Trusts&Estates
The Journal of Wealth Management for Estate-Planning Professionals - Since 1904

Feb 1, 2012 12:00 PM

Emerging Directed Trust Company Model

Offering unbundled services provides great flexibility and lower fees for families and their advisors

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Much has been written about modern "multi-participant trust" governance structures (sometimes called "open-architecture trust designs") and evolving principles of state trust law related to "directed trusts."[1] The directed trust model threatens to undermine the market share and pricing power of traditional bundled trustee service firms.

The emergence in several progressive trust jurisdictions of upstart nondepository public directed trust companies (DTCs) is a disruptive force to be reckoned with. Those trust service providers who recognize and are willing to exploit these opportunities can offer the unbundled services, a la carte pricing and inexpensive access to the progressive states' trust laws that are increasingly coveted in the growing national trust marketplace. Traditional providers of bundled trustee services with unwieldy cost structures and embedded cultures will be challenged to adjust their business models to compete in this new environment. Here are some observations on the opportunities and perils that the DTC model presents to professional fiduciaries, consumers of trust services and their estate-planning advisors.

Defining "Directed Trust"

A traditional bundled professional trustee performs all fiduciary functions for the trusts under its management. These include exercising the important labor-intensive and liability-sensitive discretionary investment management and distribution responsibilities, performing all ministerial administrative responsibilities necessary to implement those exercises of discretion, preparing fiduciary accountings and trust tax returns and otherwise administering its trusts in accordance with the governing instruments and applicable state trust law.

Traditional Bank Trust Departments

A large bank trust department[2] designed to deliver bundled trust services requires elaborately structured risk management policies and procedures to allow the bank's personnel to perform the multiple fiduciary responsibilities inherent in the role and limit the bank's exposure for claims of breach of fiduciary duty. The directors, officers and support personnel are compensated commensurate with their experience, expertise and level of responsibility. The department's policy manual describes the roles and responsibilities of various committees of directors and officers, including a trust committee, investment committee, special asset committee, discretionary action committee, audit committee and various subcommittees. Day-to-day trust portfolio management is typically handled by highly compensated investment officers, some of whom possess the certified financial analyst credential. Distributions and operations are the responsibility of trust operations officers, trust administration officers and, in many cases, client-facing relationship managers and marketing officers.

The classic regulated corporate trustee collects from each of its trusts annual fees of between 50 and 120 basis points, depending on the value of the trust's principal. These fees have historically been adequate to cover the trust department's extensive overhead and provide a comfortable and relatively stable profit margin to supplement the bank's more cyclical net interest and other operating income from its commercial and retail banking operations. Before directed trusts became popular, the high costs of operating in a regulated industry with significant barriers to entry for alternative business models gave the incumbent bundled service providers significant pricing power and created an almost infinitely elastic demand for their services.

Modern DTC

Unlike this comprehensive trust service model, a directed trust arrangement involves a co-trustee or a non-trustee fiduciary, typically a “trust protector” or “trust advisor,” empowered to direct the trustee holding legal title to the trust assets to execute the empowered party's directions concerning the critical discretionary investment or trust distribution powers, or both. The independent DTC is relegated to implementing those directions and often performing other administrative functions such as recordkeeping, maintaining principal and income accounts and preparing and filing trust tax returns. This is why DTCs functioning in a completely directed trustee capacity are often referred to as “administrative trustees.”

DTCs can operate lean and mean in inexpensive, highly utilitarian, Class B office space, with more manageable risk management policies and procedures, less high-priced management personnel, no investment professionals and an appropriate number of administrative personnel to handle their accounts. As nondepository institutions typically operating under hospitable state regulatory regimes, they can benefit from lower capitalization and bonding requirements and less onerous supervision, reducing operating overhead.[3] DTCs generally charge a relatively modest annual fee for services commensurate with the DTC's correspondingly lower levels of risk, responsibility and overhead. This allows any other co-fiduciaries handling more labor-intensive, higher risk investment and distribution functions to profitably charge a reasonable fee for their services. Thus, the total fees paid to the DTC and the other compensated participants can be comparable (in some cases lower) to the single annual fee paid to a traditional bundled provider.[4]

Demographic Trends

Several demographic, industry and legal trends have coalesced to drive the increasing demand for directed trusts and the DTCs that serve them.

Unlike in previous generations, when wealthy families were generally more conservative investors and looked to the institutional stability of banks as their trustee and investment advisor/manager of choice, today's affluent prefer a specialized approach that gives them the flexibility to choose their own investment professionals. They increasingly reject the notion that a jack-of-all-trades can be a master of any. That's particularly the case in the modern world of complex dynasty trust administration involving layers of discretionary distribution powers and wide-open trust investment standards.5 The new directed trust structures offer the promise of the best of both worlds. On one hand, the settlor and trust beneficiaries have the comfort and stability of a local, state-regulated and adequately capitalized financial institution to serve as administrative trustee, hold legal title to the trust assets and charge a reasonable fee for those services. On the other hand, in a prudent investor environment, they avail themselves of the broader benefits of being able to choose from a wide-open universe of non-trustee distribution directors and investment specialists with extensive research capabilities, contrasting investment styles and access to alternative investment classes. These governance structures can also accommodate those families looking to play a direct role in investment management and distribution decisionmaking through committees that can empower settlors and beneficiaries to control or influence all but “tax sensitive” discretionary powers.

Six Progressive States

The evolution of the legal and regulatory environments in all but a handful of progressive trust states hasn't, however, kept pace with the increasing demand for these open-architecture governance structures. The few states that have taken up the directed trust gauntlet have recognized that creating a hospitable legal, regulatory and tax environment will foster the development of a thriving trust services industry within their borders and provide all of the incidental economic development benefits of white collar jobs, tax revenues and ancillary service providers. The progressive trust states that are on this short list are: Alaska, Delaware, Nevada, New Hampshire, South Dakota and Wyoming. Each of the six has, to one degree or another, built sufficient legal infrastructure in the three critical areas necessary to sustain a competitive local directed trust industry.

These progressive states recognize that the popularity of long-term (even perpetual) trusts as wealth management, asset protection and wealth transfer tax avoidance structures, combined with tremendous concentrations of fungible financial wealth, liberal choice and conflict-of-law principles, as well as the relaxation of interstate banking restrictions, have created a national marketplace for directed trust services. A family living in a regressive trust state needn't move to a progressive state to secure the benefits of a directed trust established and administered in that jurisdiction. They need only enter into a trust agreement with a DTC domiciled in a preferred state that will own and administer the trust's intangible personal property.

Directed Trustee Statutes

Each of the progressive states has codified directed trust principles that meet three critical requirements. First, they specifically recognize the classes of non-trustee participants that can perform trustee functions. Most of the six progressive states' statutes identify “trust advisors” and “trust protectors” to serve in these roles.[6] Although it's not necessary, some jurisdictions helpfully provide an exclusive or a non-exclusive listing of the powers and responsibilities that each of them may assume. Second, these statutes provide as a default rule that each empowered party, whether a trustee or non-trustee, performing a trust function will do so in a fiduciary capacity with direct accountability to the trust beneficiaries and submission to the jurisdiction of the preferred state's local courts. Finally, each of the six states' laws protects a disempowered directed fiduciary from liability for following the directions of the empowered party, except to the extent that the directed fiduciary, negligently or in bad faith, fails to execute the directions. Most of them satisfy this third and most critical requirement by defining a directed trustee as an "excluded fiduciary" with no duties to: (1) question whether the empowered party is acting within the scope of that party's authority, (2) intervene to prevent or redress a breach, or (3) warn the beneficiaries that any given direction exceeds the empowered party's authority or otherwise constitutes a breach.[7]

Being governed by a clear and comprehensive directed trust statute will enable a DTC domiciled in a progressive trust state to price the administrative services it provides without a fiduciary surcharge premium or to cover the costs of exercising due diligence responsibilities on the empowered party's directions that would be appropriate in the absence of the "excluded fiduciary" exoneration provision. Moreover, it will send a clear signal to any court, in surcharge litigation initiated against the DTC, that the state's legislature has declared as a matter of public policy that the DTC will be liable only for bad faith or negligent execution. No such assurances can be given to a DTC operating in a state with no directed trust legislation or a statute that doesn't satisfy each of the three critical elements described above.

For example, the directed trust statute in a state adopting the Model Uniform Trust Code (UTC) won't protect a DTC operating in that state from liability for executing directions if the DTC's administrative personnel knew that doing so would constitute a "material breach" of the empowered party's fiduciary duties or would be "manifestly contrary to the terms of the trust."[8] These vague standards leave the door open wide for a disgruntled beneficiary or a results-oriented court to mine the deep pockets of the DTC if, for example, it implements a direction that results in loss or damage to the trust principal. A DTC operating in a state without bulletproof directed trust laws would face diminished prospects for a successful appeal of a surcharge order based on the deferential standard of appellate review for questions of fact and mixed questions of law and fact. Even some non-UTC states with statutes that attempt to go beyond the UTC protections could leave a DTC vulnerable.[9] Reaching that result would have been difficult for any court applying the statute of a progressive trust state that clearly negates any such duty to warn on the part of a directed trustee.[10]

Trust Modification Opportunities

Each of the six preferred trust states offer liberal opportunities for non-resident situs seekers to "retrofit" their existing irrevocable trusts' governance structures from the bundled trusts to the directed trust format and change their principal place of administration from a regressive trust state by facilitating the appointment of a directed trustee in the preferred jurisdiction. These opportunities include (without limitation) decanting, accessible trust modification standards (particularly related to administrative provisions), nonjudicial settlement agreements and virtual representation.

Lighter Touch Level of Oversight

All of the progressive states also have enacted special banking act provisions for the chartering and supervision of public nondepository public DTCs or limited purpose trust companies that can't accept deposits or make loans. These relaxed requirements recognize that a lighter touch regulatory regime is appropriate, given the diminished risk of public harm and receivership costs in the event of the failure or misconduct of a nondepository institution, when compared to the trust department of a traditional state or federally regulated institution that also takes deposits and makes loans. The relaxed requirements are generally reflected in lower initial capital requirements, lesser fidelity and liquidation insurance and bonding requirements, more liberal options for investing statutory capital, less frequent examinations and relaxed (or no) requirements for resident directors and bricks and mortar in the chartering state or some combination of those attributes.

Among the six states, Delaware's regulatory regime is regarded as cutting the least slack for their limited purpose trust companies and South Dakota is regarded as having the most accessible and least costly chartering and supervision requirements.[11]

Regulator Sophistication

Implicit in each of the progressive state's trust and banking codes is the legislature's policy value judgment about how hospitable it wishes to be as a domicile of choice for nondepository DTCs and trusts that might migrate from other states. Some of these six states have erected higher regulatory barriers to entry and operation for DTCs than others. They've done so presumably because they wish to keep out nefarious, undercapitalized providers without solid backing or well considered business plans and discourage “rent-a-charter” interlopers who plan to conduct all or a majority of their business outside the state.

In reviewing a DTC's charter application and examining existing DTCs, each state's bank commissioner will take his cues from the tenor of that state's banking code's chartering and supervision requirements applicable to DTCs. The regulator has a mandate to be conscientious in his review of a bank or trust company candidate's charter application and the banking department's examination and enforcement activities to guard against consumer harm, maintain the integrity of the state's banking and trust industry and preserve the regulator's limited resources available to cover the costs of receivership and liquidation. A banking commission operating under a special light touch statutory regime applicable to DTCs must balance that prophylactic purpose with the legislature's mandate that the regulator not be so heavy handed as to discourage responsible charter applicants and impose unmanageable regulatory burdens and compliance costs on any given DTC with a sustainable business plan and operating in a responsible fashion. To do so would prevent the progressive state's directed trust providers from charging competitive fees and attracting sufficient business to compete on a national scale, thereby frustrating the policy goal of the progressive state's trust and banking law reforms.

Some banking departments in the preferred trust jurisdictions have done a better job than others in striking a reasonable balance among these competing considerations.[12] All of them, however, remain competitive relative to the more regressive trust law jurisdictions that have one-size-fits-all, full-bore regulatory regimes applicable to both depository and nondepository institutions.

State Trust Income Tax Environment

Finally, many trust situs-seekers and migrators reside or maintain their non-grantor trusts' current situs in states that impose high trust tax rates on accumulated income and capital gains. They may be seeking a state income tax shelter if: (1) the laws defining their home or trust situs states' trust tax jurisdiction are drawn narrowly enough to allow them to achieve that result, and (2) the destination state won't tax the trust after the move.

Here again, all of the six progressive states aren't created equally. Some don't tax trust income and capital gains at all. Others will prorate the trust's taxable income based on the percentage of beneficiaries who live in the destination state, exempting from state taxation all trusts having exclusively non-resident beneficiaries.

Disruptive Business Model

The process of creative disruption has transformed many an industry as traditional business models are forced to adapt to upstarts that offer a compelling alternative value proposition.13 For families and their advisors who are willing to do their homework on prospective new DTCs and the open-architecture trust governance alternatives available to them in the progressive trust jurisdictions, as well as for traditional providers willing to consider serving in directed trustee roles, the new unbundled trust governance model offers the promise of vastly greater choice and many attractive possible permutations that can deliver best-in-class trust service across all trustee functions at a reasonable overall cost.

Endnotes

1. *See, e.g.*, David A. Diamond and Todd A. Flubacher, "The Trustee's Role in Directed Trusts," *Trusts & Estates* (December 2010) at p. 24; Mary Clarke and Diana S.C. Zeydel, "Directed Trusts: The Statutory Approaches to Authority and Liability," www.flprobatelitigation.com/uploads/file/DirectedTrusts.pdf. Attorney John P.C. Duncan coined the term "multi-participant trust." *See* John P.C. Duncan and Anita M. Sarafa, "Multi-Participant Trusts Need a Coordinator," *Trusts & Estates* (November 2008) at p. 32. "Open-architecture trust" refers to a multi-participant governance structure first described in this magazine by John H. Lahey in "Open-Architecture Trusts: The Wiser Choice," *Trusts & Estates* (August 2003) at p. 44.
2. Although this article refers to bank trust departments in discussing the attributes of a bundled trust service provider, the discussion applies to any regulated trust institution (bank-affiliated or nondepository) that isn't directed as to the investments of the trusts it administers. For purposes of this article, a "bundled trust service provider" will mean any regulated (state or federal chartered and supervised) institution possessing trust powers that manages investments in-house or outsources the investment management functions (through agency arrangements, separately managed accounts or unified management accounts), but retains non-excluded fiduciary status for the investments of some or all of the trusts that it manages, as described in note 7, *infra*, and the accompanying text.
3. States with one-size-fits-all regulatory regimes that make no concessions to nondepository trust companies are a vestige of the days when only bank-affiliated trust companies provided fiduciary services. There's obviously a significantly greater risk to the public welfare and costs associated with the failure and receivership of a bank that collects deposits and makes loans, versus a nondepository directed trust company (DTC) that takes mere custody of trust assets. This is discussed in more detail in note

11, *infra*, and the accompanying text.

4. It's important at this juncture to distinguish between a “directed trust” and the ability of a trustee to “delegate” investment responsibility. A trustee possessing its investment responsibility and delegating all or a portion of that responsibility to a compensated agent is held to similar standards of fiduciary responsibility (and liability) that would apply if the trustee directly manages the investments. *See generally* Diamond and Flubacher, *supra* note 1, at pp. 25-26 (discussing how unlike directed trusts, delegated trusts don't achieve true “bifurcation” of investment risks and responsibilities and will therefore require the delegating trustee to extend more effort, assume more risk and presumably charge more of a fee than a directed trustee); Al W. King III and Pierce H. McDowell, “Delegated vs. Directed Trusts,” *Trusts & Estates* (July 2006) at p. 26.
5. There's an old adage: “How do you make a small fortune? Give a bank a large one to manage in trust.” Jesse Dukeminier and James E. Krier, “The Rise of the Perpetual Trust,” 50 *CLA L. Rev.* 1303, 1335 (2003). In defense of the banks, this bias is perhaps most attributable to historically restrictive fiduciary investment laws (“legal lists” and prudent men) that hamstrung bank trust investment personnel. There's empirical evidence that the more prudent investor standards and total return regulation have freed institutional trustees to better compete with other compensated professionals investing non-trust assets. *See* Max M. Schonzenbach and Robert H. Sitkoff, “The Prudent Investor Rule and Trust Asset Allocation An Empirical Analysis,” 35 *ACTEC Journal* 314 (2010). Also, many corporate trustees (particularly the largest ones) have complemented their in-house investment capabilities with best-in-class open-architecture platforms or embraced open architecture completely. Still, the prejudice persists and will create serious headwinds for corporate trustees attempting to market their proprietary investments.
6. For a complete discussion of the directed trust statutes of some of the proposed jurisdictions, *see* Clarke and Zeydel, *supra* note 1.
7. For a discussion of some of these statutes and some important substantive differences among them, see Diamond and Flubacher, *supra* note 1, at pp. 26-27.
8. Uniform Trust Code Section 808(b).
9. For example, despite the superficially clear directed trustee exoneration language of the Virginia directed trust statute that was reviewed by a Virginia appellate court, the court nonetheless vacated and remanded a lower court's dismissal of an action against a directed trustee for a determination of whether that trustee violated its “duty to warn” the trust's beneficiaries of an investment director's decisions that went wrong. *See Rollins v. Branch Banking & Trust Co. of Va.*, 56 Va. Cir. 147 (Va. Cir. Ct. April 30, 2001).
10. *See Duemler v. Wilmington Trust Co., Del. Ch.*, C.A. 20033 NC, 2004, Strine, V.C. (Nov. 24, 2004). A more detailed discussion of both *Rollins, ibid, Duemler* and their implications appear in Diamond and Flubacher, *supra* note 1, at pp. 27-28, and Clarke and Zeydel, *supra* note 1, at pp. 17-18.
11. For example, South Dakota requires minimum capital of $200,000 for start-up public DTCs and imposes only minimal requirements for South Dakota resident officers and directors and presence (office space and personnel). Delaware, by contrast, requires $1 million of minimum capital and scales its resident employee and office space requirements to the trust company's assets under management. South Dakota's statute prescribing the capital requirements for nondepository trust companies specifically “… recognizes that [South Dakota's] capital requirements … are [not intended to] be judged by the same standards as banks” and that the basic protection for fiduciary clients is provided through bonding and insurance, not capital. *See* “South Dakota Sets Record for New Trust Companies,” *The Trust Advisor Blog* (May 15, 2010) (*Trust Advisor*),

www.thetrustadvisor.com/news/sd-record.

12. South Dakota's Division of Banking recorded a record number of public DTC charter applications in 2010. *See Trust Advisor, ibid*. In addition to the favorable statutory chartering requirements, the blog quotes the Division's then-legal counsel (now director) as contrasting South Dakota's "business friendly" system for manageable costs for DTC "startups" to Delaware's rules that "… only really allow for big companies." Because in every state the DTC pays the tab for the regulator's examinations, many DTCs that are seeking the lowest ongoing supervision cost are encouraged by the efficiency of the Division's well-trained examiners, several of whom hold the Conference of State Bank Supervisors' "qualified trust examiner" credential and specialize in examining nondepository DTCs.
13. Disruptive innovation in an industry has been described as follows:

    …a dynamic form of industry change that unlocks tremendous gains in economic and social welfare. Disruption is the mechanism that ignites the true power of capitalism in two ways. First, it is the engine behind creative destruction… Disruption allows relatively efficient producers to blossom and forces relatively inefficient producers to wither. This destruction, and the subsequent reallocation of resources, allows for the cycle of construction and destruction to begin anew, enhancing productivity, lowering consumer prices, and greatly increasing economic welfare.

    See Clayton M. Christensen, Sally Aaron and William Clark, "Disruption in Education," www.educause.edu/Resources/DisruptioninEducation/158712. Harvard Business School Professor Clayton M. Christensen is considered to be the dean of "disruption theory," first identified in Joseph L. Bower and Clayton M. Christensen, "Disruptive Technologies: Catching the Wave" (*Harvard Business Review* 1995). Perhaps the forces of creative disruption will operate to transform traditional bundled trust service providers in the same manner as it did for closed-architecture investment management firms in the 1990s, as aptly described by Greycourt & Co., Inc.'s chairman Gregory Curtis in Greycourt White Paper No. 38, "Open Architecture as a Disruptive Business Model," www.greycourt.com/white-_papers.html. Curtis discusses application of the principles of creative disruption on trust design in Greycourt White Paper No. 48, "Best Practices Trusts," www.greycourt.com/white_papers.html.

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SPOT LIGHT

Ski Patrol

"Winter Sports in the French Alps," (40 in. by 25 in.) by Roger Broders sold for $8,000 at Swann Auction Galleries' "The Complete Poster Works of Roger Broders" sale in New York City on Dec. 15, 2011. The French Alps feature 200 ski resorts spread across 15 locations and serviced by 2,382 ski lifts. If placed end to end, the ski lifts would stretch from Lyon to Cairo, some 1789 miles.

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