find that with beneficiaries, if you educate them properly, they are actually quite interested in the trust."

Schoenfeld added that getting the family involved at the outset is incredibly useful because, while dealing with these "major control desires," it's the responsibility of the professionals to counsel them "that there is a flip side and a flip message to that".

Trusting the Trustees

A flip side? While the discussion so far centered on trusting the beneficiaries, what about trusting the trustees? San Mateo, Calif.-based Randy Werner, loss prevention executive at CAMICO, urged conference participants to truly think about what is involved. The first thing you need to ask yourself, she said, is why is a trust being created and why am I being asked to be the trustee? Following that, one must consider if he or she has the competencies to do it. There are situations that can occur out of nowhere that can get a trustee in trouble. One such situation, said Werner, is when a death occurs. In 2013, her firm was working with an individual who was a fairly young man, very productive, with his own thriving manufacturing business. His death was sudden and, as his particular business was very specialized, not just anybody was suitable to fill his role. "The problem for the CPA [who was serving as trustee] was that he then had to step into this role himself," said Werner. "He had been this trusted financial advisor who knew more about the business than anybody else and was in the process of trying to search for a replacement because the death happened so fast. There was no way to plan for the succession. It created an enormous amount of problems for him and an enormous amount of problems for the business."

Werner again addressed the "do you have those competencies" question. "We call it the back to the future rule," she quipped. That is, if a bad thing were to happen, what would it look like? Then professionals, such as

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herself, can step in and help plan for the possibility before it happens.

Twomey spoke at length about a special purpose trust, with particular emphasis on holding shares in a family business that has, perhaps, gone public since the trust was created. She stressed that, while the trust agreement expressly states the desire of the grantor to go public, it doesn't mean it will be shielded from liability forever. Twomey called for careful consideration and mindfulness of the rules in one's particular state.

"What we found is important is for trustees to take the time to document their decision-making," she said. "In other words, don't just hold the stock in the publicly-traded business forever because the trust document says so. Sit down annually and consider why it makes sense to do so. The grantor's intent and the family control of the company are both good reasons. But the idea is to monitor a situation actively, to make a record of your decision-making, to consider the alternatives and to have all of that in writing."

Schoenfeld weighed in on the undiversified position. This can include the family-owned company or the publicly-traded company where the parents have worked their whole lives and accumulated tons of stock. As trustee, it's of great benefit to review and document, as Twomey also urged. "Even though the beneficiaries can't tell the trustee what to do, it certainly makes sense to get their buy-in on a regular basis because you don't want them suing you later," said Schoenfeld.

And what about the issue of "trust fund-dependent" or "trust fund babies"? The best piece of advice, according to Hauser, is to keep educating the beneficiaries. She noted that it's also smart marketing for any professional advisor to build those bridges via education with the next generation - and to keep them involved. Hauser pointed to the example of one very prominent US family that has traditionally written trusts but, as a practical matter, decided to create committees instead. These are not mentioned in a trust agreement, she underscored. One of the committees is concerned trust distributions, which Hauser also emphasized, have no legal authority. "[Nonetheless,] it's become an entrenched family discipline that, every quarter, the adult beneficiary looks at their needs for income for the next quarter. They put together proposals, the cousins get together and work on it themselves and everyone's on board, everyone participates. Then they make that request to the trustees," she details. "I find it very interesting how much you can add to the life surrounding a trust. You keep thinking of the necessary, fair tie with next generation (i.e. the beneficiaries) and what you can do to help them and have them participate."

Another part of this topic is the issue of non-pro-rata distribution. This applies to "pot trusts," or one big trust created for all family members with the idea that it provides tremendous flexibility. For instance, say there is one child who becomes a teacher and another becomes an investment banker. They may reach a point where the trustee is asked to give larger distributions to one or the other. Why? It could be that the teacher wants to start a business and needs a distribution from the trust while the other child is getting along just fine with the current income distributions. These situations are generally discretionary, notes Twomey. Why would a trustee do that? "I often find trustees are really quite nervous to do that," she said. "Because they are worried the other beneficiaries will come back later and say you favored this beneficiary over me - why did you give them equal assets - that kind of thing." Here again, having a disciplined process around documenting as well as clear communication with the beneficiaries are key. "I think those are two important tenets so there aren't any surprises," said Twomey. "Beneficiaries not getting a distribution can be made to understand what the request is, why the trustee deems it appropriate. And the trustee can seek information from the beneficiary requesting outside distribution, asking why he needs it and how he plans to use it, and then document that it made sense at the time."

For the trustee, Werner offered suggestions to minimize his or her own risk as representative. There are two likely scenarios: either the trust has already been drafted or you

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are working with a settlor and you can make suggestions, she said. The more suggestions you can make, the better, as the settlor is going to have their own family members and their own best interest at heart. "You want to make sure you get the no contest clause, you want to make sure there is indemnification - you have to defend yourself.... Our experience is, when they are not well-drafted, there are problems. So I do encourage any trustee - even an attorney - to have somebody with a different set of eyes look over that trust and point out some of the problems because you are ultimately going to be the one in the hot seat in a lawsuit or a claim."

Walking a Fine Line

There is also the issue of conflict of interest. For trustees, just how do you avoid them, real or perceived? A situation arose for Werner and her firm in which the parents had both passed away and the successors, two sons in this case, were essentially trust fund babies. The trustee, she described, had a very strong personality and was charging quite a bit for his services, which he felt were valued appropriately. One son became unhappy and called Werner and the tax partner who managed the engagement. The son had a longstanding relationship with the tax partner. As it turned out, the trustee was originally the tax partner's mentor and, at one point, his business partner. Meanwhile, the son took the tax partner out for dinner and proceeded to detail his unhappiness with the trustee and his desire to get him fired. Precarious position? Absolutely. Werner noted the thin line that had to be walked to get everybody on board. "What was important was he was the keeper of all the historical knowledge of this family group - that was one of the problems," she said. Werner voiced her opinion that she didn't think the son would like to be running the business. A few days later, she got a call saying he also wanted to fire the CEO because he didn't like him either, even though he had run the business very successfully. That posed an even bigger problem. At that point, disclosure could be made to the trustee. "You have to have that back to the future conversation with yourself to decide: How am I going to protect myself? How am I going to protect the interest of the beneficiaries of the trust? It's a very difficult line to walk," said Werner. And the more complex the trust, and the more numerous the trusts are, the more likely you are to have personality clashes.

Inevitably, the talk around private trust companies surfaced, a trend that has been discussed more widely in recent times. Twomey's take? "I would say it's a good thing to consider for families of a certain wealth. However, I will say that most of those families opt not to pursue them because of the amount of administration necessary, the added expense, all of those things that play into it. Although I do think it's an important thing for advisors to know about and bring to clients for consideration," she said. Twomey added that she has seen clients use them in a number of different ways. One use is to get around very restrictive trust terms, perhaps a trust that only allows for one or three trustees.

But there are many family members who would like to participate in the administration of the trust, she also said. "We put a family trust company in place so that it could have a board that encompassed more members of the family. Those family members feel included, eliminating some of the potential disenfranchisement of having to pick one senior family member and then pass it to another senior family member," she said.

In another instance, her firm utilized a family trust company when it had a trustee who moved to a state that would impose new taxes on that trust. The purpose is for the firm to continue to have an active role. Lastly, Twomey said the firm had some families in which all generations share a fierce desire for family privacy. The firm has seen families explore family trust companies in those situations as well. "It's a shared value and it's something that keeps them together because it's such a strong shared value." said Twomey, adding: "But I would say in most instances those three factors are not present and we end up looking at it and deciding it was nice to have thought about that option but we are not going down that road at this point."

Hauser added that if a family does want to have a private trust company, then the "friendly amendment" she would

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offer is to have that family run a private trust company that acts more like a front office and then make an arrangement with a real trust company to do the administrative, regulatory and back office work. "All the big banks I know of are happy to do that," she said. "So you kind of have the best of both."

Perhaps the greatest takeaway from the day's discussion was the critical importance of starting conversations as early as possible. It's openness that will lead all parties to the much-sought-after ideal of trust.

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