

Note: It is Planned to Send This Article by *Heirs* to Congressmen
With an Interest in Financial Reform

*The Irrevocable Trust
And
A Word About Dead Hand Control*

It is well understood that the irrevocable personal trust is a useful device for protecting family assets from creditors and reducing estate taxes while at the same time providing for the financial security of a loved one. While irrevocable trusts can be complicated as well as extremely flexible in meeting the needs of the individual settlor, there are a few key points worth mentioning. For example, the trust 'creator', i.e. the settlor, must delegate administration – generally to a third party – who is required to administer the trust for the exclusive benefit of the beneficiaries and in a manner consistent with the terms of the trust 'instrument'. The choice of trustee, whether it be an individual or corporation, is critical because it will likely be costly and time consuming for beneficiaries to remove an incompetent or incompatible trustee even if the circumstances are egregious and even if there is a trustee removal clause available. Needless to mention, trustee powers are sometimes misapplied by both individual and corporations despite an abundance of state and federal fiduciary law designed to protect the interests of both settlors and beneficiaries. In this respect note that corporate trustees unlike individual trustees are not known to filch the assets. Nevertheless it must be recognized that the corporate trustee does suffer two conflicts of interest simply because it both controls the portfolio's risk profile¹ as well as administers trusts as a revenue generating business. On the other hand, the individual trustee whether compensated or not typically serves primarily because of a personal relationship with the settlor.

Since 1991, *Heirs* has listened to and learned from the complaints of many trust beneficiaries or at least those who are sufficiently dissatisfied to voice their concerns.² To be sure some are often angry and even abusive with their trustees because they did not receive their inheritance outright. Others do not understand trusts or the rules of their administration. Nevertheless, there is generally one common denominator; all feel powerless and frustrated.³ Psychology aside, more often than not trust beneficiaries do raise issues that appear to be legitimate, issues that suggest that corporate administration in particular could be improved especially regarding fee and investment matters.

One reform believed to stand out as both practical and cost effective is legislating account 'portability' or in other words, offering beneficiaries a practical means of exchanging corporate trustees or substituting corporate for individual management. Experience suggests that locking a beneficiary into a particular trustee based on a document drafted years ago, a document which could not adapt over the years to a beneficiary's changed circumstances or shifts in corporate administration practice is not good public policy. On the other hand, freeing the beneficiary to become personally involved by offering the freedom to seek out better management seems to make sense. In fact, we believe a properly drafted portability bill, viz. one that did not burden the beneficiary with showing cause but minimized court involvement as well would allow a trust to focus on fulfilling a settlor's true intent which was, presumably, to provide for his beneficiaries' emotional and financial welfare. With portability in place, no longer would changing corporate trustees involve a time consuming and confrontational removal process, a process ill affordable by many beneficiaries and yet typically defended using trust assets as well as a process requiring beneficiaries to locate competent, and, most importantly, independent counsel willing to risk 'disharmony' with the local banks. Portability would also not require a beneficiary to confront a deeply pocketed adversary whose priorities, especially if the trust be worth north of an average one million, may tend to be more commercial than fiducial when the issue is lost revenue.⁴ In fact we hope that most (?) banks would go the extra mile to solve the problem rather than risk losing an account! In any event, it is reasonable to expect that portability could do no other than improve corporate management simply by virtue of substituting competitive enterprise for, if you will, monopolistic control. Finally, with the expected forthcoming increase in taxes on unearned income, portability would provide both a timely as well as invaluable assist to beneficiaries interested in finding a corporate trustee willing to emphasize the generation and distribution of (lower taxed) capital gains by conversion to the 'new' unitrust model or so-called 'total return' trust.

Portability would also benefit banks as well as independent trust administrators as, for example, Glenmede, Bessemer, Pitcairn and for several reasons. Settlors who otherwise might forswear the irrevocable trust for lack of an acceptable corporate or qualified individual trustee might now elect corporate management. And beneficiaries burdened with ineffective or dishonest individual trustees would also now have an alternative. And again, once it was recognized that beneficiaries could for the first time easily move their accounts, it would not be unreasonable to expect a corporate trustee to try harder rather than risk losing an account to a competitor.⁵

Would you agree that portability is a simple reform which would (rest assured!) be gratefully received by today's or future beneficiaries? Despite multimedia coverage of beneficiaries' complaints over the years, an *Heirs* sponsored portability bill circa 1995 failed to win passage in Pennsylvania due to consistent industry opposition.⁶ To quote a local banker at the time: "if this bill is passed we will lose every trust account we have"! Considering such a response at the state level, we believe that portability requires a federal initiative.

Is this topic of interest to you? (See footnote 1.) If so, could we work together to bring this needed reform to fruition?

¹ This assertion bears a bit of explanation. Based on personal experience with one particular bank trustee, it is argued that a bank may tend to over-diversify a trust portfolio by limiting the capital invested in any one issue. It does so presumably to discourage beneficiaries from filing a surcharge action should a particular issue go south. As a result, even ignoring internal diversification by larger companies such as GE, for example, and the inclusion of proprietary funds, a trust portfolio begins to bear resemblance to an index fund (and an expensive one at that!).

² The number of corporately managed trusts both irrevocable and revocable managed by domestic financial institutions in 2009 was 969,504 totaling almost one trillion dollars for an average or about one million per trust. While no data is available as to the number of associated income and remainder beneficiaries, experience suggests an average of four for a total of at least four million. Though most beneficiaries are individuals, note that public institutions such as charities are also irrevocable trust beneficiaries. Also included in the total are so-called 'master' trusts each of which comprises multiple sub-accounts but is managed as a single entity. Note, however, that an unknown but likely small percentage of the total are revocable rather than irrevocable trusts. While it is true that revocable trust beneficiaries can petition for trustee removal, they are unlikely to do so since the settlor can revoke at his discretion. Finally, data is not readily available on the numbers of beneficiaries with individually managed irrevocable trusts. However, that number is thought to be an order of magnitude higher than the numbers reported above. (Data are from *Trust Performance Report 2010* and are published with the consent of A.M. Publishing Inc., Chicago IL.)

³ A corporate trustee typically has sole signatory control (perhaps now as a matter of law in New York) over the trust assets thus limiting a beneficiary's negotiating powers. This fact also limits the ability of a co-trustee to support the interests of a beneficiary. That's because a co-trustee can only suggest or veto a corporate action but not prevent the corporate trustee from seeking resolution in court if a dispute cannot be resolved amicably. Furthermore, a co-trustee is not necessarily an independent arbiter such as a family member but sometimes is a corporately recommended lawyer who, experience suggests, will support the interests of the corporate trustee rather than those of the beneficiary.

⁴ For a current example of fiducially inappropriate corporate administration, see www.trusteefraud.com. For further information see enclosure entitled *Trust Updates*.

⁵ Carrying matters one step further, suppose one of the two major domestic trust administrators, *Northern Trust* and *Bank of America* (or for that matter any institution providing trust services) voluntarily adopted a *Be Kind To Beneficiaries* program. The essential provisions of such a program would include a) an agreement (subject to court approval) to resign voluntarily at the beneficiary's request as well as support the choice of a replacement corporate trustee absent a removal clause in the instrument or legislation facilitating removal, b) a refusal to accept any trust which did not include a trustee removal clause and c) full disclosure prior to appointment as to its administrative responsibilities, management practices and remedies available to a beneficiary should a dispute not be resolvable amicably. It is believed the market reaction to such a program would be overwhelmingly positive.

⁶ Note that even if the trust instrument contains a trustee removal clause, atypical with older irrevocable trusts, a well designed portability bill would ensure that both income and remainder beneficiaries participate in any decision to change trustees, handle issues such as an unauthorized termination fee and/or demand that the remainders sign a release in lieu of charging the trust for a final accounting as well as provide for a timely changeover.

Available for your review is an *Heirs* drafted bill formally introduced in the Pennsylvania legislature circa 1995 which failed to clear committee despite the support of key legislators. The bill authorizes only corporate to corporate or individual to corporate transfers. Excluded are corporate to individual and individual to individual transfers which would be inappropriate in some situations. The bill does not include a provision that one (or more) of the income beneficiaries share signatory authority with the trustee. Nevertheless despite possible tax consequences, sharing actual control over the trust assets would (neatly) balance corporate conflicts and help preclude theft from the individually managed trust. Surveyed at the time, banks and certain major independents generally rejected portability while two smaller independents showed interest although freezing the fee rate was off the table.

Trust Updates

Proprietary Mutual Funds -- Driven by Fees and Fears of Reprisal

(July 13, 2010 --Chicago, IL) -- In proprietary mutual fund litigation, plaintiffs usually paint banks as fee-hungry mercenaries with no regard for rules. State and federal securities regulators in recent filings similarly portray executives of Regions Bank's Morgan Keegan subsidiary. They accuse executives of loading six proprietary mutual funds with junk bonds, promoting them as investment-grade securities, and hiding losses, all in an effort to earn higher fees.

Key to regulators' allegations is a deposition taken of Carter Anthony, former head of the asset management division, who was also responsible for trust investments. Regions Bank's trust services were managed through Regions Morgan Keegan Trust, F.S.B.

Anthony's deposition, while focused on who authorized the junk bond investments, gives a behind-the-scenes glimpse into the pressure that trust bankers say they often feel to invest in proprietary funds.

According to regulators, Anthony, who considered the six funds below trust investment grade, tried to discourage use of the funds by trust accounts but had to be "discreet" in his discouragement for fear of reprisals.

"If I stand up and beat on the table and say we are not putting any of those [mutual] funds in our trust accounts, I'm fired, I'm gone," Anthony states in a deposition taken by Alabama regulators last October.

The proprietary mutual funds in 2007 lost over \$2 billion, regulators say, primarily from investments in subprime mortgage securities.

Prior to those losses, the six mutual funds often reported above average returns. What Morgan Keegan failed to disclose to mutual fund shareholders, including Regions Bank's trust customers, regulators allege, is that investments in junk bonds were driving those returns. Regulators say investors were intentionally misled regarding the type of securities the funds were investing in and the underlying risks.

"The misrepresentations, omissions, and sales practices," say state regulators in their 60-page complaint, were intended to "entice investors."

The losses have spawned scores of individual and class action lawsuits, as well as numerous arbitration cases.

For more on this story, see the current issue of **Trust Regulatory News**.

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