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Navigating the Perilous Waters of Trusteeship

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Who do you trust? It's a sensitive question for most everyone. But, in the family office world - well, that'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 when she first started out was a 65 year-old man. His money was held in a trust with payments that only began at age 60 and he was fed up; that he wanted to manage his own money. From there, Hauser developed an expertise in breaking rigid trusts all the 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, with whom she ended working for years with. His charge to her was how to control his family through using trusts for the next 300 years. "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 horror trust stories; a client who had 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 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 over the course of the last 15 years of her career, she has spent time periodically finding ways to enable the children to benefit from the property of the trust, yet still 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 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 little bit more control, benefitting from a more limited stream of income or being limited 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 in a lot of flexibility into its trusts. One aspect is talking to clients about developing a philosophy about trusts, Twomey said. Things put o the table are: how important is this level of control; do they really like the trust because it either provides some tax efficiency, provides some asset protection, protection from spouses, getting their children 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 at a particular age. or to at least be able to remove the trustee in certain circumstances that the child feels more aligned with the funds," 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, like divorce and even if they are in a happy marriage particularly from clients, stipulations have been made. "It's an excuse for them to be able 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" its the responsibility of the professionals to counsel them "that there is a flip side and a flip message to that".

Trusting the Trustees

Another flip side? While the discussion had been centering 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 its role and what is truly 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/she has the competencies to do it. can i do it? There are situations that can occur out of nowhere that a trustee often gets into trouble with. One area, said Werner, is when you start having deaths. She pointed to a situation in 2013 where her firm was working with an individual who was a fairly young man, very productive and had 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] is he then had to step into this role himself," said Werner. "He had been this trusted financial advisor and 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 could happen, what would it look like and then professionals such as herself step in and help you plan for it in the here and now.

Getting more into investing side of a trust, Twomey spoke at length about the special purpose trust, with particular emphasis on holding shares in a family business that has perhaps since the trust was created, gone public. She stressed that while the trust agreement expressly says the desire of the grantor was to do just that, it doesn't mean you are going to be shielded from liability forever. Twomey called for the utmost care in consideration and to be mindful of the rules in your particular state.

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

Schoenfeld weighed in on the un-diversified position, either the family-owned company or the publicly-traded company that the parents will have worked in their whole lives and got tons of stock. As trustee it's of great benefit to review and document, similar to what Twomey was urging. "Because 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"? Distribution was another area for discussion. 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 as a family group to create committees. These are not mentioned in a trust agreement, she underscored. One of the committees is about trust distributions, which Hauser also emphasized has no legal authority. "[Nonetheless,] it's become an entrenched family discipline that every quarter, the adult beneficiary look 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 and 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, then 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."

As a part of this topic, the issue of non-pro-rata distribution. This applies to "pot trusts", or one big trust for all of the family members and their dependents with the idea that it provides tremendous flexibility. Say, there is one child who becomes a teacher and another becomes an investment banker. Perhaps you reach a point where the trustee is being asked to give larger distributions. Why? It could be that the teacher or one of the children wants to start a business and is looking for a distribution from the trust and the other child is getting along just fine with whatever the income distributions are. 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, documenting and having a disciplined process is key as well as clear communication with the beneficiaries. "I think those are two important tenets - so there aren't any surprises," said Twomey. "Beneficiaries not getting any distribution have been 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 and ask them why they need it, what they plan to use the money for, and 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 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 and there are problems. So I do encourage any trustee - even an attorney - to pass somebody with a different set of eyes, look over that trust that has already been created, or look at the draft and point out some of the problems for you because you are ultimately going to be the one in the hot seat along with the other professionals 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 real or perceived conflicts of interest? A situation can arise, as it did for Werner and her firm, where the parents have both passed away and both 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 was valued appropriately. One son became unhappy and called Werner with the tax partner who managed the engagement. The son had a longstanding relationship of 15 years with the tax partners. The tax partner had a long career in tax advising and moved around to several different firms. In this case, as it turned out, the trustee was originally his mentor and at one point his business partner. Meanwhile, the son took the tax partner out for dinner and proceeded to tell him he was very unhappy with the trustee and wanted 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 it's been very successfully run. That posed an even bigger problem. At that point, disclosure could be made to the trustee, because he was trustee for the business. "You have to do 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 - and it's a very difficult line to walk," said Werner. And the more complex the trust, and 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 that goes on, the added expense; all of those things that play into it. Although I do think it's an important thing for you as advisors to know about and to bring up for your clients to consider," she said. Twomey added that she has seen clients use them in a couple of different instances. One is to get around very restrictive trust terms, perhaps a trust that only allows for one trustee or three trustees.

But there are many family members who would like to have an ability to participate in the administration of the trust, she also said. "We have had a family trust company put in place so that you can have a board of the trust company that encompasses many more people in the family and therefore they feel included and eliminate some of the potentially disenfranchising having to pick one senior family member and then pass it to another senior family member," she said.

In another instance, her firm has utilized family trust companies when it has a trustee who moves to a state that would cause new taxes being imposed on that trust. The purpose is for the firm to continue to have an active role. And then lastly, Twomey said the firm does have some families where not just the senior generation but the entire generation shared a fierce desire for family privacy and in those situations it has seen families explore family trust companies 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 offer in their planning is to have that family run a private trust company that acts more like a front office and make an arrangement with a real trust company to do the administrative, regulatory and back office work. "All the big banks I know of in the end 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 you can. It's the openness that will lead all parties to the much-sought after ideals of trust.

